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Fall 2010

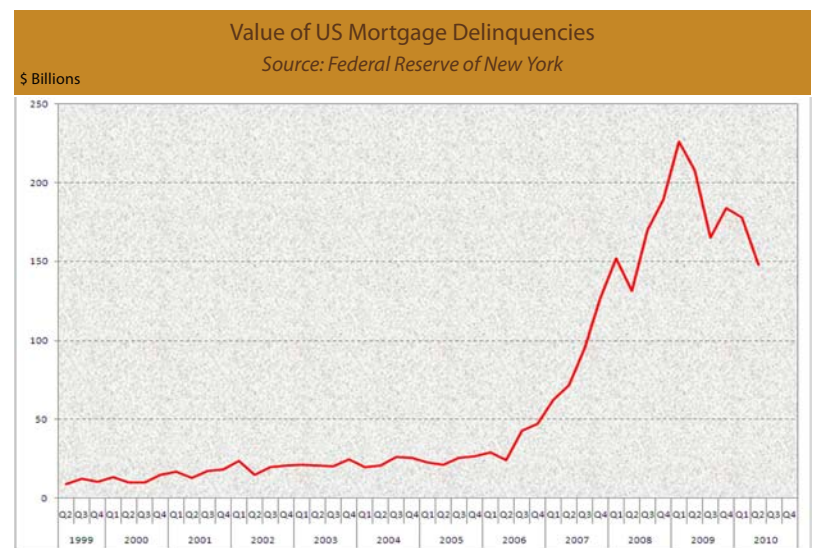
"The size of the employment gap, combined with the fact that inflation has been running below the level I consider consistent with long-term price stability, suggest that it would be desirable to increase monetary policy accommodation to boost aggregate demand. Inflation could stay below desirable levels for the foreseeable future."

Charles Evans, President, Chicago Federal Reserve

Recent Federal Open Market Committee (FOMC) statements have made it quite clear that the Fed is ready to resume additional quantitative easing (putting more money into circulation) whenever necessary. This is an important gesture because it sends a signal to the market that the Federal Reserve (Fed) will not tolerate deflation or excessive economic weakness. As the past quarter unfolded, markets rallied largely on the expectation that the Fed would continue to stimulate the economy with additional easing.

The U.S. economic recovery is clearly fragile, which is a shared conclusion of both the Obama Administration and the Fed. With the Administration hamstrung on the fiscal front, any new action would have to come in the form of new monetary stimulus.

As we've written numerous times in the past, the steady increase in personal debt over the past twenty-five years has hidden a multitude



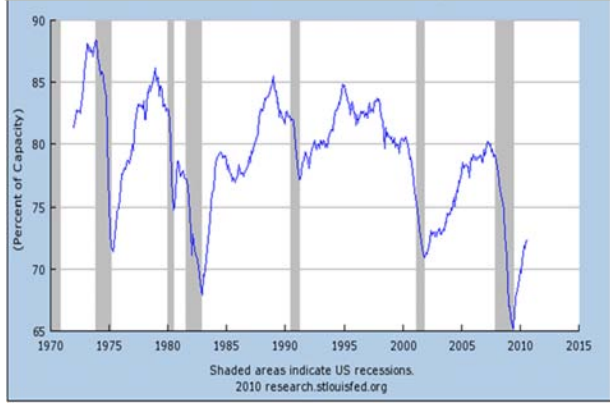
of sins. Current market distortions in housing, credit, and the financial system are huge and potentially unstable. The recovery in the U.S. labor market has been frustratingly slow – a report in Economic Times stated that “one out of every six workers in the US who would like a full time job can’t find one”. As a result, foreclosure rates keep escalating. The same Economic Times report postulated two million Americans lost their homes in 2008, 2.8 million more in 2009, and the

number in 2010 will be greater yet. The prospects of an improved employment picture remain bleak. Capacity utilization rates hit an all-time low at the end of the past recessionary period and, despite a significant rebound, still indicate significant weakness (see chart on next page). According to work prepared by Shilling & Company, a US economic research firm, GDP growth in the US must remain above 3.3% to get any appreciable employment growth.





