CANACCORD Genuity
Wealth Management

LePoidevin
GROUP

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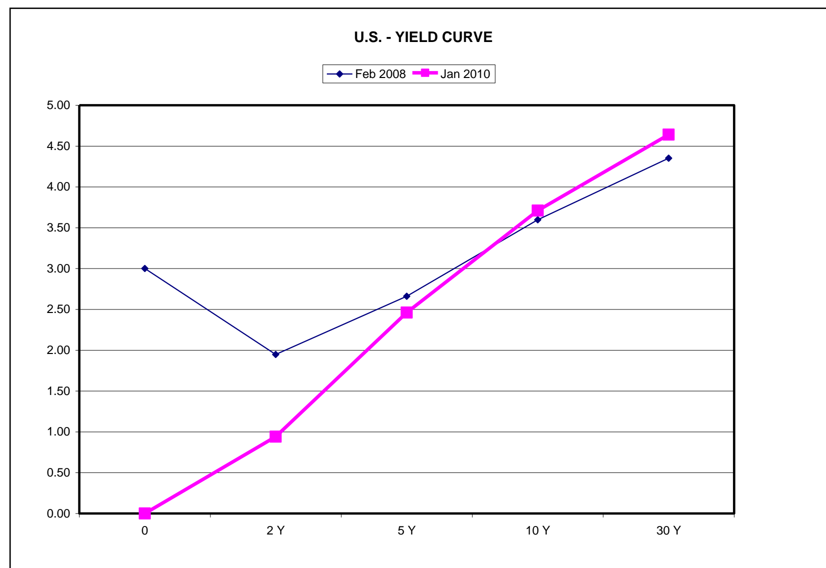
Yield Curve Predictions for 2010



Consumer spending makes up the lion's share of economic output (approximately two-thirds). So, as in the recessions of 1981 and 1991, our "Great Recession of 2008/9" has seen drastic declines in consumer spending. However, the similarities end there. In the '81 and '91 downturns, household debt relative to income was actually quite low, but double-digit spikes in interest rates dramatically increased the cost of servicing any level of debt-- to the point that even low-level debts were unmanageable for many households. This situation was quickly remedied by falling interest rates (back to pre-recession level), and as a result both earlier recessions were short-lived.

This is in stark contrast to our present situation. U.S. mortgage rates have been consistent at approximately 5% for most of the past decade, with no spikes prior to the recession. But problems are arising because of the massive amount of debt now carried by each individual household.

Governments around the world have attempted to counteract the fall in consumer spending by massive government spending. Furthermore, interest rates have been lowered to near zero, and tax incentives created (e.g. the Canadian renovation tax credit) to encourage even more debt and spending. Keeping in mind that too much spending and debt is what got us into this mess, the talk in town is that interest rates are going to rise in 2010; and my own thought is "Yes, and to what level?"

In February 2008, I titled my *LePoidevin Letter* "Recession", and included a yield-curve graph of interest rates. Oil was then over $90 per barrel, on its way to $140; and commodities were surging. Although the U.S. housing market had started to show some cracks, house prices remained strong. In 2008, U.S. inflation as measured by the Consumer Price Index peaked close to 6%; yet short-term interest rates were only 3%. Since short-term rates of 3% derailed a strong economy, it is doubtful that rates could rise any higher than 4% today without unleashing further deflation.

Investors have become fearful of rising interest rates. People sometimes talk about interest rates as if interest rates and the yield-curve always move in a parallel fashion. Notice that since 2008, the U.S. short-term interest rates have fallen from 3% to near zero; yet long-term interest rates have actually increased from 4.3% to 4.6%. This is partly due to the massive issuing of government bonds, even though most of the bonds have short-dated maturities. However, most of the reason for the rise in long-term rates is the expectation of future interest rate increases.

And, indeed, there is a high possibility that both Canadian and U.S. short-term interest rates will increase in 2010; but I believe that an increase to 4% would throw the economy back into a "depressionary" state.

That being said, the most likely outcome for 2010 is that the yield-curve will flatten – that is short-term interest rates will rise and long-term interest rates will fall. My forecast, then, is for short-term interest rates to rise to 2%-2.5% and for long-term rates to fall to 4%-4.25%.

Moreover, the peak spending years of the baby boomers are likely over. Statistically, fifty and sixty year-olds tend to consume less than thirty or forty year-olds. So if interest rates rise too high, consumption would plunge still further and savings rates would rise.

In March 2009, I stated that "the current values of stocks indicate that they are in-line with the lowest valuations of other bear market bottoms." As we begin 2010, traditional stock valuation measures show that stocks are starting to be on the high side of valuation. It may seem counter-intuitive to some, but it is not economic growth that drives stocks higher: it is new money going into the markets. In the absence of a panic, if the interest rate alternative is considered poor, money will likely flow away from cash and into stocks and bonds.

Conversely, as I have previously cautioned, there are dangers in an inverted yield-curve (high short-term rates). A steeply upward-sloping curve, as we have now, suggests that it is best to stay invested.

That being said, I am cautious about the economy, and so prefer to remain on the defensive. The following is a list of what I have been buying or adding to my own portfolio. Fear often creates the best investment opportunities: fear of rising interest rates, in fact, is where I myself have found the best values.

1. Mid to Long-term U.S. Treasury bonds
   I expect the yield-curve to flatten so I have purchased mid- to long-term U.S. government bonds above 4%.

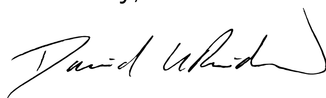
2. Straight Preferred Shares
   Some of Canada's safest companies can be purchased at deep discounts to their par values, and are typically yielding 5.5% to 6.5%. In a taxable account with a dividend tax credit, one would need over 7% interest to get the same return.

3. U.S. Multinational Companies
   As I mentioned in my September letter, I am finding better values in the U.S. stock market with household names such as Kraft, Coca Cola, Proctor & Gamble, and McDonalds, to name a few. Moreover, these companies yield 3% to 4%.

As far as the Canadian dollar is concerned, I expect there will be a spring election. After which, much of the housing stimulus funds will likely be removed, which will in turn mean that the Canadian Gross Domestic Product will under-perform that of the U.S. in the second half of 2010, and thereby put downward pressure on the Canadian dollar.

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

Sincerely,



David LePoidevin, CIM
Senior Vice President
Portfolio Manager
Telephone: 604.643.7073 or Toll Free: 855.643.7073
www.lepoidevingroup.com

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