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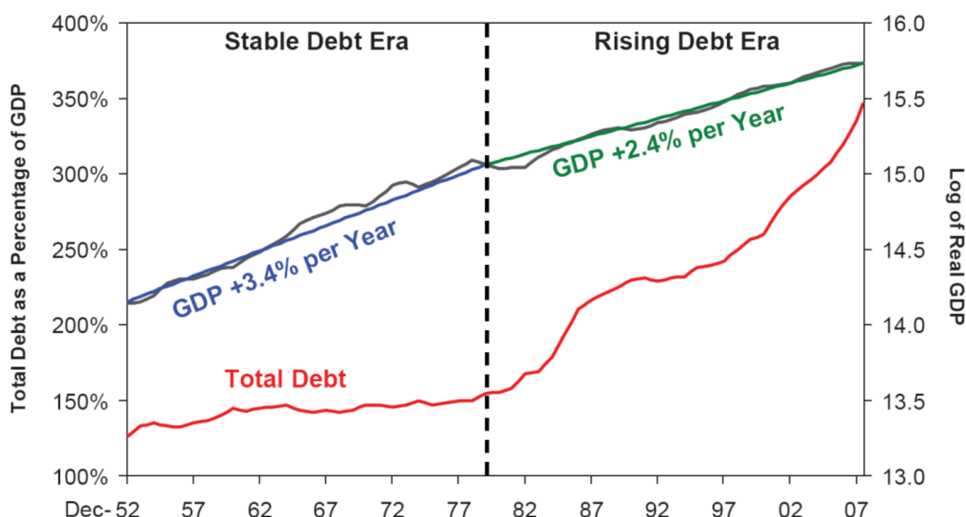
November 2010

Quantitative Easing: What Investors Need to Know

Exhibit 1
Debt Does Not Create Growth!



Source: Federal Reserve Flow of Funds, Global Financial Data   As of 6/30/08

The term “quantitative easing” is a convenient euphemism which makes it sound as if central bankers around the world have the tools to achieve growth. I think it should be called what it truly is: deliberate currency debasement through printing money.

Having already lowered interest rates to zero, the U.S. Federal Reserve (The Fed) recently announced details of the second round of quantitative easing, or QE2. The plan is for The Fed to purchase $600 billion of short-term bonds on the open market with newly-created funds, hence creating money through wires and cheques for the sellers of these bonds. The hope is that with all this extra new money sitting in bank deposits, the banks will be encouraged to lend some of this money out. In other words, the solution to an overly indebted society is to foster and create more debt.

In fact, The Fed had hinted in August that it would continue currency debasement – I mean quantitative easing. Just the hint sent the U.S. dollar lower, while stocks and commodities rose.

At the G-20 Summit in Korea, world leaders attempted to come up with a framework for currency stability. The U.S. accuses the Chinese of having a currency that is too low; while the rest of the world accuses the U.S. of achieving an advantage by deliberately lowering its currency. In the end, no agreement was reached, and it seems a consensus that every country's currency should be weakened against everyone else's.

Asian currencies have been embarking on a quantitative easing program for over a decade. Since the Asian crisis of late 1998, the People's Bank of China, the Bank of Japan, the Central Bank of the Republic of China (Taiwan), and the Bank of Korea have created the equivalent of $5 trillion worth of their own currencies to support a low currency and thereby foster export-led development.

Recent data from China shows money-supply growth at a whopping 28.7%, as opposed to 4.7% in the U.S.

Quantitative easing is a huge global experiment which likely will not end well. The very people pulling the strings on this gamble are the same people who saw no problems with the tech bubble, nor any with the later real estate bubble.

The goal of QE is three-fold. One, lower the value of the currency to encourage exports. Two, provide more liquidity to banks to encourage more lending. Three, prop up stock values so people feel wealthier, and are thus encouraged to spend more.

But increasing debt does not create real growth. Growth accompanied by stable total debt levels from 1952 to 1980 exceeded growth levels between 1980 and 2007, when debt exploded upwards. This would seem to be the financial crisis that keeps on giving.

In the short run, many European nations have seen rapidly rising interest rates, led by Ireland where 10-year bond yields touched 9% as investors fear default.

Another risk is that the increased money-supply could continue to inflate food and energy prices, which could then cause consumers to retrench on discretionary spending decisions.

Money-printing and zero interest-rates could cause investors temporarily to flee cash for stocks and commodity investments, into 2011. But stay tuned, as one will need an exit strategy when the world's central bankers again begin raising rates late 2011 into 2012.

In Canada, I continue to hold Canadian preferred shares with yields of 5 to 5.5%. I also continue to accumulate U.S. multinational companies with yields generally between 2.5% to

5.5%. Don't forget that U.S. companies trade at roughly a 30% discount to Canadian companies.

The Canadian dollar traded at par to the U.S. dollar in September 2007, yet it has failed to appreciate against the falling U.S. dollar. On the basis of purchasing power parity, the Canadian dollar is about 20% overvalued against the U.S. dollar, so currency gains are possible for Canadians at some point.

The advice of Jim Grant, of Grant Interest Rate Observer, is that it is perhaps wise to place one's money in a currency where the housing market has already gone bust, rather than in one where there's still a bubble in the housing market, as in Canada.

To summarize, the economic recovery will remain sub-par for many more quarters, or perhaps even years. Consumers in the western world have been consuming at rates above their income for years, stealing consumption for present purposes from some time in the future. I would argue that for the majority of people that future time is now upon them. That being said, cash globally continues to pay rates lower than the inflation rate. These negative real rates may cause investors to continue to flee cash in favour of stocks and commodities, for a while yet.

If you would like to review your portfolio, please do not hesitate to give me a call.

Sincerely,

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