MILESTONE COMMENTARY

January 23, 2014

"*Nobody Told Me*"

Bottom Line:

The year 2013 proved to be very solid year for global equities, particularly for U.S., Europe and Japan. One of the primary drivers of this solidity has been unprecedented stimulus and accommodative policies from central banks around the world. Sentiment has risen with some improving economic data and equities have continued to rise at a pace far greater than the rate of corporate profit growth.

Are we entering a new secular bull market where valuations increase well above historical norm, or are we simply getting closer to the end of this current cyclical bull market? There is no clear answer to this question, as the current global experiment has no precedent. The best approach is one of balance and diversification, and keeping a close watchful eye on the internal strength and movements of markets.

Fixed income markets did not fare so well last year. As the late John Lennon described in one of his songs titled *Nobody Told Me*, "Nobody told me there'd be days like these, strange days indeed." Unfortunately, it was a strange year for many bond investors as their "safe" fixed income investments declined for the first time in many years.

The Canadian bond market lost ground in 2013 with the DEX Universe Bond Index producing a negative 1.2% return for its first annual loss since 1999 and worst decline since 1994 - the only other losing year since 1985. We witnessed the 10-year Government of Canada benchmark yield rise from 1.8% to 2.8%, resulting in even larger declines for those holding long-dated government bonds. The DEX Government Bond Index was down 2.4% on the year.

The most probable scenario going forward is a continued upward trend in risk assets and stabilization of bond markets. For 2014, we expect positive returns for both with a normalization of equity market returns. We will also likely see volatility increase at some point in 2014.

Economic Overview:

Is the U.S. economy turning the corner?

We have seen U.S. economic data take a much more positive turn of late, a move that has inspired our optimism. There has been recent strength in manufacturing, industrial production, retail sales and consumer spending, and employment, while the housing market continues its recovery effort. The unemployment rate has fallen from 7.8% to 6.7% over the course of the last year. We have seen the GDP annualized growth rate increase from 1.1% in the first quarter, up to 2.5% in the second and now 4.1% in the third quarter. The U.S. annual growth rate is now back to 2% or more. Canada is slightly below that level, but not growing nearly as quickly of late (2.7% annualized in Q3). What will drive this strength going forward? We know that the U.S. Federal Reserve has started to decrease the level of quantitative easing, but only marginally to this point. Will there be enough underlying strength to shut the valves off?

We expect a continued, if slow, reduction in quantitative easing and for the U.S. economy to continue its economic recovery. Will this lead to U.S. equity returns like we saw in 2013? We see this as unlikely, but we also don't see any extraordinary clouds on the near horizon. With the U.S. signaling that it will start to remove stimulus, we will likely see heightened volatility at some point in 2014, as this process may have created some misallocation of capital and issues with foreign currencies.

One caveat to our relatively positive stance on the U.S. economy and their markets is that, at some point, there will likely be normalization - not systemic panic like 2008 - of valuations, growth expectations, market volatility, the cost and availability of capital, and real income and earnings expectations. We believe this normalization will only come about once markets accept that current central bank polices are not sustainable or consistent with real economy success. The jury is still out on this verdict.

There are many that believe that the only outcome of these policies has been the significant distortion of investment capital, leading to excessive speculation, financial engineering and greater wealth disparity, at the expense of the broad health of the economy.

The recent decline of the Personal Consumption Expenditures index (commonly referred to as the PCE deflator) from 2% to 1.1% has been a benefit to 'risk' assets, although any sustained move below 1% (deflationary) would not be good for growth expectations and likely equity markets, and particularly for the credibility of the Federal Reserve. There is also the camp who believes these policies have successfully created an environment conducive to lending, and that rapid growth that will pull the U.S. economy away into a new long-term growth regime.

