



MILESTONE COMMENTARY

July 15, 2013

When Correlations Converge

Bottom Line:

The second quarter, particularly the back half, experienced some heightened volatility. Most stock markets around the world were negative on the quarter and several are now down on a year-to-date basis, including the S&P/TSX Composite here in Canada. Normally, a decline in stocks would be accompanied by an increase in bonds. Generally being perceived as the safer choice, a run away from stocks usually means piling into Government bonds. However, in the past quarter, bonds and stocks seemed to be trending together. There have been several days where bonds and stocks are up, and other days when both bonds and stocks have been down. That makes it difficult for traditional asset allocation to achieve portfolio diversification. Instead of having part of the portfolio offsetting the other, everything starts to move together.

Although we have seen some solid housing and employment improvements of late in the US, the overall global economic backdrop remains weak in our view. The concerted and continuing effort by central banks around the world to stimulate their economies remains evidence of this. We believe that Canada is fiscally and monetarily well positioned versus many other countries.

Correlation: [kawr-uh-ley-shuh-n]
The extent of correspondence between the ordering of two variables. Correlation is positive or direct when two variables move in the same direction and negative or inverse when they move in opposite directions.
[from Medieval Latin *correlātiō*, from *com*, together + *relāiō*, relation]

Economic Overview:

All money flowing into the US

The US market continues to hold up, although it too was quite rocky this quarter. Investors from around the world are once again viewing the US as the global safe haven. For most of the first half of 2013, money was flowing into US stocks as well as US bonds (government and corporate bonds). That trend changed somewhat this quarter with US bonds topping out in late May and staging a quick and dramatic pullback. During that same time period, US stocks were bouncing around, but were essentially flat.

In addition to stocks and bonds, the US dollar has been consistently strong. This again reinforces the concept of global money finding a home in the US. For the first half of 2013, the

Canadian dollar is down 5.7% against the US dollar, the Australian dollar is down 12.1%, the Euro is down 1.4% and the Swiss franc is down 3.1%. The Japanese Yen is down a shocking 14.3%. So when looked at in the global context, we start to get a feel for how strong the US dollar has been.

Update on Japan

In our January and April commentaries we discussed the economic experiment that the new Abe government in Japan is conducting. In summary, the new Prime Minister Abe was elected on a platform of pumping stimulus, both monetary (money creation) and fiscal (government spending programs), into the struggling Japanese economy. The goal is ambitious but simple – increase economic growth and decrease the value of the yen. At first blush, it seems to be working.

One beneficiary of a weaker yen is the huge Japanese export sector. If the yen were to continue to drop by say 10% per year, you may soon be able to buy a Lexus (Japanese) for less than a Hyundai (Korean). This currency play then reverberates through most other export sectors such as electronics where Korean based products from LG lose ground to the likes of Japan's Sony.

However, can it be that simple? This might be the initial round of what could develop further into a full blown currency war between major nations. How will their neighbor China (also very reliant on cheap exports) feel about this new competition? How will the big German automakers will be able to compete? Will the Eurozone try to retaliate by trying to devalue their currency?

Secondly, the amount of QE (Quantitative Easing) money printing is much higher than what the US is currently doing (as a percentage of their economy). In fact, nothing of this magnitude has been attempted. Will the Japanese Central Bank be able to turn off the taps when/if they achieve the GDP growth they are hoping for?

How to end QEternity?

That brings us to the big question of the day. How does a Central Bank pull back on, much less stop, printing money to stimulate a struggling economy? During the second quarter, much of the volatility in both the stock and bond markets centered around the US Federal Reserve. The market seems to be hanging on every word the Chairman Ben Bernanke says.