Capacity Utilization: Manufacturing (NAUCS) (MCUMFN)
Source: Board of Governors of the Federal Reserve System



The bleak job-creation picture has not only cast doubt on the sustainability of the economic recovery, it has also become a huge political problem for the Obama administration as well as the Democrats. The pain felt by the middle class is palpable. It is not an exaggeration to hypothesize that without a meaningful pickup in employment growth or a noticeable fall in the unemployment rate, a second term for President Barack Obama is doubtful.

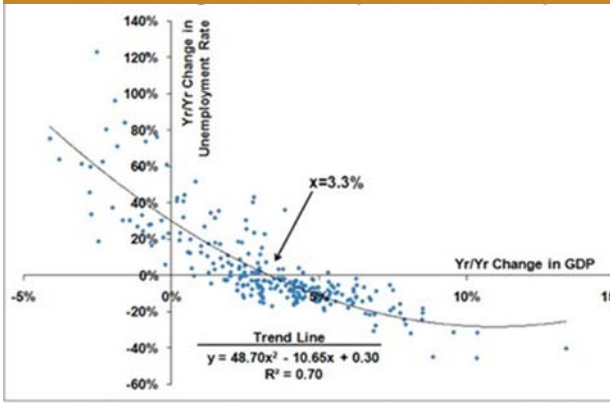
Over the past eighteen months, in response to an escalating housing crisis, the US Federal Reserve has become a lender of first resort rather than last. Credit risk is being assumed by the government and market risk by the Fed. Providing that interest rates remain low (which is dependent on a continuation of quantitative easing), the credit and market risk remain low. While investors continue to purchase US dollar assets at artificially low rates, the government will likely continue "quantitative easing" to keep the debt service level cheap.

Of course, as the chart to the right illustrates, printing more money negatively impacts exchange rates and a tidal wave of new currency is being released by all developed countries. Currency exchange "wars" are not confined to the well-publicized pressure on China to increase the value

of the Renminbi. The Japanese Yen and the Euro have, over the past decade, required less liquidity in the markets. However, the chart also clearly illustrates the impact to the Euro from 2008 as governments, struggling with nationalized debt problems, increased the amount of currency in circulation. Of course, the US currency issues are well documented – and clearly shown in this chart below. The once-mighty greenback has limped out of the last decade – and with additions to US money supply, the US dollar should continue to fall in international markets.

With interest rates remaining low to maintain cheap debt service costs, it's unlikely that governments will stop

Reference: Shilling & Company



printing currency. Therefore, while governments continue to pay lip service to deficit reduction, unless the debt service level becomes unmanageable, there is little pressure to gain fiscal prudence despite increasing pressure to do so from the electorate.

What makes this unsettling to the investor is a US bond market that is seriously overvalued. Moreover, there is an increasing necessity to maintain confidence in US dollar assets (China owns approximately \$3 trillion US dollar assets at last measure). It is quite possible to envision a reversal in support for US assets and the subsequent spike in interest rates necessary to regain foreign support.

10 Year Changes to Currency Valuations
Reference: StockCharts.com





While Canada has deservedly had a good ride in recent years particularly through the global recession, due to strong Federal Government finances and a strong balance sheet, all is not quite as rosy as meets the eye. The chart at right shows that, while the U.S. savings rate has gone from 2% to 6.5% since 2007, the Canadian savings rate, after a brief rally, has collapsed to about 2 1/2%. Canadian households have continued to add to their debt, seemingly to the changed world environment. House prices rose to new highs during the recovery, while U.S. house prices are down over 30% from their peak. Moreover, while federal debt levels and trends are good by world standards, provincial debts are concerning.

