Market Intelligence

August 2011

Positioned for Opportunity

By the McLean & Partners Investment Committee

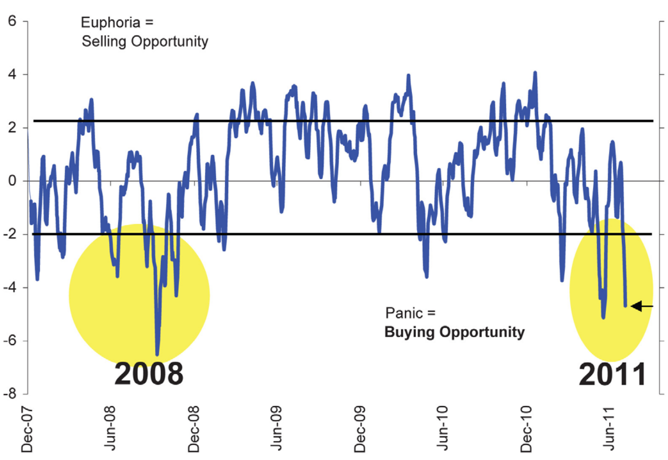
The last few months the markets have been driven by headline news events. The U.S. has raised their debt ceiling, thus buying them time to take the necessary steps toward a more fiscally responsible direction. Offsetting this was Standard & Poor's downgrade of the U.S. debt. Yet there are two key overhangs which still keep the markets in volatile territory.

United States – It is undeniable that U.S. economic environment is deteriorating and the rash of data over the past couple of weeks clearly points us in this direction. In addition, this phenomenon is being aggravated by a concurrent slowdown in the global economy as well. This is supported by Global Manufacturing Purchasers Managers' Index which fell to 50.6 in July, the lowest level in two years. Another key factor has to do with confidence. Markets are clearly worried that policy makers are running out of bullets to deal with the problems of low growth and high unemployment. This fear was compounded by the way U.S. lawmakers handled the debt ceiling issue.

Eurozone – In Europe, policy makers have failed to act decisively to stem the contagion and are once again left backpedaling and behind the curve. The market is clearly looking for more "shock and awe" from the European Union in order to get ahead of the curve. There are clear policy paths for the European Union to follow to stem the contagion but they require difficult choices that ultimately must be made.

As a result investor confidence has shifted downward to levels near the peak of pessimism we saw at the bottom of the 2008/09 financial crisis.

U.S. Panic-Euphoria Indicator (2007-2011)



Based on VIX Index, Put-Call Ratio, U.S. Credit Spread and RSI index
Source: Scotia Capital, Bloomberg

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That said, there are other important events unfolding right now.

Inflation – As we outlined in our Outlook 2011 in January, the emerging markets have been fighting a very intense inflation battle for the past year or so. This battle has been particularly acute in China, India and Brazil. We expect inflation in those countries to peak in the next couple of months allowing their respective central banks to ease restrictive monetary policies which in turn would be very beneficial for stocks. Using Brazil as an example, inflation on month-over-month basis has subsided quite substantially from 0.77% in April to 0.16% in July. We expect this decline to help show the year-over-year picture improving in the coming months.

The Fed – When QE1 was announced in November, 2008 the S&P 500 had declined over 40% from the October, 2007 peak and the U.S. ten-year yield had also dropped over 40% from its 2007 peak. The S&P 500 returned +22% from the November, 2008 QE1 announcement to August, 2010 announcement of QE2.

When QE2 was announced in August, 2010 the S&P 500 had only dropped 15% from the April, 2010 peak, but the U.S. ten-year yield had once again fallen by over 40% from its March, 2010 peak. The S&P 500 returned +16% from the August, 2010 announcement to the end of QE2 on June 30, 2011.

There was anticipation leading up to the FOMC speech on August 9th that the Federal Reserve may make an announcement regarding a new stimulus package – like a QE3. We believe the probability of this type of program has been heightened as the U.S. ten-year yield falls.

What we know for certain is each and every time a central bank has announced the beginning of an asset purchase program; equities in that particular country have gone up.

Portfolio Strategy – Since mid July we have been raising cash levels in our portfolios and reducing cyclical exposure within our equity sectors. As an example, the current cash weighting within our International Pool is 20%. The week of July 26th we also increased our macro hedges by 30% within our pool portfolios. This strategy utilizes Put options on the S&P 500 Index to add layers of insurance as the stock markets weaken. These hedges cover 30% of the notional value of our equity exposure in our pool portfolios. We have also hedged 80% of our Euro Currency exposure within our pooled funds. We have been utilizing currency hedges on the Euro since the start of this year and have also been utilizing macro hedges since the spring of this year.

Over the next month we expect market volatility to remain high as investors grapple with the extent of the U.S. economic slowdown and the Euro Debt Crisis. Global policy makers and in particular the U.S. Fed will be watching events very closely and are ready to implement policy action based on future market indicators.

Longer-term investment themes that we continue to believe in and look to position the portfolios toward are the following:

1. The emerging markets like China, India, and Brazil are areas of future global growth. As we see their inflation rates stabilize and roll over, we believe that in addition to strong economic growth rates and favorable demographics these countries can consider reducing interest rates this fall and/or adding additional monetary stimulus that will help sustain the long-term growth trends in these markets. For investors, lower interest rates and above average economic and profit growth should translate into higher stock prices.

2. Secondly we continue to focus on companies that demonstrate a consistent track record of dividend growth and provide attractive yields. With the recent market correction a number of dividend paying stocks have seen dividend yields pushed back up into the 3-4% range. One thing we are very confident in is that corporate balance sheets globally are flush with cash and corporations, including a good portion of the global banking sector, are currently very well capitalized and very liquid. With investors stampeding into bonds and driving yields on five-year Government Bonds down below 1.50%, well capitalized and attractively valued dividend yielding companies begin to look very appealing for long-term investors.

3. Finally investors should incorporate market alternative investments into their portfolios. Earlier this year we introduced two new private pools to compliment our existing strategies of bonds, preferred shares, and dividend growth investing.

- M&P Alternative Income
- M&P Alternative Growth

These new offerings are designed to help offset market risk and generate yield using option based strategies.

Now would be an ideal time to speak with us to discuss your portfolio and ensure you are properly positioned for the road ahead.

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