



<p>Canada</p> <ul style="list-style-type: none"> ➤ Bank of Canada President, Mark Carney warns of a potential housing bubble forming in Canada ➤ Canada's labour market tightens as economic expansion continues <p>United States</p> <ul style="list-style-type: none"> ➤ U.S. economic expansion and job growth slowing ➤ Housing market stabilizing across most regions ➤ U.S. approaching debt ceiling, expect modest spending cuts from US Federal government <p>Europe</p> <ul style="list-style-type: none"> ➤ German economy continues to surprise on the upside, led by exports into China and Eastern Europe 	<p><u>Second Quarter 2011: Decision Making and Uncertainty</u></p> <p>In our first quarter commentary, we felt that economic growth was set to moderate as a result of two transitory factors: the spike in the price of oil from the shock of the civil war in Libya; and the disruption in the global supply chain after the Japanese tsunami of March 2011. The economic weakness that we projected led to a broad sell off in stock markets during the second quarter of this year ending June 30th, and a strong rally in investment grade and government bonds.</p> <p>The short-term slowdown in the global economy has reduced speculation in the oil markets, with crude falling from a high of about \$110 per barrel to a low of \$90 in June. In turn, gasoline prices have moderated, which will help with consumer sentiment and consumer spending going forward. In Japan, full power has been restored throughout the Japanese electrical grid, and the supply chain is coming back to normal at a faster than expected rate.</p> <p>However, despite these improvements, consumers in the U.S. are still struggling with high debt levels, and are responding by increasing their savings rates. The desire to reduce debt at the consumer level, combined with slowing government spending going forward, will mean relatively slow economic growth in the U.S. for years to come. In turn, high savings rates will keep interest rates low and inflation in check.</p> <p>In Europe, the bigger issues still revolve around the so-called periphery economies of Greece, Portugal and Ireland, and their ability to manage their debt and access the capital markets to fund their deficits. On that front, the news has been somewhat encouraging with Germany winning key financial concessions from Portugal and Greece in exchange for European Union (EU) support to reduce the cost of their debt, and to help finance their current account deficits. Despite this progress, Greece's inability to rein in spending is likely to persist for some time, and a significant debt restructuring that shares</p>
---	--



<p>➤ European Union struggles to find long-term solutions for the debt problems of Greece and Portugal</p> <p>China</p> <p>➤ Chinese inflation rates remaining stubbornly high</p> <p>➤ Chinese government is continuing to restrict bank lending and raise interest rates</p> <p>➤ Economic growth slowing but still above 9.5% driven by investment spending and real estate construction</p> <p>➤ Chinese economy remains highly vulnerable to any slowing in exports or in their booming and over-valued real estate market</p>	<p>losses between the sovereign and private sectors is inevitable at some point.</p> <p>Along with Europe, the great wild card in analyzing global economic trends continues to be China. On the surface, Chinese economic growth appears to be very strong at 9.6% per annum. However, these high growth rates are almost entirely driven by two factors: real estate development; and infrastructure spending. Consumer spending remains a small percentage of the Chinese economy (36%) as Chinese citizens are prodigious savers in part to make up for a lack of government supported social security, unemployment insurance and health care.</p> <p>So the big question when looking at China, is just how sustainable is its growth rate going forward? There certainly is evidence that the Chinese real estate market is in a valuation bubble, and the government has reacted by severely restricting the availability of mortgages. They are also using the state-owned banks to provide cheap construction loans to real estate developers in order to increase the supply of new homes. Together, this will either create a “soft” landing for their real estate market or, worse case, a crash. Either situation is likely to slow Chinese economic growth going forward.</p> <p>With respect to investment spending on infrastructure projects, the Chinese government is sitting on \$US 3 trillion of foreign reserves, and can fund investment projects almost indefinitely. Investment spending represents about 35% of the Chinese economy and continues to expand rapidly.</p> <p>Taken together, we believe that consumer spending and infrastructure will continue to grow, but real estate spending will decline. Overall growth in China is likely to slowly decline from today’s headline numbers of 9.6% to a more sustainable 7.0% rate over the next several years.</p>
--	---

