

THE ALITIS STRATEGY REPORT

JANUARY 17, 2012

WWW.ALITISINVESTMENTCOUNSEL.COM

Significant Risks Continue

Alitis' investment outlook continues to be very cautious. Significant downside risks around the world truly make caution the best approach going into 2012. When we first wrote about the significant risks in June, 2011, we listed four major risks — US deficits, European debt, China, and US stock market valuation. To simplify things and make it easier to analyze many different inputs, the list of risks has been cut to three regions of the world — Europe, the United States, and China.

Risk #1: Europe

The Greek Tragedy Continues...

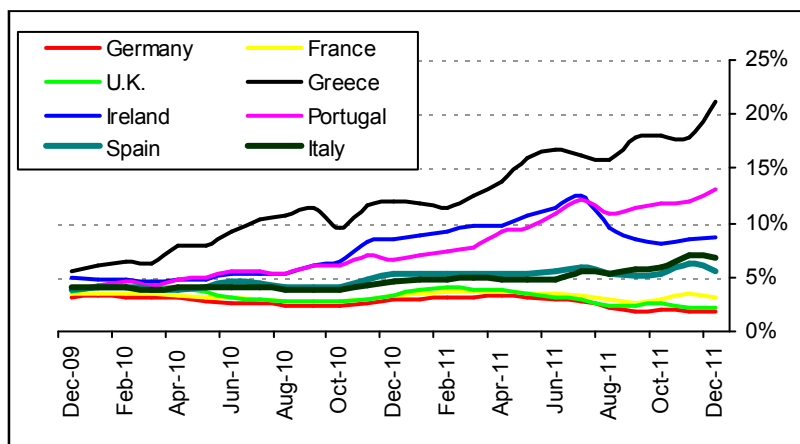
Everyone has probably grown tired of the European debt story but, unfortunately, it is still by far the biggest problem hanging over the world today. As we write this report, Greece and its creditors still have not come to an agreement on how much to write down the value of Greece's loans. Last summer, it was expected that private lenders would "voluntarily" accept a 50% write-down on their loans; now it appears that they are being asked to take an 80% write-down. Needless to say, a number of lenders are baulking at taking such a dramatic "voluntary" cut and may just try and force an outright default. In the long run, it may best to get the default over with since even this deal will leave Greece with a massive amount of debt to be repaid by a ruined economy. The question is if Greece defaults, who will be next? Portugal? Ireland? Greece is simply the start of the game. How the game ends is still up-in-the-air.

Much to Borrow at a Much Higher Rate

As is shown in the chart below, interest rates continue to generally head higher, particularly in those countries that are judged to be weaker. These increased borrowing rates will over time translate into significantly higher costs for

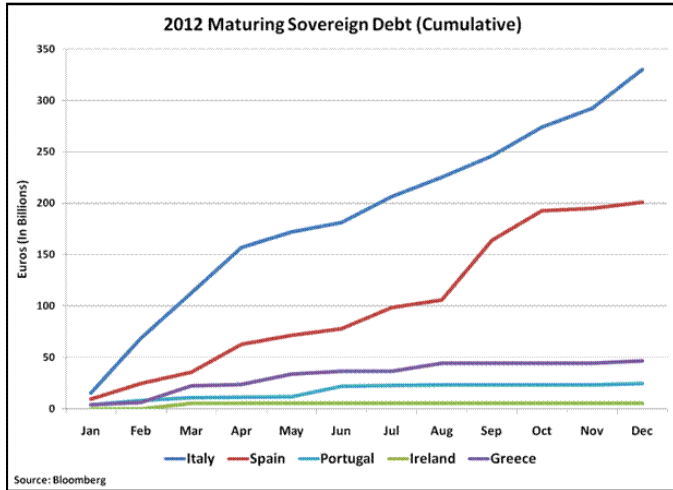
the affected governments in Europe. The truly scary countries to watch in 2012 will be Italy and Spain. As shown on the next page, these two countries have a substantial amount of bonds maturing this year — all of which will have to be rolled over into new bonds. If all purchasers of the maturing bonds reinvest into new bonds, then there will be no problem. If, however, investors want to take their money out of these perceived riskier countries, then interest rates will have to go up to induce further investment. The problem is that paying higher interest will make the countries even more risky and further push up rates — a rather vicious cycle.