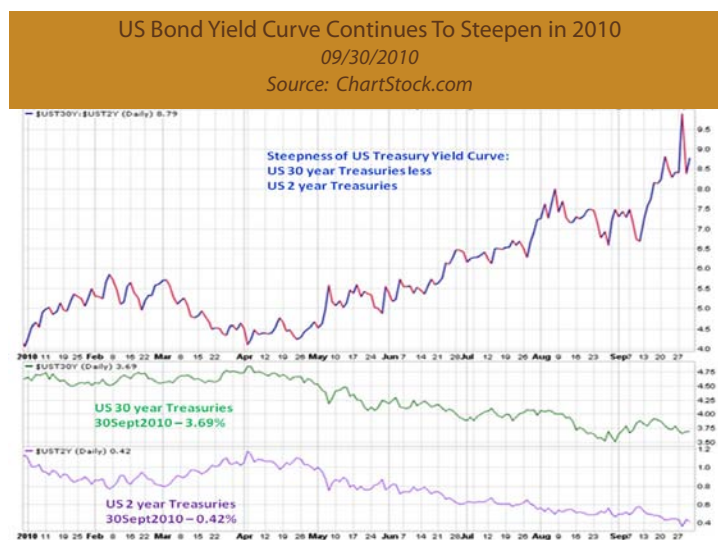
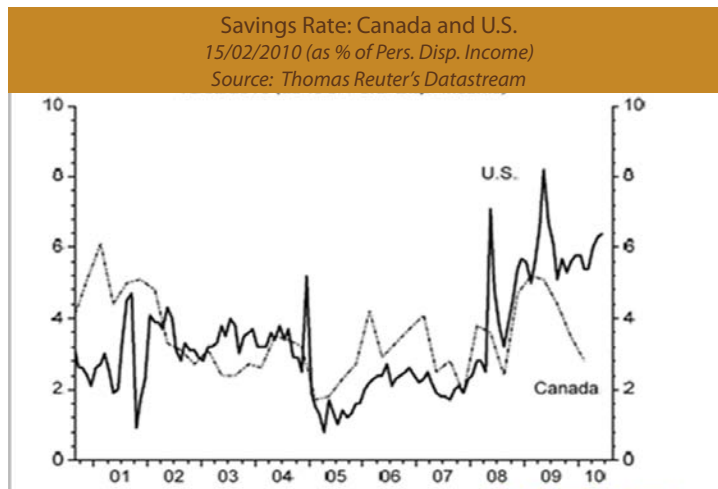
Interestingly, one might speculate that the run-up in both gold and bond prices might, in fact, be a hedging between inflationary (gold) and deflationary (bond) forces. With bond yields well below historical norms, the market is discounting any near term inflation and, if anything, indicating deflation or possibly stagflation. Despite continued media coverage by the “talking heads”, gold bulls should be wary – bond markets have seldom been wrong in predicting economic direction.

We expect that US monetary policy will likely remain highly stimulative, and tax cuts expiring at the year’s end will probably be extended. Thus, US growth should remain solid, if unspectacular. Economic growth in other developed economies is likely to remain positive; Japan in particular should be aided by its

recent currency intervention. Given that most developing economies are growing robustly, the outlook for global growth remains good.

Our investment stance that began at the beginning of this year remains intact. We believe that equity investments will likely outperform bonds, though there are strong arguments for continued strength in the latter: the aging baby boomers’ growing appetite for income, quantitative

