Second Quarter 2014 – "Texas Tea Time"

Iraq Turmoil, Strong Growth and Peak Driving Season Push Oil Prices Higher

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Energy Keeps Shining Thanks to Iraq Turmoil; The ECB Hits the Lower Bound on Rates

- The S&P/TSX Composite Total Return Index gained 6.4% during the 2nd quarter of 2014.

- The most cyclical sectors, Energy and Industrials, led the TSX Composite Index in the quarter while the Health Care, Telecom, Utilities, Consumer Staples, Financials, Consumer Discretionary, IT and Materials sectors trailed.

- Adding to a strong Q1, oil prices reached the highest level in 9 months and gasoline prices hit a 6 year high due to turmoil in Iraq that saw an oil refinery and most of central Iraq's oil reserves fall into the hands of the radical group ISIL (Islamic State in Iraq and the Levant). It is estimated that Iraq's oil production has fallen by over 500,000 bbls/d of oil since ISIL captured much of central Iraq. The possibility of U.S. intervention via air support benefitted gold prices and hurt the U.S. dollar in the month of June. Continuing conflict in eastern Ukraine also added to worries about global energy security. With gasoline prices already at a 6 year high, further price escalation could slow economic growth and stymy the recovery.

- Global economic activity, as measured by the JP Morgan Global All-Industry Purchasing Manager's Index (PMI), hit its highest level in over three years. Growth divergences between the developed world and emerging markets widened to its largest gap ever. The UK saw its strongest rate of growth in the 16 years of available survey data. U.S. economic activity hit a cycle high and the Eurozone also improved from last quarter. Though worry about the Chinese economy was the story of Q1, Chinese growth returned with both the official PMI and HSBC PMI revealing economic expansion in Q2. The Indian economy showed improvement following the election of business-friendly Narendra Modi while Russia and Brazil fell back into contraction territory.

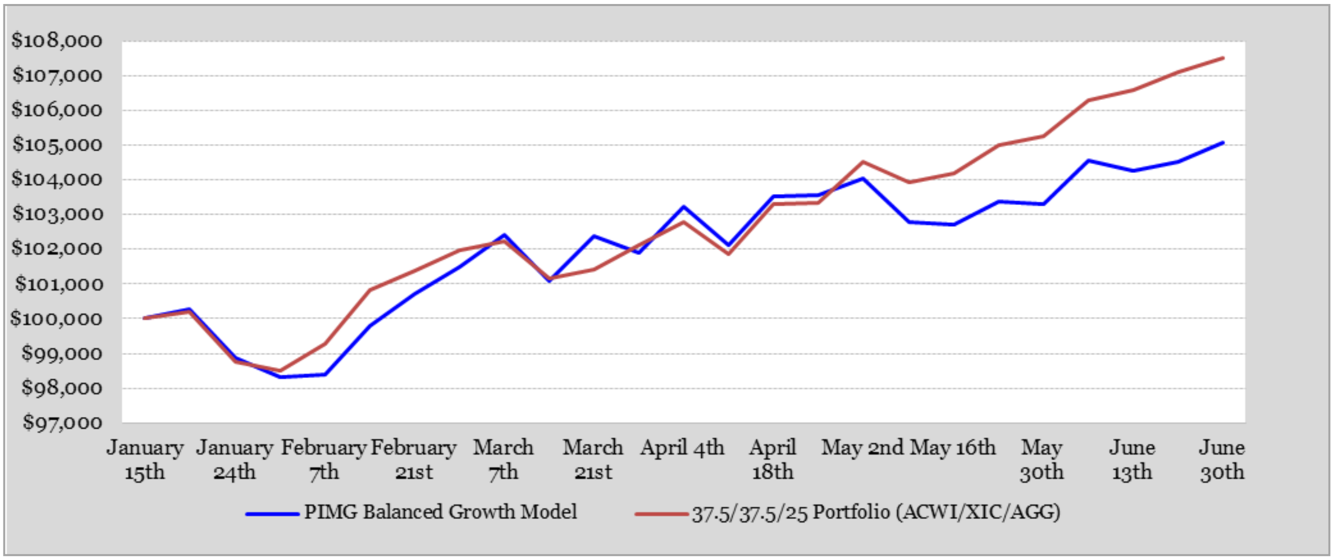
- In early June, following several months of low inflation data, the European Central Bank (ECB) took action by lowering its main interest rate to 0.15% and its deposit rate to -0.1%. ECB President Draghi stated that the ECB has reached its lower bound on rates and that other measures (possibly American- or Japanese-style quantitative easing) will likely follow, if needed. Initiating such a program would face considerable resistance as it would likely involve purchasing and monetizing the debt of European countries that were very recently in critical condition, something that German, British and Scandinavian politicians fought against at the height of the European debt crisis in 2011-2012.

