

LEITH WHEELER INVESTMENT OUTLOOK



First Quarter 2011

We 'll Get By With A Little Help From Our Feds

The global economy and the markets have improved significantly since the peak of the banking and credit crisis in 2008, with our central bank friends providing a steady flow of easy money and our federal government friends dishing out plenty of fiscal stimulus and bailout money. In the book *This Time Is Different*, Carmen Reinhart and Kenneth Rogoff show how this is the usual course of events after looking at eight centuries of countries “lending, borrowing, crashing – and recovering – their way through an extraordinary range of financial crises.” So after the *Helter Skelter* of these crises what does the road to recovery generally look like?

The Post-Crisis Challenge

The answers from an economic point of view are examined in *After the Fall*, a recent National Bureau of Economic Research paper, which studies the 1929 stock market crash, the 1973 oil shock, the 2007 U.S. subprime collapse and fifteen severe post-World War II financial crises. The good news is that economies do recover; the bad news is that most of the time they take 10 years or more! The table below shows the typical path for advanced economies in the decade after a crisis.

Economic Growth	1% lower (on an inflation adjusted, per capita basis)
Inflation	Lower (other than the 1973 oil shock)
Unemployment	About 5% higher
Housing	Inflation-adjusted prices below their level the year before the crisis, nominal prices 15% to 20% lower.
Financial Leverage (credit/GDP)	Declines by an amount comparable to the pre-crisis surge. The process is often delayed and lengthy.

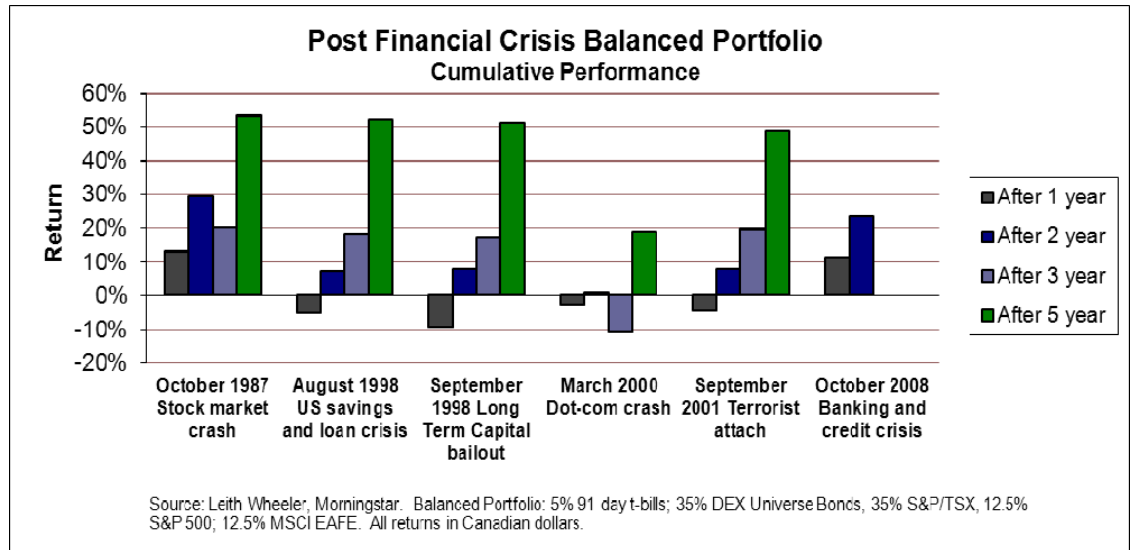
The Post-Crisis Opportunity

While there may be a few more years of subdued growth and higher unemployment, it is reassuring to see the typical post-crisis path points up as our Fed friends keep supporting the economy until the private sector takes over. We are seeing this at home, as the Bank of Canada overnight rate is expected to remain low even after some potential increases later this year. On the fiscal front, Canada is running a budget deficit, although it may get smaller as we move toward long term fiscal balance. In the U.S., the Federal Reserve has affirmed an extended period of near zero short term rates, and the purchase of another \$600 billion of U.S. Treasury bonds (on top of the \$1.7 trillion already purchased). Coupled with the recent agreement to extend U.S. personal tax cuts and unemployment benefits, U.S. federal spending remains high.

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Given the economic challenges and corresponding support from our Feds, how has a balanced portfolio fared after recent financial crises? As illustrated in the chart below, the longer term results are very good, with cumulative five year returns in the range of 20% to 50%. Given that we are only two years beyond the 2008 crisis, this bodes well for balanced portfolio returns if, as Mark Twain said, "history doesn't repeat itself, but it does rhyme."



The Post-Crisis Bottom Line

According to history, it was no surprise that our central bank and government friends applied the required medicine to prevent a further downward spiral and sow the seeds of recovery. While easy money and deficit spending will need to be reversed in the long run, for the next year or two we don't expect inflation to be a major problem in North America. As Federal Reserve Chairman Ben Bernanke put it "with inflation expectations stable, and with levels of resource utilization expected to remain low, inflation is likely to be subdued for some time." Our tracking of manufacturing and service sector activity surveys points to positive, albeit more moderate growth. That said, earnings at the companies we follow are growing, and their balance sheets are healthy.

Our estimates of future returns favour overweighting stocks versus bonds. While the *Long and Winding Road* ahead could still be bumpy given the economic and sovereign risks that abound, we still expect high single digit returns for balanced portfolios over the next few years. Our intention, given the presence of these risk factors, is to remain focused on our investment discipline. Buying companies with attractive valuations, stable business models and conservative financing will provide a margin of safety in the event that the economic recovery falters. This is an approach that has served us well through previous markets cycles and should, in our view, provide excellent opportunities for the long term investor.

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