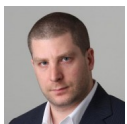


Japan's debt problem

The Japanese economy has been thrust into the spotlight in the past week, but David MacNicol was concerned about its outlook far before the devastating 9.0 magnitude earthquake hit



Peter J. Thompson/National Post



JONATHAN RAINER

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Manager: David MacNicol, MacNicol & Associates Asset Management

Portfolio: Global balanced

Description: Combination of equity, fixed income and alternative asset strategies

Assets under management: \$350-million (300 families)

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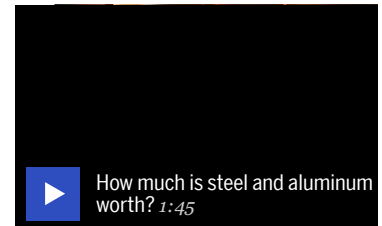
Japan has been running a 0% interest rate policy for almost 20 years, but the deflationary environment has produced positive real returns for Japanese investors. But that is starting to change, says the president and portfolio

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manager at Toronto-based MacNicol & Associates Asset Management.

“It’s not a matter of if Japan starts defaulting on its debt, it’s a matter of when,” MacNicol says. “In time, they are going to be forced to raise rates in Japan and they are not going to be able to afford it.”

Japan’s government debt to revenue ratio is above 1900%, compared to about 300% for the United States. The government interest expense to revenue ratio is more than 20% in Japan, versus slightly more than 5% in the United States.

“The concern is if Japan ever defaulted on any of its debt, the ripple effect back to the United States and Canada will be palpable,” MacNicol says. “That really concerns me. I think inflation is their worst enemy right now.”

He is also worried about what the coming end of the Fed’s quantitative easing program will mean for equity investors given that it has fuelled the market since the credit crisis. MacNicol suggested that could lead to the old broker adage: “Sell in May and go away, don’t come back ‘til Labour day.”

The manager remains a big believer in precious metals, with gold and silver at the top of his list. He favours other hard assets such as oil, as well as seeing a strong outlook for oil service companies in this environment.

“If any sort of shock to the system happened, such as a Japan default, it would be very bearish for global equity markets and cash would be king,” MacNicol says.

As an alternative to cash, he has been using investments in real estate, private companies and third party hedge funds to help diversify this risk.

BUYS

Market Vectors Junior Gold Miners ETF (GDXJ/NYSE)

Why do you like it? This is a play on precious metals, which is propelled by the geopolitical risks in the Middle East, increasing commodity prices and scarce food supplies, coupled with increased domestic demand from developing countries such as China and India. As precious metal prices increase, takeover activity of junior gold miners will increase; which will enable the ETF to pay dividends from the considerations.

What is the upside? Gold continues to become a store of value and an alternative to paper currencies worldwide. We have an upside target of US\$50 on this 60-company ETF.

The biggest risk? Lower gold prices.

Describe the position: Has been buying gold since 2002, but this ETF is a recent addition.

Owens-Illinois Inc. (OI/NYSE)

Why do you like it? This company is perfectly positioned to expand in emerging markets, where glass packaging growth rates are much higher than in mature economies. It has made three acquisitions this year, which added capacity and made it the sole manufacturer of glass containers in several countries. An activist manager is also seeking shareholder value.

What's the upside? Earnings have been lower since the financial crisis but are expected to stabilize in the next few years. If volumes return to 2007 levels by 2013, it should earn US\$5 per share and we see upside potential of US\$45 for the stock.

The biggest risks? Due to its exposure to emerging markets, the company can get hurt by unfavourable currency fluctuations and a halt in global recovery.

Describe the position: Recent addition.

Migao Corp. (MGO/TSX)

Why do you like it? Migao benefits from the growing Chinese agricultural market, while being positioned for growth through major expansions of its operations. The stock still has a less expensive valuation compared to bigger players such as Agrium Inc. and Potash Corp.

What's the upside? Chinese Farmers curtailed purchases of fertilizer during the credit crisis, but they will be forced back into buying as the economy improves. Target price is \$14.

The biggest risks? Lower potash prices and an appreciating yuan will lower earnings as the company reports in Canadian dollars.

Describe the position: Sold down an expensive fertilizer name in Agrium and bought Migao in November 2010.

SELL

The India Fund (IFN/NYSE)

Why don't you like it? Constant interest rate increases from the Indian government have been unsuccessful in stopping alarming food inflation of 10.4%. The Indian market is experiencing heightened volatility, while its IPO market is prone to high valuations, indicating irrationality.

What is the downside? Taking into account the recent market turmoil, we see a downside risk of up to 30%.

A potential positive? Continued global stimulus and an increase in crop yields will stabilize food inflation in India. This will support the Indian economy and provide an opportunity to focus on growth.

Describe the position: Continuing to sell after some strong profits.

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