10-Year Government Bond Yields



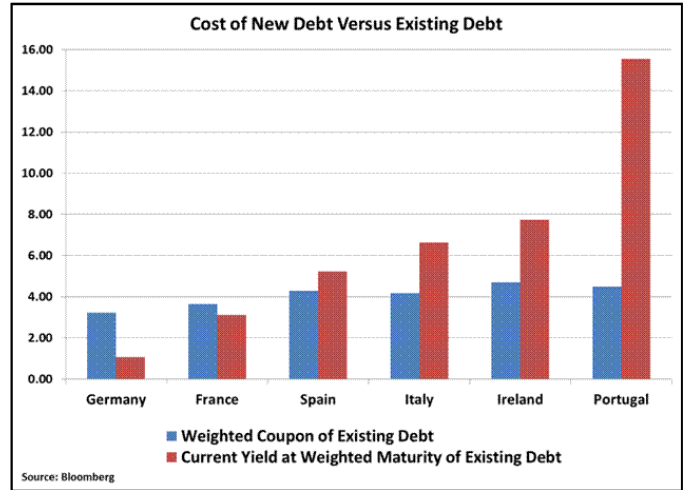
Source: European Central Bank, <http://www.ecb.int/stats/money/long/html/index.en.html>

Italy & Spain Have a Lot of Debt to Refinance...



Source: Bill Hester, Hussman Funds, "Five Global Risks to Monitor in 2012", <http://www.hussmanfunds.com/rsi/fiveglobalrisks2012.htm>

...and the Cost is Going Up!



Source: Bill Hester, Hussman Funds, "Five Global Risks to Monitor in 2012", <http://www.hussmanfunds.com/rsi/fiveglobalrisks2012.htm>

Conclusion

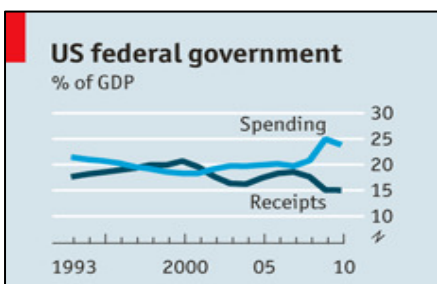
What was just presented are just the most pressing issues in Europe. There are certainly other risks which could pose serious problems. European banks need to refinance an awful lot of debt as well in 2012 (approximately 600 to 700 billion euros) and raise capital to meet new capital requirements. Given the wobbly state of European banks, who would want to lend to them or invest in them? And then there are all the political issues within the Eurozone. There have been numerous summits to solve the European debt crisis, but it still continues. Obviously, the politicians have completely underestimated or misunderstood the markets. The Bank of Canada summed up the European situation very nicely today in their latest update:

The sovereign debt crisis in Europe has intensified, conditions in international financial markets have tightened and risk aversion has risen. The recession in Europe is now expected to be deeper and longer than the Bank had anticipated in October. The Bank continues to assume that European authorities will implement sufficient measures to contain the crisis, although this assumption is clearly subject to downside risks. [Bank of Canada, "Bank of Canada maintains overnight rate target at 1 per cent", January 17, 2012]

Obviously, the Bank of Canada is hoping that the Europeans fix their problems but if not, there is clearly "downside risk." Our view is that potential rewards in Europe are not worth the risks.

Risk #2: United States

Debt, Deficits and Politics



Source: The Economist, "Shame on them" July 7, 2011

Since we last wrote about the US debt and deficit problem in June 2011, a lot has happened yet nothing has been fixed. The US government came close to defaulting on some of its debt in August when their debt ceiling was raised only at the last minute. Playing politics with the national debt was certainly not a confidence booster for the US economy or the markets, as witnessed by the market turmoil in August and September.

