THIRD QUARTER 2011 REVIEW AND OUTLOOK

Macquarie Private Wealth

A world of opportunities

WORTH / ALLAYE-CHAN

WEALTH MANAGEMENT GROUP*

CUSTOMIZED INVESTMENT SOLUTIONS

*Worth / Allaye-Chan Wealth Management Group is part of Macquarie Private Wealth Inc.

S&P/TSX Composite Performance – 3rd quarter 2011

Chart Source: Bloomberg

3rd quarter review

Fear and risk aversion dictated asset class returns for most of the quarter. After much political wrangling, the eventual raising of the U.S. debt ceiling in August did little to relieve investor concerns about the deteriorating fiscal situations in both the U.S. and in Europe. Bond rating agency Standard and Poors stripped the U.S. government of its coveted AAA rating, lowering its long-term sovereign credit rating to AA+, and warned of the possibility of further downgrades. The raising of the debt ceiling is actually a fairly regular occurrence (raised 75 times since 1962!), and wasn't the primary reason for the downgrade. The S&P specifically cited that political brinkmanship, and resulting instability in governing and policymaking at a time when quick and effective response to current fiscal and economic challenges is of particular importance, as being a major factor in this downgrade. Monetary policy in the U.S. continues to be hugely accommodative; by keeping interest rates at extraordinarily low levels, borrowers are provided the opportunity to refinance their mortgages at much lower rates, effectively putting more money back in their pockets.

The ongoing European debt worries also damaged investor sentiment with concerns about the possibility of a Greek default. European policymakers continue to work on a solution to support European financial institutions in the event of a Greek default, and also to isolate the damage to Greece. Equity markets as a result have been buffeted by every bit of news from Europe, leading to uncomfortable volatility. Any solution must be substantial enough to be effective in calming investor fears of a sovereign debt contagion within Europe. Loss of investor confidence can largely be blamed on the snail's pace at which European policymakers have moved towards a workable solution.

Once again, the risk-off approach led to outperformance in Government debt in the quarter (the U.S. 10 year bond now yields only 1.70%), and significant pullbacks in emerging markets, and resource sector equities.

Canadian market outlook and summary

Weakness in the commodities sector has been quite pronounced within the S&P/TSX Composite, with some large cap household names breaching or approaching multi-year lows on concerns about the global economy. In particular, Canada's currency and commodities sectors have been particularly impacted by a new concern, a dramatic slowdown in China's economy. Although some high quality resource names are attractive at current prices, this bottoming process may be volatile and may take a fair amount of time to play out. We would only participate in the highest quality names during this time. On many valuation measures, this selloff appears to be rather overdone.

Our overweight call on dividend yielding stocks remains, as we believe the recent decline in bond and GIC yields will prompt investors to seek alternative investments to generate cash flow for investment portfolios. Within the dividend universe, sustainability of the dividend remains the key as investors should question why certain high dividend yielders are trading at such excessive yields. More often than not, the pricing reflects an eventual dividend cut.

Stocks appear to be attractively valued on multiple valuation metrics. Also, with cash providing no return and bonds providing little return after taxes and inflation are factored in, we believe any positive catalyst for the equity market could potentially provide the underpinnings for a strong rally in the fourth quarter. If only the world's governments would behave and quit playing their games.

US market outlook and summary

Although the headlines would lead us to believe that the U.S. will be indefinitely mired in economic quicksand, U.S. monetary policy has probably never in history been as accommodative and stimulative as it is currently. The average American who is handcuffed by mortgage debt payments has been given an opportunity to substantially lower debt maintenance costs, via mortgage refinancing.

The volatility in the stock market and knee jerk response to every bit of economic and government debt related news masks a very healthy American corporate profit picture. Excluding the U.S. financial services sector, corporate balance sheets are indicative more of economic boom times. Most recent economic indicators have actually been slowly turning higher, evidence that despite inept government, the economy is in fact seeing small incremental improvements on the manufacturing and jobs fronts in particular. These gains though will be limited without effective fiscal policy. At this point in time, the Obama administration and Republicans are seemingly at opposite ends of every issue. Until there is some compromise in Washington, it is very likely that U.S. economic growth will remain subpar.

