Taking Shelter from the Inflation Storm

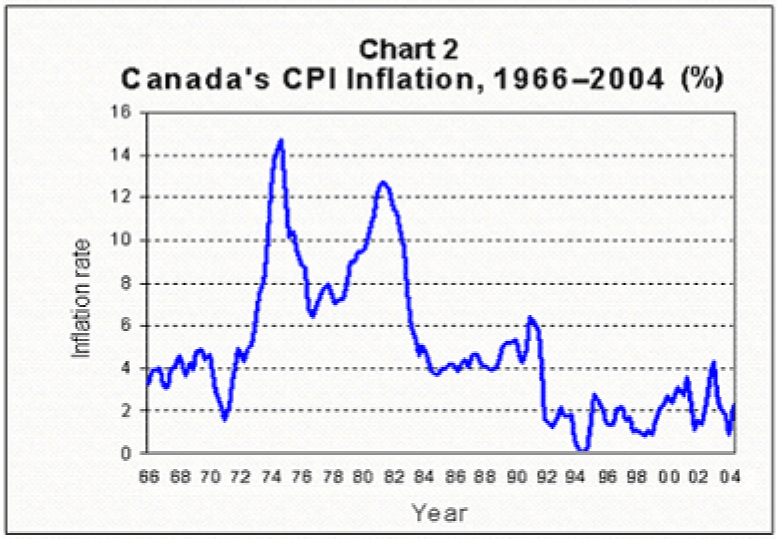
April 2011

David P. Baskin, President
Barry Schwartz, Vice-President

www.baskinfinancial.com
416-969-9540
1-877-227-5468
info@baskinfinancial.com

WHY WE BELIEVE THAT INFLATION WILL BECOME A PROBLEM

Canadians have been insulated from inflation for twenty years. Annual increases in the Consumer Price Index (CPI) have averaged about 2% per year. At this rate, prices double in about 38 years. Far from being a problem, this level of inflation is positive for the economy.

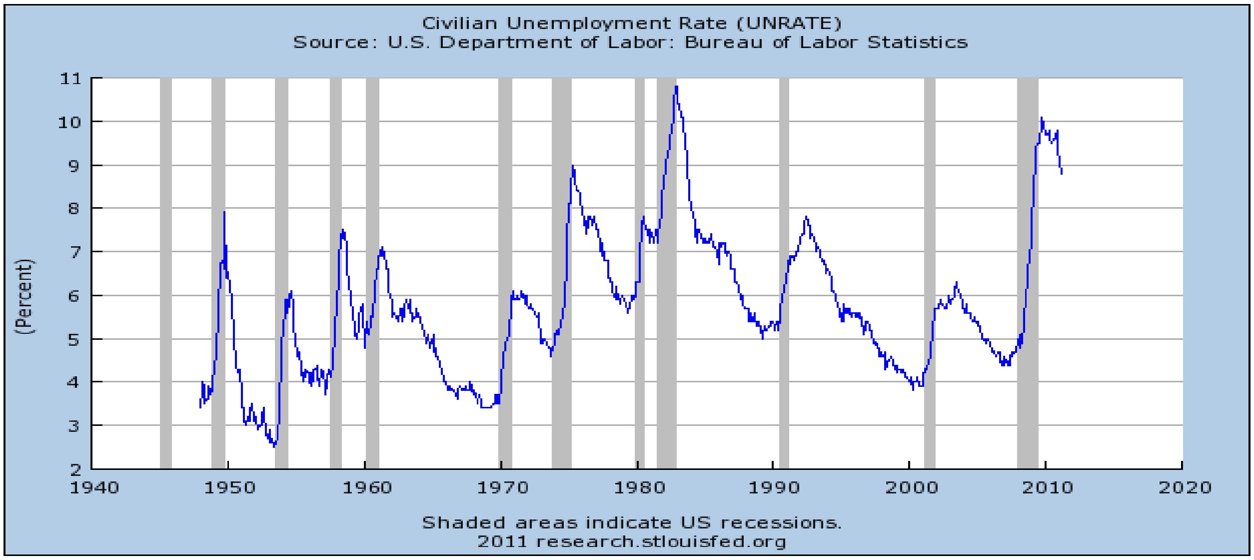


However, it has not always been quiet on the inflation front. From 1972 to 1983, Canada had more than a decade of high inflation during which the consumer price index rose rapidly. In fact, prices almost tripled between 1972 and 1983.

