MILESTONE COMMENTARY

July 15, 2011

Patching the Leaks or Changing Vessels?

Bottom Line:

We enter the third quarter much the way we entered the second d quarter of 2011. Our cautiously optimistic stance that we have held since September 2010 remains fully intact. This past quarter has seen some elevated volatility with a mid-quarter correction; however, the intermediate-term trend from a year ago remains positive. We believe this volatility will likely continue into the back half of this year. As such, we continue to slowly add risk assets to portfolios in a prudent and methodical way. The same risks we discussed in our last commentary prevail today; therefore, although we are increasing risk assets we believe our portfolios are well positioned to sustain a larger correction over the balance of this year.

Economic Overview:

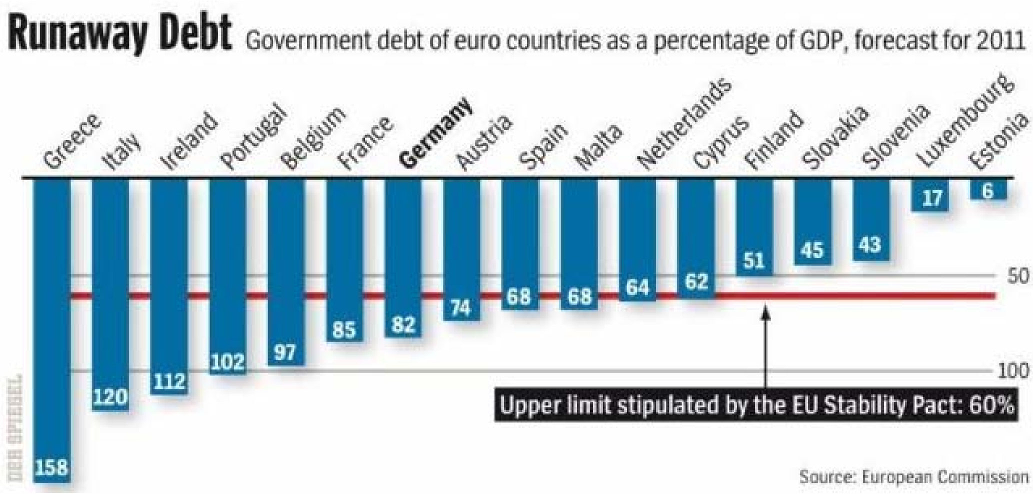
The second quarter of 2011 was dominated by several news stories, creating a great deal of volatility. The big recurring headlines were the continuing problems in Greece, the end of QE2, oil & food price inflation and US Real Estate.

The Greek Debt Crisis:

"Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks."
- Warren Buffett

In our April 2010 commentary we wrote to you about the predicament of Greece, the PIGS (Portugal, Ireland Greece & Spain) and the general pattern that leads to a country to default on its debt obligations. True to form, Greece has followed this pattern and now finds itself in the self-feeding loop of declining confidence in their ability to repay debt and the market insisting on higher interest rates to compensate for this risk. We have recently witnessed Portugal's debt get downgraded to junk status but Greece is certainly the furthest down the default path and facing the most immediate problems.

The following chart from the European Commission shows the runaway debt levels of some of the nations. These charts include only government debt. We have seen sources conclude that major issues start to develop when this ratio goes over 100%.



Greece's problems are very complex, but at the risk of over-simplifying, we will attempt to summarize their situation. Greece joined the Eurozone in 2001. In order to qualify to join the new Euro currency, countries needed to comply with certain financial and economic parameters. Some countries who adopted the currency were in better financial condition than others – there has even been some speculation that some countries used "creative accounting" to make their financial situation look better than it otherwise would in order to be included. For the most part, everything appeared to be progressing well in the Eurozone. However, under the surface those countries' with unhealthy balance sheets were not getting any better. Unfortunately, the global economic slowdown and financial crisis of 08/09 exposed those unhealthy countries (Iceland actually declared outright bankruptcy in the fall of 2008).

The problems in Greece are extensive: the economy continues to be in a recession (GDP is contracting), their unemployment rate continues to rise, taxes are high and heading higher, and government services are being cut. The government debt is huge and they are running a large annual budget deficit. On top of this, they have government bonds coming to maturity this month and next that require refinancing. The people are not reacting positively to the austerity measures being imposed on them by their government, nor are the people being overly "compliant" with reporting and paying their taxes. However, their government has little choice – they must impose certain measures in order to qualify for continued (and desperately needed) aid from the rest of the European Union.

