MILESTONE COMMENTARY

July 18, 2012

Tortoise Versus the Hare

Bottom Line:

In April, we continued our cautious stance even though the equity markets had a solid first quarter. We noted that our leading indicators were still pointing to a slowing period ahead, so although equity markets were generally positive, our stance remained unaltered. With the second quarter now behind us, these leading indicators appear to be proving correct with many pieces of economic data being revised lower. For every report in the past three months that beat expectations, two have disappointed.

The second quarter proved to be a difficult one for equity markets, somewhat reminiscent of last year's third quarter, but not quite to the same extent. On the other hand, Canadian and US bond markets rallied. Europe continues to be at the forefront of global economic and politic headlines, however, there are some pressing issues for the US in the near future as well. Therefore, we believe that we may see some heightened volatility in the weeks and months ahead leading into the US election. Our investment strategy in this market environment will remain the same until the weight of evidence we examine changes.

Economic Overview:

We would like to separate our comments this quarter by three geographical locations so that we can discuss specifically what we feel is affecting the largest economies in the world at the present time.

Europe:

The first half of 2012 hasn't been any kinder to Europe than 2011 was. Much of the focus has shifted from Greece to Spain, however the problems still remain. The ultimate challenge, as we have written about previously, is that the world is awash in too much debt. A problem of too much debt can not be solved with more debt. We do realize that this statement is self evident, but the governments of the world continue to try to fight a debt problem by taking on ever higher levels of debt.

Spain commanded much of the attention this quarter. Being the 12th largest economy in the world (just slightly smaller than Canada), Spain could become a much bigger problem than

Greece. Their government is running a budget deficit equivalent to approximately 7% of GDP, a rate approaching what the investment community would deem unsustainable. The Spanish unemployment rate is at 24% with youth unemployment (under age 25) running over 50%. The government just raised the sales tax to 21% and is instituting tough cutbacks which will lead to both a slower economy and bigger budget deficits.

However, perhaps Spain's biggest challenge is their banking sector. This quarter, the European Union announced a plan to provide approximately $125 billion to bail out Spain's banks. The market's celebration of this announcement was short lived when it was quickly realized that there is no clarity as to where this money will come from and how the EU will actually inject money into the Spanish banks.

It seems increasingly clear that European politicians are determined to kick this can down the road for as long as they can. Unfortunately, that will only make the eventual reality that much more painful. At some point Europe has a decision to make: keep this currency union or break it up. Seemingly simple on the surface, it becomes complicated due to the fact that when the currency was created no provisions were made to deal with the possible exit of a country (voluntarily or otherwise). If the Euro is to stay together, it will inevitably need to have some sort of central financial and political authority. Simply sharing a currency, but allowing each country to conduct their own finances, has not worked.

If the Euro were to break apart (or shrink in size to include only weak countries or only strong countries) this would prove to be very expensive. The weaker countries like Greece, Spain, Italy and others would most likely end up defaulting on their government debt, which would lead to massive losses incurred by large French, German and UK banks. Those governments would most likely need to bail out their own banks. In addition to the costs incurred by the banking system, the value of the currencies adopted by the stronger countries (i.e. Germany would go back to the Deutschmark) would increase dramatically and immediately. This would make exports of these countries much more expensive and lead to a slowdown in those economies.

United States:

For 2012, we were concerned about the prospect for the recession in Europe to spill over into North America. In the first half of the year, the US does not appear to be in a recession; however, growth has been very sluggish and may be slowing further. In the first quarter of 2012, GDP growth was a mere 1.9% real annualized growth rate. Furthermore, average job growth was only 75,000/month (historically low) during the second quarter, keeping the official unemployment rate stubbornly high at 8.2%. Although this is the rate most people focus on, the U-6 employment rate in the US is currently 14.9% (this includes those working part-time for economic reasons and those who have been discouraged and stopped looking but still want work). The Institute of Supply Management's (ISM) manufacturing report or Purchasing Manager's Index (PMI) has recently dropped to 49.7 (a number under 50 denotes contraction) for the first time since July 2009. On the service side, the ISM's non-manufacturing index has fallen to 52.1 in June (lowest level since January 2010). Retail sales for June declined 0.5% for the third straight month (this has not occurred since the second half of 2008).

All of these indicators seem to point towards slowing growth at the least. The possibility of a recession here in North America is still on the table.