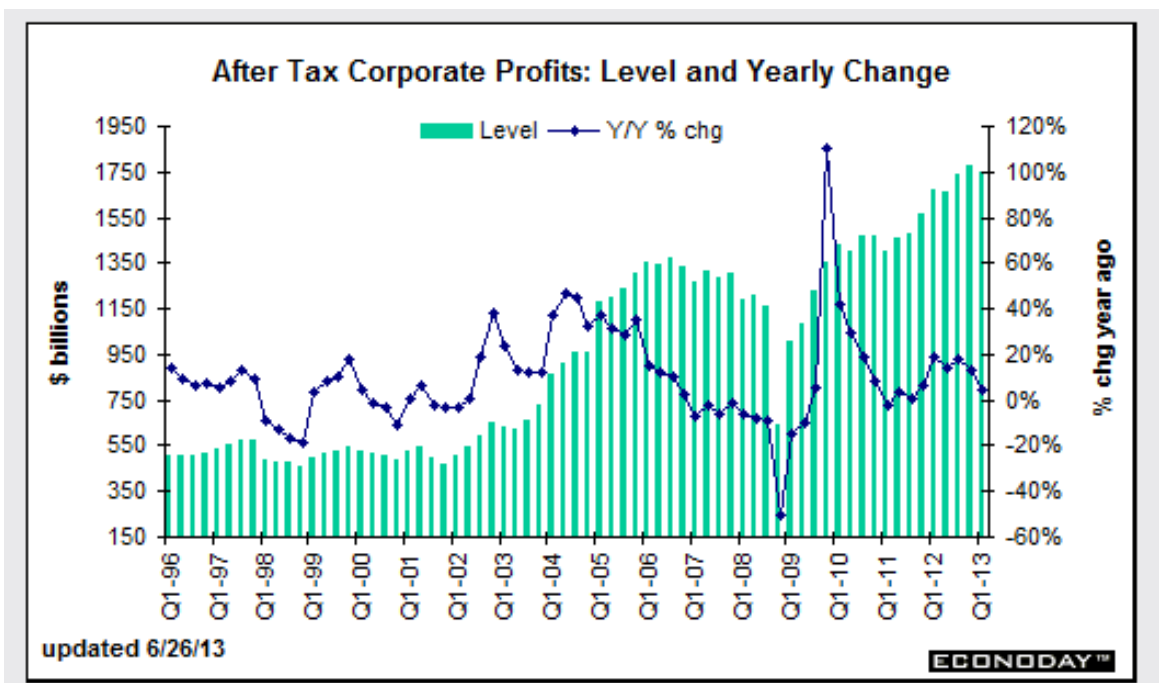
These are truly unusual times. A healthy economy (and by extension stock market) should not need to be fully reliant on monetary stimulus. During times of an expanding healthy cycle, an economy should be able to generate a decent 2 – 3% or more in real GDP growth ('real' meaning over and above inflation). During very good times, even higher growth rates can be experienced (think China over the past decade). But it has now been four full years since the US recession officially ended, and the US economy is still stuck below 2% real GDP growth (Canada as well). In fact, in this entire recovery/expansionary phase, the US economy has now produced just one quarter at a 3% annualized growth pace.

Now if all of this was happening without the help of monetary and fiscal stimulus, we could just chalk it up to a weak recovery/expansion. However, factoring in the unprecedented efforts to generate growth, this has truly been and continues to be a very weak period for the economy.

More recently the US looks to be potentially getting up off the mat. Housing prices are up, which in turn means that millions of Americans are less under water on their mortgages. The unemployment rate is still relatively high, but is improving. Consumer sentiment is gaining some steam and the consumer is spending again. This puts Ben Bernanke in a tough spot. Merely the mention of turning down the taps on QE leads to an instant sell off in stocks – not just in the US, but around the world. It is evident the entire global stock and bond markets have become fully addicted to QE. We must prepare for what the withdrawal symptoms look like and map out a plan to navigate it.

US Corporate Profits

An important trend we are watching closely over the last couple of quarters is that of corporate profits. Corporate profit growth has been a large tailwind behind the US stock market rally but lately the growth has declined substantially. US corporate profit growth has dropped from 13.3% y/y in the fourth quarter last year to just 4.7% the first quarter of 2013. Even worse has been revenue growth, which has been mostly stagnant. It will be difficult for US corporations to maintain record high profit margins without increasing revenue.



Source: Haver Analytic, Econoday

This is not necessarily a large negative if it were not for the outlook. From the corporate guidance this past reporting period (among the most negative guidance on record), one may expect that trend to continue down. According to Thomson Reuters estimates in mid-June, there was a 6.6:1 negative to positive guidance ratio for Q2 earnings. This is the most negative

reading since the first quarter of 2001.

Precious Metals

Gold has just completed its worst quarter on record. Silver has dropped even more in percentage terms dropping a total of 55% from a high of US\$43.37/oz to its June 30th closing price of US\$19.47/oz.

There are many theories as to the recent swoon in the price of precious metals, but our take on it is twofold. First is the strength in the US dollar. The second is a general global sense that our leaders have everything in hand and that all will be ok with the economy.

We have spoken earlier about the strength in the US dollar. In previous commentaries we have referred to gold as more of a currency than a commodity. So it stands to reason that with the US dollar increasing against most other global currencies, the same would be true for gold. Even more broadly, since most commodities are priced in US dollars, they should struggle in terms of price when the greenback appreciates.

The concept that 'everything is going to be ok' is really a reflection of the fact that the world is in a bit of a lull of bad news. The problem countries in Europe haven't been hitting the headlines lately. US housing seems to be finally showing some life. Japan could be showing some growth. There are no large scale geopolitical concerns at the moment which has investors stepping away from gold as their safe haven.

However, our position on gold has always been to hold a small portion of a portfolio in gold as a hedge against excessive money printing. We have a Real Assets category in our asset allocation and we still feel that owning solid assets like gold bullion is worthy of a place in our portfolios. With bearish sentiment toward the shiny metal at extremes there is a good chance we will see a recovery effort in gold later this year.

