

Not Too Many Bulls Live in Hibernation

Canada

- A good Christmas retailing season
- 4th Quarter economic indicators positive
- Housing sector leading the recovery
- Export sector is the main drag
- 4th Quarter GDP growth of around 3.0%
- Economic gains have been widespread
- Composite leading indicator strength
- Hiring plans have turned up
- Help-wanted index up for 4 consecutive months
- Residential building permits signal higher starts
- Alberta, B.C. and Sask. 2010 recovery leaders

United States

- Durable goods orders show slow recovery
- Industrial production rebound at year-end '09
- Inventory rebuilding is finally getting underway
- However credit crunch is not over yet
- Shadow banking system still shut down
- Foreclosure crisis not over; house price risks
- Consumer confidence remains weak
- Employment outlook improving; fewer layoffs
- Temp employment and hours worked increasing
- However new hiring has not started yet
- A Federal jobs stimulus package is needed
- State and local governments need more help
- Fed will not raise rates in 2010
- Climate legislation to favour natural gas vs. coal

Global

- Surprisingly strong base metals rebound
- Strategic commodity stockpiling by China
- China's Nov. industrial production up 19.2% y/y
- China's 2009 vehicle sales exceed U.S. sales
- However euro zone employment still declining
- Also Japan is still battling deflation
- World oil market will tighten in 2010
- China and Russia are possible buyers of CAD
- Consensus CAD forecast US\$0.97 by June 2010

Happy New Year. We are not just ringing in a new year but a new decade as well. A new decade causes us to look back and determine what went wrong and what went right and what did we learn to help us move forward.

Time Magazine recently labeled the last decade, "The Decade from Hell." There is turmoil in every decade whether it be wars, disease or natural disasters. The first decade of the millennium didn't seem to be any worse and in fact, one could make a case that the decades including the two world wars, (1910s and 1940s) where tens of millions were killed, might warrant such a title.

In truth, it was only a "Decade from Hell" if you were looking at it from a US or possibly European financial perspective. A recent *Wall Street Journal* story noted that the last decade for the U.S. stock market was the "worst decade ever." In nearly 200 years of recorded stock market history has a decade seen such a dismal performance as the 2000's.

The huge 2009 rally in technology stocks already reflects a strong improvement in the general economy that has not yet materialized. It may not materialize. There are still many problems that need to be addressed. The economy has been artificially propped up by enormous fiscal stimulus. Government spending is out of control. The housing market has been held up by huge purchases of mortgages by the Fed both in the US and Canada. Interest rates are unsustainably low. Unemployment will likely be an intractable problem. The US consumer is weighed down by huge debt levels accumulated during the boom years. US bank balance sheets are still loaded with bad loans and banks are less willing to lend. Mortgage resets for "prime", Alt A and option adjustable mortgages are set to spike higher again over the next couple of years. Home foreclosures are still surging. Protectionism is rearing its ugly head (especially with China). The list of issues goes on and on. Yet stocks reflect a healthy sustained economic rebound. Bullish sentiment is high. In 2010, it is time to be cautious.

Canada

There is a big difference between Canada and the United States. The job market is stronger in Canada than the US. Employment increased by a surprisingly large 79,000 in November from the month before. Full-time employment increased by an impressive 39,000. This was a third consecutive monthly increase. The latest employment growth is widespread across Canada. The most pronounced increases are in Ontario, Quebec and Alberta. Most of the recent job growth is in the services sector. In the U.S. total employment is still declining. While there are not as many layoffs now there is not yet any new hiring. If you lose your job in the US, you are not likely to find a new one anytime soon. If new hiring does not reappear in the US in 2010, the economic recovery will be threatened. Fiscal and monetary economic stimulus measures will not work without job growth. The good news is that some of the job market leading indicators in the US are finally looking better. Canada is well ahead of the US in its job market recovery. In contrast to the US new net hiring plans in Canada are positive. They are at their highest level in 12 months. Total employment in Canada is still down though by 321,000 from its October 2008 peak. Using a "rule of thumb" of 10 to 1 comparing the US and Canada, this would translate into a 3.21 million job loss. This is far less than the 7.2 million jobs actually lost in the US since the US employment peak in December 2007.

