RAYMOND JAMES

Steele Wealth Management

Second Quarter 2012 – "Standing on the Edge of a Cliff"

Europe Faces Confidence Cliff, U.S. Faces Budget Deficit Cliff, China Faces Growth Cliff

The Team:
Brian Steele, CA, CFA
Laura Prust, CPCA
Jeannine Campbell
Kelly Townsend
Matthew Bell, CFA

An Array of Uncertainties Send Risk Markets Reeling in Q2, Though Some Progress Made

- The S&P/TSX Composite Index lost 5.8% during the second quarter of 2012.

- The less cyclical and consumer facing sectors – Health Care, Consumer Staples, Telecom, Utilities, Industrials and Consumer Discretionary – outperformed the TSX Composite Index throughout the quarter.

- While the more cyclical and industry facing sectors – IT, Materials, Energy and Financials – underperformed the TSX Composite Index.

- The S&P 500's streak of outperformance finally came to an end in Q2. U.S. jobs and manufacturing data weakened with the manufacturing sector contracting for the first time since July 2009, raising the risk of a recession.

- Markets reacted unfavourably to the rise of an "anti-austerity" political party in Greece which vowed to cancel the European bailouts. Though this party did not win the election, the winning party promised to renegotiate the bailouts, raising doubt about the willingness of Northern creditor nations to offer bailouts to peripheral countries in future. Despite this uncertainty, Cyprus was able to procure a bailout and Spain secured a bailout of its banks with few conditions attached. At quarter end, Eurozone policymakers agreed to form what seems to be a banking union which may be the first step towards a fiscal and political union, supporting the Eurozone's longevity and the Euro currency.

- Inflation and inflation expectations continued to cool throughout the quarter providing more room for monetary easing by central banks. Several actions were taken throughout the quarter including an extension of Operation Twist on behalf of the U.S. Fed, interest and reserve requirement rate cuts in China and an interest rate cut to a historic low in Brazil. Subsequent to quarter end, the European Central Bank lowered its interest rate in hopes of spurring investment amidst a widespread European slowdown.

- <u>Cliff</u>. Confidence in the European Union and its politicians hit an all-time low in the quarter as bank runs in Greece and Spain put pressure on the banking system and had many market mavens calling for a breakup of the union. Despite a banking supervisory and joint bank recapitalization agreement near quarter end, markets continue to doubt policymakers' motives and their populaces' readiness to accept further integration.

- <u>After Cliff</u>. Worry about U.S. policymakers' willingness to compromise on how to cut the budget deficit is beginning to escalate as automatic cuts are set to begin in January 2013. The U.S. economy will contract substantially should Democrats and Republican fail to find a common ground and allow the automatic cuts to take place.

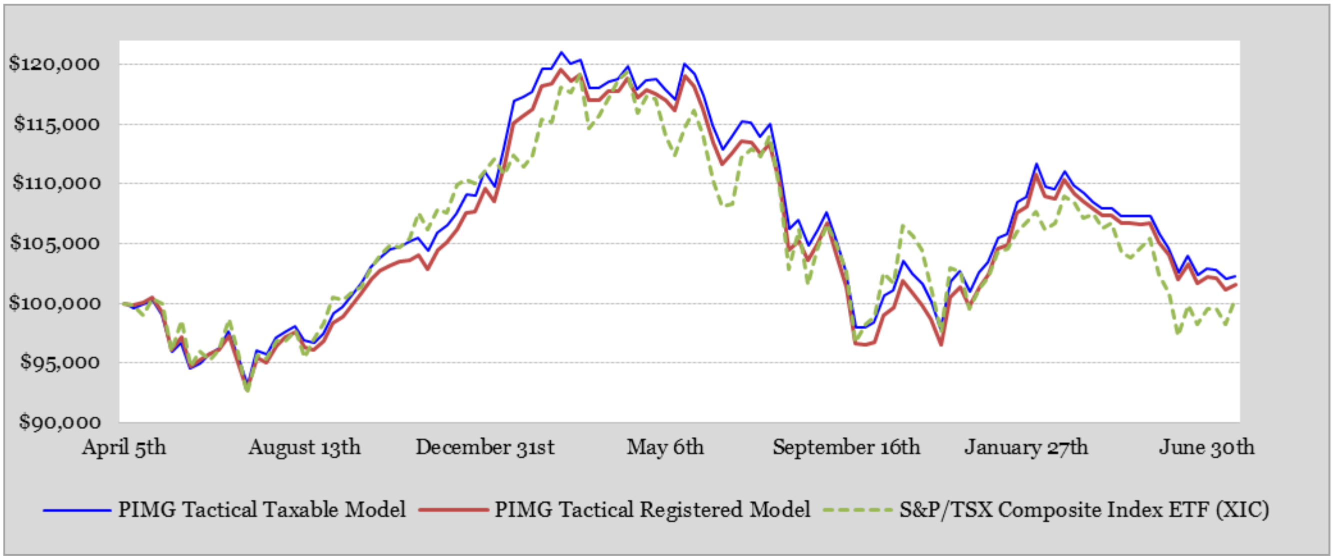
- <u>After Cliff</u>. The Chinese economy continues to slow and many worry that policymakers will be unable to prevent a sharp contraction in activity due to the investment-led and resource-heavy nature of growth seen in China previously. Many doubt that China's economy can continue to grow as it once did and fear an economic "hard-landing".

