J.C. HOOD INVESTMENT COUNSEL INC.

Monthly Newsletter – July 2011

Hello Everyone:

Defaults and Markets: Whenever I return from holidays, I am always intrigued by the fact the so much financial reporting is redundant and so many financial issues are undigested. The market swoons to the meter of the latest Greek fiscal tragedy and sparkles whenever another bailout appears on the horizon.

I am certainly not sanguine however about how these events may unfold, particularly the August 2 deadline for the US to raise its debt ceiling; nevertheless, we have not changed our strategy. As our long term clients know, we manage risk through rebalancing and caution, not by erratically chasing the returns of a hot sector nor panic selling in response to the latest media exhortations on jobs/trade/default threats.

Nevertheless, several of our new clients, and a few of our longer term clients as well, have expressed their concerns about being in the market with this amount of uncertainty and potential volatility. These are unquestionably valid concerns and it is in part the objective of this newsletter to address issues that are important to our clients.

There are several differences between the financial crisis that began in 2007 and the current environment. The most obvious difference is that in July/07 virtually no one anticipated it; we were all caught flat footed as global credit seized up overnight. Banks could not trust one another's paper that were infested with subprime mortgages, and, as was revealed subsequently in Europe, subprime nations. There has, of course, been a surfeit of pundits who retroactively said they saw it coming, but in fact, there were few true voices in the debt wilderness.

We didn't foresee it either but fortunately, we maintained our conservative/growth approach and hence were about 40% in cash and bonds, therefore we had less volatility and more importantly, the ability/cash to react and buy into the market early.

This crisis however is different in that everybody knows about it! We have been watching these grim events on a daily basis for months but there are a number of assumptions that we can make. First, Greece is toast! Insolvent! No bailout will rescue them from 300% debt/GNP caused by three generations of the Papandreaus socialist spending habits and entitlements. The question isn't about what will happen to Greece but how quickly the Euro banks will acknowledge the default and take a 'hit' for 'subprime' sovereign lending. The Euro banks just don't want to take the hit now so that they can continue to build up their reserves from recessionary levels and meet the new capital requirements.

The USA is not Greece: The Americans have a spending problem (too much) and a tax problem (not enough) which is being exacerbated by arm wrestling over next year's presidential election. Neither party wants to provide the other with a rallying cry that 'we' solved the default crisis. As William Watson argued in the Post this morning 'A country that regards itself as the leader of the world should not be running such a risk with the world economy.'

This is obviously a dangerous game with every politician seeming to shamelessly ask "what's in it for me?" Realistically, the Democrats and Republicans have only till next Friday to solve this mess. Moodys indicated today that the US was on the 'credit watch' status. So I suspect that in Washington next week, there will be an orgy of arm twisting, self aggrandizement, posturing and arrogance that will lead to a diluted but palatable compromise. In other words, politics as usual but with a greater sense of urgency! Political intransigence may in fact prevent a

solution but I believe that both parties are cognizant of the enormous taxpayer resentment that may ensue and which could seek vengeance at the polls.

There are however several reasons for optimism too. According to Rita Nazareth and Lu Wang in the Post, China reported a second quarter growth rate of 9.5% squelching rumors about much slower growth and lower commodity prices. China needs metals for the export market and for domestic infrastructure projects which is good news for Canada. Markets rallied yesterday as Fed Chair Bernanke suggested further stimulus through QE3 thereby maintaining low interest rates as well as keeping the USD low, hence gold's upward thrust. But low interest and a low USD has provided an extraordinary environment for US manufacturers and exporters. As described by Kevin Carmichael in the Globe, many US firms are expanding their workforce and some are even repatriating production from Asia. 'US exports rose 20% in 2010 from the previous year to reach $1.3 Trillion. That's more than double the $629Bil worth of goods the US shipped in 1996…this trend continues to gather strength…US companies exported $125Bil in May.' As Nazareth and Wang reported in the Post, earnings for the S&P 500 are ahead of valuations, i.e. the index is trading at lower than normal multiples. As David Kelly at JP Morgan suggests 'people who are buying stocks today are buying an undervalued asset.' 'Caterpillar and Dow will probably report 63% and 42% growth in the second quarter'. Not to mention that roughly 50% of earnings from S&P500 companies come from offshore and these very successful businesses are awash with cash.

Investor Psychology: Investors however remain cautious. Legg Mason reports that despite positive earnings growth, 'there's been a fundamental shift in psychology in terms of risk aversion after 2008… people react more quickly to uncertainty…that's why you're seeing attractive valuations that seem to be persistent.' In other words, if you are feeling a little bit like a 'nervous Nelly', you are not alone.

I have been reading an excellent article on investor psychology in the most recent edition of MoneySense magazine by Andrew Hallam 'The enemy in the mirror'. He quotes John Bogle, founder of Vanguard funds that over a 25 year period, mutual funds averaged 10%/year from 1980-2005 but the average investor only made 7.3%. Why? Because 'investors sell or cease to buy after a fund has become cheap and buy like lunatics when the fund becomes expensive'. Often their advisor will say 'this fund hasn't been doing well lately… we're going to move your money to another fund that is doing better at the moment.' As Hallam describes 'Whether it's an index fund or an actively managed fund, most investors perform far worse than the funds they own because they like to buy high and they hate buying low'. But the long-term consequences of this deeply flawed market timing is that $50,000 invested at 10% for 25 years results in $541,000 but at 7.3% is just $291,000. That doesn't even take into account high fund costs, DSC (deferred commissions) on switching or tax implications in non-registered accounts. Investors often believe that they can somehow time the market but even the pros are dreadful at timing. As John Bogle said 'After fifty years in this business, I do not know of anyone who has done it successfully and consistently.' Burton Malkiel, author of a 'A Random Walk down Wall Street' would share that opinion.

If you have any questions, please call.

Regards
John