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We See Opportunities

October 2010

We have been asked by family and friends to shed some light on recent developments in global equity and fixed income markets. Before we articulate our views on the markets we want to stress to our readers that the economy and the markets, while highly correlated in the long run, are different beasts facing different challenges.

We will first focus our discussion on the broader health of the economy, including GDP, inflation/deflation and employment conditions. GDP growth is driven by three forces: public spending and investment, private spending and investment, and the trade balance. The U.S. has been experiencing an unprecedented contraction in private spending. This has prompted monetary authorities (the Fed and the Treasury) to pump trillions of dollars to cover the shortfall until fiscal policies (the unprecedented deficit we hear about) take effect and start closing this gap. Unlike monetary stimulus, fiscal spending is a political and bureaucratic process that takes time. It is usually accompanied by criticism and debate about the necessity of the expenditures and the overall benefit to society.

Keynesian style economists would argue that where the spending initially goes is irrelevant as the money will eventually be circulated in society and will ultimately be used to increase savings or reduce the debt/leverage ratio.

Market	YTD Return
TSX	10.38%
S&P 500	8.04%
DJ Euro	9.46%
MSCI EM	15.21%
OIL	-1.88%
Gold	22.20%
USD/CAD	1.0239
USD/EURO	1.3859

As of October 26, 2010. Source Bloomberg

Mr. Bernanke is certainly an advocate of this theory. He was given the nickname "Helicopter Ben" when he stated that he would print money and throw it out of a helicopter over New Yorkers to force them to spend. The theory is valid and has been proven to work; however, it does have implications on inflation and employment. Mr. Bernanke is not overly concerned about future inflation at this stage, and we should not be either, as the more pertinent threat to our society right now is deflation. Inflation is not necessarily bad if kept within limits and if the increase in real wages is kept in pace with the increase in inflation. Mr. Bernanke is counting on higher inflation in the future and so is highly leveraged corporate America. Inflation helps the borrower at the expense of the saver. With real interest rates close to zero, inflation will reduce the real amount of debt that will eventually be paid back. For example a corporation borrows $100 today and will have to repay (in real terms) only $50 in 10 years, assuming nominal rates are 5% higher in 10 years[1]. This process will help corporate

[1] The change in the price of a bond is inversely related to the change in nominal rates multiplied by the duration of that specific bond. In the above example, we have used duration of 10 years to simulate current borrowing terms and we assumed a 5% change in rates over the 10 year period. Therefore, the percentage change in price is equal to -1 x Change in Rates x Bond Duration (-1 x 0.05 x 10= -50%).

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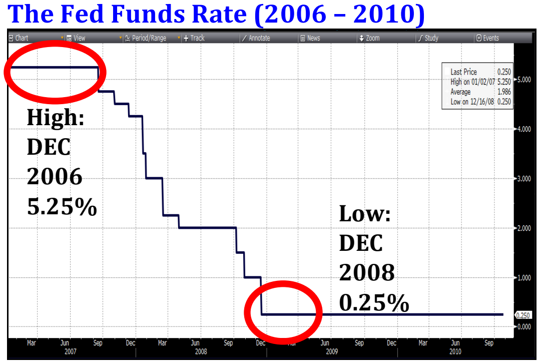
America, which is Mr. Bernanke's main objective. We believe that he will be successful. Therefore, many highly leveraged companies should outperform in the short to medium term. The downside of this strategy is that middle class Americans will become poorer. They will also represent a smaller percentage of the total American population because the shift in rates and inflationary pressures over the next 10 years will deteriorate their purchasing power. We do not expect much change on the unemployment front. In fact we expect it to remain stubbornly high even as we undergo an economic recovery. The fix to reduce the high unemployment rate is a structural solution – not seasonal or cyclical – and structural adjustments could take anywhere from 3 to 20 years to take effect. We believe that the current cycle will take approximately 7 to 10 years to unwind.

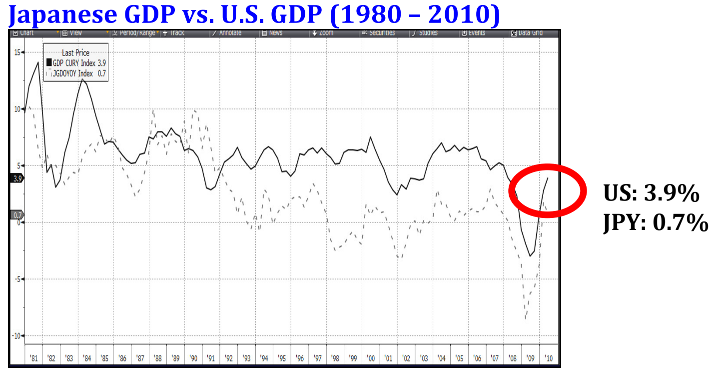
The Fed Funds Rate (2006 – 2010)



