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R E P O R T

Economic Environment

2011 ended on a somber note, with most equity markets finishing down in the double-digits. In particular our TSX Composite fell 11% for the year, dragged down by slowing economic growth and demand for commodities. General concern over the health of the global economy is foremost on the minds of policy makers and the world is watching closely to see whether Europe can navigate its way through its self-inflicted debt crisis. It is our view that the greatest risk to Canada and the global economy are one in the same –a misstep by European leaders that results in a global financial crisis. The primary challenge in avoiding this will be how to structure an orderly Greek default, while limiting contagion to other heavily indebted European nations. Our Macro outlook is that the European fiscal crisis is far from over and will likely get worse before decisive action is taken sometime in the first half of the year. This will likely result in higher market volatility for Q1 and Q2, though our expectation for equities is somewhat better in the second half of 2012.

Fiscal austerity and the challenge of bringing spending within existing levels of taxation will be the daunting task for Developed nations both in 2012 and going forward. This will act as a drag on economic growth, though not necessarily enough to tip the balance towards recession. Emerging market economies are now slowing in response to earlier tightening of fiscal and policies, leaving less fuel for the global economic engine. Our best guess is that the global economy will muddle along, but muddle through the challenges of 2012, which suggests that market returns will be relatively muted over the next 12 months.

In an environment of lukewarm economic growth, Central Banks can be expected to keep monetary policy hyper stimulative. Europe's central bank has room to reduce rates an additional 25 to 50 basis points and Bank of England remains committed to another round of Quantitative Easing (injecting new money into the banking system to ensure it remains well capitalized. Depending on the degree to which we see a synchronous global slowdown, the U.S. Federal Reserve may embark on further Quantitative Easing for the same reasons. Closer to home, we continue to expect the Bank of Canada to keep the overnight rate at its current stimulative level, unless they see signs that Canada is headed back into recession, or in response to a global financial crisis.

Our overall outlook remains cautious, though with some small degree of optimism. This stems from the view that the world economy will fare slightly better than in 2011, if only because the balance of probabilities discounts the same economic and non-economic variables occurring in 2012. For example, the earthquake-tsunami-nuclear catastrophe in Japan, which had significant negative economic consequences, is unlikely to happen in sequential years. Similarly, market declines resulting from the realization that a European country will default on its debt cannot occur again, as markets have accepted this reality and have priced in this scenario accordingly. Too, the situation where the U.S. saw its debt downgraded for the first time in its history due to political gridlock over taxes and spending is most likely to resolve itself. 2012 is an election year and with that, either the Republicans will emerge with the Presidency in hand and can move aggressively forward with their cuts to spending, or, should Obama be re-elected, Democrats and Republicans will be forced to compromise with four years of gridlock simply not an option. Canada will remain as always, at the mercy of these larger economic and political forces. Our GDP can be thought of as a barometer of the global economy and is therefore likely to see growth on par with the relatively cautious outlook for 2012.

Canadian Equity Funds

Despite the relative strength of the Canadian economy, our equity market was down, in part due to the weakness in natural resource stocks. It is our view that commodity prices remain vulnerable in the short term, as the uncertainty surrounding Europe and downgraded global growth prospects weigh on valuations. A slowing world economy suggests oil prices may fall, though rising political and military tensions in the Gulf over Iranian sanctions may offset this. We do not expect commodities to experience the kind of dramatic price swings as they saw in 2008 (where copper lost two-thirds of its value). Moreover, these near-term cycle swings mask the continued global structural change in demand for commodities. Twenty years ago, developing countries were only one-third of the world economy. They now account for close to half and are their way to reach two-thirds over the next twenty years. These rapidly growing countries are in a commodity-heavy phase of their industrialization, which should support commodity prices in the long term. This together with a sound banking system and a diversified economy, positions Canada to continue to perform reasonably well relative to many other Developed countries. With healthy corporate balance sheets and solid dividend records, Canadian equities may reverse their 2011 declines as investors look beyond the short term and recognize the return potential that Canadian stocks offer.

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Global Equity Funds

With the exception of the United States, global markets suffered double-digit declines. Counter-intuitively, the largest drops were seen in Developing countries, including China, which fell by 22%. Here, nervous investors were pulling money from emerging market equities and seeking safe haven in US, Canadian and German bonds. Despite a slowing or even stalled global economy, the outlook for corporate profits remains good and is supportive of equities. With economic fundamentals still pointing to modest profit growth in 2012, a case can be made for equities looking attractive, though investors are likely to experience considerable volatility at given points in the year. With every year that passes where equities are flat or negative, the nearer term prospect for stocks looks better. Historically, equities have outperformed other asset classes and the underperformance over the past decade suggests that stocks are more likely to begin their upward march sooner than later. The last prolonged period of market stagnation was from 1968 to 1982. Over this 14 year period, stocks failed to advance (excluding dividends). Following this, from 1982 to 2000 stocks delivered some of their strongest gains, and handsomely rewarded long term investors. We expect global equities to rise in 2012, although the gains are likely to be company specific and not across the board. Here, the value of active money management is likely to be realized, as institutional money managers differentiate themselves from the broader markets through higher returns and lower volatility.

Fixed Income Funds

Bonds delivered another solid performance in 2011, outperforming every asset class on a risk-adjusted basis. Real Return bonds delivered gains better than 10%, while conventional government bonds were roughly half that. Corporate and high yield bonds too had positive results, as higher yields offset some volatility in the face value of the underlying bonds themselves. With interest rates expected to remain where they are and company's balance sheets flush with cash, we are anticipating another good year for this asset class. Bonds continue to offer investors steady, predictable investment returns, with less volatility than stocks and a higher degree of capital preservation. The risk to bond holders in 2012 could only come in the form of higher interest rates or a credit squeeze, such as the one seen in 2008. We consider both of these unlikely, as Central Banks are committed to holding rates were they are in an effort to stimulate economic growth, and remain vigilant and willing to inject as much capital as is necessary to ensure the liquidity of the global banking system. As such, we remain overweight in bonds and see them as offering investors a stable and secure asset class to protect and grow their retirement savings.