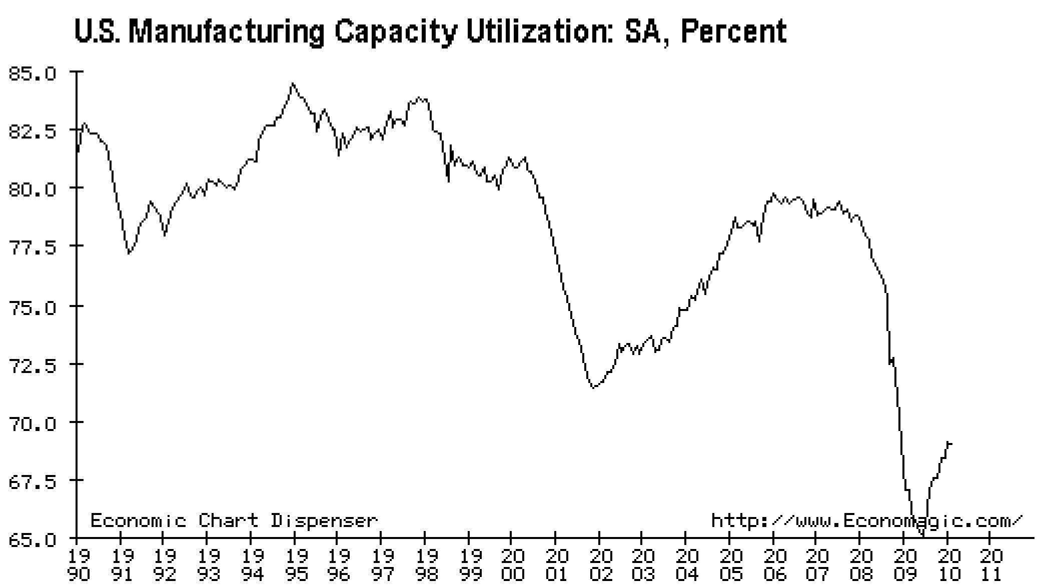
YEAR	INDEX	CHANGE	CUMULATIVE CHANGE
1972	21.9	4.8%	5%
1973	23.6	7.8%	13%
1974	26.2	11.0%	25%
1975	29	10.7%	39%
1976	31.1	7.2%	49%
1977	33.6	8.0%	61%
1978	36.6	8.9%	75%
1979	40	9.3%	91%
1980	44	10.0%	111%
1981	49.5	12.5%	137%
1982	54.9	10.9%	163%
1983	58.1	5.8%	178%

As recently as last summer, the Chairman of the US Federal Reserve Bank, Ben Bernanke, was giving speeches warning of the dangers of deflation. Now, no one is talking about deflation anymore. Instead, the headlines are all about rising inflation. From being off the radar screen last year, suddenly inflation looks like an oncoming, perhaps unstoppable, freight train.