Fixed Income takes a step back

The likelihood that we have seen the end of the 30-year bond bull market continues to rise. We saw the U.S. 10-year Treasury yield touch down to 1.39% in July of 2012 (peak at over 15% in 1981). It currently stands at approximately 2.7-2.8%. Over this recent period, we saw the largest spike during the second quarter of 2013 where the 10-year benchmark yield rose from 1.85% to 2.48%, resulting in widespread negative returns for most fixed income instruments. Canada's yields have mostly risen in line with the U.S.

This past year's poor performance is not a reason to abandon fixed income altogether. They continue to have the potential to stabilize a portfolio when equity markets have their next correction or crisis. Fixed income's position in a portfolio remains just as important as before.

We are likely moving into a longer term rising rate environment, but we do not feel the pace of the recent rise in yields will continue. We believe the likely result will be a more gradual increase – with setbacks along the way.

For a balanced portfolio, it is essential to have a fixed income component for diversification and stabilization, especially during times of high volatility. That period will no doubt come again. That being said, starting in the third quarter of last year, we have shifted the composition of our fixed income to reduce its interest rate sensitivity, by reducing the maturity length and duration of our fixed income. We have also shifted to areas that we feel are more conducive to positive returns in a slow-rising interest rate environment.

Falling Loonie

We've received a lot of questions and concerns with regards to our currency of late. What is causing this recent depreciation to a level not seen since mid-2009? The recent decline in our loonie has mostly occurred only in the last three months. What could possibly have changed so drastically in such a short period of time?

Firstly, one has to consider that currencies don't move the same way equity or bond markets move. When they make a trend change, they quite often move very quickly as the collective expectation changes for a country's economic growth rate, interest rates, inflation or other factors.

Our dollar has recently dipped below US0.90 cents which is the lowest level in the past four and a half years. It is an extremely difficult task to determine a "fair value" on one currency compared to another, and even if you feel confident about a currency's value, it can stray from your forecast for long periods of time. For this reason, we do not provide currency forecasts but we can comment on what may or may not push the loonie lower.

We believe the recent decline in our dollar is primarily due to the recent strength in the U.S. economy relative to Canada. A stronger economic rebound in the U.S. relative to Canada could boost interest rates faster in the U.S. than in Canada. Many expect the U.S. to grow around 3% or higher this year, while Canada is expected to grow closer to 2%.

Whether this prediction proves correct remains to be seen, but it only takes a change in expectations to move currencies. There has also been some speculation that we may see a short-term rate cut by the Bank of Canada sooner rather than later, with weak inflation cited as a concern.

There may be some other factors at play. Global money management firm AllianceBerstein believes that the Canadian dollar was too high for too long due to the commodity boom, and that this resulted in the loss of thousands of manufacturing jobs. Since 2000, the U.S. has seen a 25% increase in the output of durable goods, whereas in Canada, output is down by 15%. We also believe some of the recent economic data from Canada, like the increase of our unemployment rate from 6.9% to 7.2% and a recent contraction in our manufacturing industry, has put a lot of pressure on our currency.

With the recent technical breakdown of the Canadian dollar in terms of chart patterns, it is both possible and likely that we will see further declines. These declines will be data dependent as we start to see Q4 data roll in over the coming weeks.

A final comment on global currencies

One of the consequences of developed central bank policies is the potential strong devaluation of emerging market currencies. Even today, we are witnessing this potential threat. There are many who believe that emerging economies like Brazil, Indonesia, Turkey and India cannot survive the deflation that the Eurozone – and especially Japan – are exporting to them. Their uncompetitive labor markets, deficits and heavy indebtedness could be a recipe for disaster in this environment and cause detrimental ripple effects across the global economy.

So although we are on balance positive for 2014, this year we suggest that currency wars could very well be one of the largest risks. The Yen is now the major funding currency of the global carry trade so any minor sign that Japan may be tightening its accommodative policies would prove challenging for global markets.