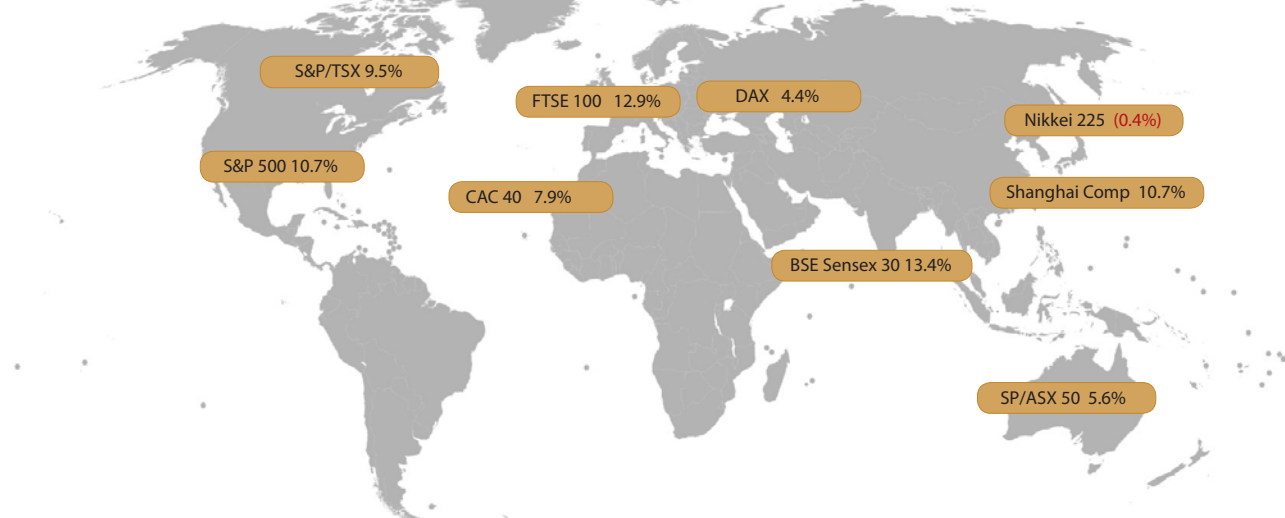
easing, and deflationary pressures driven by private sector deleveraging. Equity investments are, at the moment, providing solid cash flow growth and dividends though the markets are still relatively expensive against historic norms. Maintaining a well diversified, conservative portfolio will benefit investors through this continued period of volatility.





Equity Comment

GLOBAL EQUITY MARKET PERFORMANCE (Price Only) Third Quarter 2010 - in Local Currency

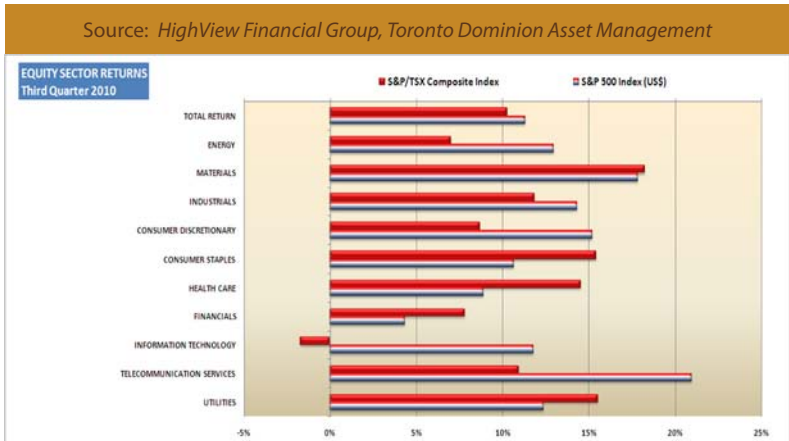


Stock returns surged in September, raising the S&P/TSX Composite Index to a 3rd quarter total return of 10.3% and raising the year-to-date gain to 7.5%. The US market was even stronger as the S&P500 had its best September since 1939 with a monthly gain of 8.9% and finishing the quarter up 11.3% in US dollars (8.1% CAD). Year-to-date the US market has gained 3.9%, though Canadian investors have earned 2.2%. The big gains for the quarter came from international stocks, with the MSCI EAFE Index up 13.2% when converted to Canadian dollars during the quarter. Year-to-date however, the MSCI EAFE Index is down -0.2% with European bourses in negative territory.