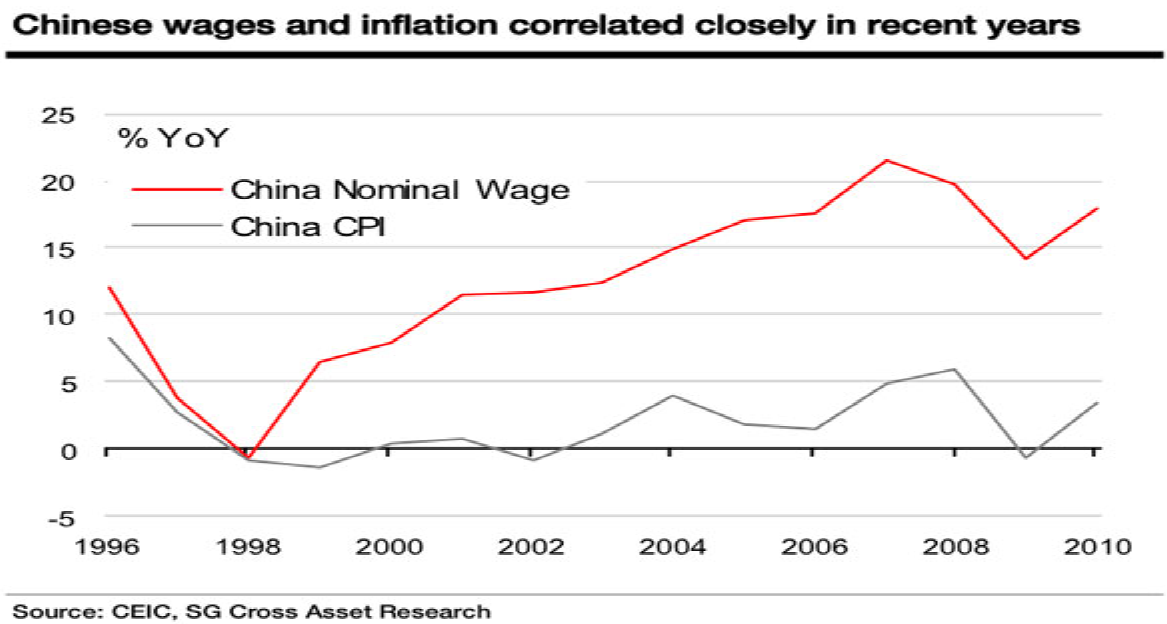
There is evidence on both sides of the inflation debate. On the one hand, there is excess labour, particularly in the U.S. High unemployment tends to keep wage costs down.

