January 20, 2012

The Wisdom to Know the Difference

Bottom Line:

Our leading indicators are pointing to rough seas ahead and therefore capital preservation is paramount. We have seen some improving data points out of the U.S. recently which has anecdotally put a positive spin on many 2012 forecasts; however, the set of economic evidence that is presently available to us is instead associated with a much more difficult outcome. We will remain defensive until the evidence, primarily leading indicators, points to a more positive outcome. We continue to believe that a tactical approach is required to navigate through the current volatility.

Economic Overview:

The fourth quarter was a nice relief after a very tumultuous third quarter, where global equity markets (MSCI World Index) were at one point down 18% over the course of two months. In early October, we believed a short-term equity bottom was at hand that we would likely see a strong finish to the year and even into the New Year. This typical positive seasonal bias did play out this way, although it remains to be seen if this trend will stay intact over the next couple quarters.

Much of the improving data we have seen over the course of the last several weeks are not associated with leading equity markets, and thus we are reserving any positive equity outlook until this occurs. If the equity markets can hold up over the course of the next couple months along with an improving data set that has previously demonstrated stronger leading qualities, we will shift our defensive stance to more constructive. We are hopeful this is the case, however, it is always our stance to let the economic evidence tilt in our favor before setting an asset allocation in favor of equities, as opposed to basing it on hope or anecdotal evidence.

Much of the perceived global risk is heavily weighted to the issues at hand in Europe. We have discussed this extensively in the past. The structural problems there are far from being solved in our view. We believe the potential risks may come into an even greater focus this year. It is likely that these risks, whether they become more severe or come to pass, will be a large driver of global stock markets in 2012. We view the main risk this year to be the substantial level of

2012 sovereign debt maturing and needing to be rolled over at much higher interest rates. We think Italy is likely the most important factor here as they have the largest amount of debt maturing, particularly in the first four months of the year, and core Europe is long a mountain of their debt.

Secondly, the persistence of wide interest rate spreads between Germany and the weaker nations is worrisome and putting a constant strain on smaller euro nations' ability to grow. Although the U.S. is growing at a slow pace, Europe has stalled and many nations are contracting. Risk of recession spreading across Europe this year is very high in our view, although it is difficult to determine how this will affect the already fragile U.S. economy.

Lastly, it remains to be seen whether or not the ECB's long-term refinancing operations (known as LTRO) will be effective in European banks borrowing from them and buying sovereign debt. If it does prove effective, we still find it difficult to determine how this will solve the ultimate problem of too much debt and too little growth to sustain those debt levels. According to Bloomberg there is up to 700 Billion euros of European bank debt coming due this year with 200 Billion of that in the first three months. It seems as though these banks will not have the extra capital as a result of this LTRO. The ECB itself is now becoming deeply involved in the debt crisis being levered 33 times its own capital with a balance sheet at approximately 2.7 Trillion euros which may put the quality of its collateral in question.

The attention on the structural issues in the U.S. has been temporarily diverted over to Europe, however, we do not believe they have gone away. This year will likely be very important for the U.S. to get their fiscal house in order in this Election year. We have a great deal of hope that we can see some solid long-term solutions to their structural problems. We believe Dr. John P. Hussman of Hussman Econometrics Advisors in the U.S. has put it best:

"…our hopes are not for more bailouts, or money printing or any of the myriad policies that investors seem to hope will save bad investments and sustain elevated valuations. Instead, our hope is that in 2012, the market will finally "clear," in the sense that bad debt around the world will be recognized as bad and restructured; that overleveraged financials will be taken into receivership instead of forcing austerity on every corner of the global economy in order to make them flush again; that rates of return will rise enough to compensate and encourage saving – and high enough to encourage borrowers and other users of capital to allocate the fund productively"… "In short, our hope is for events that will unchain the global economy from an irresponsible past and open the gates toward a prosperous future."

<u>Let's take a step back in recent history:</u>

Now for those of our readers who like Stock Traders Almanac type predictions, let's revisit the January Barometer and the Lucien Hooper's December Low. Although with increasing government intervention in the capital markets (Quantitative Easing, Operation Twist etc) these tools tend to get a little bent out of shape, it is still worth reviewing. The January Barometer suggests that so goes the first week of the New Year, so goes the month, so goes the year.