The Markets & Our Strategy:

Below is the 2013 performance summary of global equity and North American bond markets:

Equity Markets			
Canada	**Level**	**2013**	**2013 C$**
S&P/TSX Composite	13622	9.6%	9.6%
S&P/TSX 60	784	9.8%	9.8%
S&P/TSX Small Cap	611	4.4%	4.4%
US	**Level**	**2013**	**2013 C$**
Dow Jones	16577	26.5%	35.5%
S&P 500	1848	29.6%	38.8%
Nasdaq	4177	38.3%	48.1%
Russell 2000	1164	37.0%	46.7%
International	**Level**	**2013**	**2013 C$**
DAX	9552	25.5%	39.9%
FTSE 100	6749	14.4%	24.8%
Nikkei	16291	56.7%	35.7%
MSCI EAFE	1916	19.4%	27.9%
MSCI World	1661	24.1%	32.9%
MSCI EM	1003	-5.0%	1.7%

Fixed Income			
Indices / Rates	**Level**	**2013**	
DEX Universe Bond	883	-1.2%	
DEX Real Return Bond	469	-13.1%	
Mer Lynch US High Yield Master II	1023	7.4%	
LIBOR 3-month	0.2461%	-19.6%	
Government Bond Yields	**3-mo T-bill**	**10-yr Bond**	**30-yr Bond**
Canada	0.91	2.758	3.229
US	0.05	3.029	3.969
Spread	0.86	-0.271	-0.74

Source: TD Asset Management

The Canadian equity market finally started to come around in the latter part of 2013 after being down at mid-year, posting a respectable 9.6% return. The U.S. equity market had another very strong year, this time setting its best calendar year performance since 1997. Other global markets also fared well, with the U.K. and Japan equity markets up 25% and 36% in Canadian dollar terms. On the other side of asset allocation, fixed income had its worst year in almost twenty years. The more conservative a portfolio, the more difficult a year it was, as we saw strong declines in longer term government bonds. Although we saw a small decline in our overall Canadian bond market, the DEX Long Term Bond Index fell 6.6% and the Canadian Real Return Bond index (most interest rate sensitive) dropped a whopping 13%.

In the real assets space, the price of gold fell a very large 28% to its lowest level in four years. Oil prices rose about 7% and Natural Gas prices skyrocketed up 26%.

Our Canadian dollar dropped 6.5% in 2013. Of particular interest, the Japanese YEN declined 21% against the U.S. Dollar for its largest decline since 1979.

We came into 2013 with a fairly defensive stance, citing many scenarios at play that were potentially worrisome. At the time, the U.S. economy was very fragile, and, as fiduciaries of capital, we believe we had all the right reasons to be concerned. Some of these concerns began to dissipate as the year progressed.

As we discussed in our last commentary, in late Q3 and early Q4 we moved our asset allocation back in line with our longer term targets due to recent economic performance and expected low levels of volatility. The trend is currently higher, and that will likely continue for the near future. On the longer term horizon, we do still see some issues for global economies. We believe that our portfolios are currently well diversified across assets classes and investment strategies that should do well in the current environment. We also believe they should be able to sustain the small correction that we predict at some point in 2014.

Our overall ‘SIRP’ investment strategy (a term coined by economist David Rosenberg which stands for ‘safety and income at a reasonable price’) is still our investment philosophy. As long as we see current monetary conditions in place, we will be maintaining and even gradually increasing our global equity exposure for those whose objectives are a fit. That said, in terms of our global equity exposure, we have put a lot of due diligence into finding equity strategies that we feel comfortable with in terms of risk-adjusted return potential. We feel this will benefit our portfolios going forward.

With recent economic improvement in the U.S., in both the service and non-service sectors, we are hopeful that the current path of low volatility, positive equity sentiment, containment of long term interest rates and gradual removal of stimulus will be the right recipe for a prolonged bull market. We continue to monitor economic data as it arrives, primarily leading indicators, in addition to sentiment and market internals. We are also watching currencies closely, and heeding what they may be telling us about the health of emerging markets, which have been a strong driver of global growth in the past.

Our investment decisions are based on a full market cycle and we continue to maintain globally diversified portfolios with a focus on capital preservation and risk-adjusted returns, while maintaining a solid income yield for our clients.

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

Respectfully,

- **Your Milestone Team**