



FIRSTCAPITALFINANCIAL
WEALTH MANAGEMENT • RISK MANAGEMENT



T H E

First Capital Financial

Q U A R T E R L Y

September 30 • 2010

R E P O R T

Economic Environment

Investors remain concerned about the economic outlook, and rightfully so from a macro perspective, the US economy is struggling to keep its head above water. Consumer, business and investor confidence are poor, retail sales are sluggish, credit formation is weak, unemployment remains stubbornly high and the housing market remains depressed. This reality is echoed around much of the developed world, though Canada's economy has performed better on a relative basis, underpinned by a solid banking system and strong demand for commodities from the developing world.

Continued weakness coupled with the withdrawal of stimulus money from the economy, suggests that a double-dip recession is more likely than not. It is this big picture macroclimate, not company specific micro news (much of which has been quite good on balance) that has driven markets this year. Our view is that whether the developed world slides back into recession or not, it will feel like we have, as economic growth will remain muted for some time yet. This position is supported by the over-hang of consumer debt, accumulated over the last 10 years. Restoring consumers balance sheet through debt reduction and higher savings will ultimately be beneficial for developed economies, though will extend the period of time the economy takes to recover.

Interest rates and inflation remain low by historical long-term averages, though some rate tightening has occurred in the last quarter (notably in Canada, which saw two 25 basis point rate hikes over this time period). With growth so sluggish, the consensus of opinion is that central banks will keep rates more or less where they are now, to encourage capital expansion -central to economic expansion. The silver lining in the cloud continues to be the balance sheets of corporations, which are holding record amounts of cash. The hope is that the deployment of this moneys in the form of share buy-backs, increased dividends and mergers and acquisitions (such as BHP Billiton \$45 billion bid for Potash Corporation) will stimulate the economy and drive up share prices.

In summary, an improving economy requires greater consumer confidence, however greater consumer confidence first requires an improving economy. This dilemma is at the center of the current economic situation. Time is the great equalizer and over time the economy will right itself. Additional government borrowing to try to offset sluggish retail sales will prove to be largely ineffective in the near term and certainly negative in the long term (higher taxes and reduced government programs will be the result). With the economy expected to grind along slowly, we remain committed to our defensive portfolio allocations. Yield is key to investors generating positive returns in the slow-growth environment we are currently in and likely to remain in for the balance of the year and into 2011. Government, corporate and high yield bonds, together with dividend paying common and preferred shares and income trusts offers investors a balance of capital protection and yield, both of which are beneficial to investors while they wait for better economic times down the road.

Canadian Equity Funds

Year-to-date Canadian Equities have traded above and below par, as investors buy and sell based on better or worse than expected economic data. The demand for commodities remains strong, as developing markets continue their frenetic economic transformation. This demand explains the relative out-performance of the Canadian economy from the US and much of Europe, however, Canada's economy is far too integrated with the US to avoid being negatively affected by America's long hard road to recovery. This weighs on the outlook for stock prices of Canadian companies, keeping the TSX Composite range-bound for some time to come. As an aside, gold notably, set a record level in the 3rd quarter, though much of this can be explained by the continued weakness of the US dollar. Should things look better sooner than later in the United States, prices are expected to drop sharply.

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

Global Equity Funds

International markets too have largely mirrored our TSX Composite, with exchanges trading above or below their starting levels at the beginning of 2010. With the economic outlook muted, the expectation is that stock prices will remain subdued for the balance of the year. Further, investor apprehension about the prospect of deflation, has contributed to keeping equity prices down. Though just one measure, the Rule of 20 (20 minus current inflation of 2%) suggests that markets should theoretically be trading at 18 times earnings, or roughly 30% higher than current levels. Historically, when stocks are below trend, future returns have been strong. However, there have been periods of underperformance by equities, such as the 1930s and 1970s. Economists point to specific and protracted economic problems including deflation in the 1930s, inflation in the 1970s and subpar economic growth for both those decades as the reason for this. Comparisons have been made to the present, where years of slow growth are expected. Then as now, stock markets will likely underperform, making the case for building portfolios emphasizing yield and capital preservation.

Fixed Income Funds

International markets too have largely mirrored our TSX Composite, with exchanges trading above or below their starting levels at the beginning of 2010. With the economic outlook muted, the expectation is that stock prices will remain subdued for the balance of the year. Further, investor apprehension about the prospect of deflation, has contributed to keeping equity prices down. Though just one measure, the Rule of 20 (20 minus current inflation of 2%) suggests that markets should theoretically be trading at 18 times earnings, or roughly 30% higher than current levels. Historically, when stocks are below trend, future returns have been strong. However, there have been periods of underperformance by equities, such as the 1930s and 1970s. Economists point to specific and protracted economic problems including deflation in the 1930s, inflation in the 1970s and subpar economic growth for both those decades as the reason for this. Comparisons have been made to the present, where years of slow growth are expected. Then as now, stock markets will likely underperform, making the case for building portfolios emphasizing yield and capital preservation while serving to protect investment capital.