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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 first three months of 2011 has witnessed political upheaval in the Arab world and both man-made (nuclear) and natural disasters (earthquakes and tsunami) in Japan. Both have combined to rattle markets, with equities initially experiencing considerable volatility to the downside. In Tokyo, the Nikkei index fell by almost 11% in one day. With one of the worst debt positions among industrialized countries, the cost of insuring against default on Japanese sovereign debt soared. Prices fell sharply on a range of commodities amid worries that the disaster in Japan could hurt trade in East Asia and beyond. Since then, markets have rebounded as oil prices have eased slightly and the global economy continues to expand.

Political discussion in Europe continues to be dominated by debt worries for struggling member nations. Leaders of Euro-zone countries agreed to beef up the bail-out facility for the currency block. Greece won a modest reduction in the interest rate it is paying on its loans, but Ireland received no such concession because it insisted on keeping its low corporate tax rate.

Inflation remains on the radar screen, however it is our view that the current inflation rise will more likely be transitory than permanent. Higher oil prices will impact consumers in the Developed World, however food and energy generally make up far less of the overall Consumer Price Index (CPI) relative to developing nations.

Quantitative Easing (QE) is expected to continue throughout Q2 and the balance of 2011. This process whereby the Federal Reserve, Bank of England and the European Central Bank creates money to buy both mortgage-backed securities and government bonds is precedent setting. Moreover, it is seen by some as vital to maintaining stock market confidence. However, with every expansion of the program, it becomes harder to unwind. This is a concern for us as it suggests higher interest rates as investors may demand a higher return to compensate them for the risks of inflation or dollar depreciation. Higher interests could stall the recovery in North America and Europe as debt-strapped citizens see even more of their income going to servicing their liabilities.

In summary, while bullish sentiment has cooled somewhat, the overall picture for the global economy remains better than it did last year at this time. Growth in emerging economies including China, India and Latin America remains robust. In the Developed World, households continue to rebuild their balance sheets through paying down debt and increasing contributions to their investment portfolios. The recovery continues to move forward despite the enormous challenges facing the world at this time. This is in itself further reason for measured optimism. Only a few years ago, the same combination of political, economic and societal events currently unfolding would have sent markets plunging and undermining real growth in the economy. Now, the momentum of global economic growth appears to be continuing upward, suggesting that underlying fundamentals remain solid. Our outlook for the 2nd fiscal quarter is for this trend to continue, however events may ultimately unfold.

Canadian Equity Funds

Canadian equities continue their upward march, posting solid gains of 4% for the first fiscal quarter. Strength in energy (led by oil), commodities and precious metals combined to send our TSX Composite up for the 4th consecutive quarter. Mergers and acquisitions (M&A) increasingly feature as part of the continued strength in Canadian equities. Notably even the exchange itself is in play with a possible merger with the London Stock Exchange. While it is unclear as to whether this particular deal will transpire, the expectation is that M&A activity will surpass last year's totals, as companies will be motivated to acquire due to trillions of dollars in underutilized capital sitting on their balance sheets. This augers well for Canadian equity investors, as do the announced and anticipated increases in dividends paid to investors. Our outlook on Canadian equities has improved, where we are looking for additional capital gains going forward. This said, we remain of the view that yields remain an important component of overall returns for investors and continue to emphasize yield-generating equities in our asset allocation models.

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Global Equity Funds

Capital markets globally have seen mixed results with US exchanges up over 5% and Japanese stocks (understandably) down almost 7%. Emerging markets and Europe have delivered small gains in local currency terms, although are up more than 5% expressed in US dollars. US GDP Growth is expected to surpass Canada's in 2011 and US corporate earnings have been strong, including in the financial sector. Record amounts of cash on the balance sheets of US companies portends well for US stocks, and makes a stronger case for US equities going forward. Bullish sentiment towards Europe is certainly lower, as the region has failed to deal adequately with its debt issues. International banks have more stress tests on the horizon and struggling European countries including Greece, Iceland, Ireland, Portugal and Spain likely have not seen the last of their fiscal challenges. Emerging markets which attract a risk premium even during times of peace and stability, have been unsettled by the unrest in the Arab world. This has not changed our bullish view on emerging markets, and we view the current market volatility there to be a short-term issue. Strong fundamentals make the case for emerging markets, where investors properly assign an appropriate portfolio allocation commensurate with their risk-return profile.

Fixed Income Funds

Both government and corporate bonds have posted small gains in 2011, with the yields from the bonds slightly more than the short term declines in the face value of bonds themselves. High yields continue to offer a return premium of more than 5% above the 10 year US Treasury note. Our view on government bonds is unchanged since December, where we expressed concern over interest rate sensitivity and sovereign default worries. Investment grade corporate bonds remain attractive as they offer strong yields backed by healthy balance sheets. High Yields have done well in 2011, although we are looking to reducing exposure to this asset class, as the return premium shrinks relative to government bonds. Overall however, we remain committed to an investment strategy that emphasizes capital preservation with steady, predictable investment returns. Here, bonds offer investors both and as such remain an integral part of a well diversified investment portfolio.