The Markets & Our Strategy:

Below is the price performance summary of global equity and North American bond markets up to June 28th, 2013:

Equity Markets				
Canada				
	Level	Wkly Chg (%)	YTD	YTD C\$
S&P/TSX Composite	12129	1.1%	-2.4%	-2.4%
S&P/TSX 60	696	0.9%	-2.6%	-2.6%
S&P/TSX Small Cap	538	1.5%	-8.1%	-8.1%
US				
	Level	Wkly Chg (%)	YTD	YTD C\$
Dow Jones	14910	0.7%	13.8%	20.6%
S&P 500	1808	0.9%	12.6%	19.4%
Nasdaq	3403	1.4%	12.7%	19.5%
Russell 2000	977	1.4%	15.1%	22.0%
International				
	Level	Wkly Chg (%)	YTD	YTD C\$
DAX	7959	2.2%	4.6%	9.3%
FTSE 100	6215	1.6%	5.4%	4.6%
Nikkei	13677	3.4%	31.6%	21.2%
MSCI EAFE	1639	0.8%	2.2%	8.3%
MSCI World	1434	0.9%	7.1%	13.5%
MSCI EM	940	4.4%	-10.9%	-5.5%

Fixed Income			
Indices / Rates			
	Level	Wkly Chg (%)	YTD
DEX Universe Bond	879	0.1%	-1.7%
DEX Real Return Bond	480	0.6%	-11.0%
Mer Lynch US High Yield Master II	968	-0.1%	1.5%
LIBOR 3-month	0.2731%	0.1%	-10.8%
Government Bond Yields			
	3-mo T-bill	10-yr Bond	30-yr Bond
Canada	1.03	2.439	2.898
US	0.03	2.487	3.5
Spread	1.00	-0.048	-0.604

Source: TD Asset Management

The US and Japanese equity markets continued their advance in the second quarter, up over 2% and 10% respectively. However, with the Nikkei in particular, we saw some extreme volatility with the index dropping by over 20% intra-quarter. The German DAX index was also slightly up on the quarter. Outside of these major markets, most other markets struggled. Our own equity market continues to out of breath with the S&P/TSX Composite dropping almost 5% this quarter and is now down 2.4% on the year. Of note, our equity market is still 20% below its all-time peak in June 2008. We have also seen a substantial drop in the world's second largest economy, the Chinese equity market (Shanghai Composite), was down almost 13% year to date.

We see short-term corrections all the time, but what made this correction somewhat more disappointing is that government and corporate bonds also fell. We saw yield curves steepen substantially pushing the prices of longer-term bonds down. In Canada, the DEX Government Bond Index fell over 2.5% this past quarter (over 2% in June alone) and now down 2.2% on the year.

In commodities, Gold was down another 23% this past quarter and is now sitting at US\$1224/oz (a drop of approximately US\$450/oz to midyear). The price of Crude Oil (WTI) was basically flat on the quarter but up 5% year to date.

In terms of investment strategy, we continue to approach our portfolios with a 'SIRP' mindset (a term coined by economist David Rosenberg which stands for 'safety and income at a reasonable price'). This past quarter was particularly difficult with falling bond prices and defensive Canadian dividend paying companies saw large corrections in June. With rising long-

term interest rate expectations, Real Estate Investment Trusts also took a hit. With the correction we are seeing some buying opportunities in certain sectors.

Our investment decisions are based on a full market cycle. Making hasty emotional decisions due to short term corrections or heightened volatility is not a good long-term solution. We continue to maintain our focus on capital preservation and risk-adjusted returns, while maintaining a solid income yield for our clients.

The back half of this year for equities could be very important for the longer-term trend. We continue to monitor economic data as it arrives, primarily leading indicators, in addition to sentiment and market internals. We are continually mapping out different scenarios for global economies and striving to maintain a diversified portfolio that can endure and thrive.

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

Respectfully,

- **Your Milestone Team**

CANACCORD Genuity
Wealth Management

 **milestone**
ASSET MANAGEMENT

Canaccord Genuity Wealth Management is a division of Canaccord Genuity Corp., a Member of the Canadian Investor Protection Fund, the Investment Industry Regulatory Organization of Canada (IIROC) and the Toronto Stock Exchange (TSX). Independent Wealth Management advisors are registered with IIROC through Canaccord Genuity Corp. and operate as agents of Canaccord Genuity Corp.

This newsletter is solely the work of the author for the private information of clients. Although the author is a registered Investment Advisor at Canaccord Genuity Corp., this is not an official publication of Canaccord Genuity Corp. and the author is not a Canaccord Genuity Corp. analyst. The views (including any recommendations) expressed in this newsletter are those of the author alone, and are not necessarily those of Canaccord Genuity Corp.

The information contained in this newsletter is drawn from sources believed to be reliable, but the accuracy and completeness of the information is not guaranteed, nor in providing it do the author or Canaccord Genuity Corp. assume any liability. This information is given as of the date appearing on this newsletter, and neither the author nor Canaccord Genuity Corp. assume any obligation to update the information or advise on further developments relating to information provided herein. This newsletter is intended for distribution in those jurisdictions where both the author and Canaccord Genuity Corp. are registered to do business in securities. Any distribution or dissemination of this newsletter in any other jurisdictions is prohibited. The holdings of the author, Canaccord Genuity Corp., its affiliated companies and holdings of their respective directors, officers and employees and companies with which they are associated may, from time to time, include the securities mentioned in this newsletter.