

It's been a good year! The decision to be overweight in equities and more importantly to be focused in the energy and resources sectors has proven to be very profitable for all of us. So what do we do in 2011?

For the past two years the overriding investment themes that have been the basis of our investment decisions have been the following:

Emerging Markets

The growth of the emerging markets will be a game changer for decades to come. In 2010 China surpassed Japan as the second largest economy in the world. The growth of the Chinese middle class has created an enormous demand for goods and services as well as increased demand for resources and energy. China has been trying to cool off its economy for most of 2010 and will continue to do so in 2011. The current ten percent growth rate is not sustainable but even a move to the seven or eight percent rate over the next couple of years should keep demand for resources at elevated levels. I also expect India to get more attention in 2011.



Jim Armiento

Weak American Consumer

Over the past year we have been saturated with the news of the woeful American consumer. Enormous debt levels, no savings, crushed by the collapse in housing, high unemployment levels. All of this of course is true, but what does it mean to us as investors? In 2001 Canada exported 85% of its goods to the U.S. In 2010 only 70% of our exports went south of the border. The American consumer has less of an effect on all world markets. Make no mistake, they are still a powerful economic force, but with the emergence of the developing nations that continue to grow despite America's troubles, Emerging Markets will continue to be the catalyst for global growth.

Corporate Profits

In the U.S the S&P earnings growth, year over year, is 60% which is the highest on record. Many analysts have been saying that this is a misleading indicator because the profits are being derived by cutting costs and not increased demand for product. The only thing I can say about that is that analysts should have to run a business before they become analysts. Of course a prudent manager is going to cut costs when demand for their product goes down. The objective is to remain profitable or at least minimize losses while the economy is hurting. What we are looking for is what happens when demand finally does come back. With accommodative government policies, increasing exports and large cash balances, corporate America is looking strong. In 2011, I believe domestic demand will begin to return and add fuel to a rejuvenated American economy.

Supply of Resources

We have already mentioned how the demand for resources is growing due to the emerging markets, but what about supply? Oil is now approaching \$100 per barrel. Although alternative energy sources are in some stage of development, it seems unlikely that they will have any significant effect in the foreseeable future. In the mean time, the new oil that is coming to market is very expensive to find and process (oil sands, offshore drilling). Earlier this year I also made a comment on the supply of copper. There have been no new world class copper mines developed in several decades. Prior to this commodity bull market, which began around 2002; metals had been in a twenty five year bear market. During that period, it was not necessary to find and bring any new resources online. In 2011 and beyond, I expect to see continued strength in commodity prices. However, because of the magnitude of the move over the past two years, it is time to take our profits and reduce the exposure to this sector. I would suggest moving the Canadian equity portion of your portfolio to market weight in both the energy and materials sector.

Bond Market

I like to save the best for last. Several times over the past year I have commented on how the flow of investment capital has been heading straight into the bond market and in fact leaving the equity markets. This bond mania is sowing the seeds for the next leg up in this equity bull market. There is some evidence that this is already occurring. PIMCO, which is a bellwether bond fund in the U.S, recently had its first monthly outflow in two years. In addition the yield of the 10 year American treasury bond has gone from 2.5% to 3.48% in about a month (bond yields increase because of the decreasing price of the bond), indicating some selling pressures on the bonds. I believe that this trend will continue and gain momentum throughout 2011. The increase in demand for equity caused by this redistribution of assets will be the engine that drives this equity market to new highs.

“The essence of portfolio management is the management of RISKS, not the management of returns. Well-managed portfolios start with this precept.”

Benjamin Graham

Over the past two years we have had a wonderful run in the resource sector and I expect this to continue. The problem is that we started this run over weighted in the resource sector and the price appreciation of these assets has increased this over weighting. The hard part of managing risk is having the discipline to sell your winners early in order not to overexpose yourself to any one sector. **Over the next quarter, I believe that we should reduce our exposure to the resource sector (down to market weight) and move the funds primarily into high yielding blue chip American equities.**

Last month we saw both GE and BCE raise dividends. Over the last six months, we have seen numerous dividend hikes. The money that flows out of the bond markets in 2011 will be looking for a safe home with predictable yield. That is why I believe that the high dividend blue chip market will finally outperform the small caps. I also believe that it is time to increase our exposure to the American markets. The U.S market has underperformed for much of the past decade and is still currently out of favour. Some strategic purchases of American equities will expose us to industries that are hard to find in the Canadian markets and therefore will also allow us to de-risk your portfolio as we enter the third year of this current uptrend.

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Dec 30/2010

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