RAYMOND JAMES

# Steele Wealth Management

## Third Quarter 2012 – "A Liquid Diet"

Central Bankers Prescribe Liquidity to an Ailing Economy as Politicians Fail to Act


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

**Central Bankers Look to Spark Economic Growth as Politicians Dither; Markets Recover**

- The S&P/TSX Composite Index gained 6.9% during the third quarter of 2012.

- The most cyclical sectors – Materials and Energy – outperformed the TSX Composite Index throughout the quarter.

- While the least cyclical sectors – Health Care, Utilities, Consumer Staples, Consumer Discretionary, Telecom, Industrials and Financials – underperformed the TSX Composite Index.

- Commodity and equity markets reacted favourably to the flood of prospective and tangible liquidity added to the system throughout the quarter. In September, the U.S. Federal Reserve initiated another round of monetary stimulus dubbed QE3 or QE-Infinity whereby it committed to buying $40 billion in mortgage-backed securities every month until U.S. employment improved substantially and vowed to keep this stance until this improvement is well established, so long as prices remain stable. Chinese central bankers cut the key interest rate in July and proposed ~$157 billion in infrastructure spending and injected $58 billion into its money markets in September. The European Central Bank (ECB) proposed buying an unlimited amount of sovereign bonds dubbed the Outright Monetary Transactions (OMT) program whereby sovereign nations commit to austerity measures set by the ECB and the ECB will buy their sovereign bonds in the open market.

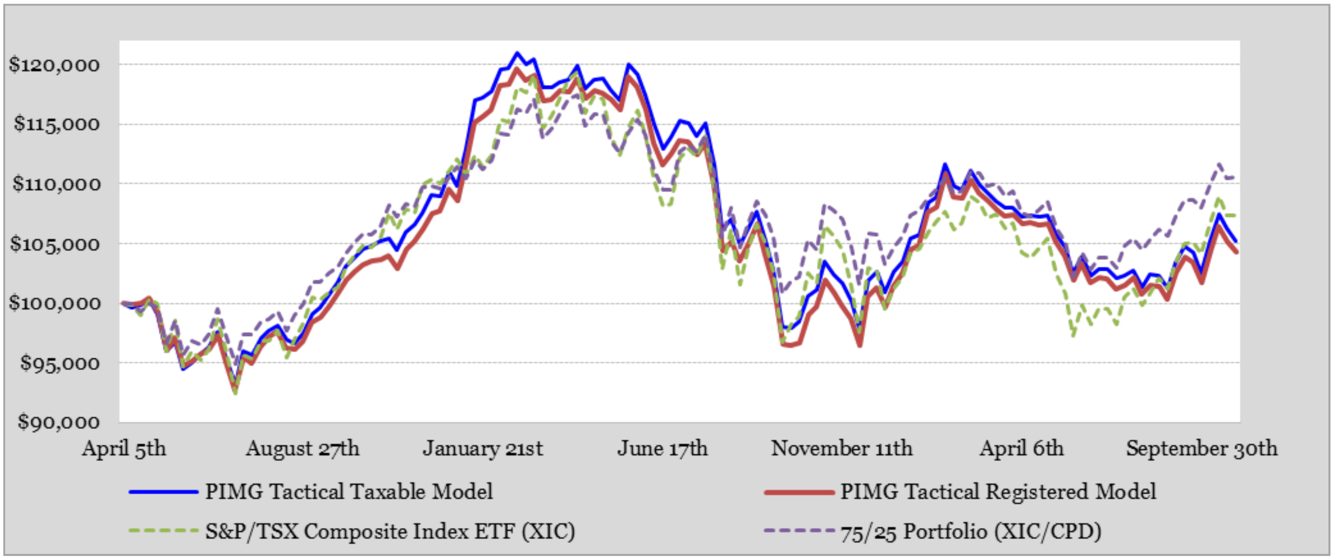
- Inflation expectations rose slightly on the back of the aforementioned stimulus measures but remain subdued as the looming U.S. fiscal cliff (January 2013), stagnating growth in China and an approaching Eurozone recession combined with little progress in forming a Eurozone banking union suggests a fragile global economy.

