April 20, 2011

Cautious Optimism

Bottom Line:

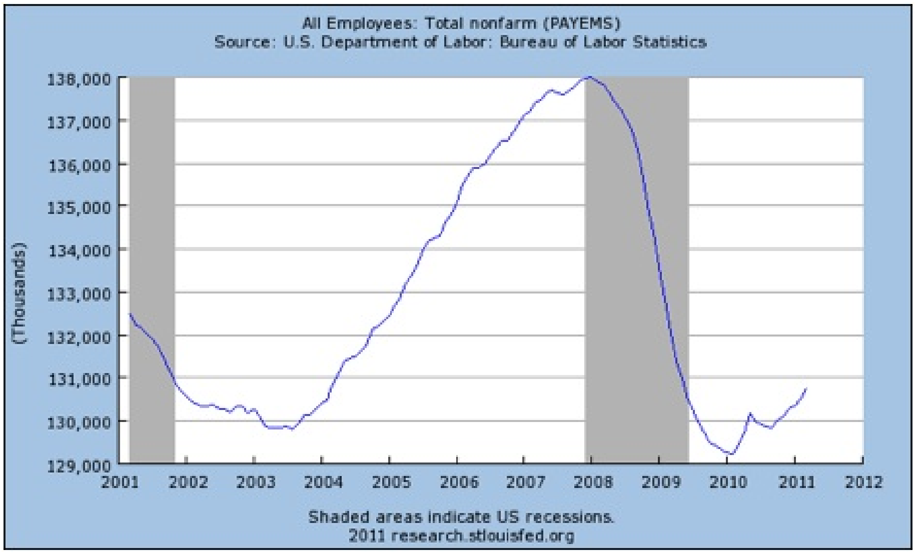
We enter the second quarter of 2011 in our cautiously optimistic stance that we have held since September 2010. There are still risks to the recovery, but we believe the recovery is intact. As such, we continue to slowly add risk assets to portfolios.

Economic Overview:

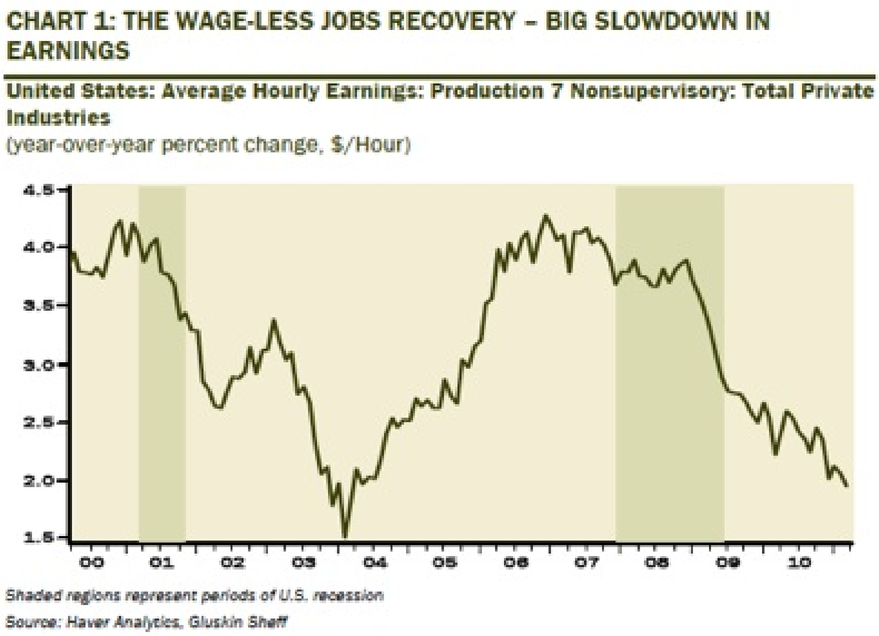
There is a saying in our industry, “the trend is your friend”. This is indeed true today, and we must respect this trend. We will continue to gradually increase our exposure to risk assets where appropriate for our clients, as we see the fundamentals we look at continue to improve. At the same time, as this trend has persisted, we believe some risk have become elevated as well. What are some of these risks?