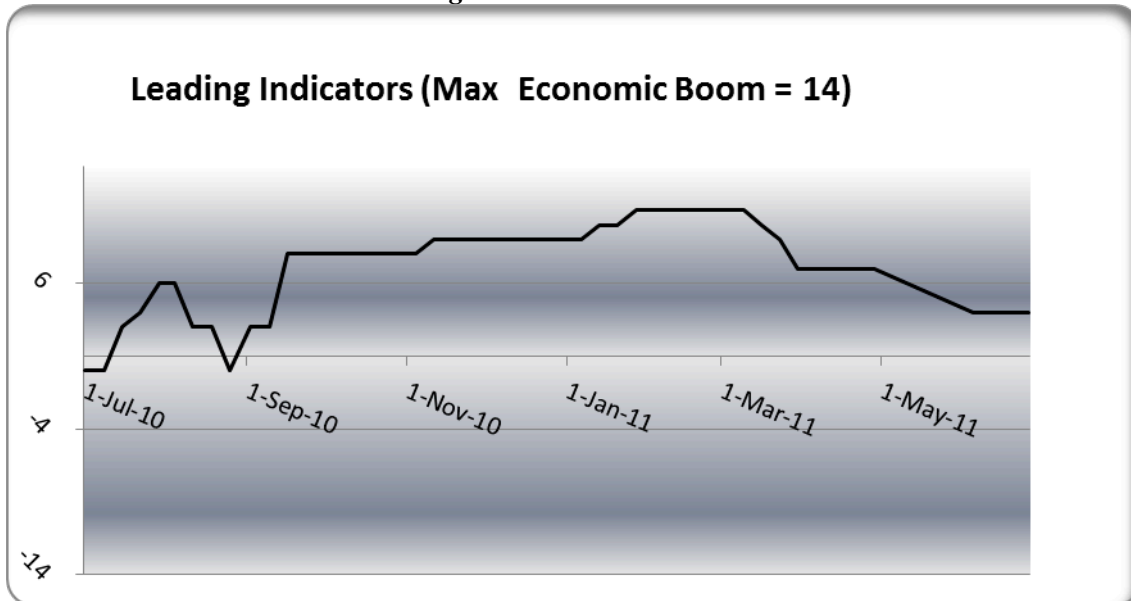


Economic Outlook 2011-2012:

Main Street Growth Slowing – All-in-all, recent geopolitical events will cause a measurable reduction in global growth, while ensuring that short-term interest rates will remain at extremely low levels. This macro environment continues to be supportive for investments in stocks, corporate debt and selective commodities including copper, oil, gold and silver.

Our leading economic indicators (**Chart 1**) declined during the second quarter of 2011, and are at levels that suggest economic growth is likely to remain sluggish going forward. Employment growth in the key U.S. market has slowed, but there are signs that the all-important U.S. housing market is beginning to stabilize. If so, bank lending and employment growth may improve in the second half of 2012.

Chart 1 - Global Economic Leading Indicators



The Trillion Dollar Elephant in the Room – As we have written numerous times in the past, the greatest long-term concern to the capital markets both for bonds and for stocks, is the huge U.S. fiscal deficit. This is a concern that we have had going back to 2002 when we started buying gold and precious metals as a hedge against the U.S.





government's irresponsible spending combined with the ill thought out tax cuts enacted under the presidency of George W. Bush. Today's U.S. deficit is running at \$1.3 trillion per year, or 9% of the Gross Domestic Product (GDP) of the United States. The net U.S. federal debt is about 70% of GDP, which is still below the levels of most developed countries, but this total excludes looming deficits in the U.S. Social Security and Medicaid programs as baby boomers begin to retire.

There is no question that the long-term viability of the U.S. economy (and of their currency) is dependent on the ability of their politicians to tackle difficult and politically-charged issues with respect to government spending, entitlement programs and taxation. The Republican Party is adamant there will "be no new taxes", and in fact, Republicans wish to reduce corporate tax levels from 35% to 25%. The Democrats are equally adamant that taxes for high wage earners must increase, and that corporations must also share the burden. The U.S. public, by a margin of almost 2:1, sides with the Democrats on this all important debate, so one way or another, taxes will rise in the U.S., and spending will be cut.

With respect to Social Security, there may be room for compromise with the Republicans, led by the Chairman of the House Budget Committee, Paul Ryan, offering to grandfather those 55 and over, while reducing government retirement promises to those under 55. Retirement age for public employees is likely to rise in the not-to-distant future. While these policies will help to put the U.S. Social Security program on a sustainable path, the vast philosophical differences between the two parties in terms of the role of government, and how to fund that role, will still make it very difficult to significantly reduce Federal government deficits in the short run. Under these circumstances, the most likely path is a gradual slowing in government spending alongside entitlement reform, and a slow reduction in the deficit as a percentage of GDP.