- Despite plenty of liquidity, all of the "cliffs" are still present: <u>The European Policy Cliff</u> is still outstanding as policymakers have made no major compromises as of yet, leaving Spain and Italy with high debt servicing costs; <u>The U.S Fiscal Cliff</u> is outstanding as there has been little in terms of progress/news as politicians appear to be waiting for the results of the November presidential election before committing to serious discussions, leaving little time to make the necessary agreements before automatic tax hikes and spending cuts take place in January 2013, and; <u>The Chinese Growth Cliff</u> is still outstanding as monetary and fiscal stimulus has failed to boost economic activity thus far and as Chinese policymakers remain committed to reigning in the Chinese real estate market thereby limiting their stimulative options.

- Though commodities have spiked in response to monetary stimulus, end market demand for most commodities, particularly the base metals, looks exceptionally weak. Chinese policymakers' unwillingness to stimulate their economy in a "shock and awe" fashion is limiting demand in China and abroad. Should the commodity supercycle be over, commodity importers (the U.S., the Eurozone, etc.) should do well while the commodity exporters (Canada, Australia, etc.) will notice a gradual downshift in their economies. Importer equity markets are already beginning to outperform exporter equity markets.

# The S&P/TSX Composite Total Return Index
# vs
# The PIMG Tactical Taxable & Tactical Registered Models

*April 5$^{th}$, 2010 (Inception) to September 30$^{th}$, 2012*




| | PIMG Tactical Taxable Model | PIMG Tactical Registered Model | S&P/TSX Composite Index ETF (XIC) | 75% XIC / 25% CPD |
|---|---|---|---|---|
| Cumulative Return Since Inception | 5.26% | 4.32% | 7.38% | 10.61% |
| Compound Annual Return | 2.08% | 1.71% | 2.91% | 4.14% |
| Standard Deviation | 10.92% | 10.92% | 14.81% | 11.27% |
| Sharpe Ratio | -0.08 | -0.12 | -0.01 | 0.10 |
| Largest Monthly Gain | 7.87% | 7.80% | 6.48% | 10.63% |
| Largest Monthly Loss | -9.89% | -10.21% | -9.12% | -8.01% |
| Number of Up Months | 14 | 14 | 15 | 18 |
| Number of Down Months | 16 | 16 | 15 | 12 |
| Correlation with Tactical Taxable | -- | 0.99 | 0.86 | 0.86 |

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 75% XIC / 25% CPD index is an index consisting of 75% iShares XIC (S&P/TSX Compositie Index ETF) and 25% iShares CPD (S&P/TSX Preferred Share Index ETF). 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, etc.

<u>PIMG Tactical Taxable Model:</u>

- Gained 2.98% during the quarter
- The model's asset allocation as at September 30th was 9.2% cash, 29.7% preferred equity and 61.1% common equity.

<u>PIMG Tactical Registered Model:</u>

- Gained 2.62% during the quarter
- The model's asset allocation as at September 30th was 10.1% cash, 4.6% convertible debentures, 24.3% preferred equity and 61.0% common equity.

<u>The top five outperformers in this quarter were:</u>

- Eldorado Gold (Materials/Gold) at +20.02%
- Legacy Oil+Gas (Energy/Oil & Gas) at +19.57%
- iShares S&P/TSX Capped Materials Index ETF (Materials/Diversified) at +13.13%
- Canadian Natural Resources (Energy/Oil & Gas) at +11.44%
- Suncor Energy (Energy/Oil & Gas) at +10.29%

<u>The top five underperformers were:</u>

- Labrador Iron Mines (Materials/Iron Ore) at -26.59%
- TransAlta Corp (Utilities/Diversified) at -11.04%
- Teck Resources (Materials/Diversified) at -6.72%
- Telefonica SA (Global Telecom) at -1.95%
- SNC-Lavalin Group (Industrials/Engineering & Construction) at +0.08%

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

- Dundee Corp Preferred A: We purchased a full position of Dundee Corp Preferred A as we continue to view Dundee Corp as undervalued relative to the banks. These shares have a much higher yield than comparable bank issued preferred shares. Dundee Corp has little debt and roughly half of its balance sheet consists of Bank of Nova Scotia common and preferred shares.