Firstly, as with any trend, one that becomes ‘long in the tooth’ is always a concern. We have seen some high end extremes in just about every measure one can look at in terms of valuation, trend and sentiment over the past several months. These are too numerous to go through in this commentary. This can no doubt continue for an undetermined period of time, but at the same time the ‘tail’ risk also becomes more substantial and the prospect of long term returns on equities can diminish.

Secondly, employment levels are still not at a pace that has historically been attributed to post-recessionary recovery periods. We have definitely seen some improvement south of the border but unfortunately the pace of this is still sub-standard and there is a very long way to go to get us back to where we once were. Here is a chart from the St. Louis Fed which shows the painfully slow recovery to this point.

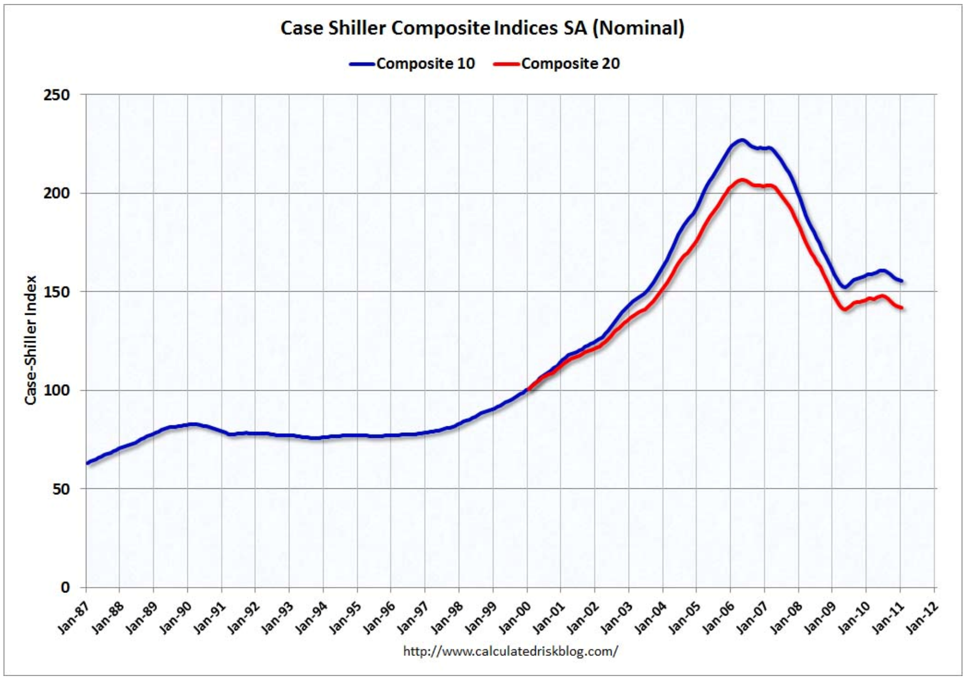


Although the pace is slow, at least we are seeing some positives here of late. What is more of a concern is the fact that wages are now flat in four of the past five months in the face of higher energy and food costs, currently about 23% of the average person's income (according to John Mauldin, author of *The End Game*). We could see this affecting consumer spending for the second half of this year. David Rosenberg, Chief Economist and Strategist at Gluskin Sheff, has termed this the "wageless recovery" and for good reason. Their chart below shows the continued decline in wages since 2007.



The US Census Bureau publishes the real median household income every May, so we don't have the latest data for 2010, but one can expect from the above that it has continued to decline. Last years data showed a slight decline after a large decline in 2008. In fact, real median income has not grown now for almost 14 years. Although we have seen a more productive workforce (good for corporate profits), it has yet to be reflected in higher wages which it has in past cycles.

Thirdly, the US real estate market has recently reversed its shallow recovery. The S&P/Case-Shiller Composite index shows that prices are now down in the last six months in a row (latest data to the end of January). The latest level is just slightly higher than where it was at its recent low registered in April 2009 at the depth of the recession and back to the same level first reached in mid-2003. This confirms that the housing market recession there is not over yet. With housing being the single largest component of a consumer's balance sheet, one can surmise this will not help long-term consumer spending patterns, which is the majority gross domestic product (GDP). In addition, US new housing starts in February plunged



22.5% from January (fewest homes in nearly two years) which was the second-lowest number of starts on records dating back more than a half-century. The equity markets seem to be clearly ignoring this risk at least in the short-term. However, we believe this is an important factor in the overall long-term spending decisions of consumers.