Simplistically this means that if the first week of trading is good and January is a good month for US equities then the year will most likely be a good year for investing. Its track record through the past is solid enough to warrant paying attention to.

The December Low states that if, at any time during the first quarter, the Dow Jones index goes below its lowest point reached in the preceding December then "watch out". Lastly, if you encounter a double violation, a negative January and a breach of the December Lows then historically this has led to a bad year for investing.

In fact we had written to our clients precisely on this topic on March 20th 2009 in an article entitled 'Predicting the Weather'. In it we referenced that both metrics had been violated signaling the "get out" alarm. We, on the contrary, ignored this signal. In this missive we had identified an "inverse head and shoulders" pattern occurring in the technical charts suggesting that the markets appeared to be reversing their white knuckle decline from 2007. In our April quarterly reviews we began re-deploying money back in to equities in what ended up being and excellent year for investing (Dow up 18%, S&P500 up 23.5%).

> *"God grant me the serenity to accept the things I cannot change, the courage to change the things I can, and the wisdom to know the difference."*
> - Reinhold Niehbuhr

We were quick to sidestep making "predictions" but we did mark several other "observations" in this March 2009 newsletter that are interesting to reflect upon. In opposition to nearly unanimous cheerleading for Calgary real estate at the time, we suggested that home prices should be largely unchanged for that year and the next couple years. Since that time median house prices for Calgary have experienced a -0.35% annual growth rate net of inflation.

For oil, we referenced its price bouncing off $35/barrel but not able to push through its intermediate term trend line (30-week moving average). However, in such a glum market we made a case (via what the industry refers to as stochastic oscillators) that things should pick up from that point. True enough; the price did eventually push through this resistance, subsequently peaking at $115 a barrel and since settling down to around $100 a barrel.

Lastly, we identified the declining trend of Natural Gas and that at $4 the downward trajectory was not investor friendly. We cited $2.50 as a possible downside target. Nearly three years on the price is now hovering around $2.35 (a 41.25% decline).

So we do pay attention to many of the trends and patterns identified in the Almanacs but we place a heavier reliance on economic fundamentals and shorter term technical trends & turn signals. We roll back a significant portion of our revenues to access these resources from objective sources so that our guidance is as independent and informed as we believe it can be. It is from these sources that we have arrived at our current conservative stance.

The Markets & Our Strategy:

Here is a price performance summary of global equity and North American bond markets in 2011:

	End Level	2011	2011 C$
S&P/TSX	11955	-11.1%	-11.1%
DOW JONES	12218	5.5%	8.0%
S&P 500	1258	0.0%	2.3%
NASDAQ	2605	-1.8%	0.5%
RUSSELL 2000	741	-5.5%	-3.2%
NIKKEI 225	8455	-17.3%	-10.8%
MSCI EAFE	1413	-14.8%	-12.8%
MSCI WORLD	1183	-7.6%	-5.5%
MSCI EM	916	-20.4%	-18.6%

	End Level	2011
DEX Universe Bond	863.0	9.7%
DEX Real Return Bond	524.7	18.3%
Mer Lynch US High Yield Master II	823.6	4.4%

Source: TD Asset Management

Global equity markets had a difficult and volatile year with the U.S. being the only developed nation to put in a positive year (large caps only). Our own S&P/TSX Composite fell over 11%, being pulled down by our Energy sector. On the other side of the coin, government and investment grade bonds performed extremely well. The Cdn Dex Universe Bond index had one of its best years ever. The yield curve in US and Canada continues to flatten with long-term rates dropping more than short-term rates. Currencies continue to play an important driver of investment returns. The U.S. dollar index saw a large increase in the second half of last year, primarily due to a weakening Euro. We believe that trend is likely to continue, at least in the short term. Lastly, 2011 saw a continued divergence in energy markets, with oil prices up 8% and natural gas down 32%.

We believe we will likely continue to see elevated volatility at certain points this year, and that a tactical approach is necessary to navigate our way through. Our defensive stance is warranted based on the weight of evidence we currently have, but we are willing to adjust this going forward as we see the data improve. It is very much our hope that we see the risks in Europe dissipate and that we see good long-term solutions to the structural issues in the U.S. this Election year. However, with the deflationary risks that we have identified in the past, capital preservation still remains paramount and the primary investment objective for our clients who have accumulated substantial wealth.

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

Respectfully,

- **Your Milestone Team**