Debt

Behind the scenes, the bigger concern is still what is going on with Global debt levels, including those Emerging Markets where problems have been brewing in December. The bigger concern is debt levels in the US and the impact that will have on the US\$ in 2010. At some point in the next few months, there is a very good chance that slow growth in the US will be overwhelmed by debt concerns. The US has \$2 trillion of short term debt coming due in 2010 that needs to roll over, and on top of that there will be another \$2 trillion deficit growth this year. The US needs foreigners like China to continue supporting these auctions or the US government will be forced to print a huge amount of money. We will be watching this situation closely in 2010, but we are sure that this is going to heat up in the second half of 2010.

We think North American markets will feed off improving US Q4 data and EPS. A very strong snap back in growth occurred as stimulus packages kicked in last quarter, and we are expecting GDP growth to climb from 2% to 4.5%. The markets will be riding that wave with stocks that lead out of a recession. The volatility in the currency markets is being fuelled by a power struggle between the slowly growing US market and the rapid growth in China. If we can get some stability here in the form of more robust and sustainable US growth, then a more aggressive asset mix will be warranted. Until then, we think that a more defensive approach is warranted.

Bonds

Turning to bonds, given all the deflationists and all the money that is poured into the bond market, one might be surprised to know that 2009 was the worst year for the long bond in **40 years**, as the yield rose from 2.7% to around 4.6%. We believe we will be in a protracted period where bonds "yield" nothing but losses. Especially mid to long term bonds. That, as the funding crisis is due to make itself known this year -- the only question being whether problems erupt first in the bond market or the currency market. We will probably learn a lot more on that score between now and March when Fed Chairman, Ben Bernanke, is supposed to end quantitative easing.

Of course, the fact that we are going to have a funding crisis is a function of the Fed. Bernanke made a speech recently, covered by Bloomberg in a story headlined "Bernanke Says Low Rates Didn't Cause Housing Bubble." The fact that he is so deeply in denial just goes to show that he really does not understand money printing.

In fact, he is not alone on that score. It seems that all of those folks who inhabit Wall Street these days -- referred to, euphemistically, as Bankers, as well as nearly all of the Politicians -- want to get back to

business as it was and are trying to pretend that 2008 never happened. If the Fed, in the form of Bernanke, cannot admit its mistakes, it is due to continue making them exactly as Greenspan always did.

So where does the US government get the money to cover 2009's \$1.42 trillion deficit? It is not a coincidence that that amount just about equals the amount of money the Fed printed (out of thin air) through its quantitative easing programme. Effectively, the Fed has been monetizing the US governments' deficits over the past year. It has been printing the money to purchase bonds (directly and indirectly).

Precious Metals - Gold

We do not consider ourselves "gold bugs". That denigrating term used by gold haters typically refers to the stereotype of a gun toting survivalist waiting for the end of the world. Precious metals started off the year with a bang -- silver, especially, as it recently leapt about 4% to gold's 2%. Last year was the ninth year of the gold advance -- an amazing feat, especially when contrasted by how vociferous all the gold bears are.

Nine years of successively rising gold prices. What does 10 years of steadily rising gold prices mean?

Last day of the year quotes (spot gold).

2000 -- \$273
 2001 -- \$279
 2002 -- \$348 – MacNicol & Associates Asset Management started to accumulate precious metals
 2003 -- \$416
 2004 -- \$438
 2005 -- \$518
 2006 -- \$638
 2007 -- \$838
 2008 -- \$889
 2009 -- \$1096

The DJIA ended 2009 at 10,428, almost 1,100 points lower than it began January 1, 2000. The Nasdaq, home to most technology stocks, is still nearly 45% lower than its starting point 10 years ago. The Nasdaq 100 Index, the more heavily technology weighted index soared 102% in 1999 on top of 1998's 85% surge. It quadrupled in value in just two years. The gold haters of 2010 might want to reconsider their thought that gold is currently in a bubble. Gold gained 24% in 2009 following a 5% gain in 2008. Compared to the technology bubble of 1998/99 this is hardly a parabolic move.