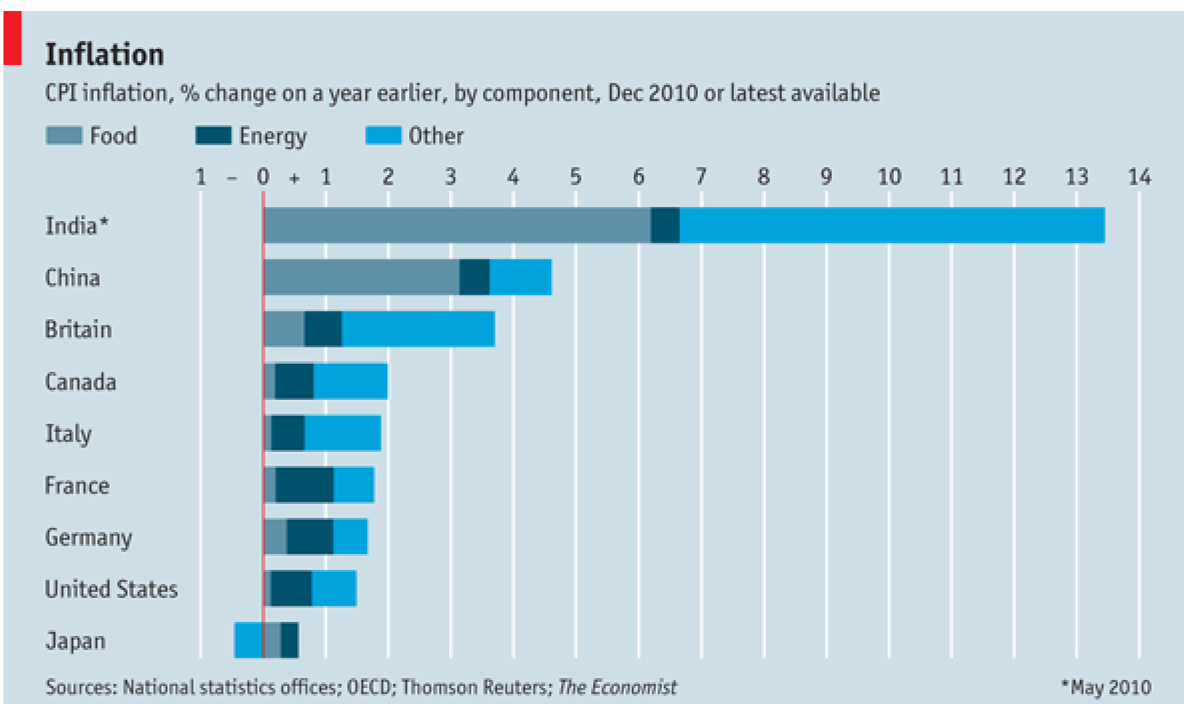


As well, the U.S. economy is still operating far below its capacity. In general prices only rise when the economy is operating at or close to capacity (85% utilization).



On the other hand, many of the North American unemployed have seen their jobs outsourced to other countries, particularly China, India and Mexico. Outsourcing has dampened inflation in North America due to low wage rates in newly industrialized countries. As wages and inflation rise, these increases will filter through to goods and services consumed here.

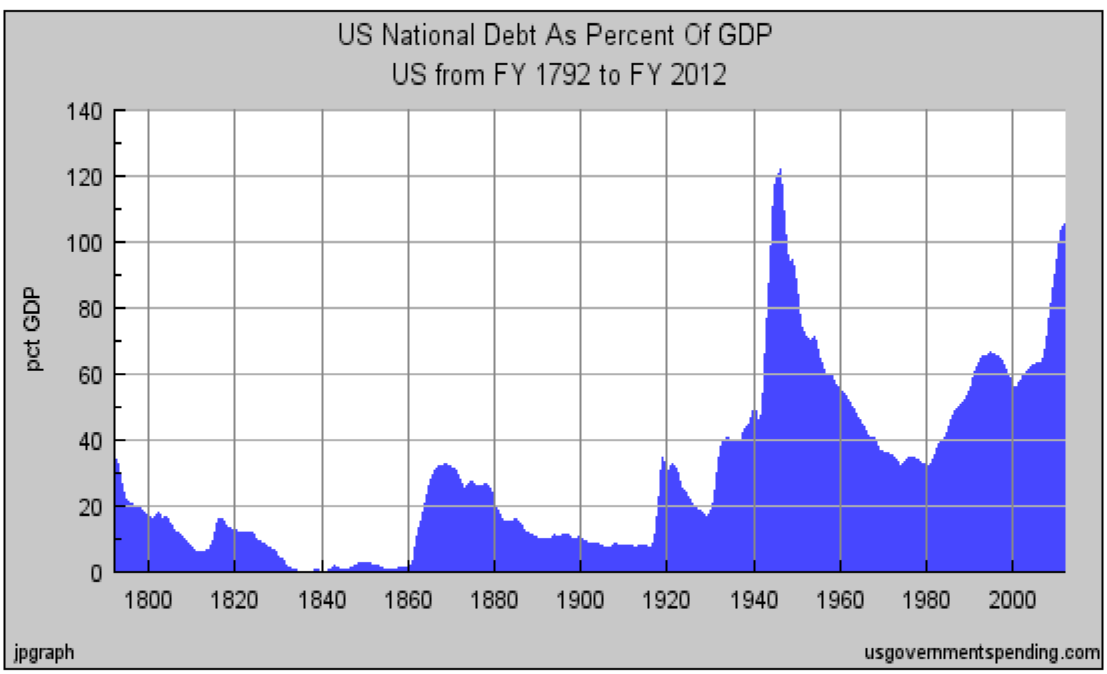




We are also seeing tremendous rises in the prices of basic commodities. These price increases tend to filter through to many other products. Three examples, one metal, two agricultural, of a broad trend:

Price growth in basic commodities ends up increasing the final prices of all finished goods from automobiles (steel, copper, plastics, glass) to clothing (copper, synthetic fabrics) to processed foods (corn is a huge input in the form of fructose).

