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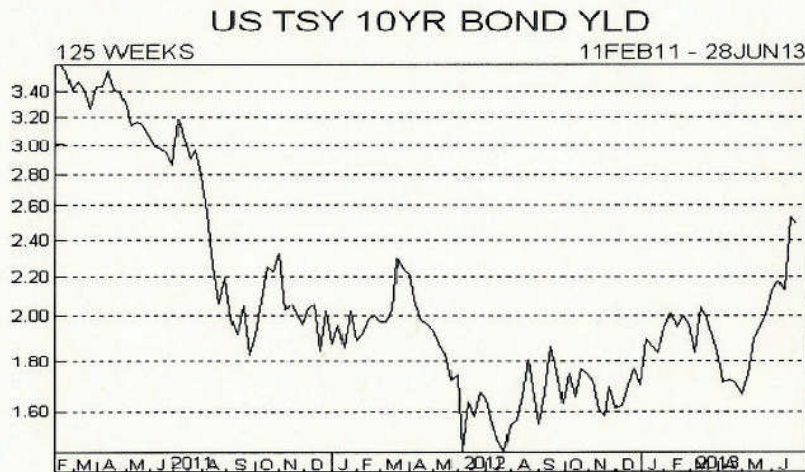
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Second Quarter 2013

June was a loser. It snapped a seven month winning streak for the S&P 500 and dragged the S&P/TSX Total Return into a year to date decline of 0.9%.

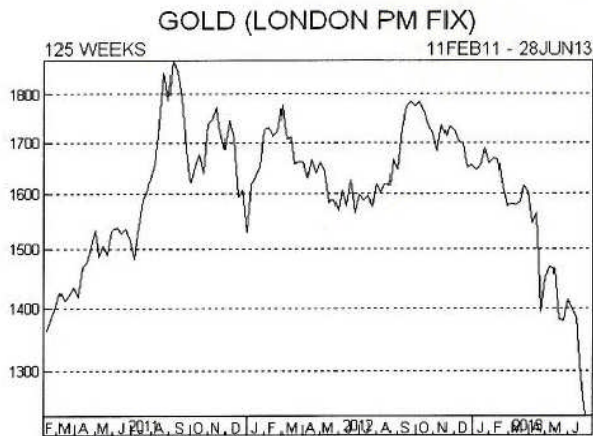
On Wall Street every quarter it seems there is a new piece of jargon and the hands down winner this quarter was 'tapering'. During congressional testimony on May 22, Federal Reserve Chairman Ben Bernanke didn't reject a suggestion that the central bank could begin tapering back bond purchases. The Fed's asset purchase plan, QE3, has been buying bonds at a rate of some US \$85 billion a month, split between Treasury securities and mortgages backed securities. After Bernanke's remarks, interest rates surged. The yield on ten-year U.S. treasuries rose from 1.7% at the end of April to 2.5% at the end of June.



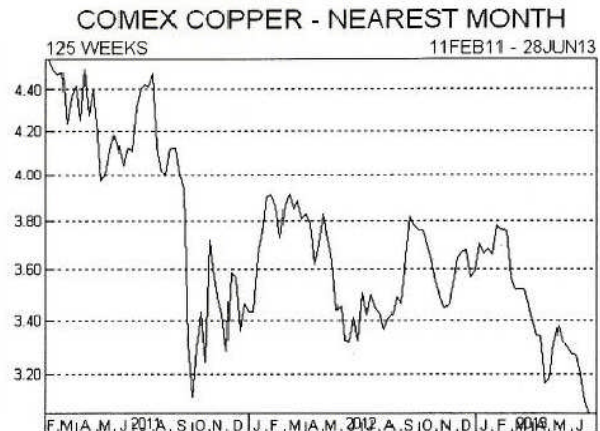
RBC Trend & Cycle, July 2ⁿ, 2013

The extraordinary thing is that rising US bond yields because of stronger economic activity (and Canada is tied at the hip to the US) you might think would be associated with higher inflation and therefore higher prices for things, like copper and gold. Not this time. Gold had its worst quarter ever (since it became freely traded in 1975 that is) down more than 23% in U.S. dollars, silver 30%. Copper was down 10%, aluminum 8%.





RBC Trend & Cycle, July 2^h, 2013



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Last quarter a strengthening US economy was paired with what seems to be a weakening Chinese economy. In the month of June alone the Shanghai Composite was down 14% in US dollars and is now deep in bear market territory.



RBC Trend & Cycle, July 2^h, 2013

Strength in the American economy and the perception of weakness in China undoubtedly contributed to the U.S. dollars' 6% gain against the Canadian dollar in the first half of this year.



RBC Trend & Cycle, July 2^h, 2013

Our portfolios suffered a little from bullion's weakness but suffered more in June from the rise in interest rates. A 1% increase in 10 year bond yields equates to about a \$8.9 decline in the price of a 10 year bond. However, the bond will be worth its par value on its maturity date, (which is why I like individual bonds and not bond funds, which have no fixed maturity dates). Also, staggered maturity dates will give us opportunities to reinvest maturing issues at higher rates.

We're confronted with another type of exposure to rising interest rates. Precisely in those stodgy predictable dividend paying stocks that served us so well in 2011 and 2012, principally pipelines and utilities. Robert Kwan, RBC Capital Markets Analyst, has estimated that for the Canadian Energy Infrastructure companies he follows he would "expect that share price declines could average 10% to 15% for every 100 basis points [1%] back-up in 10 year GOC [Government of Canada] yields." (June 24, 2013) Even for these most interest rate sensitive companies there are mitigating factors. Some will be able to eventually increase their dividends at a rate high enough to offset at least a gradual rise in interest rates and, regulated utilities will be allowed to increase their tariffs to offset their higher interest costs.

Of course, it is quite possible that markets overreacted in June and that bond yields moved up too far, too fast.

Last weekend I was sitting around the public pool, chatting with some parents of friends of my 5 year old Diana. One Dad said to me that when he asked Diana what I did for a living Diana said I was an "inventor". I'm sure she meant investor and, when I work in front of the computer at home, both my kids seem to think that I just play video games all day. But inventor couldn't be farther from the truth. I don't think there is anything really new in investing, just sometimes new combinations, like rising yields and falling inflation.

Enjoy your summer.

Sincerely,

George Stedman, CFA
Portfolio Manager

Please visit us at www.georgestedman.com