Why is Greece such a concern to the global markets? The reason is because the global financial system is so intertwined in modern times. For example, Greek government bonds (debt) are held by financial institutions, other governments and the ECB (European Central Bank) itself. These financial institutions in turn have bought a type of financial insurance called CDSs (Credit Default Swaps) from American and other financial institutions. So if Greece were to default on its debt, the ripples would become very large waves as banks in Europe would take losses on their Greek debt, then make claims to American banks for the insurance…if any of this sounds very familiar, it should. This is a similar set up to Lehman Brothers in the US back in 2008.

Of a much similar serious concern are the other countries that could be looking at a similar fate. If Greece decides to walk away from its debt obligations, perhaps Spain, Italy, Portugal and Ireland would consider doing the same. So it becomes apparent that the ECB needs to keep 'kicking the can down the street' for as long as it possibly can. Of all the analysts we read, consensus is almost 100% that Greece will eventually default; none of them know when and how it will play out, but it does appear a matter of when rather than if.

It isn't totally fair to pick on Greece. As mentioned above, the US has its own deficit and debt problems. So why doesn't Greece initiate their own form of Quantitative Easing? They belong to the Euro currency, which is governed by the ECB. At this point, the ECB's charter does not allow for money printing, so QE isn't an option at the moment. However, this crisis has led the ECB to break many of its own rules, so it certainly is a possibility that they would enter into their own program of QE. In fact, it has been argued that printing new Euros could help by bringing down the value of the Euro relative to other currencies, making countries like Greece et al. more competitive on a global basis, not to mention bringing down their debt in terms of other currencies.

The End of Quantitative Easing 2:

Quantitative Easing is a relatively newly minted economic term. As defined by Wikipedia:

Quantitative easing *(**QE**) is an unconventional monetary policy tool used by some central banks to stimulate the national economy when conventional monetary policy has become ineffective. A central bank implements quantitative easing by purchasing financial assets from banks and other private sector businesses with new money that it creates electronically.*

In much more simple and cynical terms, it has been called 'money printing' by the US Federal Reserve. While this is much too simplistic, it is not inaccurate. After the economic recession of late 2008 and early 2009, the US government embarked on unprecedented stimulus and bailout efforts. To pay for these and subsequent programs, the US is running massive annual budget deficits of over $1 Trillion. There simply isn't that amount of money floating around in the world's debt markets willing to lend to the US government at almost zero interest rates. To solve this dilemma, the US Federal Reserve creates new money on their balance sheet and uses that new money to buy US government bonds. This creates liquidity in the financial system (keeps money moving around in the economy), but also enables the US government to continue to run its budget deficit.

Quantitative Easing 1 was announced in the depths of the financial crisis in 2008 as a way to jump start economic activity. By the spring of 2010, the market had recovered somewhat, but the economy was showing signs of faltering. It was beginning to appear that the $1Trillion+ of money pumped into the US economy was not translating into a sustainable pick up in the economy. Unemployment levels were still very high, GDP growth was positive but not stellar and the important housing market was still struggling (the first time home buyer tax credit was expiring at that time).

Towards the end of August 2010, the US Federal Reserve started hinting at a second round of

Quantitative Easing (referred to as QE2). In November, that was confirmed with an estimated $600Billion more dollars to be created and used to purchase US government bonds. With this new liquidity in the financial system, values for risk assets (commodities, stocks etc) were able to be bid up. The US economy once again got a nice spurt of growth in the fourth quarter of 2010, but once again that growth seems to have settled down to a lack-luster pace so far this year.

The QE2 bond buying program has just expired at the end of this past quarter. There has been much speculation on what, if anything, that will mean for the markets (bonds and stocks) and the economy. We have read much on all sides of the debate, some bearish and some bullish, and even some with no opinion at all. What we do know is that there is much uncertainty.

While it is impossible to predict the outcome of government induced market fluctuations, our stance is pretty straight forward. If the stock markets begin to sell off to the extreme they did when QE1 was winding down (remember the flash crash of May 6, 2010?), we believe the Fed will step up in some form; perhaps QE3. While the economy may not be very strong, if the markets can hold up reasonably well, the Fed will try to stay away from more Quantitative Easing. We shouldn't have to wait very long to find out the answer.