- Labrador Iron Mines: Early in the quarter, we added to our position in Labrador Iron Mines following several announcements pertaining to monetary and fiscal stimulus in China, the Eurozone and the U.S. We believed these announcements would bring some stability to world markets and possibly jump-start economic growth. Most importantly, these announcements marked a shift toward more accommodative fiscal and monetary policy.

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

- Labrador Iron Mines: We sold our position in Labrador Iron Mines following a rapid decline in iron ore prices in August. The economic and monetary stimulus announced throughout the summer was effective in reducing tail risk in global markets but failed to jump-start economic growth. The combination of worsening Chinese manufacturing data and Chinese policymakers' commitment to curbing the Chinese real estate market has slowed iron ore demand growth in China (which consumes ~50% of all iron ore produced globally).

**Going Forward:**

We entered the third quarter with a bullish outlook, having deployed most of our cash in late Q2. Our bullish positioning towards equity markets was proven to be the correct stance but our still sizeable exposures to cash (~10%), preferred shares and convertible debentures (~30%) and base metal producers (7%; which did not participate as much we had hoped in the rally as emerging markets continued to struggle) left the models trailing the market. We continue to favour small- to mid-cap stocks in the energy, materials and industrials sectors as these stocks should perform well when mergers and acquisition activity eventually rebounds.

We believe that the reluctance of Chinese officials to present stimulative programs similar to the American “shock-and-awe” programs will likely end the commodity supercycle as demand for most metals has caught up to supply and prices will likely remain suppressed going forward (with the exception of precious metals). Energy (oil and gas) prices will also likely remain suppressed but will continue to be vulnerable to supply shocks. For these reasons, we eliminated exposure to all metals except copper (still in a major supply/demand deficit) and gold (large budget deficits and monetary stimulus should continue to support gold) and will maintain quality exposure to the oil and gas sector (i.e. own companies with strong free cash flow and manageable debt levels).

The state of the global economy remains poor and there are only a few signs of possible improvement. The U.S. manufacturing and housing sectors appear to have stabilized and sustained improvement in these sectors may eventually increase confidence in U.S. financials and the U.S. economy as a whole. The flood of liquidity unleashed by the world’s central banks is expected to keep prices stable and reduce the odds of a deep recession, but the world economy needs more than liquidity to sustain a healthy rate of growth. Firstly, a market and economy friendly solution to the U.S. Fiscal cliff is needed whereby loopholes are closed and major spending cuts and/or tax increases are delayed or are enacted gradually. Furthermore, European policymakers need to compromise meaning Greece needs less harsh austerity terms and some degree of debt forgiveness and Spain and Italy need to ask and receive help if needed. Finally, China needs to find better ways to stimulate its economy and allow its real estate market to float freely. Though there is much to be done before the world economy is back on track, we believe the reduction in equity market tail risk as a result of monetary stimulus makes the market somewhat attractive at this point.

The expected yield in our Models increased to 4.1% vs. 3.9% at the end of Q2. This increase in yield was due to an increase in our fixed income allocation (i.e. our purchase of Dundee Corp Preferred A). This is an impressive yield considering we still have a ~10% cash allocation which we will likely invest in more dividend paying common or preferred shares in the upcoming months. We continue to believe that the combination of a high portfolio yield and exposure to small- to mid-cap cyclical stocks will provide the best long-term return.

Sincerely,

Steele Wealth Management