

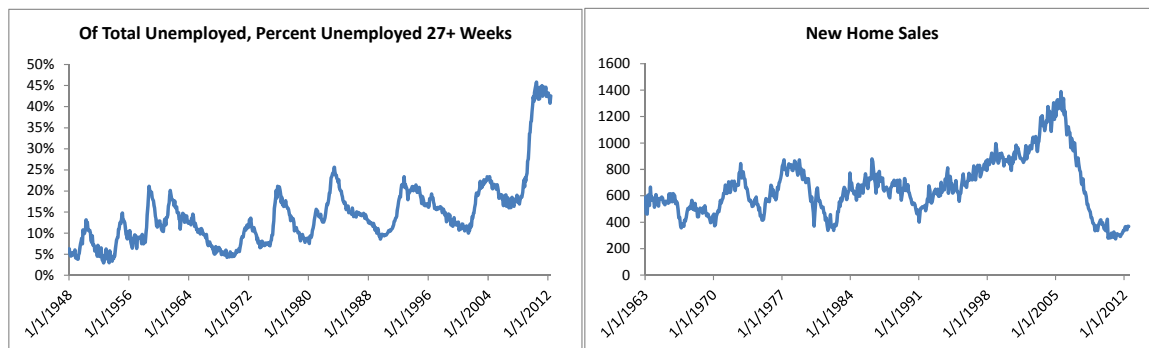
We begin with an update on the crisis in Europe. In a word, it's worse. The Union is currently holding a summit to develop solutions to the situation. A proposal has been put forward that includes taking steps toward a banking union that would provide for centralizing supervision and deposit insurance. In addition a fiscal union that would allow the EU to approve member countries' budgets is recommended. The end result of such measures is a loss of sovereignty for individual countries, which is abhorrent to Greece, Spain and Italy amongst others. On the other hand, such centralization of power is exactly what Germany wants to see before it will consider backstopping the debt of the weaker periphery nations. The one positive is that no one expects anything good to come out of this summit. Therefore any positive development would likely move markets higher. Germany is in an extremely difficult position; it cannot guarantee the debts of other countries without some control over budgets and policies, yet the alternative, the breakup of the EU is perhaps even more dangerous. It cannot ask the German worker to finance the spending of others (France is proposing to lower the retirement age and raise the minimum wage), but the Finance Ministry has done research that suggests the German economy would shrink by 10% and 5 million jobs would be lost if the Euro collapses. In addition through the internal payment system of the Euro Zone (called *Target2 Balances*), Germany is owed €700 billion by other central banks. If the monetary union collapses, Germany is unlikely to see any of that money, which is five times the capital of the Bundesbank.

Greece recently elected a coalition government that supports the austerity deal with the EU, but which has already demanded an easing of that program. The coalition's first Finance Minister has held the position in a previous Greek government (must have done a good job?) but he developed nausea and resigned (after seeing the books perhaps). The new Minister is ironically known as "Mr. Euro" for the major role he played in the creation of the currency. You can't make this stuff up.

Spain has been effectively priced out of financial markets. Notes with a 6 month term recently sold at 3.24% - up from 1.74% one month ago. Spain has formally requested aid from the EU to prop up its banks as it can't do it itself. As an aside, while not firm, the EU proposes to lend Spain \$125 billion at 3%. Italy's portion of that would amount to approximately \$22 billion. Currently Italy borrows at 5-6%; that's bad math.

The US continues to muddle along economically; although of the 12 economic releases so far in June, 10 have been below expectations. Experts are arguing over whether this is just a "soft patch" or a new decline in activity. We fall in the second camp. The Federal Reserve in its most recent outlook lowered its GDP forecast for 2012 to 1.9-2.4% from 2.4-2.9% and for 2013 to 2.2-2.8% from 2.7-3.1%. Consumer confidence also came in very weak and the "fiscal cliff" still looms ahead. The uncertainty for companies as the "cliff" nears could affect the economy as early as September - October. We have become aware of an 1988 Act of Congress known as WARN (the Worker Adjustment and Retraining Act) which requires corporations to give 60 days' notice of plant closings or mass layoffs. So as an example, the "sequester" scheduled for January 1 includes large decreases in the defense budget which would mean companies such as Lockheed Martin might be giving notices before the November elections.

Throughout our career we have been told many times to never assume "it's different this time". However, here are two long term charts that at least suggest we are dealing with circumstances that none of us dealt with before.



Here in Canada we are being buffeted by the slowing Global Economy and the consequent decline in commodity prices. (Note the chart below) The modest growth in the US, weakness in Europe and slowing growth in emerging

**Corporate Profits and Consequently the TSX
Move in Tandem with Commodity Prices**

nations all will have a negative impact on our economy. The growth slowdown in world trade is exemplified by emerging market export growth in April: China – 5%; India – 13%; Brazil – 12%. Finally, the Federal Government is walking a tightrope as it attempts to reign in consumer debt levels without impairing an already fragile economy.

