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Are happy days here again?

2010 ended much the way it began: central bank policies (low interest rates and quantitative easing) drove up the value of equities, bonds and commodities. With near-zero interest rates, capital preservation fell out of favor as investors took on more risk in the search for greater returns.

With markets now reaching pre-downturn levels, are *"happy days are here again"* or are investors once again ignoring all the risks?

Economic overview

Despite signs of growth, the economic recovery in most parts of the world remains sluggish and is being driven mostly by corporate spending and emerging markets. While investor sentiment is once again extremely bullish, many of the major risks (listed below) have not abated:

- Government deficits remain unsustainably high in many countries
- Euro contagion is spreading – many countries are being forced to pay much higher interest rates
- Austerity budgets in Europe and in the U.S. states and municipalities will dampen the recovery
- The U.S. federal deficit is not yet being addressed
- A high rate of unemployment persists
- Food and energy prices have risen sharply, creating an inflationary environment
- Quantitative easing (printing money) may cause excessive inflation
- Currency wars – increased government intervention may impact trade
- High inflation in several of the BRIC countries, especially China, is causing concern and governments have implemented measures that may curtail growth

Debt, inflation and interest rates

Many countries are running enormous deficits. To address this, governments across Europe, as well as several states and municipalities in the U.S., have begun austerity programs. Notwithstanding these efforts, balanced budgets are a long way off. These deficits are structural, with underfunded pension plans being a major issue. 2011 will bring further credit rating downgrades, which may cause nervous bond investors to demand higher interest rates. While the U.S. federal government still has easy access to credit, S&P and Moody's recently warned that the U.S. AAA credit rating is at risk of being downgraded if its deficit is not addressed. Despite the lack of political will at present, spending cuts and tax increases are inevitable.

The high level of consumer debt is also a significant issue. Bank of Canada Governor Mark Carney recently cautioned that the level of personal debt in Canada has become excessive and warned that it "cannot continue." Canada's personal debt-to-income ratio surpassed that of the U.S. for the first time since 1998 and now stands at a record 148%. By comparison, it was close to 100% back in 1990. In the

U.S., government attempts to help consumers deal with high debt levels have been largely unsuccessful and the foreclosure rate on homes remains at peak levels.

To make matters even more tenuous, inflation is on the rise, led by a spike in food and energy prices. The risk that this poses to the nascent recovery cannot be overstated. Rising inflation would almost certainly force central bankers to raise interest rates, threatening to stifle demand and stall the economy. This would not bode well for asset prices.

Gold – another asset bubble?

Fear of inflation and U.S. dollar issues have led to a renewed interest in gold, a traditional safe haven. The latest "gold rush" has caused many to invest in the metal, without examining the fundamentals.

In the gold bubble of 1980, the price rose to $850 in January of that year, up from approximately $220 the year earlier. Some may remember the line-up of gold buyers outside the Bank of Nova Scotia in Toronto who wanted to get in on the action. By the end of 1980, however, the price declined some 30% and did not reach the $850 level again until last year.

The recent rise in the price of gold has once again sent investors clamoring to buy something that seems to be a "sure thing" (and today they no longer have to wait in a line-up). This time around, not only can one easily buy gold through one of the many heavily marketed ETFs, but various *gold-dispensing ATM machines* have sprouted up from Abu Dhabi to Florida.

Historically, the majority of demand for gold has come from jewellery. Over the last decade, however, investment demand for gold has increased dramatically, rising from approximately 10% of the total in 2000 to nearly 40% today. This has been the main driver behind the sharp increase in price. As jewellery demand has waned due to high prices, investors have more than offset the difference. It is important to note these changes, as investor demand for a commodity has never, to our knowledge, led to sustainable price increases.

What we are seeing in the gold market is reminiscent of the oil market in 2008, when speculators pushed prices to nearly $150/barrel. When investor demand tapered off, prices fell back to earth. As with most commodities, higher prices also lead to increased production. Gold is no different. Production is expected to rise considerably over the next few years, which will drive prices down if the appetite from investors does not keep pace.[1] As the old adage goes, "the cure for high commodity prices is high commodity prices."

Equities, performance and our large cash position

In light of the many risks, we believe that equity markets are currently overvalued.

While this environment makes hunting for value all the more difficult, we recently added two compelling investments to our portfolio.

[1] According to Pawel Rajszel at Veritas Investment Research, the growth plans of 20 gold producers, representing half of the world's current mine supply, will see production increase by 25 per cent, from 40 million troy ounces in 2010 to 50 million by 2013.

Sanyo Engineering and Construction Inc. (TSE:1960)
Established in 1937, Sanyo Engineering and Construction Inc. has been providing mechanical and electrical engineering services for quite some time. The company operates in several business segments, including Electrical Power, Machinery Manufacturing, Ventilation and Water Supply. It has been steadily growing its business both domestically and abroad and presently has corporate offices in eight countries in Asia. Thirty percent of their revenue now comes from outside of Japan.

Sanyo Engineering and Construction Inc. has a strong balance sheet, carries virtually no debt and is flush with cash. Their dividend has been rising consistently and is now yielding 3.5%. At current prices, it is trading at an astonishing 0.2x tangible book value. Perhaps even more amazing is that the stock price is only 46% of its net cash value. This essentially means that we are buying $1 for 46 cents and getting a profitable, dividend-paying business, with virtually no debt, ***for free***.

CTI Engineering Co., Ltd. (TSE:9621)
CTI Engineering Co., Ltd., together with its subsidiaries, provides engineering consulting services related to public works for rivers, dams, roads, environment and information in Japan and internationally. The company is headquartered in Tokyo, Japan and was founded in 1945 as Japan's first engineering consulting firm.

CTI Engineering has a long track record of increasing profitability and dividends. It has no debt and, like Sanyo Engineering and Construction, trades at an irrational price: 0.36x tangible book value, 10x earnings and 56% of its net cash value. The dividend currently yields 3.4%.

<u>Investment outlook</u>
Low interest rates have been inflating equity markets. Rising rates will have the opposite effect. Despite virtually all of our equity investments performing well, we continue to hold a large amount of cash on the sidelines, as we believe we will have ample opportunity to invest in companies at cheaper prices than those available today.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,

Lorne Steinberg