There is a big difference between a bull market and a bubble. Gold is simply in a bull market which started 9 years ago after a 20 year bear market. So far there are no signs of a top. Gold's move has been very orderly with periodic sell offs helping to keep any frenzy from forming. A testament to the fact that the general investor is not yet involved in gold in any major way is the performance of gold stocks – or rightly, the underperformance of gold stocks relative to the price of gold. At the beginning of 2008 the Market Vectors ETF Trust (GDX) which mirrors 30 of the largest gold mining stockings in the world was at 49.90. Over the last two years, this index has declined to 46.21. Certainly no bubble!

Gold was the best performing asset for the decade, up nearly 15% per year on average.

So it was technology stocks in the early nineties and precious metals last decade – what will it be in the new decade? For now we will stick with precious metals. The secular bull market in precious metals is not yet over. The biggest gains still to be made will be in mining stocks, rather than the metals themselves. In typical precious metal bull markets the mining stocks outperform the precious metals by a factor of at least 2 to 1.

Through the first nine years of this bull market, the precious metals mining stocks have badly lagged the metals. December's precious metals pullback only exacerbated the imbalance.

While gold is up close to 80% over the last three years, the gold miner's gains are just a bit more than 20% (gold stocks are actually down over the last two years). The problem for the gold miners has been that while the price of gold has risen dramatically over the past several years, their costs (energy, materials, exploration and development) rose at a similar rate. The bottom line leverage that typically occurs in precious metal bull markets has not yet been realized. Gold miners should realize an average price of about \$1,100 an ounce in Q4. While that is nearly 15% higher than in Q3 the bottom line leverage is infinitely greater as that increase is all pure profit. When gold mining companies report Q4 numbers beginning in late January to early February there are going to be some strong results.

With the US government still ratcheting up its spending levels to ever greater heights, we just do not see how they will fund the trillion dollar deficits in the future. There are only a few options here. One is to dramatically increase taxes beyond just the rich which would likely sink the economy and violate a key Obama campaign promise (not a likely choice). Another is to drastically cut spending (also not likely). A third option would be to let the suppressed Treasury bond rates rise to levels that would attract buyers other than the Chinese. That would sink the mortgage market and drive up the government's interest payment tab. Finally, there is the old favourite standby solution of the Greenspan and Bernanke-led Feds – keep on printing. That was our main worry in 2002 and it remains the same today. We bought gold then and we continue to buy it today.

**MacNicol & Associates Asset Management Inc.
January 2010**

Appendix – End Game

From Richard Russell – Long Time Market Forecaster

On the December 28 site, I put forth my theory regarding what the Fed (and probably the administration) plan to do about our insane multi-trillion dollar debt. I want to start with three assumptions:

- (1) The people at the Fed are not stupid, they are as intelligent as you or I. True, they are operating outside of the US Constitution, but who cares about the Constitution today (well, maybe Ron Paul does)?
- (2) The multi-trillion dollar debt of the US is so fantastical, so insane, that it can never, ever, be paid off, either by raising taxes or by borrowing. Furthermore, the interest on the US debt is rising and compounding at a dangerous and relentless pace.
- (3) I believe Obama and probably Bernanke have been greatly influenced by the policies of the Roosevelt administration during the Great Depression of the 1930s. I've felt all along that Obama has followed Roosevelt's strategies. In 1931 Roosevelt, to offset deflation, raised the price of gold from 20.67 to 35 dollars an ounce.

A few days ago I received a paper, signed *anonymous*, that expanded my December 28 piece. The paper was written so clearly and so well, that I want to reproduce some of it, courtesy of the *anonymous* author. What I thought so interesting is that this idea is starting to spread around and maybe gain widespread credence. The article follows, edited a bit by Russell.

"Out of respect for the proven maxim 'do not underestimate your adversary', we assume that the deus-ex machina power elite of the political and financial system in the US is highly intelligent and completely

informed in every respect. We assume that they have in hand or have already begun to implement a carefully thought-out plan prepared years ago.

