

Canada Day should give us all cause to rejoice in our good fortune. We reside in a wealthy country that is getting wealthier. We live in a country so peaceful that the sight of three burning police cars and a few dozen broken windows sends us into paroxysms of self examination. We live with a political system so benign that the most pressing questions seem to be our policy on Afghan detainees eight years ago and the possibility that a member of the Cabinet loaned her husband her Blackberry. We benefit from a financial system that features the world's best-run banks, low interest rates and vigilant regulators. We are even enjoying good summer weather, after last year's cold and damp. Why then is everyone so miserable?

The fact that nobody has made any money in the first half of the year probably accounts for much of it. The lackluster to crummy results are not a big surprise, nor are the similarly discouraging economic indicators which have led us here. In October of last year at our annual seminars we made a number of predictions about the economy and the market for 2010. Now is a good time to look at them and provide an update based on what has happened in the past eight months.

Here is what we said in October, and what actually happened:

The recovery will be at a slow pace in Canada and the U.S.

We were right about the U.S., but mostly wrong about Canada; here the economy grew strongly in the first quarter of the year although this growth may have slackened in the second quarter. In the face of an anemic comeback from a significant recession it is not surprising that markets are volatile, trading up and down on each new data point. We do not believe in a "double dip" recession as we feel the recovery is well entrenched, but economic growth will be substandard for the rest of the year.

Housing prices in the U.S. will recover slowly.

In fact, prices in the 20 largest housing markets are up 3.8% year over year, not much compared to the more than 30% drop from 2007 to 2009. There continues to be too much inventory of newly built homes and foreclosed homes to sell. However, new home construction is at record low levels, so the inventory overhang will gradually disappear, setting the stage for a more robust recovery in this crucial sector.

Low mortgage rates and affordable house prices should spur demand.

This has certainly been true in Canada and no more so than in Toronto, which may just now be exiting from a short-lived bubble in mid-town and downtown homes. Interest rates will continue to be low, encouraging first time buyers in particular to pay too much. Recent changes in the mortgage rules in Canada will prevent this potential problem from growing into a U.S. style housing crisis.

Retail sales will recover slowly as tax cuts, government stimulus and unemployment insurance provide stability for personal incomes.

Retail sales in both Canada and the U.S. have come back from the lows of 2009, but are still below peak levels hit in 2008. Again, Canada is doing better here than the U.S. Consumers are focused on paying off credit card and installment debt, and this hurts sales of durable items in particular. Retail sales will not show a convincing turnaround until the unemployment situation shows further improvement.

Unemployment will likely stay stubbornly high through the next six to twelve months.

Persistently high U.S. unemployment, still above 9.5% after peaking at 10.1%, is the most often cited reason for the continued sluggish growth in the American economy. Canadian unemployment is 8.1%, up about 1.5% from the rate in 2008, before the recession. Job creation has been quite good in Canada but very disappointing in the U.S.

The emerging problem for banks will be commercial real estate.

Happily, we were wrong. In spite of some high profile commercial and residential bankruptcies, commercial real estate has kept its value in the low interest rate environment. This is good news for the major banks and their shareholders.

Manufacturing activity will pick up both in Canada and the U.S.

The various indicies that track manufacturing are climbing in both countries and manufacturing employment is increasing. Part of the pick-up was to replace depleted

inventory, and the recent slowdown may indicate that inventories are now back up to pre-recession levels. Strength in both the U.S. and Canadian dollar will make it harder to sell goods to Europe, but conversely, the decision by the Chinese government to let its currency float higher will increase North American exports to Asia.

Stable to rising commodity prices will favour Canada's economy.

Metal prices and oil prices are higher than they were eight months ago, benefitting a variety of companies and the country as a whole. Demand from Asia has largely made up for the slack created by the recession in Europe and North America. An increase in the value of the Chinese yuan would be very favourable to Canadian resource companies.

What Now?

As has been the case for most of the last year, the economic commentators are sharply divided. Some are calling the recent moves towards debt reduction and government austerity a disaster that will lead to a depression and deflation. Others remain convinced that the still very high levels of government debt in most countries of the world will inevitably cause inflation and higher interest rates in the medium term. The recent pronouncement from the G20 after the Toronto conference calls for a measured reduction of Government deficits over a period of years, and tries to steer a middle path between the two perils.

Our view is that a weak recovery in the short term and higher inflation in the medium term remain the most likely outcomes. Ben Bernanke, Chairman of the U.S. Federal Reserve Bank, and his counterpart in Europe, have sworn to avoid the deflationary morass which entrapped Japan for a decade. If they have to run the currency printing presses full time to do so, that is just what they will do. Inflation is caused by too much money chasing too few goods. A slow recovery with lots of freshly created money floating around is the classic recipe for creating inflation. We expect to see interest rates rising to the 6% to 8% range for long bonds within two to four years.

In the meantime, solid non-cyclical companies with high and rising dividends should give investors the best return in the second half of the year. Telephone companies, utilities, pipelines and banks are boring, but we think dividend yields of 4% and some modest price



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appreciation will beat the returns available on bonds and more cyclical stocks. Preferred shares remain a favoured asset for those seeking less volatility and more certain returns in taxable accounts.

The end of June saw outsized drops in the major stock indices as investors tried to digest the never ending stream of economic data, much of it unpalatable. Our advice is unchanged: try (if you can) to ignore the price swings. Focus on company earnings which are continuing to increase, on dividends which are continuing to rise, and on a future which, on balance, continues to look brighter than the recent past.

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