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WEALTH MANAGEMENT • RISK MANAGEMENT

T H E

First Capital Financial

Q U A R T E R L Y

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R E P O R T

Economic Environment

The second fiscal quarter of 2009 witnessed a marked improvement in capital markets around the world. Off their lows set at the end of February, indexes have risen more than 30% reflecting a consensus of opinion that the economy has turned the corner and is beginning to recover. Fiscal stimulus, low interest rates and massive government spending have combined to stabilize the global economy and establish a foundation for future global growth. A slowing in the rate of unemployment, the nascent beginnings of a recovery in the U.S. housing market and a modest improvement in manufacturing revived hopes that the recession-hit global economy is stabilizing. U.S. Banks have passed the so called stress tests required by the Obama administration, further lending support to the position that the banking system is past the worst of its concerns. Here in Canada, our manufacturing base continues to suffer, as North American carmakers and a higher Canadian dollar hurt export of finished products to our trading partners including the United States. Fortunately, the Canadian economy has considerable strength in resources, which have helped to offset the deterioration in manufacturing levels. In particular, a rebound in commodity prices -most notably oil to levels around the \$70 level, reflect the belief that demand will increase as the global economy strengthens in the second half of this year and throughout 2010. Commodities are leading indicators, meaning that an improvement in this sector augurs well for the overall economy looking forward.

Concerns exist over President Barack Obama's plans to reshape financial regulation and it's impact on the financial system and the wider economy. The proposed extra regulation will reduce leverage available to some institutions, which systemically is a good thing, as it will likely reduce the number of bankruptcies. However, it does create a lower return on equity for investors with lower level of risk for all stakeholders. Moreover the proposed plan requires large institutions to boost their capital cushions and regulating over-the-counter derivatives and securitized instruments. The long-term effect of these proposals will take considerable time to be understood, however if the bottom line result is a more stable financial system, then lower returns from financial firms may well be an acceptable consequence.

The closely watched Consumer Price Index showed inflation is still not a worry. Canadian CPI showed a core rate of inflation of 2% over last year. The Bank of Canada has said it sees inflation to remain low for quite some time and in turn, that lending rates will remain low for the foreseeable future. Consumers continue to retrench and reign in spending, with the dual effect of lower overall sales in virtually every market sector, and a rising national savings rate. While a higher savings rate is ultimately a good thing in itself, it will slow the rate of worldwide economic recovery. It is our position that responsible consumption rates and a return to long-term historical norms in terms of personal savings, will in the end, position the global economy for sustained future growth into 2010 and beyond.

We remain circumspect at this time, convinced that the world economy, though saddled with immense challenges, will ultimately prevail, with improving global markets towards the end of this year and a resumption of economic growth in 2010.

Canadian Equity Funds

Canadian equities have fared among the best of all international capital markets in the second quarter of 2009, reflecting the rise in commodity prices globally. Year-to-date, the TSX Composite has posted a gain of 12% as index-heavy weights including Potash Corporation, Encana and RIM have delivered solid gains on the belief that the worst of the recession is behind us. Canadian Financials too have seen significant gains as the default risk for consumers and businesses has fallen with the expectation that the economy will strengthen going forward. Going forward however, real and not perceived improvement is needed to sustain the rally. In the absence of this, investor sentiment -which up to now has provided the fuel for recent market gains could evaporate sending equity markets back down again.

Global Equity Funds

The second quarter of 2009 saw a marked divergence of returns from Developed and Emerging Markets. U.S. and European exchanges are trading around break-ever for year, while the returns from Brazil, Russia, India and China have averaged more than 25%. The Chinese SENSEX index is upon over 50% in 2009, on the continuing resilience of China's economy to the global economic slowdown. Unlike their Canadian counterparts, global financial firms have continued to struggle, with downgrades from Standard and Poors on many international banks and insurance companies. Defensive companies in sectors including food retailing and health care have fared better, as consumers continue to spend in these areas. As with the case of Canadian equities, future gains will depend on an actual improvement in the economy, not merely the perception that things have stabilized. It is our view that the concerted efforts by governments and central banks around the world to create conditions conducive to economic growth will result in measurable economic growth, setting the stage for modest gains in the second half of the year.

Fixed Income Funds

Bonds continue to perform well in 2009, with government issues on pace to deliver returns 3%-4% above the core rate of inflation and corporate bonds on pace to show their best year since 2003. The benchmark return for corporate bonds is 11% year-to-date, with the majority of the returns coming from a capital gain on the face value of bonds. As the economy continues to strengthen, investors can expect additional capital gains together with solid yields from the bonds themselves. Historically, corporate bonds have led equities in terms of performance, in each of the past three recessions. As such, we remain very bullish on this asset class for the balance of 2009 and 2010. Our concern remains over the potential inflationary effects of the scale of government monetary expansion globally, however this concern has moderated over the past quarter, as sluggish growth is expected to constrain inflationary pressures for the foreseeable time.

Overall, investors have seen a clear improvement in portfolio values in Q2, as Canadian and international equities coupled with an overweight in corporate bonds have combined to deliver solid gains. Where the underlying economy delivers tangible improvements, equity investors may see additional gains in the second half of the year. Nearer term concerns over whether the rebound in markets are more perceptual than concrete remain and investors may well see some weakness in the third quarter of 2009, before additional market advances materialize. That said, it is our view that the worst of market declines are behind us, meaning that the medium term outlook and trend for investors is up.

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