The S&P/TSX Composite Total Return Index

vs

The PIMG Tactical Taxable & Tactical Registered Models

April 5th, 2010 (Inception) to June 30th, 2012



	PIMG Tactical Taxable Model	PIMG Tactical Registered Model	S&P/TSX Composite Index ETF (XIC)
Cumulative Return Since Inception	2.28%	1.56%	0.50%
Compound Annual Return	1.01%	0.70%	0.22%
Standard Deviation	10.98%	11.00%	15.24%
Sharpe Ratio	-0.18	-0.21	-0.18
Largest Monthly Gain	7.87%	7.80%	6.48%
Largest Monthly Loss	-9.89%	-10.21%	-9.12%
Number of Up Months	12	12	12
Number of Down Months	15	15	15
Correlation with Tactical Taxable	--	0.99	0.85

We have assumed a 1% performance fee when calculating the returns for our PIMG models. To the best of our knowledge, the ETF used as benchmarks track the indices they represent though material tracking error and misrepresentation can occur which is beyond our control. Volatility and correlation data are calculated from weekly returns. For the purpose of calculating Sharpe ratios, a risk-free rate of 3% is assumed.

PIMG Tactical Taxable Model:

- Lost 5.34% during the quarter
- The model's asset allocation as at June 30th was 12.7% cash, 25.1% preferred equity and 62.2% common equity.

PIMG Tactical Registered Model:

- Lost 5.35% during the quarter
- The model's asset allocation as at June 30th was 13.7% cash, 5% convertible debentures, 19.5% preferred equity and 61.8% common equity.

The top five outperformers in this quarter were:

- BCE Inc. (Telecom/Diversified) at +6.47%
- Sun Life Financial (Financials/Life Insurance) at +2.54%
- Fairfax Financial Preferred "C" (Financials/Insurance) at +2.44%
- West Coast Energy Preferred "J" (Utilities/Natural Gas Distribution) at +2.27%
- Dundee Corp Preferred "B" (Financials/Diversified) at +1.77%

The top five underperformers were:

- Yellow Media Preferred "A" (Media/Advertising) at -68.33%
- Labrador Iron Mines (Materials/Iron Ore) at -45.97%
- Copper Mountain Mining (Materials/Copper & Gold) at -18.44%
- Canadian Natural Resources (Energy/Oil & Gas) at -17.08%
- Open Text (IT/Business Software) at -16.36%

During the quarter we bought:

- Saputo: We doubled our position in Saputo, following the extension of the Fed's Operation Twist and comments about the Fed's willingness to implement further stimulus if needed. Saputo appeared to trade at a discount to its Consumer Staples peers (Kraft, Maple Leaf Foods) at the time of purchase and we believe this discount is unwarranted.

- Copper Mountain Mining: We doubled our position in Copper Mountain following the extension of the Fed's Operation Twist and comments about the Fed's willingness to implement further stimulus if needed. As we were underweight "stimulus-sensitive" equities (i.e. Materials, Oil & Gas) we thought it was prudent to add to producers trading at low price-to-cash-flow multiples. Copper Mountain trades at a material discount to its larger copper producing peers and we believe this discount will narrow as the company ramps up production throughout the year.

- Legacy Oil + Gas: We purchased a full position in Legacy following the extension of the Fed's Operation Twist and comments about the Fed's willingness toward further stimulus if needed. As we were underweight "stimulus-sensitive" equities (i.e. Materials, Oil & Gas) we thought it was prudent to add to producers trading at low price-to-cash-flow multiples. Legacy trades at a ~50% discount (on a production, reserves and cash flow basis) to its large cap peer, Crescent Point Energy. We see no reason for this discount other than due to Crescent Point's hefty dividend and larger capitalization. We believe Legacy shares will appreciate to more closely reflect Crescent Point's valuation when market conditions improve.

