



FIRSTCAPITALFINANCIAL
WEALTH MANAGEMENT • RISK MANAGEMENT

T H E

First Capital Financial

Q U A R T E R L Y

S E P T E M B E R 3 0 • 2 0 0 8

R E P O R T

Economic Environment

The past three months have witnessed a sharp decline in capital markets around the globe. Venerable firms including Bear Stearns, Lehman Brothers, Fannie Mae and Freddie Mac have disappeared from the financial picture, while others including AIG, Merrill Lynch and Morgan Stanley have assured their survival only by merger or acquisition. This fundamental re-drawing of the U.S. financial system is the end result of the fall in U.S. housing prices and the continuing sub-prime mortgage and related credit crisis.

The severity of the situation culminated with the proposal by the U.S. government to purchase billions of dollars of sub-prime mortgages and other toxic debt instruments, in an effort to avoid a catastrophic collapse of U.S. banks. This announcement was positive received, with equity markets posting their largest single-day gains in decades. The sustainability of these gains remains to be seen and equity investors are understandably concerned.

With all of the continuing uncertainty in capital markets, it is important to remember that the fundamentals of the US and global economy remain sound. Excluding housing and autos U.S. GDP is growing at an annualized rate of 4% this year. Emerging economies including China, India and Brazil continue to expand at double-digit rates and are increasingly a source of demand for global products from developed countries. In short, while the short-term outlook is one of a synchronized global slowdown, Globalization is not going to stop, making the longer-term picture look better.

With all leading indicators suggesting a continuing downward trend for both equity markets and the real economy, the question arises as to how to protect one portfolio during periods of market turmoil? Diversification is the cornerstone, with asset classes such as government bonds acting as a hedge against plunging stock markets. Too, holding funds with significant positions in government Treasuries also serves to mitigate the effects of market losses. Mindset is another. Recognizing that stock markets move in short-term cycles in response to economic news, but the long-term trend is up. Given the stock market's rising trend, market declines have been an opportunity for long-term investors to acquire equities at lower prices.

Market conditions such as these understandably test the resolve of investors. That said, a well-diversified, well-managed investment portfolio has and will, continue to represent a solid platform for building wealth over time. Historically, every equity market downturn is followed by a subsequent recovery and markets go on to record the highest return of any asset class. Our view has not changed on this and we remain confident of the outlook for equities over the long term.

Canadian Equity Funds

The TSX in Canada has fallen roughly 7% year-to-date as the rally in resource stocks in the first half of 2008 has stemmed overall declines. Volatility in commodity prices has produced some of the largest swings in stock levels since the bursting of the technology bubble in 2000. To reduce volatility, we have adopted a more defensive position, with commodities and energy exposure less than half of market weight. This is prudent given that the expected slowdown in developed and emerging markets will contribute to a drop in commodity prices. Our view is recently as June 30th of this year, was that an expected drop in commodity prices would occur in 2009. We have moved from this view and see a general weakness in commodity prices to characterize the last quarter of 2008 and into 2009.

Global Equity Funds

Global markets have witnessed greater declines than the Canadian markets, with an average loss of roughly one-fifth in value. Sub sectors including financials have fared far worse. This sharp pullback in levels will continue to re-shape the corporate landscape and create buying opportunities for longer-term investors. Core funds within our portfolios hold significant cash positions, enabling fund managers to capitalize on these opportunities. With the downward momentum of capital markets, it is highly probable that the balance of 2008 will see additional market losses. That said, for investors with a longer time frame, it is important to remember that equities have historically delivered the highest returns of any asset class and represent the best platform for building wealth over time. The most recent crisis does not change that statement and we remain confident that this Bear Market will eventually bottom and equities will resume their long-term trend upward.

Fixed Income

Government bonds have served investors well to-date, with an average return of 3%. While the flight to quality has driven down yields, we remain positive on government bonds, as they serve to protect investors' capital, while delivering predictable investment returns. The corporate bond market has been essentially flat in 2008, as the yields have been offset by a decline in the face value of bonds. This stems from general concern over the ability of corporations to service their debt. Essentially all corporate debt is being tarred with the same brush, creating opportunities for bond managers to selectively capitalize on investment-grade and high yield bonds that offer good value. Our position is that the market will eventually reward quality corporate issuers by putting a floor under the price of their bonds. Once this happens, investors will see yields of about 6.5%, with the potential for capital gains on the bonds once the economy begins to recover. On a final point, historically, high yield bonds have outperformed stocks in the last 3 recessions and it is our view that this will happen this time as well.

CALL ONE OF OUR ADVISORS TO SEE

HOW WE CAN DETERMINE THE RIGHT

INVESTING STRATEGIES FOR YOU.

PHONE: 705.646.0480 • 800.376.2293

FAX: 705.646.0482

www.fcfcorp.ca