"We use the following facts in our hypothesis;

"The US Federal Reserve Banking system was put into effect in 1913, (i.e, 96 years ago).

"The US dollar has declined in purchasing power during that time by approximately 95%.

"Youngsters (under the age of 50) do not recognize the collapse in the purchasing power of the dollar. Old timers like Richard Russell (86) do. I remember when a pack of gum was a nickel, I remember when a new Buick sold for \$1800, I remember when a subway trip around Manhattan was a nickel.

"The debt obligation of the US government has become an unpayable sum, amounting to multi-trillions of dollars. That is, the US could not collect enough in taxes, reduce its expenses enough, nor produce enough material wealth with its degraded manufacturing infrastructure and work force to pay off this debt in the foreseeable future. It's a debt that is the largest ever incurred by any society in world history.

"The US dollar is the world's reserve currency and is held as a monetary reserve in central banks worldwide. China, for example, holds approximately 2 trillion dollars of US Treasury securities in its reserves.

"The US Treasury has a declared hoard of 261.5 million ounces of gold.

"According to the US Dept. of Treasury (as of 2008) the value of US currency and coin in circulation is 85.2 billion dollars with 70% of this being located outside of the US. John Williams of "shadow stats" places this figure at \$923 billion with 50% overseas.

"The US government now has in place a domestic policy of massive credit expansion, extremely low interest rates, and the takeover of private corporations.

"Assuming the power elite seeks to maintain the status of the US as a world power and not plunge the world into an economic meltdown, there are only two ways to pay off its otherwise unpayable debt. That is, by default or by wiping it out with inflated dollars. It seems that the latter choice has been decided upon. This may be accomplished by a continuing massive expansion of credit that will have the effect of decreasing the value of the dollar, increasingly allowing cheap dollars to be used to amortize existing debt previously incurred with expensive dollars. The holders of dollars are trapped into this situation, just as they were in 1931, but at least, they would like an orderly decline of the dollar. They would like to rid themselves quickly of these failing fiat dollars but understand that a panic run out of the dollar, prompted by dollar-dumping would result in a severe collapse in the value of their dollar reserves. They need time to use these dollars while they still have an exchange value to acquire other real assets. They also will continue to trade with the US to support their home economies while they continue to divest themselves of dollars and build their internal markets and alternate markets. These captive dollar holders are between 'a rock and a hard place'.

"The fiat money game is destined to end because domestic and international confidence in the dollar will fail as the world realizes that the dollar, regardless of proclamation of the US government to the contrary, is on a path towards worthlessness. However, the US will try to keep the confidence game going as long as possible to gain time to reduce its debt obligations by payment with cheap dollars.

"About the time a currency collapse appears imminent; the US will have reduced its debt to hopefully manageable proportions or amortizes it completely with inflated dollars. The price of gold will have soared to new highs. Currently, if the US Treasury were to back the total of US dollars in circulation worldwide

with its 261.5 million ounces of gold, that gold would be priced at \$3,530 an ounce. However, if gold were to reach \$5,000 an ounce, and with circulating currency at \$923 billion (shadow stats), that would seem a propitious time to announce a new monetary policy. At \$5,000 gold the Treasury's gold would be valued at more the 1.4 times the existing dollars in circulation. The US could then proclaim that it would redeem these dollars at the market price of gold, whatever that might be. That would still leave the Treasury with approximately \$384 billion in gold if the market price were \$5,000 an ounce.

"This strategy, if brought to a successful conclusion, would leave the US solvent, debt free, and on a solid gold standard monetary system. With America once again standing behind the dollar as 'good as gold', a renaissance of recovery would come roaring back in the US and throughout the world.

"Would the power elite actually choose such a strategy? They might, thinking that within a couple of generations, they could once again reintroduce the concept of a privately owned central bank with a monopoly power to issue fiat currency. In the meantime, they would have the massive booty of 96 years reaped from a central bank fiat money system to sustain them in the lap of luxury."

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