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WEALTH MANAGEMENT • RISK MANAGEMENT

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R E P O R T

The first fiscal quarter of 2010 has begun with characteristic volatility, as the global economy struggles to recover from two years of economic contraction. Improving consumer sentiment, strength in commodities and resilience in emerging markets are weighed against weakness in the US housing market, high levels of government and consumer debt, and double-digit unemployment levels in most of the developed world. Added to the list of negative factors is the threat of inflation, which would require rising interest rates at a fragile time in the global economy.

Here in Canada, the strong Canadian dollar remains a key cooling factor for inflation. This coupled with continuing demand from China for our raw materials, has mitigated the worst of the global recession. Canadian banks and housing prices remain solid, and together provide the basis for further growth in 2010. Any such improvement should result in job creation -a prerequisite to sustained economic expansion going forward.

The overriding question that remains to be answered is whether the global economy can continue to recover as economic stimulus packages expire and interest rates move higher. The combination of the two could prove to be a difficult hurdle to overcome, particularly where higher taxes are a certainty in the near term. Fundamental issues remain unresolved globally, including the massive trade imbalance between the US and China. This reality is destabilizing long term, and requires both a significant rise in the value of the Chinese Yuan, and greater domestic expenditure on the part of Chinese consumers to correct.

Sovereign debt concerns also cloud the outlook for the world economy, with notable European countries including Greece, Spain, Portugal and Iceland facing the prospect of defaulting on their national debts if painful economic changes are not undertaken. These include deep cuts in social spending, a meaningful reduction in the size of government payrolls, pension reform and higher taxes. While none of these choices are welcome, the failure to implement these changes would almost certainly result in a far worse outcome, where standards of living are lower for future generations.

Our outlook for 2010 therefore remains a mixed picture overall. As such, maintaining a defensive position through government, corporate, high yield and yield-generating equities remains prudent. Caution is the operative word and the asset allocations in our client portfolios reflect this. We are watching interest rates closely and are prepared to make the necessary changes to respond to a higher interest rate environment. The next fiscal quarter will likely indicate the direction of rates in 2010 and set the stage for what happens next in terms of the nascent global economic recovery for the balance of the year.

Canadian Equity Funds

Reflecting the mixed outlook for the global economy, the TSX Composite has fluctuated between optimism and pessimism in the 1st quarter of 2010. The Bulls have the slight upper hand, with the index edging up on the strength on commodities. Strong demand for Canadian Resources is a convincing argument for having exposure to Canadian equities. However, risks remain, exacerbated by greater tension between the developed and developing countries. If expected interest rate hikes were to combine with protectionist measures, the global recovery could stall, sending commodity prices down sharply in the short term. It is our view that holding equities with a record of solid dividend payments to investors is key to extracting returns from Canadian stocks in 2010.

Global Equity Funds

Continuing the pattern of Canadian equities, US and European markets have alternated between advances and declines depending on the economic data being reported. Again, indexes have moved slightly to the positive, suggesting an underlying confidence that the global economy has turned the corner. Currency concerns continue to weigh on investors minds, as both the US dollar and the Euro look increasingly fragile. Balanced against this uncertainty however, is the reality that the balance sheet of global corporations remains very strong. Companies are sitting on record amounts of cash and are achieving greater efficiencies through both economies of scale and productivity gains resulting from significant reduction in payrolls. This capital will likely be used to acquire weaker competitors, buy-back shares and increase dividend yields -all of which auger well for investors. The question still remains whether this will prove sufficient to overcome the headwinds facing the global economy as it struggles to get back on track.

Fixed Income Funds

Government and corporate bonds have delivered positive returns year-to-date, adding to last year's impressive gains. The returns have come from interest yields, not capital gains on the face value of the underlying bonds themselves. Concern over defaults is always present, however our focus has shifted to the potential negative impact that higher interest rates and rising inflation could have on the sector. Inflationary pressures surfaced in Q1, although the threat of markedly higher inflation is not currently expected. The normalization of central bank monetary policy will attempt to bring interest rates back to normal recessionary levels. Increasing exposure to Real Return Bonds (inflation-indexed bonds) while shortening the average duration to maturity of bonds should help to protect investors as rates rise over the balance of the year. We remain committed to bonds as a defensive position within a well-diversified investment portfolio. Bonds serve to protect capital, while delivering predictable investment returns over time. These features lower overall portfolio risk and help investors through periods of market volatility.

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PHONE: 705.646.0480 • 800.376.2293

FAX: 705.646.0482

www.fcfcorp.ca