HOWSON TATTERSALL
PRIVATE ASSET MANAGEMENT

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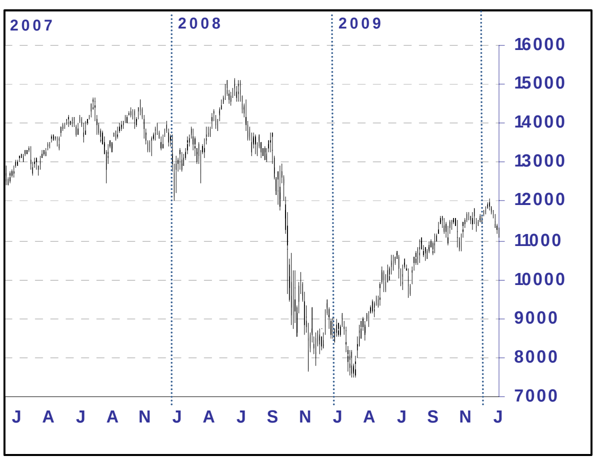
The normal nature of equity markets is volatility and that was evident in Canadian stocks throughout January. The first two weeks of the month extended the bull market of the last nine months, but a retracement during the last half of the month left the S&P/TSX Composite Index with a one-month decline of 5.4%. The twelve-month return for the Index is 31.7% but the chart below shows the Index still has a ways to go to reach the previous peaks reached in the first half of 2008.

When markets enter a correction phase, it is usually the leaders of the bull phase which take a break and give up some of their gains. To date, this bull market has been led by the Materials, primarily Golds, Energy and Financial stocks. True to form, they were the groups that fell the most in January.

The fixed income markets improved as investors appeared to be building in weaker economic growth. The PC Bond Index added 1.8% in January and produced a strong 8.4% total return for the last twelve months.

S&P/TSX A COMPOSITE INDEX



STANDARD & POOR'S 500 INDEX

Source: Yahoo Finance

We have no idea how long the corrective phase may take or how deep it could be but our observation is that time will show it to be a corrective phase rather than the beginning of a double-dip bear market.

Certainly it is not difficult to find a market observer who can point to a variety of negatives such as high unemployment, world scale deficits and U.S. home prices that are well below their peaks. It seems to us that most investors are still shell-shocked by the market declines experienced last year. There is very little boasting about gains made since March 2009. The general mood is still cautious and that is not usually what we see at market peaks.

The economic news that has come out recently has been generally positive, in both the U.S. and Canada. In fact, the central banks in both countries have acknowledged the improvement and are beginning to prepare the markets for the withdrawal of the extraordinarily easy credit conditions, which still exist, but were put into place last year to combat both the recession and the credit crisis.

As we noted last month, the equity market may be moving from easy money to sustainable earnings growth as the major driver of stock prices. Again it is interesting that the media and market observers aren't making much of positive economic news.

At different times it makes sense to follow different indicators. For example, because it was the bubble in residential real estate in the U.S., and the eventual collapse of that bubble, that initiated the economic recession and credit meltdown, it makes sense to monitor both housing and the mortgage market. The banking industry in the U.S., comprising both the large Wall Street banks and the multitude of regional and local banks, was at the centre of mortgage creation and lending, so it is important to monitor the health of this significant sector of the economy.

The banking industry has been a major beneficiary of the Fed's policy of keeping short-term interest rates close to zero. Low short-term interest rates keep their cost of funds low and their margins wide on virtually any kind of lending or investing they do, even if it involves investing their assets in low risk 2- to 3-year government bonds.

As an indicator of the health of Main Street banks, we have been monitoring the KRE Regional Banking Index which trades on the New York Stock Exchange. It is an index designed to represent the performance of regional banks around the U.S. If the KRE Index is not performing well it will be telling us that the economic recovery is not faring very well on Main Street even if the traders on Wall Street are making out like bandits.

In the last few weeks President Obama has called for measures that will specifically penalize the U.S. banking industry. This occurred at the same time the major stock indices began their retreat in mid-January. We found the reaction of the KRE Index very interesting, especially compared with the performance of the major large money centre banks in the U.S.

The accompanying chart shows the KRE Index in white and Goldman Sachs in orange, as representative of the large Wall Street banks. The chart shows the Goldman's stock price weakening in mid-January at the time President Obama announced his banking Industry proposals. At the same time we see the KRE Index performing quite well.

KRE INDEX AND GOLDMAN SACHS

Source: Bloomberg

From this we draw two conclusions. President Obama's proposals are far more likely to be punitive to the large Wall Street banks than the broad base of regional banks.

Secondly, it is likely that the U.S. economy is on an upward trajectory and the problems in the real estate and mortgage markets, especially in Middle America, are on their way to solution. This is not to say that the problems have been solved, only that the direction is the right one. We will certainly continue to monitor the KRE Index as a good indicator of what is happening in real time in the real economy in the U.S.

If you have any questions about either our investment strategy or your portfolio specifically, please contact Brian Smith at your convenience.

Sincerely,

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