In terms of stock sectors, in Canada the big gainers were Materials stocks (+18.2%) driven by increases in fertilizer stocks (Potash, Agrium, etc.) which rose 56% in the quarter. Consumer Staple and Utility stocks rose 15% in the quarter, led by food product companies and electrical utilities. Gold stocks continued their

assent for the quarter (+4%) though well behind industrial metal stocks (+42%) and steel stocks (20%). Financial stocks lagged the market (+7.8%), with 9% gains in bank stocks offset by 4% losses in insurance stocks, as did Energy stocks (+7%). Year-to-date, Telecommunication (+21%), Materials (+20%), and Consumer Discretionary stocks have been the biggest gainers, with the latter group rising on escalating prices of auto parts manufacturers (Magna Intl. has risen 64% this year). The US market was led by Telecommunication stocks (+21%)

and, like Canada, Materials stocks (+17.8%). Retail stocks rebounded on improved employment news, raising the Consumer Discretionary sector by 15%. Unlike Canada however, energy stocks have not fared well in the US this year (-0.8% year-to-date) as share prices of oil drilling & exploration companies were dragged down earlier in the year during the Gulf oil spill crisis. In the past quarter however, they showed signs of life again, gaining a respectable 13.0%. Although global stocks are only up modestly thus far in 2010, the path here has been anything but straight.





As shown in the chart at right, with the exception of the continued deterioration in the Nikkei index, major stock averages have been in a relatively 'tight' trading range for most of 2010, rallying early in the year to a peak in late April and then going into a decline through May to take index levels into loss territory for the year, where they resided until the rally back up again in September, which is traditionally one of the worst months of the year for stocks.

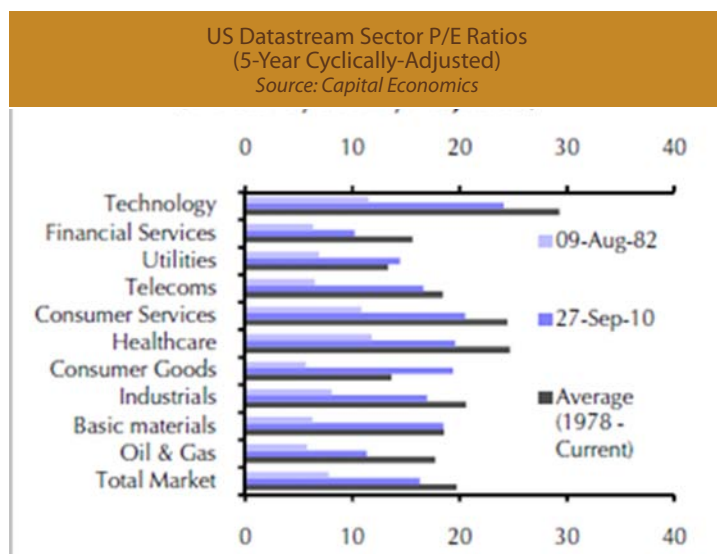
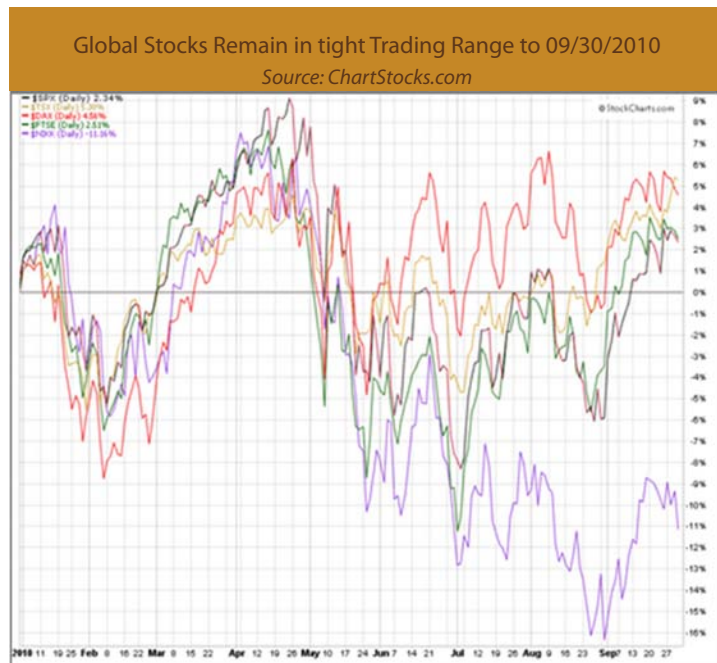
In our second quarter report we discussed investor anxiety surrounding the continued pessimistic economic predictions. After investor sentiment indicators at the end of August showed that pessimism had increased almost all the way back to the March 2009 levels, stocks reversed course in September with the US stock market seeing its best September since 1939!

