GALILEO

GALILEO Q3 2011 COMMENTARY

By Michael Waring

Over this last quarter, fiscal brinksmanship and headline risk have been the order of the day. European and US debt woes have sent panic and fear to levels not seen since 2008. With the TSX now off 13.5%[1] for the year, we would venture that when the market bottoms, it usually has less to do with fundamental economic shifts and more to do with crescendos of public panic. The challenge this time is that we are inordinately at the mercy of politicians to get their respective houses in order before sentiment can be restored. The best that can be said is that there is '*a plan to have a plan'* to solve the debt crisis in both Europe and the United States. The cost/benefit analysis heavily favours debt restructuring to outright default, yet markets remain vastly oversold and irrational. That said, this is politics: the current downward spiral may be with us for some time to come. In light of the overwhelming role of political drama in this current downturn, our analysis this quarter is region-by-region. Growth and opportunity still exist but you have to look beyond what the media and the politicians tell you.

<u>United States/Canada:</u>

Unemployment in the US remains stubbornly high and with the gauntlet already thrown down for the 2012 Presidential election, the prospects of an Obama jobs plan passing Congress are dim. Yet with the S&P posting one of the best earnings season ever (75% of companies beating earnings expectations)[2] and the September ISM Manufacturing Index moving back into expansionary territory at 51.6%[3], it appears that the US economy is not completely beholden to Washington gridlock and politics. Both Ford and Chrysler have surpassed their sales targets and Ford has committed $4.8 billion in new US factory investment[4]. Jobs in this sector are slowly reappearing, albeit at lower labour costs.

In Canada, jobs and GDP growth stalled over the first part of the quarter, yet September PMI managed to come in at a robust 55.0%[5]. The energy and materials sectors, which are down 21% and 18%[6] respectively, have led the decline of the TSX despite firmness in commodity prices. At some point the equities must catch up to the commodities and this could represent considerable opportunity – particularly in junior producers with proven reserves that can replace the production versus their senior counterparts. We now see names in the resource sector vastly oversold and trading at or below their net asset value.

<u>Europe:</u>

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[1] Source: Standard & Poors: As at September 30, 2011.http://www.standardandpoors.com/indices/sp-tsx-composite/en/us/?indexId=spcadntxc-caduf--p-ca----

[2] Source: Bloomberg. 374 out of 499 of the S&P500 report better than expected earnings.

[3] Institute of Supply Management Release October 3, 2011. http://www.ism.ws/ISMReport/MfgROB.cfm

[4] CNN Money, October 5, 2011. http://money.cnn.com/2011/10/04/news/companies/ford_uaw_deal/index.htm?iid=SF_BN_LN

[5] RBC Canadian Manufacturing Purchasing Managers' Index, October 3, 2011. http://www.rbc.com/economics/market/daily_e.html

[6] Source: Standard & Poors: As at September 30, 2011.http://www.standardandpoors.com/indices/sp-tsx-composite/en/us/?indexId=spcadntxc-caduf--p-ca----

Given the structure of the European Union, it is our view that there is a very little chance of default. For one member to leave, the Treaty of Maastricht mandates that all 27 members must agree. Hence, leaving the union is tacitly by secession and virtually impossible. The European Union is designed to achieve complete political and economic interdependence and this is its greatest test. Historically, the creation of the European Monetary Union (EMU) was a response to German re-unification and fear of Germany dominating the continent. It now seems obvious that Germany is using the financial markets to dominate the political agenda and force dramatic change in the Euro debtor nations. From a cost/benefit analysis perspective, the cost of default versus exiting the Euro for Germany is in the order of 10000EUR per head to 1000EUR per head for bailing out Greece, Ireland and Portugal entirely[7]. While rationality would seem to dictate passing a debt restructuring package, politics will continue to impede a concrete plan. We continue to believe it is in everyone's rational self-interest to get something done.

China/Emerging Nations:

Our recent visit to China indicates that the economy is slowing but we are not predicting a hard landing. Unlike in 2008, China's economic expansion is less driven by exports and more by its own internal market. In 2007, net exports accounted for 18% of 14.2% GDP growth. Over the first half of 2011, they accounted for -0.7% of 9.6% growth. GDP growth this year is anticipated to come in around 9.0% assuming a 0.5% drag from exports. Monetary policy has shifted from stimulus-withdrawal to stable as inflation has moderated. Consumer spending within China remains robust as urban disposable income adjusted for inflation has risen 152% over the last decade[8].

In Brazil, a surge in the Real over the last few months has hit manufacturing/export competiveness yet GDP is now 7.8% above its pre-recession peak and forecast to grow at 2.5% this year[9]. Over this last round of global currency volatility, the Real has fallen 18%. This coupled with tax cuts for manufacturers and some monetary easing should restore a more favourable balance of trade for Brazil. India and Russia as well appear to be firmly in positive territory with growth in those regions forecast to come in at 7.7%[10] and 3.4%[11] for 2011.

Growth at the nation-state and corporate level appear intact yet the market is heavily discounting a sovereign financial crisis. We believe it prudent to focus on the former as opposed to the latter.

As a final thought, over this quarter in the United States over $75 billion has been withdrawn from equity mutual funds while the dollar volume of insider purchases is 15% above its March 2009 peak[12]. If corporate America is using this downturn to buy back its own stock, it must indicate something the politicians and the media are not telling us. It's often said that the market is the great transferor of wealth from the impatient to the patient. Now is the time to be a patient buyer.

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[7] UBS Investment Research, Global Economic Perspectives 'Euro break-up – the consequences'. September 6, 2011.

[8] Rothman, Andy CLSA Asia-Pacific Markets Sinology,September 29, 2011.

[9] Ray, Rebecca 'Brazil: GDP Growth Slows amid Surging Imports and Flat Manufacturing' in Monthly Review Magazine. http://mrzine.monthlyreview.org/2011/ray300911.html

[10] Bloomberg, India GDP as at August 30, 2011.

[11] Bloomberg, Russia GDP as at August 11, 2011.

[12] Gammeltoft, Nikolaj and Lu Wang, Bloomberg 'Insiders Buying Stock at Highest Rate Since March '09 as S&P 500 Drops', August 11, 2011. http://www.bloomberg.com/news/2011-08-11/insiders-buying-stock-at-highest-rate-since-march-09-as-s-p-500-drops-18-.html

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