The Game Plan - Modest economic growth, low inflation, and high debt levels suggest that the economy, and public stock markets, will remain vulnerable to shocks such as this year's economic fears over Japan and the Middle-East, and last summer's fears about Europe. It would be sensible to assume that the markets will remain more volatile than the underlying economy, thus creating trading opportunities from time-to-time. For the next few years, stock and bond market returns are likely to remain at, or below, their long-term averages, meaning that high yield and alternative investments should play a larger role in portfolios. These types of investments will reduce volatility, help to preserve capital when public markets are under pressure, and generate steady income for reinvestment or retirement needs.



Capital Markets Outlook:

Bond Markets – Government bond yields in Canada and the U.S. dropped dramatically during the second quarter of 2011, as investors sold stocks and commodities to invest in bonds which tend to be viewed as a safe haven when economic growth slows. The U.S. 10-year Treasury bond yield finished the quarter with a yield-to-maturity of 2.90% (see **Chart 2** below). Shorter-term interest rates in Canada and the U.S. are still below 1.0%, although these rates may begin rising in the second half of 2011 as policy makers begin the process of normalizing interest rates. Inflation expectations, while rising in Canada, are still relatively modest with the bond market signaling less than a 2.0% inflation rate as the most likely course going forward.

Chart 2: US 10-Year Bond Yield – Six Months Ending July 11, 2011



In this environment, we see little upside to owning government bonds as the risks outweigh the potential returns by a considerable margin. Investment grade corporate bonds, high-yield “blue chip” stocks, and rent producing real estate all offer superior risk/return tradeoffs versus passively investing in sovereign debt.

North American Equity – The decline in stock markets during the past three months has moved the markets from a modestly overvalued position to a modestly undervalued position. The current level of the S&P 500 in the United States for example is “discounting” future long-term returns for equity investors of between 5.5% and 6.5 % per annum. **Chart 3** on page 6 highlights the most likely paths for the stock markets going forward. The blue “Fair Value” line shows our current and future estimates for the

100 Adelaide Street West, Suite 200, Toronto, Ontario, M5H 1S3

www.macnicolasset.com

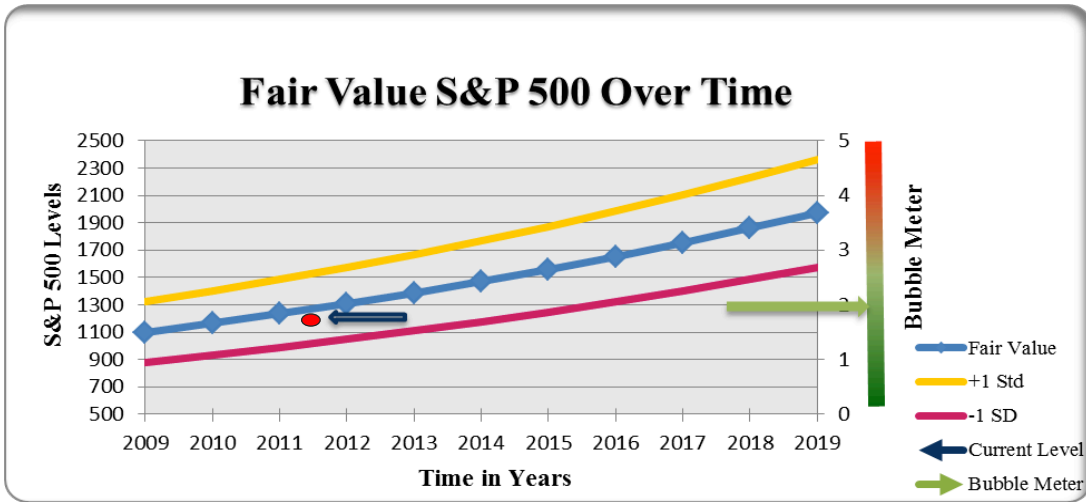




fair value of the S&P 500 equity index in the U.S. On the right axis we have superimposed our “Bubble Meter” readings which are used as a gauge to help determine the level of speculation in the stock markets. All else being equal, low speculation means less downside risk for investors and vice versa. Today, the “Bubble Meter” is in a neutral position, meaning that there is no excess exuberance (or pessimism) in the stock markets.

