



Preservation of Capital - Managing for Challenging Times

We came into 2010 having transitioned our portfolios to both a slight underweight in equities as well as a more defensive posture. We wrote in January that investors should gear up for a tougher investment climate and that over the next quarter or two things would prove to be interesting. The slowdown in China and the fiscal mess in Europe are now proving our strategy to have been timely. After initially sailing into the quarter with a full head of steam the global economic recovery has lost some of its momentum. Weighed down by the sovereign debt crisis in Europe, concerns over slower global growth and the sharp rise of the U.S. dollar, markets exhibited increased volatility. Concerns abound over the stamina of the U.S. recovery, having initially successfully responded to measures put in place to stem their economic slide. The latest economic data find that economy bogged down and struggling to stay on track. Also contributing to investor concerns was Asia, as both China and India were dealing with domestic issues. With overheating economies, and accelerating inflation, authorities were forced to institute measures which would maintain solid growth, but at a slower pace. With this in mind, but also to help transition their economy from export oriented growth to domestic consumption based growth, the people's Bank of China announced enhanced Yuan exchange rate flexibility.

The majority of the damage done to markets was caused by investors moving away from higher risk assets and considerations surrounding the repositioning of portfolios and seeking the relative safety of US Treasuries. With the slowdown in leading economic indicators along with the rapid rate of erosion in the pace of earnings upgrades, some equities in certain markets have become too risky for many investors, as have bonds of the underlying government. Equity markets such as China, Russia, Eastern Europe and other international bourses, typically at the more risky end of the spectrum, proved to be quite volatile. Commodity and energy related equities, regardless of the market, mirrored these moves. Investors seem to fear that the global economy would be dragged back into recession as a consequence of funding stresses and sovereign worries in Europe. What is striking, however, is that the growth downgrade thus far has been modest. Whereas markets may be telling us that they remain confident about the growth story, they are clearly indicating their nervousness and vulnerability should economic data turn less friendly.

While risks to financial stability have clearly shot upwards over the past six months, history shows us that in past business cycle expansions, when temporary credit market pressures erupted against the backdrop of a steep yield curve, a temporary slowdown ensued, but no recession took place. If this is the scenario that is currently in play, then what we are looking at a correction in risk assets versus a renewal of the bear market, and a temporary slowing in growth and not a double dip recession. Currently, we believe in what our good friend Robin Griffiths writes "being brave now is tantamount to being foolhardy. The correct strategy is all about preserving capital". While history suggests that equity markets often maintain a cyclical personality for several years when they come out of recession (we maintain our long term positive outlook), we would prefer to resist the temptation to chase any and all intermediate rallies until our crystal ball becomes less murky. Without a clear picture of what is going on, to try and "time" or be in front of the market, is futile.

Overview

Global economic recovery has lost some of its momentum.

Investors moving away from high risk assets and reposition portfolios.

Growth downgrade has thus far been modest.

Being brave now is tantamount to being foolhardy. Trying to time the market would be futile.

Canada's growth rate will top that of the G7 nations.

Latest data shows U.S. economy hitting some kind of wall.

Economic growth prospects for the euro land remain in doubt.

Metal markets will be amongst the first casualties in any perceived slowdown.

This is a cycle wherein investors will face greater than usual risks which also means greater than usual volatility.



United States

Struggles on the political front and a slew of soft data releases which have hindered an economy trying to get its act together, have contributed to investors' jitters. This latest data, which show the economy hitting some kind of wall, have contributed to the Federal Reserve remaining fixated on staying the course and not raising rates. While we do not share their sentiments, investors' fears now surround the notion that the U.S. economy may be headed for a double-dip recession. With little trust in European and Chinese growth, it is ironic that once again global growth expectations and the path of global equities are being driven on the back of the U.S. consumer. Unfortunately, even though all twelve Fed districts reported improving economic activity, the latest payroll report showed anemic performance, and as the U.S. labor market goes, so goes the U.S. consumer. While certainly not strong, recently released data do point to a broadening out from the manufacturing and export sector, rippling into the service sector and investment spending, with even some progress being seen in real estate lending. However, contagion fears in Europe and slowing growth in Asia have tempered expectations for further growth in trade activity, while corporate earnings revisions have reached a point where earnings upgrades are now being matched by earnings downgrades. With markets on edge regarding the prospects for global growth, Federal Reserve Chairman Bernanke's recent Congressional testimony has calmed (somewhat) rattled nerves. While warning congress that the budget is "on an unsustainable path", his cautious optimistic outlook and reaffirmation that policymakers would do what it takes to support the recovery, was welcomed by capital markets. On the regulatory front, the heavy lifting needed to reconcile the House and Senate versions of financial reform has been completed. Once signed into law, the Dodd-Frank Act will be the most sweeping overhaul of financial regulation reform since the Great Depression and while uncertainties regarding specific details remain, it should help to reduce uncertainty.