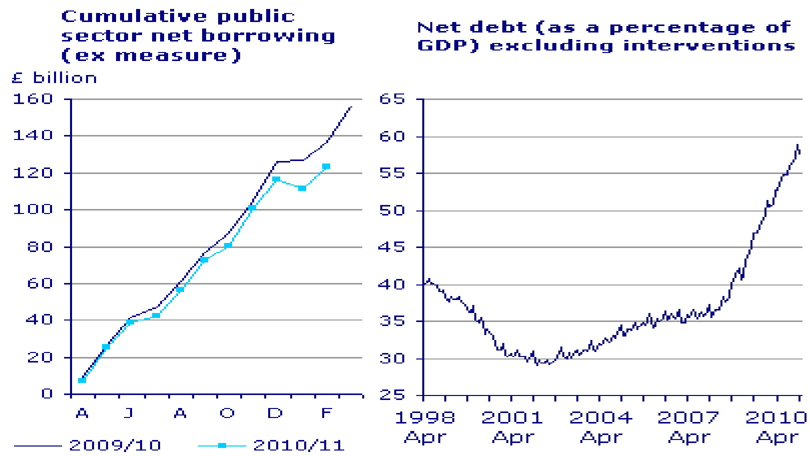
The most significant factor which leads us to believe that inflation will increase is the rapid growth in the money supply in the developed economy. Ultimately, most economists believe that inflation is a monetary phenomenon. Increases in the money supply which are greater than the increases in output must show up as higher prices. In Europe and the U.S., out-of-control government deficits will continue to result in tremendous increases in the money supply.



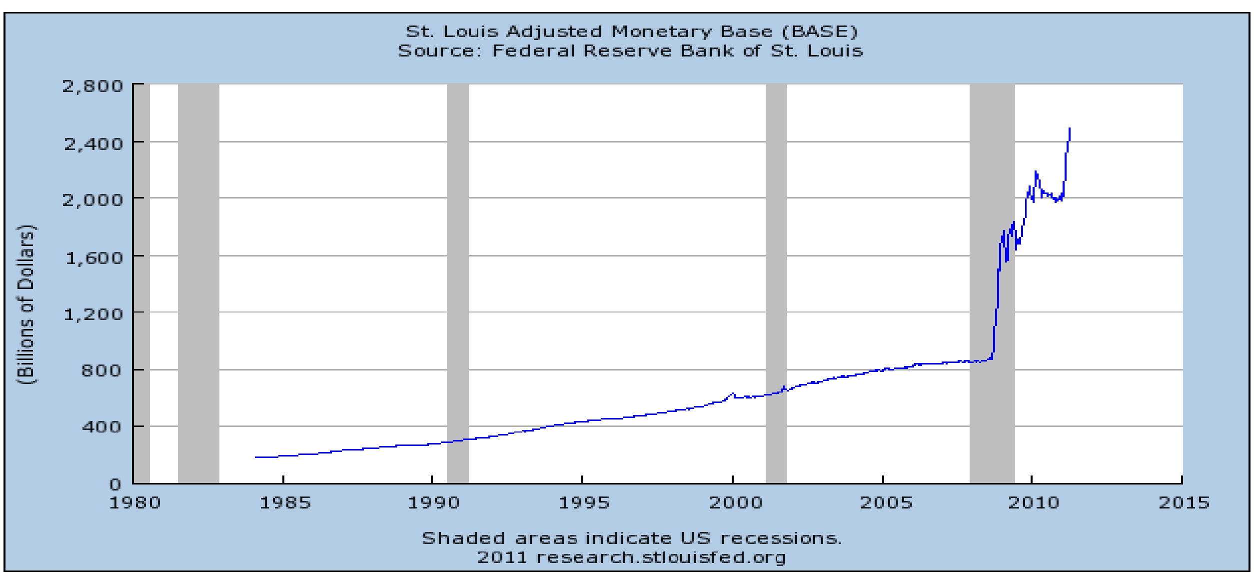
US public debt now exceeds 100% of GDP for the first time since the period immediately after the Second World War, and has more than doubled as a percentage of GDP in just ten years. The recent battles in Congress demonstrate the difficulty that the U.S. is having in taming this deficit. The same is true in most of the developed world, where aging populations are straining the health care system, and governmental pension and social security schemes.