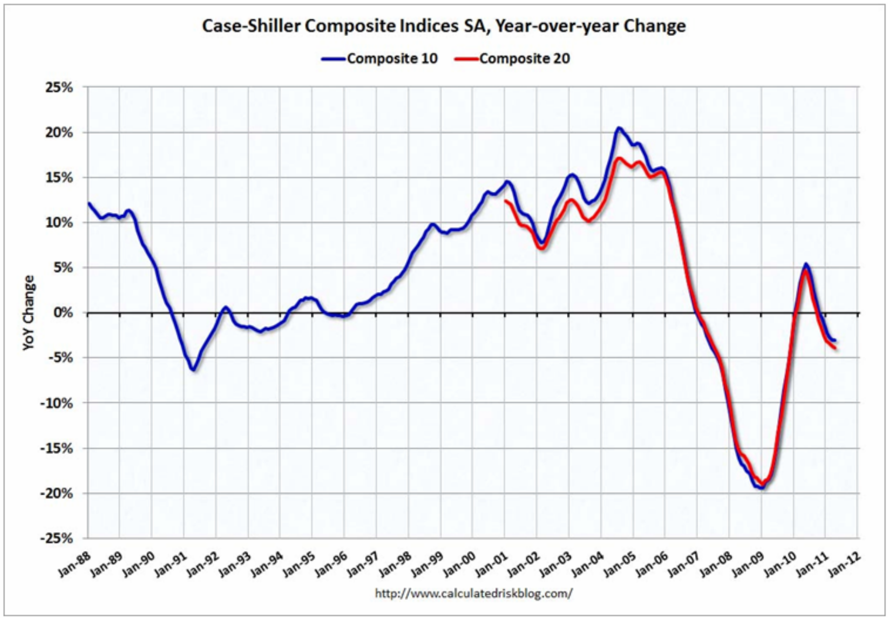
Oil and Food Price inflation:

As mentioned above, one of the consequences of a policy of Quantitative Easing is rising asset prices. For an investor, that can be good, but rising prices for commodities can have a negative effect on people and economies. Thus far in 2011, oil has risen from a starting point of around $90 to a high of over $110, before pulling back. Agricultural commodities have in turn risen as well. Both of these have a real effect on people's lives around the world – in the developed world it can mean a higher amount of a family's monthly budget going to gas and food; in the developing world, it can be much more serious by making food less affordable to those who need it most. They also can have a real effect on an entire economy – the extra costs act as an extra tax on companies and individuals, preventing them from spending and/or investing in the economy as they may have otherwise done.

US Real Estate:

The much followed S&P Case-Shiller Home Price Index in the US is something we have quoted in previous commentaries. After falling precipitously from mid-2006 to April 2009, the index stopped falling and actually posted a small increase over the course of the next year or so. Then, beginning in the fall of 2010, the index began to decrease yet again. In February & March 2011, 20-city index actually closed below its lowest point during the recession. The April report showed a slight increase in prices but still remains below the 2009 low. This latest report was not all that positive, however, as the seasonally adjusted number actually declined for the tenth straight month.

In the past we have shown nominal price chart of this index so we thought we would change that up and show instead the year-over-year rate of change on the index to get a better handle on recent price changes.



The US housing market has been in a very difficult state for quite some time now. One of the main problems it now faces, and will continue to face well into the future, is foreclosures. Firstly, there is the overhang of foreclosed homes being held by banks that have yet to be released into the market (undoubtedly at depressed prices). Secondly, there is a massive amount of homes either in the process of being foreclosed upon or in default. It could very well be years before this inventory of homes has been fully dealt with. Unfortunately, the process can be self-reinforcing because the longer prices remain depressed (or perhaps even continue to drop further), the more homeowners will be forced out of their homes, leading to yet more foreclosures.

The Markets & Our Strategy:

Developed markets registered solid gains in the first quarter, despite the setback from March's earthquake and tsunami in Japan. The second quarter was a different story, with concerns arising from growing inflation threats potentially resulting in a hard landing for emerging markets like China, sovereign debt worries in Europe and a downgrading of growth forecasts for the global economy. Below are first half results for key markets:

Index	First quarter return	Second quarter return
S&P/TSX Composite	5.0%	-5.8%
S&P 500 Index (Cdn$)	2.8%	-0.7%
MSCI World Index (local)	3.1%	-1.4%
DEX Cdn Universe Bond Index	-0.3%	2.5%

Our stance from last quarter remains the same, one of being cautiously optimistic. We are seeing some opportunities in corporate bonds and continue to favor this asset class in search for yield. On the equity side, we continue to favor strong dividend paying Canadian companies, and some emerging market economies as long-term investments. However, global systemic risk appears to be rising, not falling, and therefore we still remain defensive and on guard. We would ultimately like to see actual solutions to the issues at hand from our leaders; however, we are only currently seeing temporary band-aids holding the problems at bay. As they say in our industry, ‘hope is not a strategy’.

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. Corporate performance has been good, although we are well aware of the current global risks to this growth. It appears that equities are currently fairly valued; however, the systemic risk building from poor fiscal and economic policy in many nations around the world keeps us on full alert. We believe we are well suited to a further market advance and well positioned to withstand setbacks. 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 in us.

“If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours.”
- John Maynard Keynes

Respectfully,

- **Your Milestone Team**