

October 2, 2012

Global equity markets generally performed well in the third quarter, despite some continuing macro-economic headwinds. The Canadian S&P/TSX Composite Total Return Index generated a return of 7.0% in the quarter and the US S&P 500 Total Return Index produced a 6.4% return. By comparison, bond returns were generally relatively flat.

This trend of headline macro-economic risks and positive longer-term equity performance may continue for some time. There is little doubt that the economic recovery since the 2008/09 recession has been very gradual and below expectations. However, over the last three years the Canadian and US equity markets have generated positive annual, compound total returns of 5.5% and 13.2% respectively.

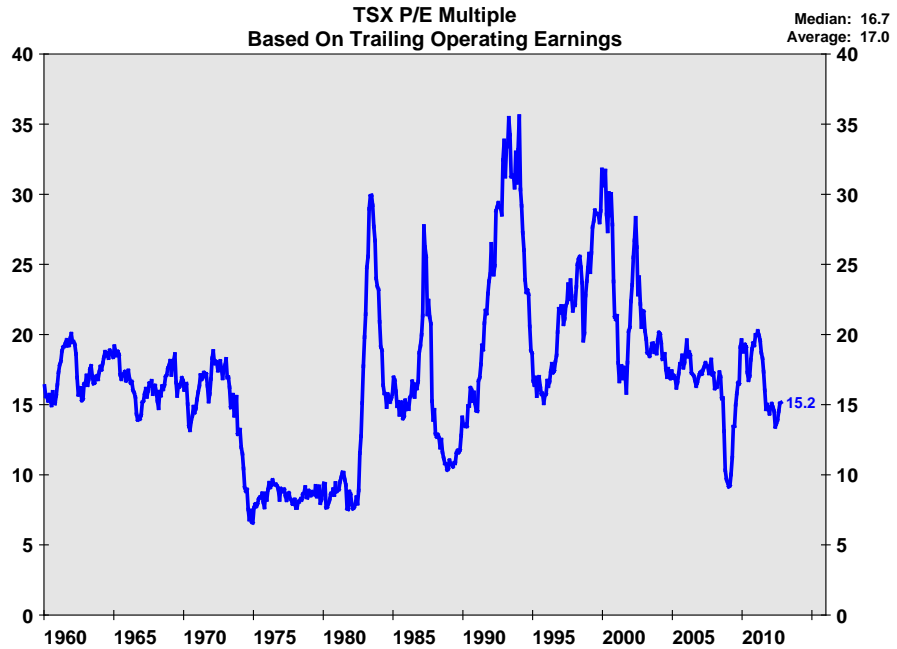
Our view is that equity investors have generally been discounting (expecting) very little economic growth *and possibly even a mild recession?* As a result, even tepid GDP and corporate earnings growth results are meeting or beating investors' expectations. However, positive earnings growth and several years of decent market performance haven't allowed investors to forget the carnage of 2008/09.

Retail fund flows into equities continue to be light. What little money is being directed to equities tends to be in balanced or dividend funds. Even professional strategists are bearish. Among Wall Street strategists, the recommended stock weighting is 44%. This compares to a long-term average of over 60%. As Tom Bradley, President of Steadyhand Investment Funds Inc. points out, ***"when everyone is bearish the downside risk is more limited because most of the distressed selling has been done"***. Bearish sentiment, even among strategists, is a very bullish indicator.

The macro-economic headwinds include a slow resolution to the European debt crisis, the gradual de-leveraging of U.S. governments and consumers and a slowdown in economic growth in China. Both the European and U.S. situations are going to require austerity in some form to be resolved. The implications of debt de-leveraging are not positive for robust economic growth. Any combination of tax increases and spending reductions will be a drag on GDP growth. These changes are going to be unpopular and take a long time. Investors will likely have to get used to slower growth than we have become accustomed to.

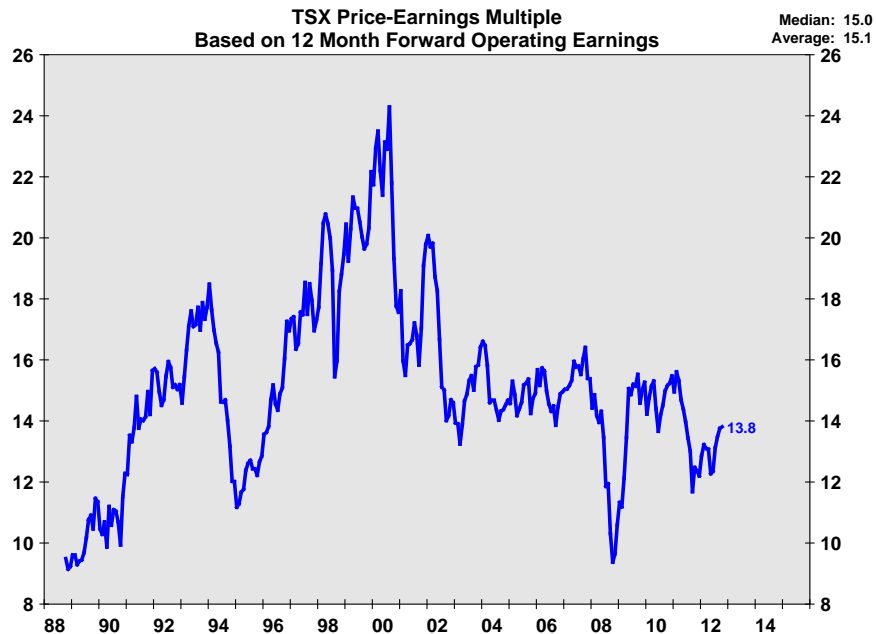
Again, the good news for investors is that this scenario seems to be what the market is discounting. Despite alternative asset classes like bonds and real estate trading at historically high valuations (low yields), stocks are trading at attractive valuation levels.

The charts below show that the Canadian market is trading below the long-term average of both trailing and forecast earnings. Forecast earnings have also recently begun to be revised upwards, an unusual situation which again indicates that even modest economic growth is exceeding market expectations.



M11

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M2050

Bottom Up Earnings Based on CPMS Consensus

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Source: TD Securities Inc.

The slowdown in growth in China has reinforced our view of maintaining only a modest weighting in Materials. Many commodities have traded above their long-term average prices (and above their marginal cost of production) for many years, largely in anticipation of an insatiable appetite for natural resources in China. Economic growth in China hasn't ground to a halt, but expectations may need to be recalibrated.

The Canadian economy and stock market have many redeeming features other than abundant natural resources. We are finding compelling investment opportunities in the Consumer, Industrial, Technology and Financial Services sectors. We continue to believe that patient, equity investors will be rewarded.

Warmest Regards,

The Seymour Team