In the present state, equity markets could be considered relatively cheap - relative that is to the bond market bubble that seems to be evolving month by month as yields fall and prices increase. In a recent report by Capital Economics, current price/earnings ratios were compared to the average since 1978. What is evident in the chart to the right, is that these multiples are definitely lower than the average since 1978, but higher than 1982 – the beginning of the last bull market phase.

Despite the higher multiples, we believe investors are better served by investing in the stocks of high quality companies with

good balance sheets, dividends, experienced management and a strong franchise. While equity markets overall may be stuck in a

trading range based on normalized multiples, opportunities exist to purchase solid corporate equity investments at discounted prices.





Bond Commentary

The Canadian bond market continues to provide investors with robust returns in the third quarter. For much of September, bond prices moved lower and yields rose as the bond market consolidated its gains of the last four months. However, a rally late in the month, driven by speculation of additional bond purchases by the Federal Reserve erased most of the losses and left the broad market with positive returns. The DEX Universe returned 3.14% in the quarter.

In September, the Bank of Canada raised its overnight target interest rate by 25 basis points, the third consecutive increase since the central bank started its monetary tightening program. In its accompanying statement, the Bank stated that it believed financial conditions remained extraordinarily stimulative. Over the balance of the month, though, economic data tended to come in below expectations, and that led to concerns about the future pace of Canadian economic growth. In particular, the trade deficit widened sharply as exports to the United States slowed, and it was revealed that the Canadian economy actually shrank by 0.1% in July. The weaker growth trajectory, ongoing concerns about global economic conditions, and worries about the elevated levels of household debt in Canada, led the Bank of Canada late in the month to backtrack from its earlier comments and hint at a pause in its tightening cycle.

In the United States, economic data was similarly mixed. As mentioned earlier, unemployment remained stubbornly high and inflation quite low. This combination prompted

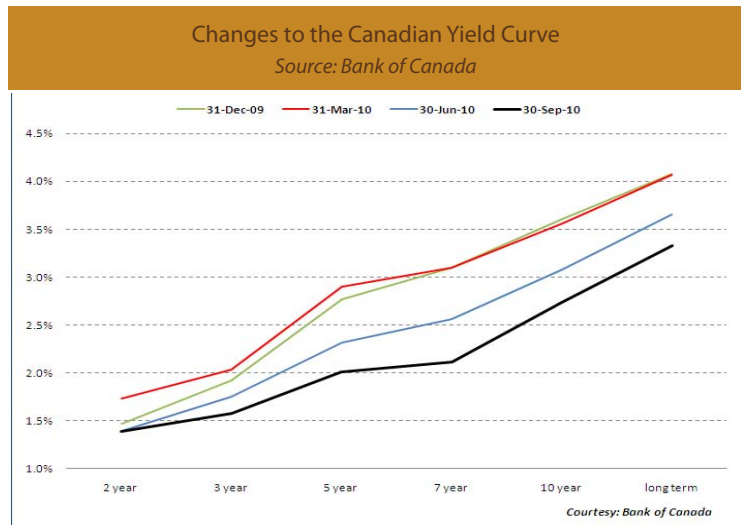
the U.S. Federal Reserve to hint at potentially initiating another round of monetary stimulus. With short term interest rates already as low as possible, additional stimulus would have to come in the form of quantitative easing in which the Fed would try to force longer term yields lower. While the U.S. central bank didn't provide details, many investors assumed the Fed would simply purchase outstanding U.S. Treasuries and that led to a sharp rally over the balance of the month.

As shown in the chart below, the Canadian yield curve has flattened noticeably through the year. Yields on 2-year Canada bonds have fallen a paltry 8 basis points year-to-date while, in contrast, yields on longer term Canada bonds have fallen 75 basis points. Similarly, in the third quarter, two year bond yields finished the quarter unchanged from June 30th (despite interim fluctuations) while longer term bonds have fallen 32 basis points.

