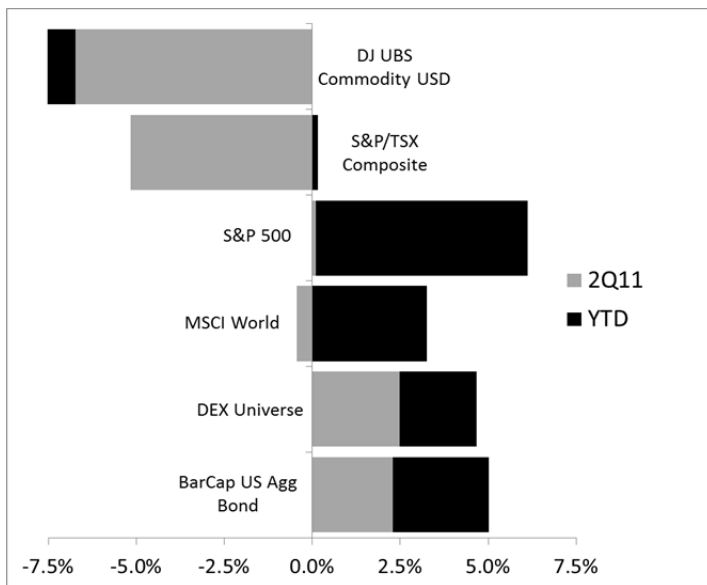


Debt, default and disappointment continue to be common themes in the media. Will Greece default? Will the US raise the debt ceiling? Will the next economic indicator be as disappointing as the last? Despite the anxieties, broad asset classes as represented by the benchmarks below are mostly positive on a year-to-date basis, with the exception of the commodity index.



Concerning the “default” question, it is widely speculated that Greece will eventually “restructure”. The Greek debt, which is reported to be €350 billion (more than 150% of its GDP), is predominately held by the European Central Bank, International Monetary Fund and within the European banking system, rather than by its citizens as is the case in Japan. As such, it is feared that a default event will cause the financial system to seize in a manner similar to the collapse of Lehman Brothers in 2008. To complicate matters further, credit default swaps (CDS), a form of insurance which protects the bondholder in the event of a default, would cause the issuers of these instruments to incur losses. Therefore, for a country that represents roughly 2.5% of the European Union’s GDP and 3% of the Eurozone population, the implications are difficult to quantify. As a result, policy makers are attempting to delay a restructuring until the financial system is better insulated from the crisis. Meanwhile, the fears of a disorderly and untimely default spread to Ireland, Portugal, Spain and Italy because their borrowing costs rise as negative momentum builds. In the meantime, Greece is temporarily supported by €110 billion in emergency loans, but is unable to raise capital on its own because of the high interest costs. Eventually, leaders will

propose a second bailout and work towards a solution that will (1) involve private investors sharing the damages; and (2) gain approval from the credit rating agencies to avoid a formal “default” declaration.

As the Euro sovereign debt mess festers, the American obsession with reckless federal budgets worsens. However, the illusion of the sustainability of increased expenditures without an offsetting increase in revenues is peaking. Unmanageable public finances and dysfunctional politics are leading to a US default, unless lawmakers in Washington reach a deal to raise the debt ceiling from the existing \$14.3 trillion cap on government borrowing. Without an agreement in force by 02-Aug-11, the U.S. Treasury will have difficulty paying interest and obligations to government employees, vendors and social program recipients. The consequences of a US default are enormous because these bonds are the exemplary “risk-free” securities. As a result, markets are becoming agitated and more volatile in contemplation of a default. Ideally, the embarrassment associated with its fiscal situation will encourage politicians to not only raise taxes but also enact measures to reduce entitlements. Historically, federal tax receipts have been unable to eclipse 20% of GDP regardless of the tax regime. Therefore, true fiscal reform and long-term debt reduction needs to involve a cut to agency spending and an overhaul to Social Security and Medicare.

Economic data has without a doubt been disappointing. Real gross domestic product in the United States - the output of goods and services produced by labour and property - increased at an annual rate of 1.9% in the first quarter of 2011. Entering the year, forecasts called for GDP growth to spike as high as 4%. A number of factors have contributed to the slowdown in growth, including bad weather and disruptions originating from Japan. Most analysts deem the poor results to be a soft patch; and, the recovery from the recession will resume in the second half of 2011 on the strength of corporate earnings, productivity gains, exports and more active bank lending. Notwithstanding the uncertainties with European and US debt issues; slow growth, low borrowing costs and tepid wage pressures are positives for stocks. In terms of alternatives to stocks and bonds, government debt levels should support precious metal prices; while base metal prices (copper and zinc, in particular) should be underpinned by inventory levels and fundamentals.

These dominant issues create short-term volatility, but it should not compel long-term investors to needlessly adjust portfolios when one’s long-term objectives and personal characteristics are unchanged.