

We continue to believe the United States presents the greatest opportunities in its economy and financial markets. While we are currently experiencing a “soft patch” similar to the spring of last year, we expect growth to accelerate in the second half of this year. As we have so often mentioned, this does not negate the necessity of being watchful of the meaningful risks to global growth and thus investment markets. Washington is a constant source of headline risk; Europe remains moribund; China is purposely slowing growth; and Canada’s economy has lost momentum.

The U.S. recovery remains “modest” (as the Fed euphemistically puts it). For example while first quarter GDP was +2.5%, estimates were at 3%, and the March payroll report came in at 88,000 new jobs, well below the forecast 200,000, but rebounded to 165,000 in April.

As the effects of increased tax rates and the “sequester” dissipate, the numbers should improve in the second half. The side-effect of increased revenue and decreased spending has caused a remarkable improvement in the U.S. budget deficit. Defense spending has decreased at a rate not seen since the end of the Korean war as troops are brought home from Iraq and Afghanistan. For the first time since early 2009, the rolling 12 month deficit is below \$1 trillion and the U.S. Treasury had no net increase in debt in April. In no way does this suggest all is well, and there remains significant risk coming out of Washington as the White House and Congress argue over such matters as tax reform and the debt ceiling.

It was not very long ago that consensus opinion had the U.S. in decline analogous to the Roman Empire. Now the talk is about the “American Renaissance or Resurgence”. There is renewed recognition of longer term advantages in the U.S.; the high productivity of the labour force, excellent transportation infrastructure, and the predicted energy self-sufficiency are among them. As an example, the respected consulting firm, Alix Partners, expects manufacturing costs in China and the U.S. (as landed on the west coast) to be equal by 2015. Alix cites that Chinese wages have increased at a double digit annual rate for the past decade, the renminbi has risen 25% against the U.S. dollar, and the cost of shipping is also more expensive. Speaking at least on a relative basis, the U.S. appears best equipped among the developed nations to grow its way out of its budget deficits.

Of course the competition is not that severe as Europe and the UK remain mired in an economic malaise. Lately the senior members of the E.U. such as Germany & France, are experiencing contraction in their economies to add to the severe problems in nations like Greece and Spain. Recently, austerity is being attacked at the highest levels of government in Italy and France in an attempt to renew growth. Of course such policies would make budget deficits much worse and fail to meet demands on those economies by the European Central Bank and the I.M.F. How this will play out and what effect it will have on the September German elections remains to be seen.

Briefly on China, it is not just a forecast but the announced policy of its new government that economic growth targets are in the 6 ½% to 7 ½% range; no longer above 10%. We see two things to consider; first China will have a less positive impact on global growth; and second, managing such a reduction is very difficult to control without mishaps.

The tempering of global growth has an outsized effect on the Canadian economy, due to the importance of export trade and commodity prices. Canada does 85% of its trade with developed countries, while only 15% with the faster growing Asian and Latin American markets. Expectations are for a mediocre 1.6% GDP growth this year. Internally, government spending is restrained and the consumer is deeply in debt. For 11 consecutive years household spending has exceeded disposable income. Bright spots are few and far between but growth remains positive.

With the continued support of the world’s central banks, there are no obvious signs that would suggest a serious downdraft in financial markets, but we continue to recommend a conservative portfolio approach, (such as our funds that write calls and buy puts to protect capital when appropriate).

The global economy still rests on a shaky foundation with unknown risks and unintended consequences. As one urban pragmatist said; “You never get mugged when you’re worried about getting mugged.... That’s when you get hit by a car”.