UK public debt is moving in the same direction, and the debt problems of smaller EU countries such as Ireland, Greece and Portugal, and larger ones such as Italy and Spain, are well known.

UK public debt:



Government borrowing to finance the huge and growing public debt, along with the US program of Quantitative Easing, has injected a rapidly increasing amount of money into the economy. This chart shows the growth of the money supply in the mid-western US as measured by the St. Louis Federal Reserve Bank and is respresentative of the US economy as a whole:



The equation linking the money supply to inflation is:

Money Supply x Velocity of Spending = Prices x GDP

When the money supply grows faster than Gross Domestic Product, prices will tend to rise. We are seeing growth in the money supply that far exceeds economic growth. Normally the lag between the growth in the money supply and the emergence of inflation is two years. The rise in commodity prices is the first indication of growing inflationary pressure. We will soon see increasing pressure for wage increases in North America as consumers find that their real income is dropping.

Note that inflation is a huge help, perhaps a necessity, for the U.S. Treasury and the heavily indebted developed economies generally. More than $3 trillion of US debt is held by foreign governments, banks and institutions. Inflation devalues this debt and makes it easier to pay down. It is in effect a default by increments. Investors are well aware of this and have started to take action. The recent record prices for gold and silver, and the decline of the US dollar against other currencies including the Canadian dollar and the Euro, are indications of the growing fear of incremental devaluation.

THE EFFECTS OF INFLATION

Economics is abstract and conceptual. Prices are real and easily understood. Here is what happened in Canada during the inflation years:

	1970	1980	1990
Average cost of a new home	$26,600	$76,400	$149,800
Cost of a postage stamp	$.06	$.15	$.25
Cost of a gallon of gas	$.36	$1.25	$1.16
Cost of a dozen eggs	$.62	$.91	$1.00
Toronto Transit Fare	$.25	$.60	$1.00
Ontario Minimum Wage	$1.50/hr	$3.00/hr	$5.00/hr

Inflation erodes the value of money over time, and the higher the rate of inflation, the more pernicious is the effect of compounding.

PURCHASING POWER OF $1,000 UNDER VARIOUS INFLATION LEVELS

Inflation Rate	Value in 5 Years	Value in 10 Years	Value in 15 Years	Value in 20 Years
2%	904	817	740	670
4%	815	665	546	449
6%	734	539	402	301
8%	659	434	296	201
10%	590	349	217	134

Some examples of the effects of inflation over time:

A life insurance policy with a death benefit of $1 million purchased today would have purchasing power of only $301,000 after twenty years of 6% inflation.

A five year Canada bond with a face value of $100,000 would have purchasing power of $65,900 after five years of 8% inflation.

A ten year fixed rate mortgage of $500,000 would have purchasing power of $174,500 after ten years of 10% inflation.

A defined benefit pension plan paying $3,000 per month would lose about half its purchasing power after fifteen years of 4% inflation.

A house purchased today for $500,000 would be worth $2.5 million after twenty years of 8% inflation.

INVESTMENT STRATEGIES FOR AN INFLATIONARY WORLD

The losers during inflation:

- **BONDS**. Bond duration must be minimized until interest rates exceed inflation.
- **PREFERRED SHARES**. Preferred shares must be approached with caution and a view towards exit mechanisms.
- **REGULATED INDUSTRIES**. Regulated industries such as pipelines, utilities and telecommunications must be reviewed carefully to ensure that prices to consumers will be allowed to keep up with inflation.
- **PRICE TAKERS**. Companies which lack pricing power should be avoided as they will lag behind industry leaders.
- **IMPORTERS**. Companies which rely on goods purchased abroad may suffer higher inflation than non-importers and may suffer margin degradation.