As shown in the chart to the left, the US government has a problem that needs to be fixed. Simply put, they spend about \$3 for every \$2 they take in revenue

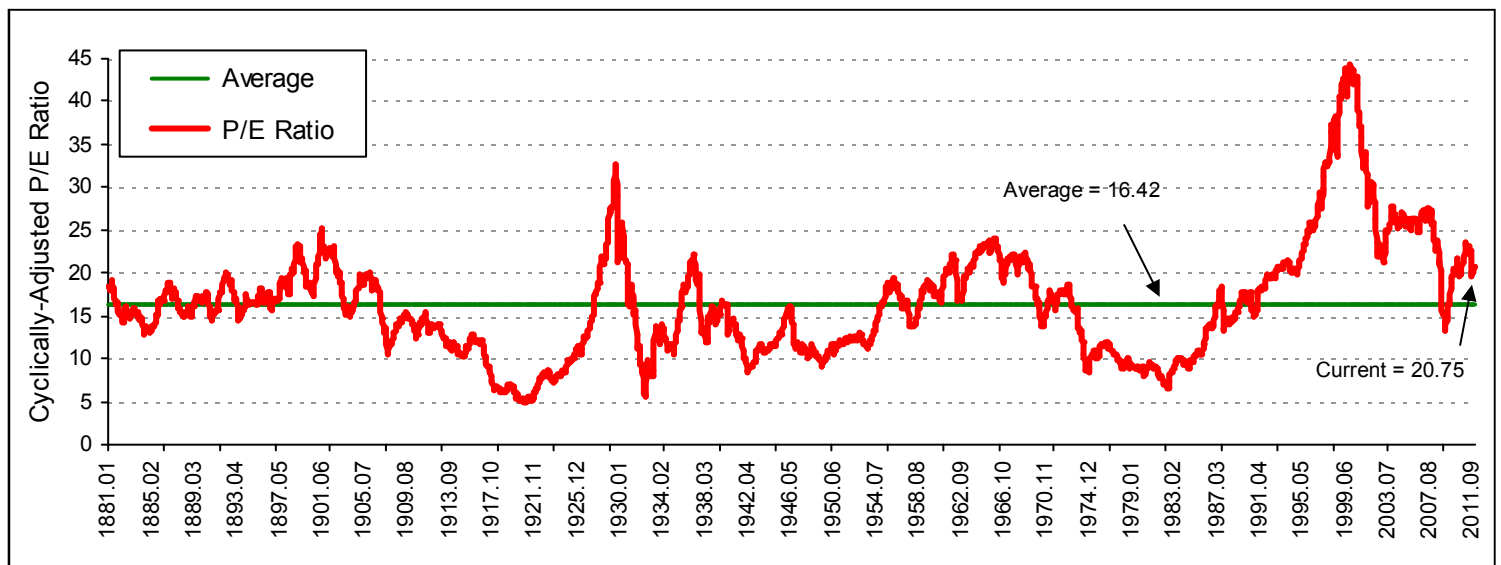
with the missing \$1 being borrowed. Obviously this situation cannot continue indefinitely, especially when the US government already has debt equal to about 100% of its GDP. Eventually, investors will stop lending money to the US government or, at the very least, demand a higher rate of interest.

In the meantime, the government has two choices — raises taxes to increase receipts or cut programs to reduce spending. In Canada, we would likely use a combination of raising taxes and cutting programs. In the US, it seems that the Democrats want to raise taxes while the Republicans want to cut programs. There is just no consensus on how to go about fixing the problem, so the problem keeps getting deferred. Since 2012 is an election year, there is little chance of anything getting decided until after the elections in November and even then, it will take some time to implement any plan to deal with the deficit. Divisive politics in the US only serves to delay dealing with the problem, which will only make it a bigger issue. When the problem is finally dealt with in a meaningful way, the US will be headed for higher taxes, lower federal government spending, and potentially higher interest rates. This will certainly lead to lower economic growth in the US as the government becomes a drag on the economy.

Stocks are Still Overpriced

Stocks are still overpriced in the US, but less so than they were back in June in our last report. According to Cyclically Adjusted Price/Earnings Ratio, stocks are trading at a price of 20.75 times earnings compared to 23.52 times earnings back in June. The average for US stocks since 1881 has been 16.42 times earnings. With the Cyclically Adjusted Price/Earnings Ratio, corporate earnings are adjusted for inflation and averaged over the previous 10 years. Research by Robert Shiller of Yale University has shown this to be a better measure of the valuation of the market than using current earnings alone. The graph below shows this P/E Ratio over time:

Cyclically-Adjusted Price/Earnings Ratio



Source: Robert Shiller, Online Data, www.econ.yale.edu/~shiller/data.htm

The current Cyclically Adjusted P/E Ratio is not too far above average but as you can see, the current value rarely stops on the average — it oscillates around the average. In this context, the P/E Ratio could easily drop below average. One also has to consider what would drive stock prices higher in this environment. It is difficult to see how prices could go substantially higher given all the downside risks in the economies of the world these days.