- The U.S. Federal Reserve (Fed) continued to taper its bond purchases to $35 billion annually from $55 billion at the end of Q1. With inflation at ~2% (at least temporarily due to rising energy prices), U.S. economic activity at a cycle high and M&A activity at a 7 year high as at the end of Q2, it is likely that the Fed will continue to taper its bond purchases.

- The Canadian equity market outperformed most peers in Q2 as it did in Q1 as the energy sector continued to rally on the back of rising energy prices and as the frothy health care and technology sectors, to which Canada has little exposure, finally underperformed the broad market following an incredible multiyear run.

Benchmark of iShares XIC/ACWI/AGG (37.5%/37.5%/25%)
vs
The PIMG Balanced Growth (BG) Model

January 15th, 2014 (Inception of BG Model) to June 30th, 2014



01/15/2014 – 06/30/2014	PIMG Balanced Growth Model	iShares XIC	iShares ACWI	iShares AGG	37.5% XIC / 37.5% ACWI / 25% AGG
Cumulative Return Since Inception	5.07%	11.37%	6.48%	3.26%	7.52%
Compound Annual Return	Insufficient Data – Minimum of 1 year required				
Standard Deviation					
Sharpe Ratio					
Largest Monthly Gain	3.22%	4.05%	5.20%	1.18%	3.53%
Largest Monthly Loss	-1.68%	-0.46%	-4.23%	-0.15%	-1.50%
Number of Up Months	4	4	5	5	5
Number of Down Months	2	2	1	1	1
Correlation with Balanced Growth	--	0.78	0.77	-0.57	0.83

We have assumed a 1% performance fee when calculating the returns for our PIMG models. To the best of our knowledge, the ETFs used as benchmarks track the indices they represent though material tracking error and misrepresentation can occur which is beyond our control. The 37.5% XIC / 37.5% ACWI / 25% AGG index is an index consisting of 37.5% iShares XIC (S&P/TSX Compositie Index ETF), 37.5% of iShares ACWI (All-Country World Index ETF) and 25% iShares AGG (Barclays Aggregate Bond Fund). Volatility and correlation data are calculated from weekly returns. For the purpose of calculating Sharpe ratios, a risk-free rate of 3% is assumed. All returns presented for the PIMG Models and the ETFs used for comparison are in Canadian dollars. Data used to calculate returns are derived from Market-Q (for ETFs) and Dataphile (for the Models). All returns presented are "total returns", meaning they include all dividend payments & interest payments.

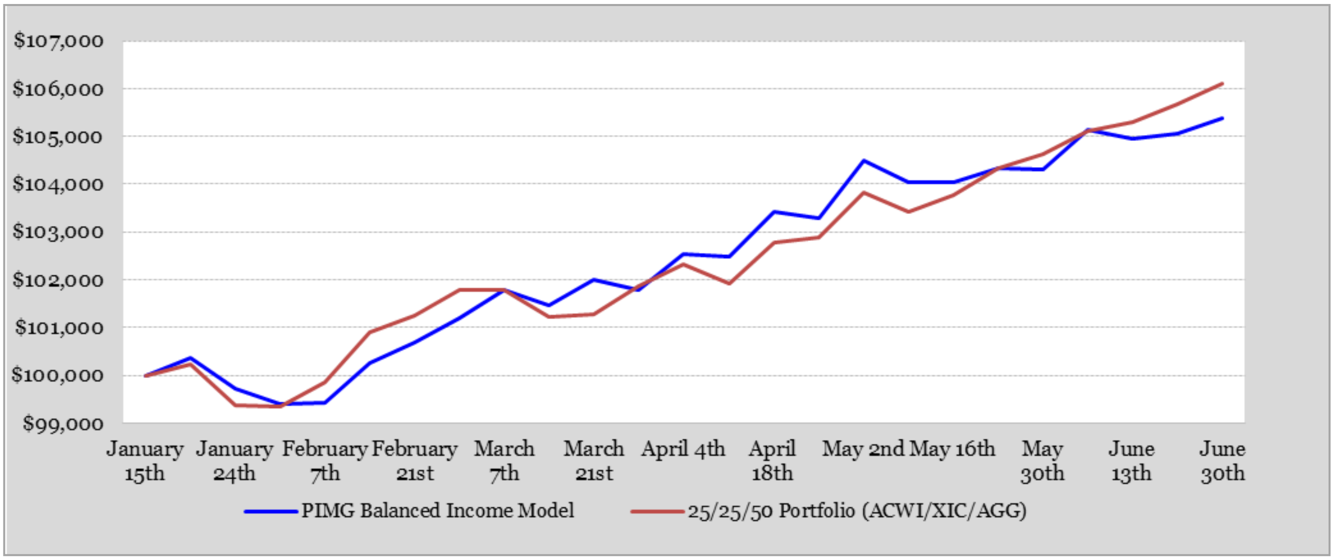
On January 15th, 2014, we materially changed the strategy and holdings of the Tactical Taxable (now Balanced Growth) model. As a result, past performance and benchmark data is not meaningful to the model as it currently stands. The data above are for the January 15th, 2014 to June 30th, 2014 period.