Fourthly, although we have seen much statistical improvement in many areas, one trend that has been anemic overall is US real final sales (GDP less change in private inventories). We believe this could stem from high unemployment and the lack of wage growth discussed previously. Real final sales did have a very large 6.7% increase in the fourth quarter of 2010. However, since the recession ended, real final sales have only managed to increase at approximately a 2% annual gain. The trend is still far below what is normal for this stage of the cycle which is closer to 4%. With first quarter US GDP expected to decelerate (consensus is now 2.4% versus 3.5% at the begging of the quarter, and an actual 3.1% in the fourth quarter of 2010), we are unsure at this point if that fourth quarter pace can continue or if we will begin trending back to this lower trend pace. Some of the recent data has shown some downside surprises on consumer spending in the first months of this year.

Lastly, there is risk of a US policy mistake and the continued burden of debt. This last point is not just a US issue, but a global issue as well, as sovereign debt problems continue to escalate in the Euro region. This in combination with rising global inflation, particularly food and energy, could pose some very real problems. The Euro region has commenced austerity measures (reduction of the amount of money that the government and people spend to live within their means). However, the US has continued its steadfast program of quantitative easing (newly created money used for buying government debt or other financial assets) in addition to keeping short-term rates near 0%. We are currently in the second round of quantitative easing, also known as QE2. It would seem logical to assume that one or possibly both of these two opposite policies will not be successful. We will discuss more on quantitative easing and its effect on the markets in a following section.

We foresee some very difficult decisions to be made in the near future for the US Fed. By the time they have their next policy meeting near the end of April, 85% of QE2 will already be complete (scheduled to end in June). The current consensus in the marketplace is that the US is on track in its recovery and that this stimulus has been a success. But what is the next step? What will happen once the stimulus is withdrawn? There are many possibilities, including some Fed Governors who believe that short-term rates will need to be raised. We recently read a piece from John Hussman of Hussman Funds, indicating that in order for the Fed "to achieve a non-inflationary increase in yields even to 0.25%, the Fed will have to reverse the entire amount of asset purchases it has engaged in under QE2". Monetary base and inflation are closely related, and with the Fed pushing its policy to the limit, the solutions become much more finite if one's objective is to keep inflation in check.

There are a few possible outcomes of this going forward. We can't be sure what will happen, but one thing we believe is certain is that there will be no easy way to exit, and that we will likely see some continued volatility in the marketplace as markets typically do not like uncertainty.

<u>Our Strategy:</u>

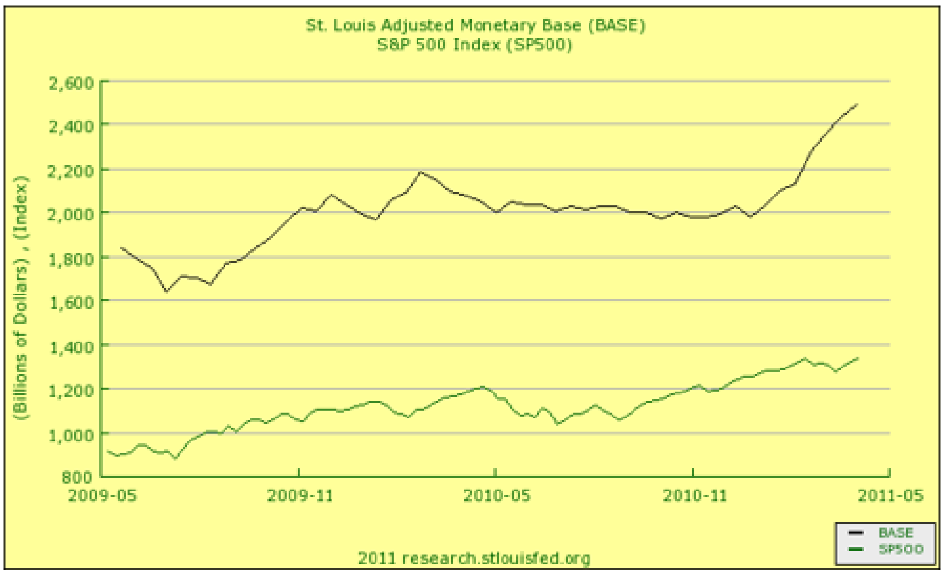
Under this framework, over the past several quarters, we have continued to gradually add to equity positions especially in Canada and in some emerging and Asian markets where we see better long-term growth potential. Overall, we remain in our cautiously optimistic stance for global equity markets and risk assets in general. In Canada, we see good opportunities in the energy sector specifically. Barring a large economic contraction, it is difficult to ignore the growth potential of our resource economy with the overseas demand for energy consumption. We have also continued to add and make changes in the Canadian corporate bond space and in convertible debentures in particular. This area has been the best performing asset class for us over the past few years. It allows us to earn a strong yield, participate in varying degrees of upside in the underlying equity positions of the company, and be higher up the corporate structure in terms of risk. Corporate balance sheets in Canada are in good shape and we continued to favor this area. With the proper due diligence, there are still attractive opportunities available.

