

GWP Quarterly
July 1, 2011

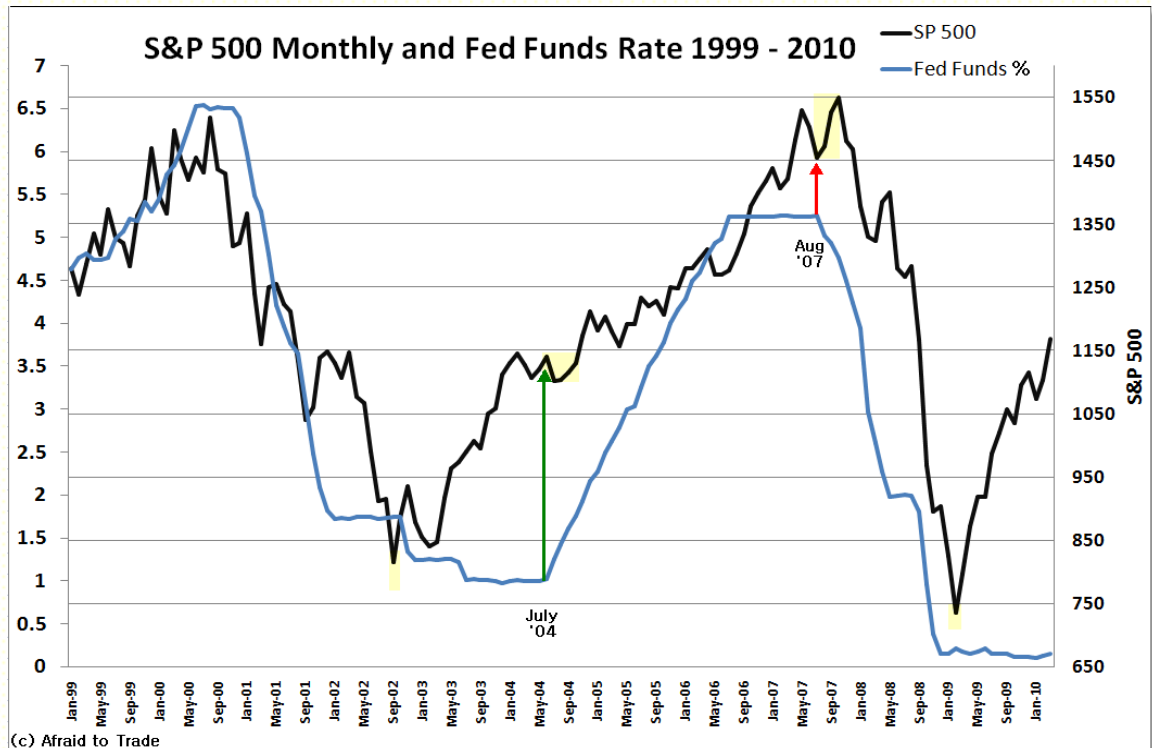
Rising rates...Falling Stock Markets?



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Anyone following market commentary on the internet or other media has already been primed to expect the stock market to plummet when the Federal Reserve announces an increase in interest rates. Perhaps this fear has been over stated!

The graph below shows what the stock market has done since 1999 when the Federal Reserve adjusted interest rates. This is typical of interest rate cycles over the last few decades. Surprisingly, the picture is not what most would have expected.