Benchmark of iShares XIC/ACWI/AGG (25%/25%/50%)

vs

The PIMG Balanced Income (BI) Model

January 15th, 2014 (Inception of BI Model) to June 30th, 2014



01/15/2014 – 06/30/2014	PIMG Balanced Income Model	iShares XIC	iShares ACWI	iShares AGG	25% XIC / 25% ACWI / 50% AGG
Cumulative Return Since Inception	5.39%	11.37%	6.48%	3.26%	6.10%
Compound Annual Return	Insufficient Data – Minimum of 1 year required				
Standard Deviation					
Sharpe Ratio					
Largest Monthly Gain	1.83%	4.05%	5.20%	1.18%	2.48%
Largest Monthly Loss	-0.61%	-0.46%	-4.23%	-0.15%	-0.65%
Number of Up Months	5	4	4	5	5
Number of Down Months	1	2	2	1	1
Correlation with Balanced Income	--	0.77	0.68	-0.40	0.75

We have assumed a 1% performance fee when calculating the returns for our PIMG models. To the best of our knowledge, the ETFs used as benchmarks track the indices they represent though material tracking error and misrepresentation can occur which is beyond our control. The 25% XIC / 25% ACWI / 50% AGG index is an index consisting of 25% iShares XIC (S&P/TSX Compositie Index ETF), 25% of iShares ACWI (All-Country World Index ETF) and 50% iShares AGG (Barclays Aggregate Bond Fund). Volatility and correlation data are calculated from weekly returns. For the purpose of calculating Sharpe ratios, a risk-free rate of 3% is assumed. All returns presented for the PIMG Models and the ETFs used for comparison are in Canadian dollars. Data used to calculate returns are derived from Market-Q (for ETFs) and Dataphile (for the Models). All returns presented are "total returns", meaning they include all dividend payments & interest payments.

On January 15th, 2014, we materially changed the strategy and holdings of the Tactical Registered (now Balanced Income) model. As a result, past performance and benchmark data is not meaningful to the model as it currently stands. The data above are for the January 15th, 2014 to June 30th, 2014 period.

PIMG Balanced Growth Model

Gained 2.98% during the quarter (from March 31st to June 30th)

The model's asset allocation as at June 30th was 0.6% cash, 9.8% bonds, 5.0% convertible debentures, 9.7% preferred equity, 4.6% alternatives and 70.3% common equity.

Top five outperformers in Q2 were:
- Legacy Oil + Gas (Energy/Light Oil) at +17.06%
- Saputo (Consumer Staples/Dairy) at +14.80%
- iShares U.S. Utilities Index ETF (ETF/Utilities Sector) at +12.04%
- Baytex Energy (Energy/Diversified Oil, Non-Oil Sands) at +8.49%
- Sysco Corp (Consumer Staples/Distribution) at +8.28%

Top five underperformers in Q2 were:
- AMC Networks (Consumer Discretionary/Media) at -12.84%
- Agrium (Materials/Fertilizers) at -8.49%
- Consolidated Water (Utilities/Desalination) at -6.90%
- Sandvine (Technology/Network Hardware) at -6.84%
- Rogers Communications (Telecom/Diversified) at -5.27%

During Q2, we bought:

- iShares U.S. Utilities ETF (IDU): We bought a position in iShares IDU at the start of the seasonally strong period for the U.S. Utilities sector. The Utilities sector had seen lacklustre year-to-date performance despite the strong rally in long-term bonds. We expect to hold this position until October, when the seasonally strong period ends.