Although it is easy in this backdrop to dismiss the equity markets for investment at this time, the growing negative sentiment towards stocks is actually a positive contrarian indicator. Stock mutual fund outflows have been strong in recent months, leading us to believe it is time to be constructive in adding some leading high earnings visibility names.

International market outlook and summary

The European Central Bank's decision to raise interest rates by 50 basis points earlier this year shows the ECB's misplaced concerns about inflation and backwards looking policies. The ECB had also raised interest rates in the summer of 2008, and there is no need for us to rehash the events of fall 2008. The focus among the European leaders is likely to shift from a bailout of Greece to protecting European banks from a Greek default and ring-fencing the Greek debt crisis. While a Greek default should be manageable, a Spanish and Italian default would be catastrophic.

A growing concern is developing in China, where strong economic growth which had previously been considered as certain as death and taxes is now showing signs of deterioration. Evidence of such is highly evident in the commodity stocks, with most significant pullbacks in the base metals an energy shares. It is interesting to note that the domestic Chinese ("A" Shares) equity markets had already entered a bear market in early August. Increasing property supply coupled with decreasing property demand in China is a definite red flag, and has negative ramifications for industrial commodity demand.

Although emerging market equity valuations are becoming attractive, these markets tend to overshoot on the upside and downside, thus further downside in such valuations cannot be ruled out. That being said, given the quickly changing demographics and expanding middle class in the emerging markets, the boom bust cycles will occur at a more rapid rate than ever before.

Canadian fixed income market

As with most portfolio managers, we have been too cautious with our bond outlook. We had been consistently calling for a short to medium term duration portfolio and sought yield pickup in corporate bonds. Looking back one year, the most profitable strategy would have been to buy long term government bonds. That being said, not many would have thought that the 10 year Government of Canada bond would now be yielding 2.2% and a 20 year Canada to yield 2.8%. Barring a prolonged recession, we cannot see much value in adding long term government bonds, particularly when inflation and taxation are factored in. A short to medium term laddered strategy is still in our opinion a preferred defensive posture in the current environment.

Worth / Allaye-Chan Wealth Management Group*

Macquarie Private Wealth Inc.
550 Burrard Street, Suite 500
Vancouver, BC V6C 2B5

Telephone: 1 604 640 0236
Toll-free: 1 800 283 8545
Facsimile: 1 604 640 0298

Email: worthallayechan@macquarie.com
Website: worthallayechan.com

*Worth / Allaye-Chan Wealth Management Group is part of Macquarie Private Wealth Inc.

The opinions, estimates and projections contained herein are those of the author as of the date hereof and are subject to change without notice and may not reflect those of Macquarie Private Wealth Inc. (MPW). Every effort has been made to ensure that the contents of this document have been compiled or derived from sources believed to be reliable and contains information and opinions which are accurate and complete. However, neither the author nor MPW makes any representation or warranty, expressed or implied, in respect thereof, or takes any responsibility for any errors or omissions which may be contained herein or accepts any liability whatsoever for any loss arising from any use of or reliance on this report or its contents. Past performance may not be repeated. Information may be available to MPW which is not reflected herein. This report is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities. No entity within the Macquarie Group of Companies is registered as a bank or an authorized foreign bank in Canada under the Bank Act, S.C. 1991, c.46 and no entity within the Macquarie Group of Companies is regulated in Canada as a financial institution, bank holding company or an insurance holding company. Macquarie Bank Limited ABN 46 008 583 542 (MBL) is a company incorporated in Australia and authorized under the Banking Act 1959 (Australia) to conduct banking business in Australia. MBL is not authorized to conduct business in Canada. No entity within the Macquarie Group of Companies other than MBL is an authorized deposit-taking institution for the purposes of the Banking Act 1959 (Australia), and their obligations do not represent deposits or other liabilities of MBL. MBL does not guarantee or otherwise provide assurance in respect of the obligations of any other Macquarie Group company. Macquarie Private Wealth Inc. is a member of the Canadian Investor Protection Fund and IIROC.