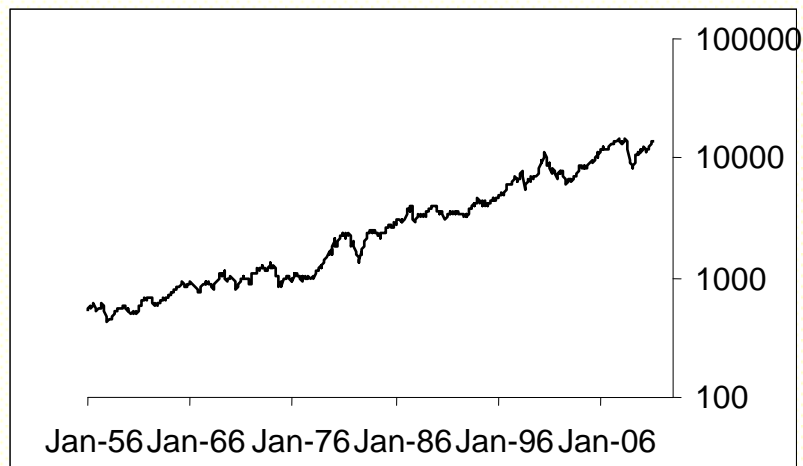
From late 2002, as interest rates were nearing bottom, stocks rallied **38 percent** before the Federal Reserve tapped the brakes to slow things down. After the initial rate increase the market did correct by about **5 percent** but then continued to rally another **40 percent** even as rates were increased **sixteen more times**. Overall interest rates increased from 1 percent to 5 1/4 percent over a period of 36 months.

When interest rates were cut in August 2007 the market continued to rally another 5 percent before crashing 50 percent. The current picture looks surprisingly similar to July 2004!

What many investors have difficulty appreciating is that the stock market is forward looking and rising rates are a sign that the economy is growing. The Federal Reserve, by increasing rates, is trying to temper growth so inflation does not get out of hand. Cutting rates is the opposite signal; the economy needs a boost.

In a speech in mid June Mr. Bernanke of the Federal Reserve indicated that he was leaving interest rates unchanged. This did not send an overly positive message to investors. What was clear is that economic growth was slower than expected as a result of some major external shocks such as the Japanese tsunami, flooding in the southern U.S. and an extremely nasty winter. He stated that these are only short term negatives and he expects growth to accelerate in the second half of the year.

The graph below shows the Toronto Stock Exchange levels since 1956. While not a straight line the direction is up, even in the face of some major obstacles. The more seasoned of us remember the Arab oil embargo of 1973 and the resultant battle with inflation in the early 1980's. Inflation hit 13 percent and mortgage rates were above 21 percent. Even with a severely damaged economy stocks recovered.



Bear markets and corrections are part of stock market investing.

Over the last fifty five years the stock market has returned 9.6% per annum (\$1,000 invested in 1956 would be worth \$153,000 today). Investors who ignore the short term noise and focus on a long term strategy always make money in the stock market!

Corporate earnings continue to improve and in the latest quarter over 75 percent of companies in the S&P index reported profits higher than expected by the investment community. Companies continue to build cash reserves as they are unwilling to reinvest these funds until they see more positive economic signs. Many are increasing dividends to shareholders or looking for takeover candidates. We still believe that corporate cash as well as investment cash being held by individuals, pension plans and mutual funds could be a major factor to fuel a substantial stock market rally.

European debt problems continue to be front page news; the casualty of the month has been Greece. The Euro zone is trying to sort out the problems but Greece has to make many internal changes before the problem can be resolved successfully.

The Greeks have to accept that they are in serious financial troubles and need to make personal sacrifices such as not expecting to retire on a full pension prior to age 60 or taking 8-10 weeks of holidays every year.

China continues to be the real growth story for the world but things are slowly changing. After a spike in housing prices and inflation, the government raised interest rates and began restricting bank lending to cool things off; the housing bubble is now deflating. Growth will be an impressive 8 percent per year rather than the run-away 12 percent of a few years ago. The largest problem facing China today is wage inflation; throughout China wages are climbing by 15-20 percent per year. The Chinese low cost advantage shrinks to 30 percent when compared with states such as Mississippi, South Carolina and Alabama. Factor in shipping cost and the advantage erodes further. The costs for manufacturing some products in China and the U.S. could converge around 2015. We have already seen Caterpillar, NCR Corp. and Wham-O, Inc. repatriate some of their manufacturing back to the U.S. Even with this shift the end is not near for China. They will continue as a major manufacturer for the world and will be producing more products for domestic consumption as the population becomes more urbanized.

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