Conclusion

Politics will likely dominate the headlines in the US this year, but we may see other issues crop up. For example, there is a significant possibility that the US will head into a recession in the first half of the year. Various indicators

are showing mixed signals, but a number of very reputable, independent economist have forecast a recession. Given the political and economic uncertainty in the US (and those in Europe!) and the current level of valuation, we do not see much upside to stocks in the US. If something bad happens in Europe, however, we could see a lot of money moving to the US as a safe haven, which would push up the US dollar and the price of their government bonds, regardless of the debt situation.

Risk #3: China

China released its fourth quarter, 2011 GDP growth rate today and their economy grew at an annualized rate of 8.9%. According to reports that is the slowest rate in over two and a half years, but it is a tremendous number given what the developed world has managed to eek out recently.

So why is China a risk when it appears to be doing fine? The problem comes from looking at China in isolation from the rest of the world. The chart to the right (which was also included in our June report) shows the approximate demand for various commodities by China as a percentage of the world demand. Obviously, China consumes a lot of commodities!

But what are all these commodities used for? Some of them are used within China, but an awful lot of are used for manufacturing items for export and,

Composition of GDP

	Agriculture	Industrial	Services
China	10.2%	46.9%	43.0%
Canada	2.2%	26.3%	71.5%
US	1.1%	22.1%	76.8%
Europe	1.8%	25.0%	73.1%

as we know, many export markets are not in good shape right now, particularly the two largest — Europe and the US.

If we look at the composition of GDP for China, it is apparent that much of their economy is geared towards the production of goods and materials — nearly twice the level of developed countries. Given the slowdowns occurring in Europe, and quite possibly the US, it is very likely that exports from China will slow or decline in the near term. This would have the effect of reducing demand for commodities, of which Canada is a major supplier. Given the interconnected world in which we live, challenges in distant parts of the world can travel by various mechanisms to reach home here in Canada.

The commodity boom brought on by China, which benefited Canada greatly, can easily be slowed or reversed should conditions in the major consuming regions of the world falter.

China's Insatiable Demand

Commodity	China % of World
Cement	53.2%
Iron Ore	47.7%
Coal	46.9%
Pigs	46.4%
Steel	45.4%
Lead	44.6%
Zinc	41.3%
Aluminum	40.6%
Copper	38.9%
Eggs	37.2%
Nickel	36.3%
Rice	28.1%
Soybeans	24.6%
Wheat	16.6%
Chickens	15.6%
PPP GDP	13.6%
Oil	10.3%
Cattle	9.5%
GDP	9.4%

Source: Jeremy Grantham, GMO Quarterly Letter, Q1 2011, Part 1, April 2011 www.gmo.com

Alitis' Tactical Asset Allocations

As you have read, there are a number of very significant risks in the major economies of the world today. Europe has the spectre of debt, default and recession while the US has politics, deficits and valuation. Hopes are pinned on China as the saviour, but it is linked to the rest of the world by the very structure of its economy and should not be relied upon to provide global growth. As an investor in Canada, what should be done?

Alitis' view is that there is still more downside risk than upside potential in the stock markets. Bonds are also highly priced, but may offer some protection from turmoil. To earn a reasonable return in this environment, we have underweighted stocks and shifted some of the allocation towards hedge funds which should be able to earn a moderate return and towards some higher yielding, private fixed income products that are not as exposed to the issues in the public markets. With respect to fixed income, we have generally overweighted this asset class because of our concerns with the economies of the developed world. Nevertheless yields are low, so we have shifted a sizable proportion of the fixed income exposure to higher yielding bonds, private debt, and mortgages. Overall, the effect across all the Alitis Pools is to reduce exposure to the public markets and shift away from stocks in particular, as is outlined in the current target asset allocations we are using to guide the management of the Alitis Pools:

Alitis Strategic Income Pool

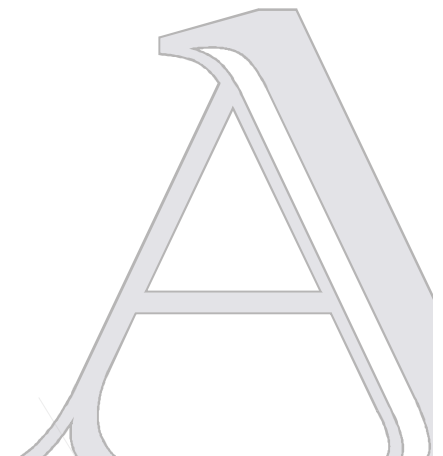
Asset Class	Min	Normal	Max	Current
Cash	2.0%	5.0%	100.0%	2.5%
Cdn. Fixed Income	30.0%	62.0%	98.0%	77.5%
- Traditional				27.0%
- High Yield				7.5%
- Private Lending				18.0%
- Mortgages				25.0%
Foreign Fixed Inc.	10.0%	33.0%	49.0%	10.0%
Stocks	0.0%	0.0%	20.0%	0.0%
Alternatives	0.0%	0.0%	10.0%	10.0%

Alitis Income & Growth Pool

Asset Class	Min	Normal	Max	Current
Cash	2.0%	5.00%	100.0%	3.75%
Cdn. Fixed Income	15.0%	31.00%	50.0%	49.00%
- Traditional				13.50%
- High Yield				3.75%
- Private Lending				15.00%
- Mortgages				16.75%
Foreign Fixed Inc.	5.0%	16.50%	25.0%	5.00%
Canadian Stocks	5.0%	10.0%	20.0%	5.00%
US Stocks	3.5%	7.75%	17.5%	3.75%
European Stocks	2.5%	5.50%	12.5%	2.50%
Asia-Pacific Stocks	0.0%	2.75%	7.50%	0.00%
Emg. Mkts. Stocks	0.0%	2.50%	7.50%	0.00%
Real Estate	5.0%	9.50%	20.0%	5.50%
Hedge Funds	5.0%	9.50%	20.0%	18.00%
Other Alternatives	0.0%	0.00%	7.5%	7.50%

Alitis Growth Pool

Asset Class	Min	Normal	Max	Current
Cash	2.0%	5.0%	100.0%	7.5%
Fixed Income	0.0%	0.0%	25.0%	19.0%
- Traditional				0.0%
- High Yield				0.0%
- Private Lending				10.5%
- Mortgages				8.5%
Canadian Stocks	10.0%	20.0%	40.0%	10.0%
US Stocks	7.5%	15.5%	35.0%	7.5%
European Stocks	5.0%	11.0%	25.0%	5.0%
Asia-Pacific Stocks	0.0%	5.5%	15.0%	0.0%
Emg. Mkts. Stocks	0.0%	5.0%	15.0%	0.0%
Real Estate	10.0%	19.0%	35.0%	11.0%
Hedge Funds	10.0%	19.0%	35.0%	35.0%
Other Alternatives	0.0%	0.0%	15.0%	5.0%



ALITIS

INVESTMENT COUNSEL

| 800 667 2554

info@alitisinvestmentcounsel.com

www.alitisinvestmentcounsel.com



Disclaimers and Disclosures

This report is provided, for informational purposes only, to customers of Alitis Investment Counsel Inc. (“Alitis”) and does not constitute an offer or solicitation to buy or sell any securities discussed herein to anyone in any jurisdiction where such offer or solicitation would be prohibited. Opinions expressed in this report should not be relied upon as investment advice. This report does not take into account the investment objectives, risk tolerance, financial situation or specific needs of any particular customer of Alitis. Each individual’s investment objectives, risk tolerance, financial situation and specific needs should be evaluated before making any investment decision.

The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. This report may contain economic analysis and opinions, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. All opinions expressed herein constitute judgements as of the date of this report and are subject to change without notice. Alitis assumes no duty to update any information or opinion contained in this report. This report may contain links to third-party websites. Alitis is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this report and is not incorporated by reference into this report.

The indicated rates of return are the historical annual compounded returns for the period indicated, including changes in security value and the reinvestment of all distributions and do not take into account income taxes payable by any securityholder that would have reduced returns. The investments are not guaranteed; their values change frequently and past performance may not be repeated.

Neither Alitis nor any director, officer or employee of Alitis accepts any liability whatsoever for any errors or omissions in the information, analysis or opinions contained in this report, nor for any direct, indirect or consequential damages or losses arising from any use of this report or its contents.

© 2012 Alitis Investment Counsel Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure, in whole or in part, or in any form or manner, without the prior written permission of Alitis Investment Counsel Inc. is prohibited by law.