With respect to valuation, the U.S. stock market as of June 30, 2011, was slightly below its fair value (red dot on Chart 3) using what we believe to be conservative inputs into our model. At today’s level, the S&P 500 is discounting future (nominal) growth rates for dividends of 5.8% per annum, which appears about right to us given today’s low dividend payout ratios, high corporate cash levels and continuing global economic growth. With reinvestment opportunities at relatively low levels, corporations will continue to increase their dividend payouts and stock buybacks, which should help to move the markets higher over time.

Chart 3 - S&P 500 Fair Value over Time



Bullion and Precious Metals - Prices for gold and silver continued to climb during the second quarter of 2011, with gold trading as high as \$1,550 per ounce. There are many factors driving this trend, the most important of which appears to be the ultra-low interest rates that currently prevail in most of the world’s developed economies and political and economic instability in the Middle-East and Greece. With short-term interest rates well below current inflation rates, so-called “real” (after inflation) interest rates are now

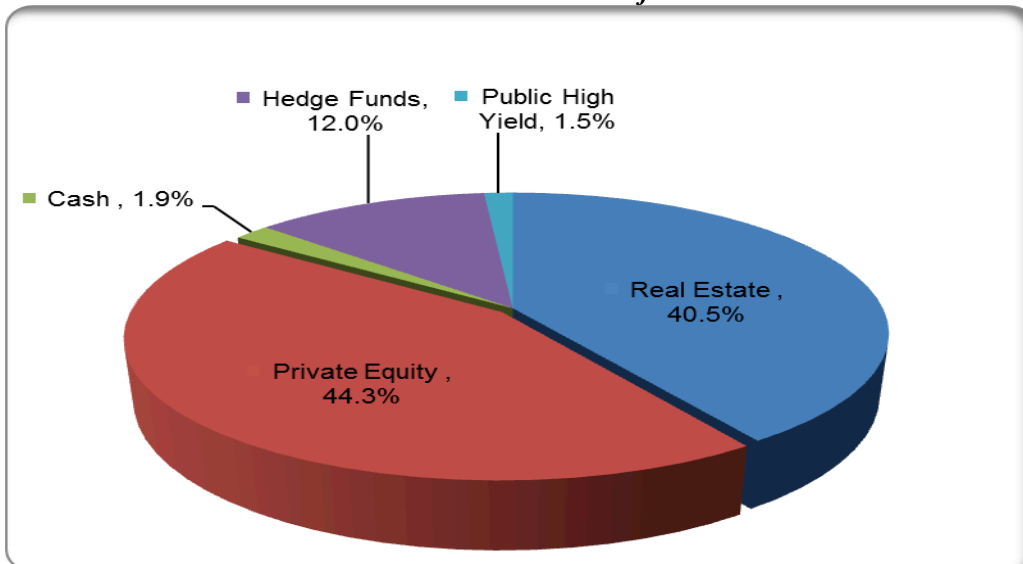


negative. This same phenomenon occurred throughout most of the 1970's which, not coincidentally, was the last great period of gold outperformance. Negative real interest rates discourage savers from investing in short-term paper, and in this environment some of the normal demand for money market and savings accounts finds its way to gold. Gold is now viewed as a substitute for paper currencies, especially when investors are not being properly compensated for investing in U.S. dollars. In addition to low interest rates, there are several additional factors driving gold higher including a perception that the global banking system is still at risk, fears of large sovereign debt levels, investor demand for alternative assets, high gold mining costs and a lack of new mine supply.

MacNicol & Associates Alternative Asset Strategy Update:

MacNicol Alternative Asset Trust– We continue to invest the Alternative Asset Trust into a mixture of North American real estate (the 360 Degree Fund), hedge funds (the Absolute Return Fund), and private equity (the Emergence Fund). **Chart 4** below highlights the asset mix of the Trust as of June 30, 2011.

Chart 4 – Alternative Asset Trust Investment Profile



During the quarter, the Alternative Trust made additional investments in U.S. real estate, with an emphasis on residential and commercial mortgages, bridge loans and garden apartment complexes. These investments are primarily focused on business friendly and growing regions of the U.S. including Georgia, Florida and Texas. The Trust also

MACNICOL & ASSOCIATES ASSET MANAGEMENT INC.



increased its investment with the Georgian Partners private equity fund. Finally, the expected initial public offering of Union Agriculture is on track for an August listing on the New York Stock Exchange. The Alternative Trust has a meaningful position in this company, and we look forward to its public market debut.

MacNicol & Associates Asset Management Inc.
July, 2011

100 Adelaide Street West, Suite 200, Toronto, Ontario, M5H 1S3
www.macnicolasset.com

