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DISCRETIONARY PORTFOLIO MANAGEMENT

Pringle Portfolio Management Group

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Integrity, Trust and Experience

Pringle

PORTFOLIO MANAGEMENT GROUP

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Economic Commentary

Financial repression

This term is being used widely today in reference to the low interest rates that central banks are creating in an effort to re-start economic growth and to allow them to deal with the debt they took on during the financial crisis. To achieve this, the U.S. Federal Reserve was the buyer of something like 60% of U.S. new bond issuance last year. Investors, from pension plans, insurance companies and banks, to savers like you and me, are being forced to lend to them at ruinously low interest rates. The question is how long can this artificial situation last? I find it interesting that one of the definitions of the word repression is "To put down by force, usually before total control has been lost."

The crisis caused by too much debt affected all parts of the western world to varying degrees, with Europe and the U.S. the most afflicted. Capital has flocked into the U.S. dollar and U.S. Treasury bonds as a safe haven in spite of the problems there. This is because it is by far the largest and most liquid currency and is the world reserve currency. This flight to the U.S. dollar has aided the U.S. Federal Reserve in its policy of financial repression.

The European debt problems have everyone's attention and fears of sovereign defaults have investors fleeing Europe in an effort to protect their capital. I believe that one of the real fears is that the crisis there will cause a bank to fail, which could trigger another world financial seizure like the one experienced in the fall of 2008. I think this is unlikely, as world leaders have learned from 2008 that due to the interconnectedness of banking today this must be prevented at all cost. As for the re-working of the European Monetary Union, I think it will ultimately be accomplished in some form or another, but that takes time. Germany, which was a major architect of the Euro and benefitted from it the most, will also benefit from keeping it together. However, before they use their savings to bankroll the poorer southern nations, they correctly will require Euro nations to be subject to spending controls to prevent excess spending happening again. Crisis, pain and time will be required to allow politicians to relinquish fiscal sovereignty with voter support.

Following the financial crisis, China implemented a massive stimulus program focused on building infrastructure. Its economy responded and boomed, as did its consumption of commodities. By last year, China's economy was growing strongly and inflation there was becoming a concern, so the government raised interest rates and tightened bank lending rules to cool the economy and inflation. These policies have worked, as growth and inflation have declined to more sustainable levels. However, some economic forecasters believe that the economic slowdown engineered to date will lead to an economic collapse. While this is possible at some point, I don't think it is necessarily about to happen at this time, as the Chinese have ample policy tools and money to prevent it.

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Although capital has been running to the U.S. dollar and treasury bonds, the U.S. is by no means in great shape. With a debt-to-GDP ratio approaching 100% (above Europe's), unemployment stuck above 8%, and political gridlock preventing government policies from being made, it appears to be the beneficiary of capital by default. It is unfortunate that there is no strong leadership from the U.S. at this critical time, as that would be meaningful given the U.S. position as the largest world economy and home of the world reserve currency. Unfortunately, it looks like the world will have to wait until after the November elections in the U.S. before strong leadership might emerge.

Many investment experts believe that the western world bond markets are in the process of forming another "bubble" that will burst as interest rates have been falling to ridiculously low levels. The 10-year U.S. Treasury bond now yields about 1.63%, which is well below the current inflation rate. This is indicative of the fear in the markets, as investors appear to be paying the U.S. to take their money for 10 years. The U.S. Federal Reserve has been buying U.S. bonds to keep prices up and yields down. This, coupled with foreign capital looking for something safer than Europe, have been big factors in driving interest rates down. Retail investors have been joining this party too, as they have been sellers of stocks and buyers of bonds in recent years. Whether it should be labelled a bubble or not doesn't matter – what does, I think, is that it is being driven by transitory and unnatural forces that are unsustainable. It is possible, even likely, that this could continue for several more months, or possibly years, but I think that there is a risk of a surprise event that could cause the unnatural level of interest rates to normalize quite rapidly.