Three very important items on our short list to keep an eye on:

1. Debt Ceiling: The first debt ceiling was established in 1917, set at a maximum US federal debt of $11.5 billion. Sounds small now as last summer the US government was mired in negotiations to increase it (in two stages) to the current $16.394 trillion. Recent research has pointed to mid-September 2012 as the next date the US will hit their debt ceiling (a year after it's most recent increase). Treasury Secretary Timothy Geithner has said that the Treasury has enough 'tools' to keep the government afloat into early 2013.
2. Election: On November 6, 2012, the US electorate goes to the poles, Democrats being represented by current president Barack Obama and Republicans represented by Mitt Romney. As of writing, the poles are looking fairly even. We remain politically neutral; however, from the perspective of the stock market, we believe that a Romney win would likely be perceived as a positive outcome.
3. Fiscal Cliff: At the end of 2012, the US government is facing two very important financial events. Firstly, there are a significant amount of tax cuts that are set to expire. Some were tax cuts implemented under the Bush administration, but extended by Obama in 2009. Others are tax cuts that were enacted in 2009 and 2010 by Obama. Secondly, as part of the negotiations to increase the debt ceiling last summer, the Democrats agreed to institute large spending cuts at the end of 2012. Cumulatively, if both the tax increases and spending cuts were to be implemented, it could result in a significant hit to an already fragile economy. The Congressional Budget Office's baseline projection calls for a potential $607 Billion drag, or around 3.7% of GDP.

China:

China has been the world's growth engine for many years. Commodities that China needs have been a beneficiary of this growth primarily driving oil, copper and coal. China's growth has slowed recently to a 7.6% annualized real growth rate. This is strong growth; however, it is slower than the 9 – 11% rate the world has come to expect from them.

This may be a significant factor in this year's slump in the very commodities China requires. This in turn affects commodity producing countries like Canada, Australia and Brazil. All three of these stock markets have struggled so far in 2012.

There is also a consistent distrust for economic statistics released by the Chinese government. This makes it difficult for the economists of the world to predict the future trends of the Chinese economy. Currently, there is concern that perhaps the growth rate is actually weaker than the reported rate, which could put further downward pressure on commodities.

The Chinese stock market had an amazing run up in the mid-2000s (very reminiscent of the NASDAQ tech bubble of the late 90s). However, since peaking out in 2007 at around 6100 points, it stands today at around 2200 (roughly flat for 2012 so far).

It's All About Jobs:

Much focus is placed on jobs numbers, new unemployment claims, unemployment rates etc. We feel that these statistics will become more and more important as the world adjusts to this 'new normal' slow growth global economy that we are in. Consumer confidence, political approval ratings and even civil unrest are affected by the employment situation of an economy.

At its most basic level, having a job is very important for an individual. It lends a person self-worth and self-esteem, increases a worker's skills and talents, allows that person to spend (including buying a vehicle, home and starting a family – all of which are good for an economy) and allows that person the ability to save (which increases the financial stability of the country and the available capital for investment in the economy and/or stock market).

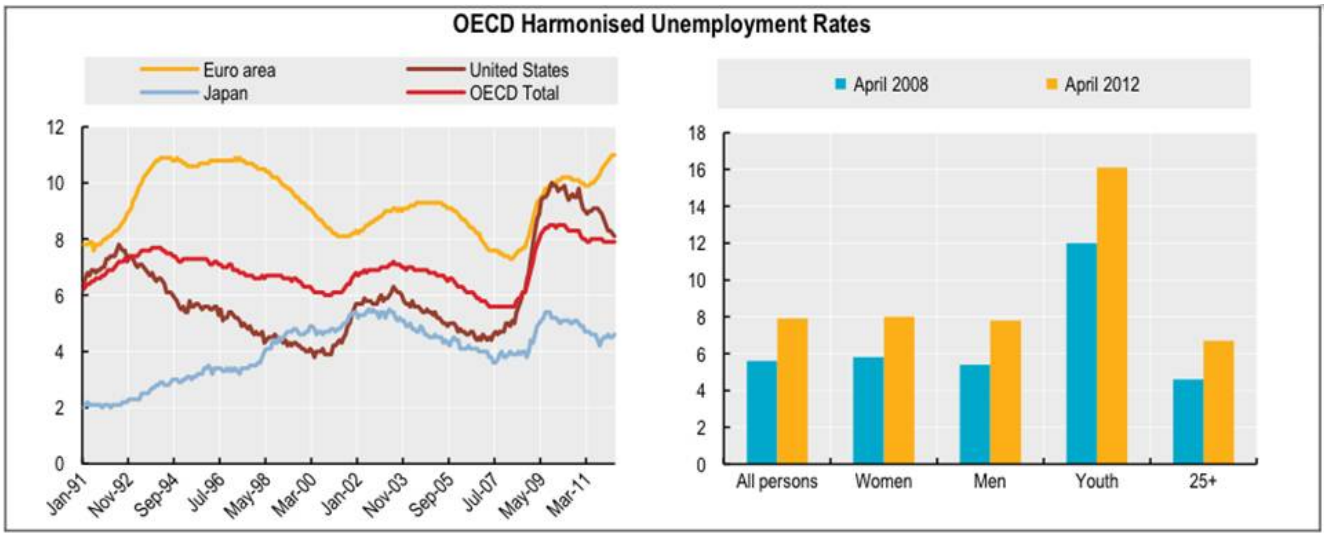
Not only is the employment rate high in the US, but perhaps even more importantly the year-over-year change in employee average hourly earnings is at a record low of just 1.5%. To put that into perspective, at no point did this trend break below 3% during the December 2007 – June 2009 Great Recession.