The winners during inflation:

- **COMMODITY PRODUCERS**. Commodity prices should lead the inflationary wave (but beware of volatility and speculative excess).
- **REAL ESTATE OWNERS**. Benefit from rising value of underlying assets, rising rents and decrease in the real value of mortgage debt owed.
- **PRICE MAKERS**. Leading companies with strong brands can pass price increases along to buyers.
- **REAL RETURN BONDS**. Built-in inflation protection allows them to ride above the storm.
- **BIG BORROWERS**. Some companies with heavy debt loads will benefit provided that the debt is fixed rate and long term.

AN INFLATION PROTECTED PORTFOLIO

Security	Size	Yield
Government Real Return Bonds	$ 50,000	2.0%
Short Dated Bonds/Preferred Shares	$ 250,000	4.5%
Canadian Apartment REIT	$ 33,333	5.8%
Canadian Bank	$ 33,333	3.5%
Canadian Coffee and Donuts	$ 33,333	1.6%
Canadian Commercial REIT	$ 33,333	6.5%
Canadian Copper Miner	$ 33,333	1.0%
Canadian Diversified Financial	$ 33,333	4.2%
Canadian Diversified Mining	$ 33,333	1.0%
Canadian Fertilizer Producer	$ 33,333	0.5%
Canadian Grocery Chain	$ 33,333	1.8%
Canadian Infrastructure Partnership	$ 33,333	5.0%
Canadian Media Giant	$ 33,333	2.5%
Canadian Oil Sands Producer	$ 33,333	1.0%
Canadian Steam Shipper	$ 33,333	1.8%
Canadian Timber	$ 33,333	7.4%
Canadian Waste Management	$ 33,333	2.0%
Diversified Oil and Gas Producer	$ 33,333	1.2%
Brazilian Iron Ore Miner	$ 33,333	1.6%
Israeli Generic Drug Manufacturer	$ 33,333	1.9%
U.S. Corn and Soybean Handler	$ 33,333	2.0%
U.S. Multinational Branded Food	$ 33,340	3.8%
U.S. Software Giant	$ 33,333	2.5%
Total	**$ 1,000,000**	

Asset Allocation

Fixed Income	**30%**
Canadian Equities	**53%**
Foreign Equities	**17%**

About Baskin Financial Services Inc.

Our Mission

We are an independently owned investment management firm providing customized wealth management to a select group of Canadians. We are committed to meeting the needs of our clients by endeavouring to protect their capital and by building their wealth over time.

Our long-term performance is based upon our strict adherence to three investment principles:

Focus on what we know

We have focused research on North American markets for over 15 years. We believe that the more knowledge we have, the better we can fully participate in growth in the up years, and experience lower volatility in the down years.

Use fundamental analysis to identify opportunities

We pay close ongoing attention to economic indicators, sector outlooks, company results and competitive positioning to identify underpriced securities and to avoid those that are overpriced.

Value is recognized over time

Our focus and fundamental analysis give us the confidence to take a position in a security when we feel it is undervalued and to hold it as the market comes to agree with our assessment of its true value.

These principles, coupled with a close attention to client service, help us to offer clients a unique discretionary investment management experience.

Founded in 1992 by David Baskin, Baskin Financial Services Inc. offers discretionary management appropriate to our clients' individual needs with a straightforward and easy to understand low fee schedule. Unlike the big banks, or other larger investment firms, we do not have multiple layers of bureaucracy. Our clients have direct access to the top people at the company.

Our goal at Baskin Financial is to provide all our clients with managed growth and peace of mind.

For More Information
Phone: (416) 969-9540
Toll Free: 1 877 227 5468
info@baskinfinancial.com

Mailing Address:
95 St. Clair Avenue West, Suite 900
Toronto, Ontario M4V 1N6
www.baskinfinancial.com