MILESTONE COMMENTARY

October 6, 2011

Tilting the Scales Back to Defensive

Bottom Line:

We came into 2011 feeling ‘cautiously optimistic’. As we enter the fourth quarter of 2011, we would put the emphasis back onto cautious and less on optimistic. We felt very much alone this spring warning of the risks on the horizon as the market pushed progressively higher. Clearly some of those risks have come home to roost and we are thankful that we maintained our vigilant stand.

Economic Overview:

The third quarter of 2011 saw continued and increased volatility from the first half of the year. The markets and media focused heavily on escalating problems in Europe as well as political and economic problems in the US. The Canadian economy turned in a fairly weak performance in the second quarter and as such, the Canadian stock market continued its downward trajectory that began in March.

One might ask, 'what has changed so much in the past few months?'. To that, we would answer that from our perspective not much has changed. What we mean by that is that the big picture macro-economic backdrop in which we find ourselves hasn't improved all that much since the 2008/2009 recession and bear market. The collective actions of governments around the world such as Quantitative Easing (QE1 & QE2) and now Operation Twist have simply managed to defer rather than solve the issues at hand. To be sure, certain things are better: the stock market is well off of its March 2009 low, the economy is growing slowly rather than contracting and commodity prices have had a nice run. However, unemployment in most developed nations has not improved much, housing prices in the US and Europe are still at their 2009 bottoms, governments around the world are running massive budget deficits and government debt loads around the world continue to climb. Lastly, does anyone remember the ‘too big to fail’ issue surrounding big players in the banking system? Banking lobby groups have continued to forestall any fundamental changes whilst quietly consolidating other smaller banks under their wings when they fell short of regulatory capital requirements. These big picture economic items have continued to be a drag on any attempted sustainable recovery. The much clichéd phrase to describe this action has been to “kick the can down the road”.

It has long been our stance in these commentaries that the economies of the developed countries would not recover as quickly as the governments believe. Traditional Keynesian

Economics would have us believe that when an economy slows down, the government's job is to step in and spend our way out of the recession. This government intervention can come in the form of tax cuts to encourage spending, lower interest rates to encourage borrowing, large infrastructure projects to create jobs, just to name a few. Quite often historically, this theory has worked. We have previously argued that we are in a long term balance sheet recession as opposed to a normal cyclical recession and that the tools being implemented would likely not work. There have been times in history where an era of prosperity and growth was the result of an overbuild-up of debt at the consumer, corporate and government levels. When that bubble begins to deflate, it can be very difficult for governments to combat the problem of 'too much debt' by simply taking on more debt. We feel that this is one of those times.

The main reason the traditional response is much less effective is that the consumers, who were able to drive an economy through spending borrowed money, no longer have the ability or desire to accumulate more debt. In many developed countries, the consumer is simply tapped out. In the U.S. to be specific, the average consumer has very little or no equity left in their home to use as collateral for additional borrowing. To compound this, the unemployment rate has stayed persistently high and incomes remained stagnant, which again makes it very difficult to spend (or borrow to spend). With consumer expenditures comprising roughly two thirds of the U.S. economy, their woes are the economy’s woes.

Recession?:

Is it possible that we could see another recession, the dreaded 'double-dip'? Many economists are now starting to issue percentage chances of another recession. Truth be known, no one has a guaranteed statistical model for offering those types of predictions, so we won't try to do so. However, we would answer yes to the possibility that North America and Europe could slip back into recession.

> *“Here is what a recession is, a recession is a process and I think a lot of people don’t understand that. They are looking for two negative quarters of GDP, but it is a process where sales disappoint, so production falls, employment falls, income falls and then sales fall. That vicious circle has started. This is a deadly combination, we are not going to escape this and it is a new recession. We don’t make false alarms; I’ve done this for twenty years.” - Lakshman Achuthan, Managing Director of ECRI*

Well known and highly regarded market strategist John Mauldin has written that according to his proprietary indicator, the U.S. should be in recession within 12 months. Another highly regarded investment manager John Hussman has a completely different set of parameters, but has come to the same conclusion. Lastly, the Economic Cycle Research Institute (ECRI), a group that we follow closely, recently joined in by issuing the same prognosis based on yet another different set of criteria. These are all sources we believe to be as credible as they come. Does that mean they will be right? Of course not, but it does make us sit up, pay attention and ask what would that mean if it came to pass.

The reality is that during typical recessions (defined by many as at least two consecutive quarters of declines in a country's output as measured by GDP), certain commonalities can be assumed:

- the stock market drops at least 20% (bear market)
- unemployment usually increases
- housing prices probably decline
- interest rates stay low or decline
- prices of commodities linked to the economy (oil, natural gas, wheat etc) probably decline

We would also like to point out that we have recently seen weakness from the Chinese economy. There has been a heavy reliance globally on their growth, but indicators are currently pointing toward a significant slowdown in economic activity, which could be confirmed by the recent sharp decline in the price of copper. We have discussed copper in the past as it correlates closely with the S&P500 and tends to lead. China accounts for about 40% of world copper consumption and so its price is mostly influenced by their demand. Our point here is that if the Chinese economy indeed slows down considerably it could have a greater impact than what the markets are currently discounting.

Europe:

The situation in Europe seems to be deteriorating. In previous commentaries, we have been of the opinion that Greece is already insolvent. This past quarter, it seems that the rest of the world, placing increasing scrutiny on Greece, can no longer see a clear way out.