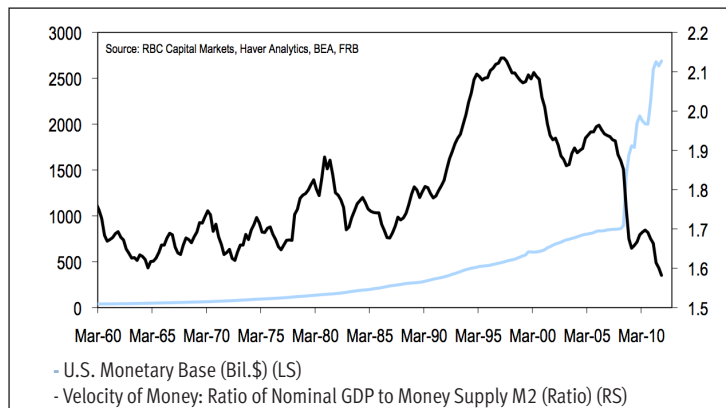
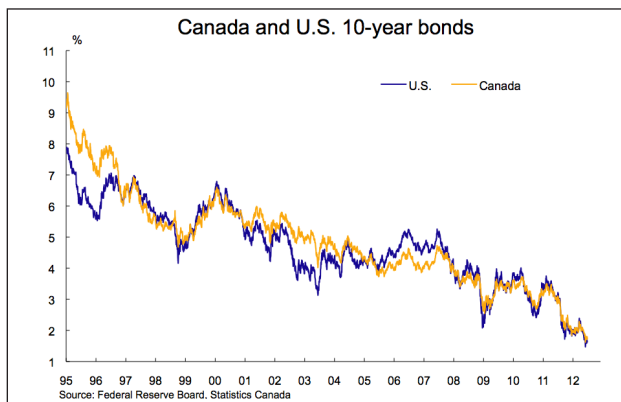
The European debt crisis has caused a great deal of "deleveraging" by banks, particularly in Europe. They have been forced to shrink their loan books in an effort to shore up their balance sheets. I believe that this has been partly responsible for the waves of selling in equity markets, commodities and gold as well. Further, the weakness in gold could possibly be anticipating sales or collateralization by European countries of their reserves in conjunction with any new pan-European bond issuance.

Equity investors have been subjected to a wild ride again this year as a strong first quarter gave way to a selloff in May as the Euro crisis flared up. Weaker economic data from the U.S., and worries over China's growth prospects have helped push commodity prices lower. Further, the flight-to-safety trade that has pushed up the U.S. dollar has helped depress commodity prices as they are priced in U.S. dollars. The result is that the Canadian stock market has been very weak due to its large commodity component, while the U.S. market has performed relatively better due to its light commodity exposure and less cyclical nature. However the sell-off in commodities is welcome, particularly in oil, as it will provide manufacturers and consumers with savings that can be spent elsewhere.

There is little doubt that the unwinding of the excess debt will be with us for several more years and will weigh on economic growth. However, with the passage of time, the western economies will rebuild themselves. There are signs in the U.S. economy that this is happening, as the all-important housing sector is showing signs of life, and manufacturing has begun to bring production home from offshore.

The financial repression being enforced today leaves investors with a choice of bonds at very unattractive levels, or equities. By many metrics, equities are reasonably valued and compared to interest rates haven't been this cheap in 50 years. Further, equities offer some inflation protection, which is desirable as it will return at some point. Finally, there are many quality companies that pay dividends well above bond yields and interest rates. The downside of owning stocks is the volatility caused by uncertainty. The global bond markets are many times the size of global stock markets, and this ratio is widening as companies buy back stock and governments continue to print money and bonds. At some point the artificial and transitory factors that are currently pushing interest rates down will change and rates will rise causing a massive bond selloff. I suspect that owning the other major asset class – stocks – will prove rewarding at that point. As always, I will do my best to protect your interests.

Tony Pringle, CFA | June 30, 2012



Welcome & Thank You

A warm welcome to the clients who have recently joined us, and a special thank you to the people who mentioned our name to them. We appreciate your trust and support.