Canada

Heading into the mid-point of 2010, the Canadian economy continues to exhibit growth and is building confidence that it is on a self-sustaining path. Recent information reinforces the view that the economy is transitioning from post recession acceleration phase to a slower growth path. GDP will likely expand across the country with the strongest growth rates being seen in the west, driven by commodities while growth in central Canada is tempered by the strong dollar. Recent employment data fit easily into this story with underlying details (the mix in jobs) that imply even better fundamentals lie ahead. As of the end of May, the economy was just 108,000 away from erasing all the jobs lost since October 2008, which is the fastest recovery in the post World War II era. While housing starts have slipped a little and current market valuations are possibly overpriced, the market is not showing evidence of an over-build at a national level and the favorable supply-demand mix should be supportive of prices. Driven by a large build-up in inventories, capacity utilization continues to rise, bringing with it a brighter picture for capital spending. While the Bank of Canada announced a 25 basis point increase, the tone of the statement which accompanied the increase was unusually dovish. Mr. Carney's concerns centered on more rapid tightening of fiscal policies in advanced economies, which could lead to a more protracted recovery. Looking forward, we anticipate that the strong growth of the past six months will slow but remain fundamentally robust and that Canada's growth rate will top those of the G7 nations in 2010.

Euro zone/United Kingdom

Europe is being lashed by storms spawned in the Mediterranean. Sovereign credit risk metrics in the club-med nations continue to generate significant levels of nervousness resulting in market volatility remaining high with downside risks to the euro persisting. Spain and Italy joined Greece and Portugal and announced budget cuts to address fiscal weakness, investor concerns and to help defend the euro. Economic growth prospects for the euro zone remain in doubt as even the experts seem divided. The European Central bank (ECB) is likely to maintain its current monetary stance as a low interest rate environment may stimulate private investment and consumption and together with a boost in exports - due to the low levels of the euro - there will be some positive underpinnings for the region's economy. Thus far, however, it seems only to be helping Germany, the manufacturing juggernaut who is now exporting record volumes. Meanwhile, in spite of what can be characterized as formidable challenges, in the U K evidence over the last few months clearly suggests that a gradual recovery is taking hold. Accommodative monetary policy remains an important source of stimulus. On the negative side, austerity measures in a number of euro area countries and domestic public spending cuts could dampen the recovery somewhat.

Asia/China/Japan/Emerging Markets

Rising velocity and a tighter labor market suggest that inflationary risks are real and rising in China. Authorities are increasingly under pressure to tighten monetary conditions - which they have been doing to stem a real estate excess. More recently, China's central bank announced that they would abandon the RMB peg against the U.S. dollar, thinking it would help control overheating by raising the value of the RMB. Some, however, viewed it as a tactical and clever move ahead of



the G20 meetings. Credit has been sharply curtailed and some investors now fear that this is a domino set in motion for Asia proper. Leading economic indicators not only in China, but for neighboring countries as well, have started to roll over. Any slowdown in Chinese activity, especially in fixed asset investment and infrastructure spending, would curtail demand for raw materials and feed negatively into industries that support the build-out. Concerns are now starting to emerge on the labor front as organized protests are far more widespread than previously thought, prompting fears of copycat industrial action that will ultimately raise costs for multinational companies. Meanwhile, although activity data may be printing a little mixed, it remains consistent with the story of an economy that is growing above trend. In India, the declining fiscal deficit is helping to crowd-in private investment spending. An increase in tax revenues, higher custom duties on gold, silver and crude oil along with the proceeds of the 3G-telecom license auction have substantially curtailed the government's borrowing requirements. Industrial production continues to expand, re-accelerating on the back of a surge in capital goods and consumer durables output. In Japan the near term focus will be on economic policies to stimulate growth while at the same time the Kan cabinet will be working to tighten its fiscal belt. The later will likely result in reduced government outlays, increased taxes and as a consequence slower growth.