In the United States, the yield curve remained steep as shorter term bond and 30-year U.S. Treasury yields fell roughly the same amount

from June 30th. The relatively small yield changes belied the volatility in U.S. bond market during September. A sharp sell off early in the month was followed by a strong rally as the market became increasingly fixated on the possibility of bond purchases by the Federal Reserve.

With the DEX rising 3.15%, Canadian Provincial bonds were the best performing sector in the quarter, returning 4.46% followed closely by the Municipal bond return of 4.23%. In large part, the strong performance reflected the longer average duration of provincial bonds combined with the larger decline in longer term yields. Corporate A bonds returned 3.18% in the quarter with investment grade BBB bonds returning 3.90%. Strong investor demand absorbed \$5.4 billion of new corporate bond issues and corporate bond yield spreads still narrowed 3 basis points. Government of Canada bonds were the worst performing sector as they returned only 2.41% in the period. The lower yield and shorter duration of federal bonds held back their returns this month.





The bond market has been driven in large part by fears the US economy may fall back into recession and the Canadian economy suffering as a result. As we mentioned earlier, while the US economy is clearly fragile and unemployment continues to plague potential growth, there are still strong signs that the US will maintain a moderate rate of growth over the next couple of years. The housing sector remains depressed with excessive overhang however there are signs that demand for new housing is beginning to turn. A turnaround in this sector, combined with improvement in other cyclical sectors such as manufacturing, should continue to improve the economic outlook and strengthen investor resolve.

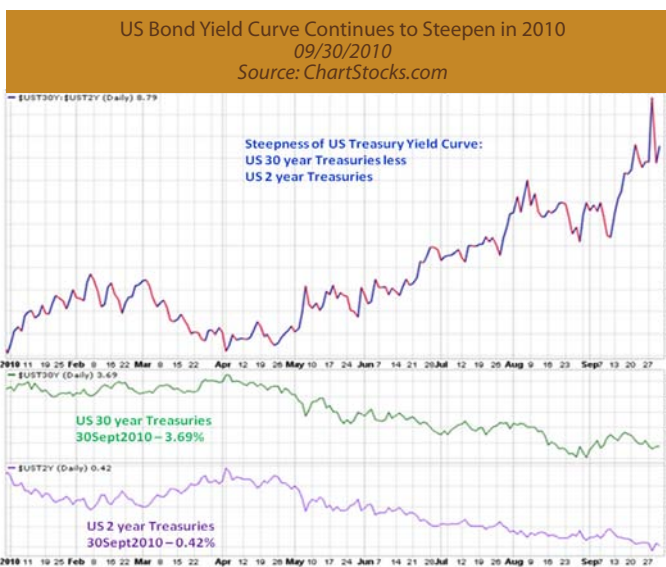
In our opinion, investors should be cautious toward the bond market. Yields on both sides of the border are too low given the current economic environment and the likely path for future growth. The Canadian economy is neither in recession nor likely to soon re-enter one given that all of the production and jobs lost in the recent recession have been recovered. In the United States, the recession was deeper and the recovery

has been slower, but economic growth remains positive though muted. Unfortunately, the typical US consumer is still rebuilding his or her balance sheet. In addition, mid-term election politics are preventing any legislative attempt to stimulate the economy.

Additionally, our cautious view of the bond market is fed by the potential for a reasonable stock market rally to draw investors away from the safety of fixed income and back into risky asset classes. Corporate profitability has been improving and many companies

accumulated high levels of cash over the past two years, suggesting stock valuations are increasingly attractive. At the margin, we would expect a shift toward stocks and away from bonds as the recovery proceeds.

Twenty years ago the US ten year bond yield was 8.25% - today that same yield is 2.53%. We expect to see yields rise as the prospect of quantitative easing in the US fades away to history and prices correct. Investors need to be wary of "irrational exuberance" in bond market prices.



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