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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 3<sup>rd</sup> fiscal quarter is ending on a decidedly negative tone –both in terms of global equity markets and the global economy. The macro picture, characterized by high levels of consumer and government debt, stagnant growth and record unemployment, have resulted in a deterioration of consumer and business confidence and a significant drop in stock markets around the world. China and Germany –the number one and two export leaders have seen a drop in their numbers, affecting commodity prices which rely on robust growth in both countries for higher prices.

The acknowledgement by Federal Reserve Chairman Ben Bernanke that the Fed has a limited range of options remaining for stimulating the economy, has weighed heavily on investors who were looking for additional re-assurance going forward. We find this reaction by investors to be curious, given that entrenched debt levels are already known; as too is that the consumer represents approximately two-thirds of all spending in the economy. With households and governments stretched, it is hardly surprising that demand will remain muted for some considerable time, and in turn, range-bound corporate profits. Markets are normally leading indicators, but here they are reacting, belatedly, to information that is well known to both retail and institutional investors. Beyond the lowering by Central Banks, of short and medium term borrowing costs –which have only a limited effect on the balance sheets of consumers and government (the cost of carrying the debt is made more manageable, but the outstanding balances still remain), and keeping inflation in check, a return to more prosperous times will result only from a slow, plodding return to relative normalcy as structural and intrinsic problems are amortized over time.

Our overall outlook has shifted short term, from tentative optimism to a more neutral stance. Markets are inherently psychological institutions, meaning that if investor confidence is shaky, so too will be stock prices. At the same time, the raft of bad news has already been reflected in a sharp drop in equities, meaning that stocks are more likely to be priced to the current mindset of investors. With every drop in the market, the downside risk declines accordingly. There is some comfort to this, though it takes some degree of sober thought to accept. In other words, if the economic outlook is poor, then a fall in the markets in reaction to this is a good thing, in that they don't have to fall again to specifically price in that particular bit of bad news. Further, there are positives in the big picture, including a slight improvement in consumer's debt picture and the commitment by governments (ostensibly) to fiscal restraint. The bank balance of companies remains very strong, with fortress levels of cash ring-fencing their balance sheets. This capital will at some point be deployed (share buy-backs, mergers and acquisitions and higher dividend yields) and in doing so, positively impact the economy. In the final analysis, at times like these, investors are reminded that at any point in history, there exist both positive and negative economic factors at work, and that the saw-off between the two is an accepted part of the equity experience. It is our view that the world economy and world stock markets will likely remain range-bound for some time, with greater volatility than investors would prefer. That said, as has been the case over the long term, ultimately the economy corrects its excesses and returns to growth through innovation, productivity gains and capital investments. Market will positively trend with this return to better times. In the meantime, investors vigilance should remain, though be tempered through a fundamental understanding of the larger historical picture which offers a more optimistic track record to re-assure investors.

# Canadian Equity Funds

Canada's TSX Composite has fallen further since June 30<sup>th</sup>, pushing the index officially into Bear territory. Resource and financial stocks which had held up relatively well to the mid-point of the year, are being affected by the overall market malaise and an unexpected drop in orders for raw materials from China. Both coal (a key ingredient in Steel making) and copper (considered a strong indicator of global market activity given its pervasive use) are down more than 10% from in the past month alone. At current levels, the TSX Composite Index is trading at roughly 13 times Price/Earnings, a modest level by historical standards, but could be seen as high when looking at the economic outlook in the near term. Our view is that Canadian equities, both dividend paying and those that predicate their business model on the continuing growth in the emerging markets, represent an important component of a well-diversified portfolio, which seeks both income and growth over time. Finally, while the mood currently is certainly somber, it is our position that there represents growth opportunities, where fund managers capitalize on overly negative market sentiment, creating buying opportunities for Value managers to capitalize on attractive share valuations. Final word: Canadian stocks may yet trade lower into the next quarter or two, but looking out beyond this time frame, our outlook is more positive. The world economy has real issues, but the story of the industrial and technological transformation of emerging markets has certainly not run its course. Few countries are as well positioned as Canada (Australia maybe) to profit from the development there, and it is for this reason that we remain focused on the medium to longer term and remain committed to Canadian equities for investors.

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## Global Equity Funds

Stock markets in both developed and developing countries sold off sharply (most notably in Europe), in reaction to a raft of gloomy economic developments. The inability of the European Central Bank and Germany and France, to resolve the debt problems of Greece, has raised the spectra of contagion spreading to larger EU countries including Italy (a top-10 global economy).

A US housing market that struggles to find traction, coupled with record levels of unemployment have sent global markets down 10%-25% year-to-date. While the balance sheets of corporations remain very strong, the 3<sup>rd</sup> fiscal quarter downturn has priced in a less favourable outlook going forward. As with TSX listed companies, valuations remain attractive by historical standards, yet investors are bearish nearer term, as they price companies based on a negative shorter-term bias. To counter this bias, we asset the position that while stocks are out of favor presently, they have an excellent track record longer term, and have been the primary driver of growth in investor's portfolios. It is difficult sometimes to look beyond the headlines of today, though to do so is to ignore the big picture. That is: holding shares in dividend paying global multinational companies at the vanguard of their industry, has enabled investors to profit from the growth of the global economy and the corporations that dominate it.

## Fixed Income Funds

Bonds, both government and corporate, have continued to perform well, even benefitting from market declines in Q3, as investors flee stocks and rush to the short term safety of interest-bearing investments. This has bid up the prices for quality debt issues (though yields have fallen commensurately) and investors have enjoyed a modest capital gain on the par value of their bond holdings. With Central Banks committed to holding rates steady for the next 2 years, bondholders can expect steady, predictable interest returns with low volatility relative to their equity counterparts. Mid-year the expectation was for higher rates and therefore the need to reduce interest rate sensitive bond exposure, including Real Return bonds. This has changed with the Q3 announcement that rates will remain level and the decision by the US Federal Reserve to purchase longer-term government debt, in an effort to lower longer-term interest rates. Corporate Bonds remain a preferred asset class within portfolios, where yields are higher than government bonds, and the default risk is low, given the healthy balance sheets of corporate issuers. As said before, bonds serve to protect capital while delivering methodical returns to investors monthly and year-over-year. Further, there is an important psychological component to bonds, where their stability lowers overall portfolio volatility, giving investors peace of mind. Finally, were investors may need income from their portfolio, bonds offer an attractive place to either structure a monthly income or withdraw lump sums periodically, knowing that they are accessing an asset class that has grown over the year (in contrast to cannibalizing equities which are down). This makes the case for the continued over-weight position in bonds, and we maintain our positive outlook through Q4 and into 2012.