- iShares U.S. Healthcare ETF (IYH): We bought a position in iShares IYH at the start of the seasonally strong period for the U.S. Healthcare sector. The large cap non-biotech Healthcare sector has lagged the broad market and was due to play catch-up. iShares IYH has limited exposure to pure-play biotech stocks that currently are richly priced.

- AGF Floating Rate Income Fund (AGF4076): We added to our position in AGF FRIF to earn a higher rate of return on some excess cash. We view the floating rate loan sector as being more attractive now following the strong rally in corporate credit since the beginning of the year.

- Sandvine Corp (SVC): We purchased a position in Sandvine following a strong quarterly report that showed a sharp acceleration in Sandvine's revenues and earnings. Though we expect this revenue growth to moderate over time, we believe Sandvine has reached a breakout point, both on fundamental and technical bases. The recent ruling against net neutrality in favour of Sandvine's business will force telecom companies to invest more into Sandvine's products and software in order to remain competitive. At the time of purchase, Sandvine traded at ~18x normalized earnings (ex-cash) and ~14x ex-cash when annualizing last quarter's earnings. This is a very low multiple for a tech company with an above average growth rate.

- Baytex Energy (BTE): We purchased a full position in Baytex following Baytex's acquisition of Aurora Oil and Gas with the proceeds of sale from Legacy Oil + Gas. The acquisition provides Baytex with another low-cost oil play whose drilling costs are fairly uncorrelated to their current plays, lowering Baytex's business risk and increasing its return potential. Baytex is one of Canada's lowest cost oil producers which should result in a low correlation to oil prices relative to peers. Baytex's high dividend yield of 6.4% pays investors while they wait for production to grow meaningfully.

- Performance Sports Group (PSG) formerly Bauer Performance Sports (BAU): We purchased a position in Performance Sports following its acquisition of Easton-Bell's baseball and softball segment. The deal diversifies PSG away from Hockey and Lacrosse, and provides it with a more stable earnings profile throughout the year. PSG trades at 17.5x trailing pro forma earnings and has a low debt-to-market cap ratio of 0.22. We see this valuation as being very low for a company with strong brand value (#1 in hockey, #1 in baseball, #2 in lacrosse) and a company with plenty of growth potential through geographic expansion (e.g. Europe, South America) and segment diversification (e.g. soccer, football).

<u>During Q2, we sold:</u>

- iShares Russell 2000 ETF (IWM): We sold our position in iShares IWM at the first sign of weakness in the U.S. small-cap market. As many of IWM's holdings are richly valued biotech and internet and technology stocks, our plan had always been to capture the gains while the getting was good and to run at the first sign of underperformance relative to the broad U.S. equity market.

- SNC-Lavalin (SNC): We sold our position in SNC following two consecutive earnings misses. Having sold the bulk of its assets, we saw limited upside going forward. We expect the company's legal and ethical issues to prevent the company from trading at a premium to peers as it had in the past.

- Legacy Oil + Gas (LEG): We sold our position in Legacy Oil + Gas to reduce portfolio risk and its exposure to oil prices. We initially purchased Legacy when it was trading at a 50% discount to our Raymond James analyst's 2P NAV but at the time of sale, it traded at a 4% premium to 2P NAV. With the discount gone and a so-so operational track record, we do not think Legacy will see much more upside unless we see further oil price gains.

- Intact Financial Corp (IFC): We sold our position in Intact as its valuation has become rich at a ~14x trailing P/E (versus 11.5x when we first purchased it). At this valuation, we do not believe the shares properly reflect the increasingly competitive landscape following Travelers' purchase of Dominion of Canada General Insurance in late 2013 and TD's increased focus on its property and casualty insurance business.

<u>PIMG Balanced Income Model</u>

Gained 3.44% during the quarter (from March 31st to June 30th)

The model's asset allocation as at June 30th was 1.1% cash, 19.7% bonds, 11.9% convertible debentures, 16.7% preferred equity, 4.6% alternatives and 46% common equity.