As of October 26, 2010. Source Bloomberg

Many investors compare the current situation to the Japanese crisis and allude to the fact that the Bank of Japan was not able to reignite the economy despite massive monetary easing and large dosages of fiscal stimulus. Japan is a good case study to refer to but we should not refer only to their policy failures but also to their successes. The Japanese authorities did a reasonable job in containing GDP levels during the downward spiral in asset values (after dropping 60%, they could have continued to drop had the authorities not intercepted). While we will never know what an alternative solution could have achieved, we can imagine what will happen to our society if we lose more than 60% of our savings, investments and property values. North American economies, however, should fare much better than Japan, this is due to better demographic trends, a larger pool of capital invested (and to be invested) in the US dollar and of course, stronger overall US trade relationships (albeit weakening recently).

Japanese GDP vs. U.S. GDP (1980 – 2010)



As of October 26, 2010. Source Bloomberg

In short, we are not optimistic about the prospect of a strong economic recovery. In fact we see this continued economic weakness spilling over from developed to developing nations. This weak economic recovery will continue to be categorized by stubbornly high unemployment rates.

The threat to developing nations also comes from the deliberate devaluation of major currencies. No one has articulated the impact of this strategy on developing nations better than the Brazilian Finance Minister Guido Mantega in saying "We're in the midst of an international currency war ... This threatens us because it takes away our competitiveness." He added "The advanced countries are seeking to devalue their currencies", a group which includes the US, Europe and Japan. We therefore feel that the road to economic recovery is going to be bumpy at best, characterized by ongoing monitory easing, printing money and deflationary pressures.

Equities

As stated at the beginning of this letter, the economy and the markets are facing different challenges. We believe that the North American equity markets should perform reasonably well on a relative basis to other regions and relative to the fixed income asset

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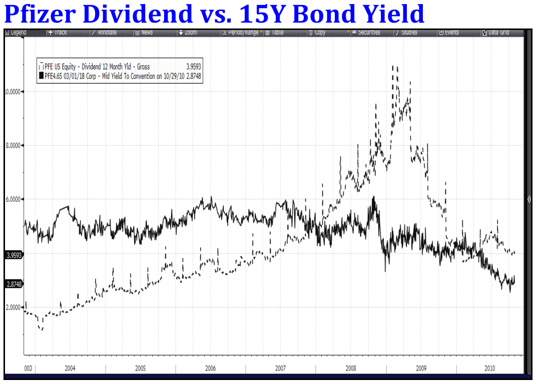
class as a whole. We are seeing record levels of debt refinancing, taking advantage of near zero real rates and higher than normal expected inflation. While corporate spreads are attractive, we feel that, given current dividend yields, investors will be better rewarded by investing in large cap North American stocks. The graph below shows the dividend yield vs. a 15 year bond yield for Pfizer. The 12 month trailing dividend is 3.96% vs. a bond yield of 2.87%, representing a 1.09% premium over the dividend yield. Corporate earnings have proven to be resilient on the back of aggressive cost cutting measures, low financing rates and external trade balances (the average U.S. Corporation earns 30% of its revenues from international operations).

Pfizer Dividend vs. 15Y Bond Yield



As of October 29, 2010. Source Bloomberg

Fixed Income

The fixed income market is also undergoing massive restructuring. The theme for fixed income investors has been focused on the "return of capital", as opposed to the usual "return on capital" mantra that investors are accustomed to. This change in approach follows 191 U.S. corporate defaults on $516 billion of outstanding debt - the highest total in 30 years. This represents roughly 82% of the total global defaults in 2009. It is also worth noting that the "downgrade to upgrade" ratio was also at its second highest reading in recorded history (according to S&P July 2010 study). Only Utilities and Telecommunications recorded lower default rates than their long term average. The trend in 2010 has seen an improvement as zero interest rates, and the expanded role of the Fed in providing liquidity, have eased the pressure on a large number of highly leveraged borrowers.

Summary of Recommendations

<u>Preferred Exposure</u>

1) North American Equities – Hedged in Canadian dollars
2) Dividend paying stocks – Utilities and Telecommunications
3) Trend based sectors such as Healthcare, and Information Technology.
4) For investors with riskier appetites: corporations that remain highly leveraged – lowest investment grade or highest speculative grade – will be the winners from this "new normal' in US policy.

<u>Asset Mix Allocation</u>

Many investors have done reasonably well by investing in the fixed income asset class in 2009 and 2010 and are wondering if this trend is expected to continue. Recent trends and investment models point to equities outperforming bonds for 2010 and most of 2011.

About Yorkville

Yorkville Asset Management is a subsidiary of Heritage Financial Group Ltd. (HFGL). HFGL specializes in RESPs, helping families reach their educational goals. HFGL manages a $2 billion fund for more that 200,000 Canadian investors.

Yorkville's team is comprised of experienced tax, law, portfolio management and investment banking professionals.