Commodities

While most key commodity prices remain well above year ago lows, the first half of 2010 has proved disappointing for those who looked for a carryover of last year's strong momentum. A number of factors are currently influencing prices – the managed slowdown in Chinese economic growth, the end of re-stocking with the OECD countries and the continued fall of the euro against the U.S. dollar. Further tightening will not only impact growth in China, but globally as many investors have pinned their sails to Chinese masts. While they may be in a long term secular uptrend, metal markets will be amongst the first casualties of any perceived economic slowdown, but also the first to recover on positive economic developments. It is probably the perception that the demand/supply fundamentals for the commodity complex will tighten into 2011 that has made investors/speculators hesitant about building aggressive short positions. That is not to say that risks aren't elevated, especially when additional regulatory uncertainty (i.e. Australia and the proposed Resource Super Profit Tax) is added into the mix. Meanwhile, crude inventories are at very high levels and history shows us that when European economies weaken, demand falls materially. The current economic challenge has seen demand decline by over one million barrels per day, and, with the worst of the troubles possibly lying ahead, uncertainty prevails. However, with uncertainty comes opportunity, and for the disciplined investor the well known trends of Chinese urbanization and industrialization should bear fruit for a “timely” constructed portfolio of commodity issues.

Recommendations

Equities have now entered the second stage of the recovery cycle consistent with an inflection in leading economic indicators. This stage is typically characterized by increased volatility within equity markets and lower returns as the onus shifts from multiple expansion to earnings deliverability. Furthermore, this is also a cycle wherein investors will face greater than usual risks which also mean greater than usual volatility. Historical analysis confirms that summer weakness is more than just market lore. Add to this the Presidential cycle, and we may have a summer which may prove particularly gut wrenching. We felt that, after sustaining a strong move off their February lows, markets were in need of a correction in order to build the next base from which they could move forward. This was reflected in our asset mix wherein we have maintained equity levels at below benchmark levels. We continue to anticipate additional rotation away from the cyclical sectors as economic and financial concerns either linger or mount, creating more volatility over the summer months – but also providing opportunities. In this environment, strict adherence to buy/sell levels can generate positive returns. Although our portfolios are currently heavily weighted to Canada, we continue to search for large-cap global companies with strong exposure to developing markets. Having felt that recent commodity and crude oil prices were not reflective of actual fundamentals (it seemed that prices were being driven more by speculation than demand), we remained underweight both energy and the materials sectors. We are anticipating that by late summer/early fall the fallout and ramifications of the euro situation and Chinese slowdown should be better understood. This should give us a clearer picture of whether or not and to what degree, we would want to establish more normal holdings in these sectors. Our emphasis has been more towards the consumer staples and discretionary sectors, two more defensive areas in a declining market and key players in our “dividends are back in vogue” theme. With the prospects of slowing growth in China, the crisis in euro land and what appears to be a jobless recovery in the U.S., we are not anticipating central banks to raise rates in the near future. With this in mind, we used market weakness during the quarter to extend the average term of our bond portfolios - emphasizing provincials and high quality corporate issues. We also continue to monitor the preferred share market, looking to use market opportunities to add to positions.



FORECAST 2010

	Current Q2/10	2010E Range	2010E Year-end
Interest Rates			
Bank of Canada Overnight rate	0.50%	0.25%-0.75%	0.75%
Federal Funds Rate	0.13%	0.13%-0.75%	0.75%
10-year Canadian Treasury	3.08%	2.80%-3.80%	3.25%
10-year US Treasury	2.95%	2.70%-3.80%	3.00%
Commodities			
Gold (US\$/oz.)	\$1,192	\$1,075-\$1,350	\$1,300
Copper (US\$/lb)	\$2.98	\$2.60-\$3.60	\$3.10
Oil WTI (US\$/bbl)	\$72.50	\$65.00-\$85.00	\$80.00
Markets			
S&P/TSX Composite Index	11,275	10,500-12,500	12,500
S&P 500 Index	1,041	1,000-1,250	1,200
Canadian dollar/US dollar	\$0.945	\$0.90-\$1.00	\$0.97

ABOUT THE FIRM

Headquarters: Montreal, Quebec
Founded: 1981
Staff: 21
Portfolio Managers: 6
Investment Style: Growth at a Reasonable Price (GARP) with a value bias.
Investment Process: Top-down / Bottom-up
 Focused portfolios, 35-45 positions
Investment Objective: To provide long-term capital growth
Assets Under Management: \$770 million

CORE INVESTMENT THEMES

- Favouring Dividend Growth Companies
- Energy (Oil/Oil Sands)
- Infrastructure (Spending)/ Technology (Upgrading)
- Emerging/ Developing Markets Exposure (direct/ indirect)
- Basic Materials (Gold, Agriculture/Fertilizer, Base Metals)

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