- Telefonica SA: We purchased a partial position of Telefonica following a resolution in the Eurozone crisis which we believe will eventually lead to a banking union and lower the cost of capital for the peripheral Eurozone countries, particularly Italy and Spain. Telefonica should benefit from this resolution as it is heavily indebted and the risk of its bonds are tied to the risk of Spanish sovereign bonds. Telefonica has a 75% share of the Spanish telecom market as well as commanding positions in many other European and Latin American markets under the brand names O2, Movistar and Vivo.

- Sun Life Financial: We purchased a full position in Sun Life following the Eurozone crisis resolution which we believe will be long-lasting. The reduced credit risk in the Eurozone and global banking system should benefit all financial companies, especially those sensitive to equity markets and interest rates. The establishment of a European banking system would bring a great deal of stability to financial markets and should increase investors' confidence in Sun Life's dividend and buoy the stock as a result.

- SNC-Lavalin: We doubled our position in SNC following the Eurozone resolution. SNC should benefit from the pact made on behalf of world leaders at the most recent G20 meeting to further stimulate infrastructure spending.

- Finning International: We purchased a full position in Finning as it continues to trade at a discount to its most comparable peer, Toromont. We believe this discount is unwarranted considering that Finning is currently undergoing a turnaround in its inventory and sourcing management which should provide a material efficiency and earnings boost over time.

- Just Energy Debenture Maturing June 30th, 2017: We purchased a full position in the Just Energy Debenture in our Registered model following a selloff in the debenture for no company-specific reason and without a corresponding selloff in comparable high yield instruments. We believe the debenture offers a great yield for the risk taken and we expect it to trade up should the high yield bond and debenture markets remain strong.

<u>During the quarter we sold:</u>

- Sandvine Corp: We sold our position in Sandvine as the stock performed well (allowing us to sell our position) following a very poor earnings release. The poor quarter combined with the company's decision to buy back stock (which is strange, for a company with negative cash flow) do not give us confidence in management's ability to make the right financial and strategic decisions.

- Sun Life Financial: We sold our Sun Life position early in the quarter as economic and credit risk appeared to be rising. Sun Life stock had performed well and was susceptible to further weakening in the Eurozone economy and banking system.

Going Forward:

We started the quarter with a bearish outlook and this outlook was deepened as contraction in the Eurozone and China intensified and as Greece's political and Spain's debt woes amplified market risk. We raised our cash positions as high as 28% in the Taxable and 34% in the Registered models to protect against uncertainty and a lack of policymaking progress and direction. We began to aggressively deploy this cash after the extension of Operation Twist in the U.S. combined with Federal Reserve statements supporting further monetary easing as well as after the European banking supervisory and joint bank recapitalization agreement. The first interest rate cut in China since 2008 also supported buying commodity plays which have been in an 18 month downtrend.

Though there are still plenty of headwinds facing the global economy and the risk of a global recession is increasing, we believe the monetary easing process initiated by emerging market policymakers several months ago will support commodities and that commodity stocks are in the process of forming a bottom. We are encouraged by the progress made at the last European Union summit meeting and believe the agreements show policymakers' commitment to the Eurozone though we understand the agreements are a work-in-progress and negative news flow out of Europe may continue to hinder commodity stocks and stocks in general. That said, we believe the global monetary easing cycle is well underway and this will help equities find their footing over the coming months making it imprudent to continue carrying our sizable cash positions.

In the last commentary we stated that we would need to see improvement in U.S. data, a shift in Chinese policymaker tone towards the property market and European tolerance towards further monetization of debt. We feel that getting two out of three (interest rate cut in China and European bank agreement) was enough to push us towards deploying some cash. Our cash positions finished the quarter at ~13% and ~14% in the Taxable and Registered accounts, respectively, providing a small buffer against further uncertainty but not too ample so as to miss out on a future rally.

Our allocation strategy is further reinforced by the global push towards monetary easing. We continue to favour positions in the Materials, Energy, Telecom and Consumer Staples sectors. Financials are becoming more attractive should the European banking agreement reduce counterparty risk at both the sovereign and corporate level. We continue to favour buying stocks linked to emerging market growth over those linked to U.S. and/or European growth.

A substantial portfolio yield is important if one wants to outperform a benchmark. While being less than 90% invested, the models are on track to yield ~3.9% annually (vs. the TSX Composite at 2.6%). Though the economic and political landscape appears to be in disarray, we hope our contrarian approach of acquiring deep-value cyclical stocks will reward our PIMG clients over the upcoming quarter.

Sincerely,

Steele Wealth Management