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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

At the mid-point of the year, markets are experiencing considerably more volatility to the downside than in the first fiscal quarter of 2011, as investors weigh all available information in an effort to decide whether the global economic recovery remains sustainable. The macro events which dominate include the on-going debt crisis in Europe, stubbornly high unemployment numbers, the US debt ceiling, the end of QE2, inflationary pressures despite sluggish economic growth and China's relative slowdown and its effect on global commodity prices. As data is made available, investors see-saw between cautious optimism and deepening pessimism, depending on whether the information is positive or negative. It is our view that after two years of strong global recovery, we are transitioning into mid-cycle. This is normally accompanied by a withdrawal of government stimulus and initial tightening by central rates. The general consensus that higher rates will be deferred in the US until after the 2012 presidential election. And with China tightening, US fiscal stimulus waning and higher energy prices, it is very likely that the global economy will go through a period of slowing growth. Historically, it is normal to have weak periods within a growth phase, so a pullback as investors decide which economic indicator is more important, is expected

As with any business cycle, there is going to be speculation as to the duration and strength of the cycle. Where concern over the durability predominates, equity markets will periodically stumble. However, unlike debt-strapped consumers and governments in the Developed World, the balance sheet of corporations is very strong. This may factor positively into equity prices in the second half of 2012, as companies continue to buy-back shares, increase dividends and merge with or acquire their competitors. As business deploy their cash to position their companies for growth going forward, the stimulus effect on the overall economy should be positive. This additional demand will be good for the economy in the short term and equity investors in the long term. Taken together, our outlook remains positive overall, as the current growth scare is not seen as a repeat of the economic decline in 2008. Caution though remains advisable, and we remain committed to our adherence to a defensive strategy across client portfolios.

In summary, while optimism has been dampened by weaker-than-expected economic news in Q2, the outlook for the global economy and global markets remains better than they did 12-18 months ago. While investors may wish the recovery would continue in a straight line, historically this has never been the case. Recognizing that a sustained, synchronized economic recovery is unlikely, given the very different states that Developed and Emerging economies find themselves. Thus, what represents a solid economic strategy (like quantitative easing or an export driven economy) in one part of the globe, creates problems in the other. The resulting economic friction serves to slow global economic growth. Viewed with a larger historical perspective however, it is important to remember that at all times, both positive and negative factors are present in the world economy and capital markets. Over time, the positive prevails and the trend line moves inexorably forward. There remains real structural issues facing the world economy, which act as a headwind to more robust growth. That being said, innovation, productivity gains and strong capital investment continue to generate global growth and over time can be relied upon to do so going forward. The final word is that investors have seen their portfolio perform well over the past 8 quarters, a pause is not altogether unexpected. It is our view that such a development does not rule out additional gains in the 2nd half of 2011, as the global economy continues its forward momentum.

Canadian Equity Funds

Canadian equities have retreated from their levels at the end of Q1, with weakness in commodity prices reflecting concerns that global economic growth has stalled. This point is underlined by specific concerns that China's economy is slowing, and therefore demand for commodities will be lower going forward. Our view is that in the macro picture, while Canadian equities are unlikely to outperform their global counterparts this decade as they did in 2010, demand for commodities will remain strong for some time, providing investors with growth opportunities going forward. Outside of resources, Canada's economy is faring well, relative to many Developed Economies. A strong banking sector, stable housing prices and an improving unemployment picture all support the position that Canadian equities may again to move forward in the 2nd half of this year. In the spotlight this fiscal quarter has been the dismal performance of Research In Motion (RIM), as the smart phone manufacturer faces challenges from rival Apple. It's decline of over 25% is roughly 10 times that of the benchmark TSX Composite this year. While it is not our position to comment specifically on any single stock, RIM serves to remind investors of the importance of being diversified, to protect against market downside risk. Looking ahead, we see opportunities in the Canadian market place for well diversified, well managed portfolio to move forward as the global economy resumes its growth in

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Global Equity Funds

Global markets too have pulled back from their higher levels seen earlier in the year, as investor uncertainty hangs over the global economy. The combination of rising interest rates in China, concern over a possible Greek debt default and the end of the Federal Reserve's \$600 billion stimulus program have almost wiped out all of this year's gains. The divergence between profit forecasts and economic indicators shows the challenge to investors after significant market gains across the board from their 12 year lows in March 2009. Currently investors are unwilling to pay for future growth. Instead, they are looking for better data, and where available, markets are expected to stabilize. In terms of the US market, S&P 500 companies are currently trading at roughly 14-15 times price-earnings. This is not excessively high and suggest that even with zero earnings growth, US companies are fairly valued. Concern the slowdown will lead to another recession will continue to weigh on all stocks, even as companies report higher income. This will act as a drag on near-term market growth, however, as with the case with Canadian equities, our view is that as the global economic recovery resumes its course, stock prices will ultimately reflect that through higher valuations.

Fixed Income Funds

Bonds continue to offer investors the combination of capital protection and steady, predictable investment returns. Year-to-date, bonds have delivered positive results, with little volatility relative to equities. Our position is that a properly diversified portfolio which includes bonds, positions investors for solid yield-adjusted returns. Where quarters such as this one see equities decline, fixed income investors have seen positive returns from their bond holdings mitigate the downside risk. It is our view that corporate bonds continue to offer the best yield opportunities (compared with government and high yield bonds), as on balance, companies are well capitalized and therefore have less default risk. Government bonds, particularly those with long durations to maturity such as Real Return Bonds, have seen lower returns, reflecting the interest rate risk they carry. Our expectation is that interest likely will remain unchanged until the end of 2011, meaning that government bonds are likely to trade at par, and offer investors their yield as the net investment return. High Yields are nearing the point where investors have to begin questioning whether they are being rewarded sufficiently for the risk they are taking. It is our view that exposure to high yields should be reduced and we are looking to reduce some exposure here, with higher exposure to investment grade corporate bonds and yield-orientated investments. Overall, we remain firmly committed to fixed income investments as a core position in clients portfolios going forward.