The problem in which Greece finds itself is a very difficult downward financial spiral. Greece continues to rely on the European Central Bank (ECB) for its borrowing needs; as a condition for additional lending, the ECB is demanding that Greece implement massive tax increases and spending cuts; as a result, the Greece economy continues to contract on its way towards a depression; as a result of a slower economy and higher unemployment, tax revenues decrease, ever increasing the Greece budget deficit which leads them back to the ECB for another round of financing. It is difficult to see how this will end well for stakeholders.

In our last commentary, we discussed the spillover effects if Greece were to default on its debts: Dominoes would fall in one direction: other countries in a similar financial situation might be tempted to default as well. Dominoes would also fall in the other direction: the banking system would be seriously damaged as banks in Germany, France, UK and elsewhere would have to write off massive loans that they have made to Greece. Both of these have become a problem during the past quarter. In addition, this could continue to put pressure on the unification of the Eurozone and the Euro itself.

Government bonds in Italy, Spain and Portugal have been going down, reflecting the bond market's waning confidence in those countries. As for the banking system, one has to look no further than stock prices: the German and French stock markets have been crushed this summer, down over 20% this quarter alone. The main stocks bringing down those markets were banking stocks (banking giants such as BNP Paribas, Societe Generale, Deutsche Bank and others).

The effects of all of the financial instability in Europe are not just financial – the spillover becomes very visible. Riots in London, public strikes in Greece, political instability in Germany in protest of the electorate's perception that they need to 'bail out' the rest of Europe. If this type of political instability continues to grow, it makes it more and more difficult for the ECB to get consensus on any type of plan to keep propping up the system.

Still some bright spots:

While it is easy to fixate on the negative, there are supportive signs out there. After rounds of prior cost cutting, corporate profitability is now looking strong and poised to accelerate going in to the end of the year. Recent highs in oil have pushed up prices at the pump and at the grocery store but by and large inflation looks to be well contained. We only need to look back six months to read of manic reports outlining the risk of hyperinflation. Should strong businesses wish to expand, the cost of borrowing is cheap and thus conducive to hiring and growing. And lastly, from a Canadian perspective the recent decrease in the value of the Loonie will be positive for Canada's manufacturing and export sectors. Sorry to all you snowbirds out there.

The Markets & Our Strategy:

As you may imagine, all the instability we just referred to has had a large impact on equity, commodity and bond markets around the world. Many large European markets have seen their markets fall over 20% on the quarter, and most are down in the 10-25% range on the year. Asia has also seen a sharp correction, with most markets down in the 15-25% range this year. Our own resource heavy market has seen a decline, with the TSX Composite falling 12.6% this past quarter and now down 13.5% in 2011. South of the border, the U.S. has actually faired the best for most developed countries with its S&P500 index down 14.3% this quarter and down 10% year-to-date. In any event, it has been a sharp reversal from just three months ago.

Here is a performance summary of global equity markets over the past twelve months:

2011	Canada	US	Europe	Japan	Emerging Markets	World Markets
First Half	-0.8%	+6.4%	+2.6%	-4.1%	-2.0%	2.6%
Third quarter	-12.8%	-15.2%	-17.9%	-9.6%	-14.8%	-15.3%
2011 to date	-13.5%	-9.8%	-15.7%	-13.3%	-16.5%	-13.1%
12 months to September 30	-4.4%	+0.7%	-10.8%	-5.7%	-11.6%	-5.6%

Source: MSCI, All cap stocks, local currency

The volatility has carried over into commodities. Gold, considered by many to be a safe haven, had a wild quarter moving from $1500/oz to over $1900/oz. and back down to $1600/oz. This may be attributable to lack of liquidity in the markets with investors selling their winners to pay down debt or other obligations. We also saw a very large drop in the price of copper of approximately 25%. Since copper is used in so many industrial applications around the world, many believe that a dramatic fall in copper prices reflects an impending economic slowdown. Lastly, oil, and its supply/demand bullish argument, has not been spared, falling $16/barrel.

On the opposite end of the spectrum, U.S. and Cdn government bonds have had a nice run, as the flight to quality and safety has pushed longer term yields down and prices up. The largest gains have been made in long-term U.S. Treasuries, considered the safest investment in the world, whose prices are up a whopping 28% on the quarter and the year. The Cdn Dex Universe Bond index rose 5.1% this quarter. In addition, the US Dollar Index has seen the potential reversal of its downtrend from the summer of 2010 rising 6% this quarter (8.9% against the Cdn Dollar).

Our portfolios have faired well in light of all this volatility and declining equity markets. We have had hedges in place for some time, and these have helped mitigate the risk. Although we are likely to see a rebound from oversold levels in the short-term, our intermediate to longer-term stance remains defensive at this point. We believe it prudent to sustain most of these hedges but also to take profits where we can and rebalance. We will also not be hesitant to sell holdings which we believe have broken down and raising cash for future opportunities. With relative out performance so far this year, our portfolios will be well positioned to take advantage of the next market advance when it presents itself.

Our overall position on the economy and strategy for our portfolios has not wavered, and our determination on this front pays off in times like this. There are numerous objective indicators we use to help us on this front, and when we see the weight of evidence tilt back in favor of being more aggressive, we will make this shift and benefit from our current patience.

We would like to thank our clients for their continued trust in us.

"Every adversity, every failure, and every heartache, carries with it the Seed of an equivalent or greater Benefit."
- Napolean Hill

Respectfully,

- **Your Milestone Team**