Top five outperformers in Q2 were:
- Crescent Point Energy (Energy/Light Oil) at +18.91%
- Saputo (Consumer Staples/Dairy) at +14.80%
- iShares JPMorgan USD Emerging Market Bond ETF (ETF/EM Debt) at +8.42%
- Toronto-Dominion Bank (Banks/Diversified) at +6.89%
- Intact Financial (Insurance/Property and Casualty) at +6.74%

Top five underperformers in Q2 were:
- Agrium (Materials/Fertilizers) at -8.49%
- North West Company (Consumer Discretionary/Retail) at -2.37%
- Calloway Debenture B (REITs/Retail) at +0.17%
- iShares MSCI All-Country Low Vol Index ETF (ETF/World) at +1.06%
- Loblaw Preferred A (Consumer Staples/Grocery) at +1.13%

<u>During Q2, we bought:</u>

- AGF Floating Rate Income Fund (AGF4076): Same reasoning as the Balanced Growth Model.

- Calloway REIT Debenture B (CWT.DB.B): We purchased a position in Calloway REIT Debenture B when it was trading at a yield-to-maturity of 2% and 5.6% in-the-money, providing it with a yield-to-conversion of 3.6%. We believe Calloway is a prime takeover candidate, given its strong property portfolio consisting primarily of Wal-Mart anchored supercenters, its industry leading occupancy rate at 99%, and the lowest average property age of 10.8 years. This debenture provides a steady, reliable income while providing most of the upside of the stock through its conversion privilege and in-the-money status.

- Great-West Lifeco (GWO): We purchased a position in Great-West when it was trading at 12.5x trailing earnings and yielding 4.1%. GWO's earnings have grown at a low single digit rate for quite some time and its shares have lagged those of its more cyclical peers over the past 18 months or so. We believe investors will once again come to appreciate GWO's more stable earnings profile when its peers' earnings are no longer helped by rising interest rates and equity markets.

<u>During Q2, we sold:</u>

- Loblaw Preferred A (L.PR.A): We sold our position in Loblaw Preferred A after it had fallen to a yield-to-retraction below that of the going money market rate of return. There was no reason to hold a security that experiences price volatility when a superior return could be achieved by buying a lower risk and non-volatile security.

- Intact Financial Corp (IFC): Same reasoning as the Balanced Growth Model.

Going Forward:

With the broad equity market posting above average returns for the first six months of 2014, the models, which are built to provide superior returns over entire market cycles, have underperformed. We would expect the models to outperform in most flat, mildly positive and down markets due to their value tilt and avoidance of highly cyclical and volatile stocks. We believe this strategy will pay off sooner rather than later with the S&P/TSX's and S&P 500's trailing P/E multiples now at cycle highs of 21x and 18x, respectively. Outside of market bubbles, market valuations have rarely been higher than they are today. Unless we see above average corporate earnings growth in the near term, which doesn't seem likely considering the negative trend in corporate earnings and the threat of rising energy prices, it is unlikely that stocks will continue to rise at the pace of the last 18 months. The year-to-date rally in both equities and fixed income may signal a stimulus driven market, not one based on fundamentals, and one that is ripe for decline.

We remain skeptical of the market advance and grow increasingly curious about the potential efficacy and effects of monetary stimulus (e.g. the Fed's bond buying program, the ECB's rate cuts and potential bond buying program) five years into the so-called recovery. If major central banks continue to stimulate the major economies 5+ years into the recovery, even as global economic activity reaches a cycle high and is at all-time highs in select countries, what ammunition will remain when the global economy enters an inevitable recession? Will faith in the central banks' ability to engineer economic growth and avoid financial calamity be lost during the next recession? The answers to these questions will present themselves in the coming months and we will adjust the portfolios accordingly.

The models benefitted from above average exposure to the Industrials sector and fell short due to below average exposure to the Energy sector. Though we note energy security as a risk to the equity market advance, we do not think the threat is enough to take a larger position in the Energy sector. Iraq's oil flow is mostly unfettered by the ISIL conflict. The risk of much higher oil prices is low as predictably rising North American production will replace much of the lost production in no time.

Our worries are reflected in how we have constructed and maintain our models. We believe holding high income securities, whether they be common equities, preferred shares or bonds, is important for achieving superior long-term returns. This is especially true in times of above average market valuations. We currently favour the Consumer Staples sector as well as select holdings in the Consumer Discretionary and Industrials sectors.

As at the end of Q2, the models yield 2.8% (Balanced Growth) and 3.7% (Balanced Income) from 2.6% and 3.9% at the end of Q1, compared to the S&P/TSX Composite at a 2.7% dividend yield.

Sincerely,

Steele Wealth Management

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