Frustration with the jobs market shows through quite clearly in the Consumer Confidence numbers. The US numbers are still at levels that are usually seen in past recessions. In fact, the much followed University of Michigan's Consumer Confidence Index level is lower than its average level during all past recessions. This confidence also spills over to small businesses where the NFIB Small Business index is currently lower then where it was the month the last recession started. The US recession technically ended over three years ago, but many consumers don't feel that there has been any real recovery to speak of. In fact, on many measures, this has been the slowest US economic recovery on record, even with near zero short-term interest rates and unprecedented stimulus.

It is of no surprise to find that a leader's public approval ratings are closely correlated to the employment picture in an economy. As the US election approaches, this topic will be increasingly important for the outcome. Approximately 70% of the US economy's GDP is driven by consumer spending. When you don't have a job, it is pretty difficult to get out there and spend a lot of money.

And it isn't just an American issue. The developed world had 47.3 million unemployed people in April 2012 and an unemployment rate of 7.9%. There are 14.6 million more people without a job now than there were in April 2008 before onset of the global financial crisis. The 17-member Euro area unemployment rate is 11% (April 2012). Australia and Japan are in better shape at 4.9% and 4.6% respectively. In Canada, we currently sit at 7.2% as of June. (Source: OECD)

The following chart shows the rising trend over the last four years in the developed world.

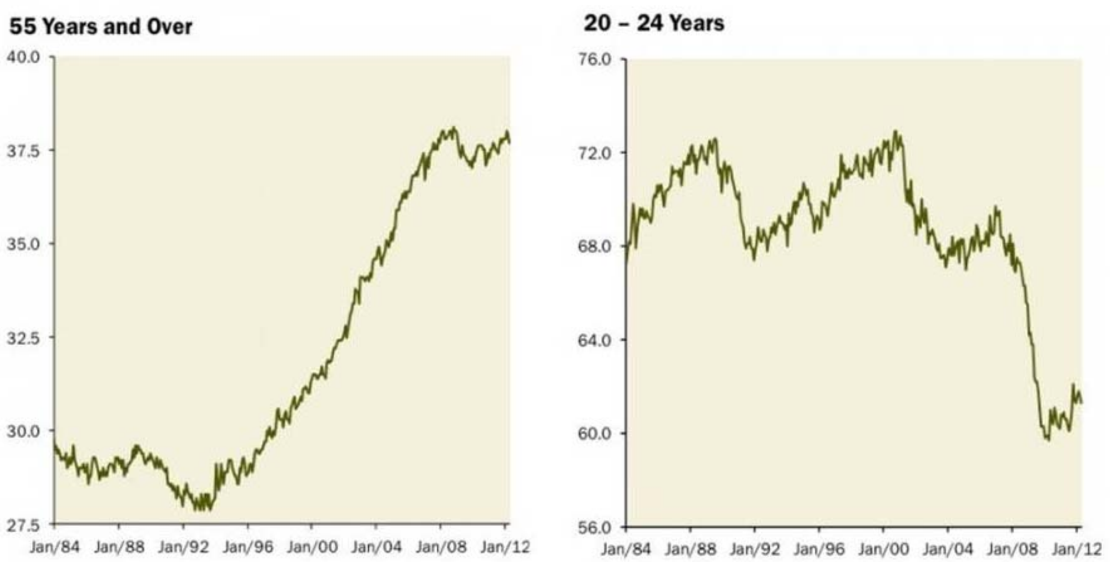


(Source: OECD)