We have also maintained some hedges in the portfolio for downside protection, namely the US dollar and US Treasuries. The US dollar has continued to drift downwards against our Dollar, and this has had some negative effect to our portfolios. We have lightened up on this exposure to some degree, and will continue to do so if we see improvement in economic indicators. However, we believe there to be a substantial amount of systematic risk in the markets currently, and this could provide some protection in the event of a shock to the system.

The Markets:

The first quarter of 2011 saw positive returns in most markets, however, to a much lesser extent than in the last quarter of 2010. Most of the returns globally in this past quarter can be attributed to the US market (S&P500) which moved ahead another 5.4% (or 1.8% in Cdn$). Our Canadian market (TSX composite) almost mirrored the US by gaining 5.1%. Outside our continent, however, returns were much more subdued, with rising geopolitical risks as well as continued sovereign debt issues in Europe. The MSCI World (ex USA) Index managed to edge up only 0.8% (local currency). If we look back over the past five quarters, there has been an obvious driver to the recent stock markets advance. We believe the US Federal Reserve Quantitative Easing program (QE2) has been a strong 'factor' influencing stock prices, commodities and other risky assets. This announcement was made near the end of August 2010 when there were fears of a 'double dip' recession to help stimulate spending and credit. At that point in time, the US equity market was down almost 6%, the Canadian market was up slightly at 1.4% and the MSCI World Index was down 2.5%. Since then, markets have continued their rapid recovery from the March 2009 low. The US and Canadian equity markets are up 15.1% (Cdn$) and 18.5% respectively while the MSCI World is up 18.7% (local currency). Although we are always hesitant to find causation in exogenous events, it is difficult to not at least come to the conclusion this has had a significant impact on the performance of risky assets over that period.

The two charts on the following page are the US equity market over the past two and a half years and the level of the US monetary base in relation to the US equity market. The expansion of the US Fed's balance sheet (monetary base currently approximately $2.5 Trillion) has had a strong correlation to the rise in the S&P500. This correlation is 88% according to Gluskin Sheff's David Rosenberg. One could infer then that the current rally can be mostly contributed to the excessive liquidity. This is likely far too simplistic, however, it does point to the concern of whether or not the economy can hold up without it.



With the risks laid out, we continue to seek out an overall asset allocation and security selection where we see the best return vs. risk tradeoff for our clients. With rates as low as they are, yield becomes important, but only yield in combination with value. We believe we are well positioned currently to withstand setbacks, and well suited to a further market advance. We will continue to communicate with our clients as often as possible, and it is our mandate to be steadfast in our independent research to obtain the timeliest and most effective information we can to formulate our investment decisions.

We would like to thank our clients for their continued trust as we move forward in these interesting times.

"The four most dangerous words in investing are 'This time it's different'."
- John Templeton

Respectfully,

- **Your Milestone Team**