Another angle that makes jobs so important in today's world is youth unemployment. With fewer jobs available, and more baby-boomers choosing to work longer (i.e. delay retirement), unemployment in the under 25 group is much higher than the stated unemployment rate for the overall population. This is already resulting in civil unrest such as the riots in London and the Arab Spring that has been heavily influenced by youth-driven social media. Left unchecked, these issues can only be expected to grow. The total developed world unemployment rate for youth is 16.1%. The U.S. rate is 16.4% and 13.9% in Canada as of April 2012. (Source: OECD)

CHART 40: OLDER THE BETTER ... FOR JOB PROSPECTS

United States: Employment to Population Ratio
(percent)



(Source: Gluskin Sheff & Associates)

Tortoise Versus the Hare:

You may recall that we were featured in the February 2012 issue of the Alberta Venture magazine. In November of 2011 we were to come up with one stock idea and one "investment theme" for the 2012 year. Utilizing Canaccord's fundamental research and our own quantitative screening, we selected Enbridge for our stock. For our investment theme we chose to go with US Government 10-year bonds. Due to our conservative outlook for 2012, a tortoise strategy of income securities appeared more prudent than the hare strategy consisting of higher growth equities.

We feel validated that these ideas have vetted well so far this year posting positive rates of return, while the TSX is down approximately 3%. While market prognostications should always be taken with a grain of salt, we are pleased to report that we occupy the top spot[1] amongst the seven investment analysts that were featured in the article. Kudos to the Milestone team!

[1] Data current to July 18 2012

The Markets & Our Strategy:

Below is the price performance summary of global equity and North American bond markets up to June 30th 2012.

Equity Markets

Canada	Level	Wkly Chg (%)	YTD	YTD C$
S&P/TSX Composite	11597	1.4%	-3.0%	-3.0%
S&P/TSX 60	664	1.3%	-2.5%	-2.5%
S&P/TSX Small Cap	559	0.5%	-9.1%	-9.1%
US	**Level**	**Wkly Chg (%)**	**YTD**	**YTD C$**
Dow Jones	12880	1.9%	5.4%	4.9%
S&P 500	1362	2.0%	8.3%	7.8%
Nasdaq	2935	1.5%	12.7%	12.1%
Russell 2000	798	3.0%	7.8%	7.3%
International	**Level**	**Wkly Chg (%)**	**YTD**	**YTD C$**
DAX	6416	2.4%	8.8%	8.3%
FTSE 100	5571	1.0%	0.0%	-0.5%
Nikkei	9007	2.4%	6.5%	6.0%
MSCI EAFE	1423	3.2%	0.8%	0.3%
MSCI World	1236	2.5%	4.5%	4.0%
MSCI EM	937	2.2%	2.3%	1.8%

Fixed Income

Indices / Rates	Level	Wkly Chg (%)	YTD
DEX Universe Bond	881	0.3%	2.0%
DEX Real Return Bond	533	0.0%	1.6%
Mer Lynch US High Yield Master II	882	0.6%	7.1%
LIBOR 3-month	0.4606%	-0.2%	-20.7%
Government Bond Yields	**3-mo T-bill**	**10-yr Bond**	**30-yr Bond**
Canada	0.88	1.739	2.329
US	0.08	1.646	2.754
Spread	0.80	0.093	-0.425

Source: TD Asset Management

Although the year-to-date numbers for our S&P/TSX Composite are not too disheartening, the recent twelve-month price change is much more daunting at -12.8%. Globally, the MSCI World Price Index (local currency) is down 4.5% in the last year. The Canadian stock market continues to struggle due to Energy and Metals markets which make up a large weighting of the index. This is reflected in the TR/J CRB Index (commodity price index) which is down 16% in the past year. The U.S. stock market has been one of the bright spots, with the S&P500 Price Index up 3.1% over the last twelve months. At the same time, we have seen long-term interest rates of ‘safe haven’ countries like the US, Germany, Switzerland and Canada hit all-time lows, resulting in strong government bond returns in those countries. On the other side of the spectrum, we are closely watching Italian and Spanish bond yields which are at or near all-time highs indicating that traders are broadly exiting these securities.

We are optimistic that long-term equity growth will return and sunny days lay ahead. For many quarters now, our strategy has been one of safety and income at a reasonable price (‘SIRP’), a term coined by economist David Rosenberg. We continue to believe this strategy to be the most prudent one in the current market environment.

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

Respectfully,

- **Your Milestone Team**