AlphaNorth Asset Management

October 10, 2011

Special Market Commentary

Given the recent extreme market volatility, we thought it would be worthwhile to expand on our regular monthly commentary and outlook with the following additional commentary. The summer of 2011 has proven to be another difficult period for Canadian equities. We did not predict the severity of the current market decline as we did in 2010.

While recently conducting some technical analysis work on the current market situation, we noted that the chart pattern for the S&P 500 index has recently traced a very similar pattern to what transpired in 1998, as noted on the attached charts. In addition, upon reviewing the news headlines of October 1998, we found that the media was reporting many of the same fears as they are today with the only substantial difference being the focus on the "Asian crisis" rather than the current "European crisis". A selection of historical media headlines from October 1998 are:

"Fears of a Spreading Recession Send Markets Tumbling…..panicky trading, reflecting investor fear that recession might be spreading from the Far East to Europe and might eventually grip the United States. But then Wall Street suddenly reversed course and produced a late session comeback in the third heaviest trading session on record….The rally also lifted the index back above the low it set in the Aug 31 market wipeout." The New York Times October 9, 1998

"Investors around the world have been piling into Treasury securities as a haven so yesterday's contrary action may suggest diminished worry about what has been described as the worst financial crisis since World War II" ." The New York Times October 8, 1998

"Nikkei Soars After Japan Edges Closer to a Bank Bailout…..The governing party edged closer today to injecting massive amounts of money into the Japanese banking system….nearly $80 billion, in taxpayers' money to recapitalize the Japanese banks" The New York Times October 8, 1998

"Negotiations over federal spending levels for next year bogged down, leading Congress to pass a temporary spending measure to keep the government funded through Monday" Bloomberg October 9, 1998

These quotes seem very similar in nature to what we have seen reported recently.

Referencing Chart 1, readers will note that in 1998, the market declined by 20% over a several week period in the late summer, before rebounding during September and then retesting the initial low on October 8th, 1998. At that time, the S&P 500 spiked below the September low on an intraday basis before rallying strongly to close above that level. It is interesting to note that virtually the same thing occurred last week with the October 4th plunge below the August 9th, 2011 low on an intraday basis before rallying strongly in the last hour of trading to close higher (Chart 2). One article stated that this was the second strongest rally in the last hour of trading since 1985. Our technical view has remained unchanged since August. We believe that the low for the current equity market downturn was set on August 9th, 2011. This still holds and is further supported by the market action over the past week. It is interesting to note that subsequent to the October 8, 1998 low, the equity market went on one of the greatest bull runs in history, taking the S&P 500 index up 50% in the ensuing 9 months (Chart 3).

We would like to reinforce that we do not maintain a permanent market view. We change our macro view with the times. We have been fortunate to have reasonably timed several of the major market moves over the past few years while avoiding being labelled a permabull/bear. For example, below is a sampling of some of our positions over the last few years:

"We continue to hold a bearish view on equity markets, particularly in view of the recent powerful rally. We believe that equity investors continue to be overly optimistic about the economy and the severity of credit conditions in the U.S. which we believe will ultimately have a negative impact on Canadian markets. We are maintaining our cautious positioning in the near term in anticipation of deteriorating equity markets." March 2008 Fund Commentary

"We are more actively researching short opportunities and have tightened the criteria for long investments in anticipation of a less favourable equity market environment over the summer months." February 2010 Fund Commentary

We also correctly identified the Fall of 2008 as an excellent entry point for Canadian equities, particularly for small caps.

"We believe that at current levels, the opportunities in Canadian small cap stocks are better than they have been since the corresponding lows in 2002 and 1991." October 2008 Fund Commentary

"We have stressed that the Fall of 2008 was a great time to be adding to equities rather than hiding in zero yielding TBills." December 2008 Fund Commentary

There are many fundamental factors which support our current bullish outlook from current equity levels, some of which we have mentioned in previous commentaries:

1. Rarely has the equity market yield exceeded the yield on government bonds as is currently the case in both the U.S. and Canada
2. High insider buying
3. Strong corporate earnings and balance sheets (much improved compared to 2008 levels)
4. Extreme low levels of investor sentiment similar to late 2008 levels
5. Low equity valuations compared to historical norms
6. Strong seasonality favours buying equities in October
7. 2012 election year in the U.S. supportive for equities (A recent study found that 3 of the 16 bear market lows occurred in year one of the presidential term, 12 in year two, one in year three, and none in year four (the election year).
8. Large cash positions on the sidelines
9. Strong outflows from equity funds into fixed income
10. Pension funds will be forced to rebalance as fixed income component has appreciated while equity portion has declined
11. Supportive economic data—auto sales up 11.2% over the past year, employment gains, ISM still indicating expansion in U.S.
12. Shares sold short are at a very high level (Bloomberg reported today 11.6% of total stocks compared to 9.5% in July)

It appears that many investment professionals have recently reduced their equity exposure. We strongly believe that this is the wrong move at this time as was proven to be the case in the 2008 financial crisis. Many investors/fund managers did the same thing at that time and thus underperformed during the market recovery. They often refer to this as "high grading" the portfolio and although investors love to hear these kinds of comments from advisors and fund managers during uncertain times, they are often the wrong moves. Gold, which has been touted by many as a safe haven, did not live up to those expectations as it declined by $201 during September. As a result, our short position in the Betapro Comex Gold shares gained over 22% for the month.

One of the factors that has contributed to our highly successful track record is that we have never deviated from our long term investment strategy during past market downturns. This has served us well during these difficult periods and our portfolios have recovered quickly. In fact, our best years in fund management have been subsequent to significant market declines. We generated 100%+ returns in each year following the 1998, 2002 and 2008 market declines.

Although the current correction has not proven to be as severe as the 2000-2002 or 2008 market meltdowns, we believe it presents a very compelling buying opportunity for Canadian equities.

We maintain our view that we will see a substantial rally in equities into year end.

Regards,

Steven Palmer, CFA
President and CEO

Disclaimer

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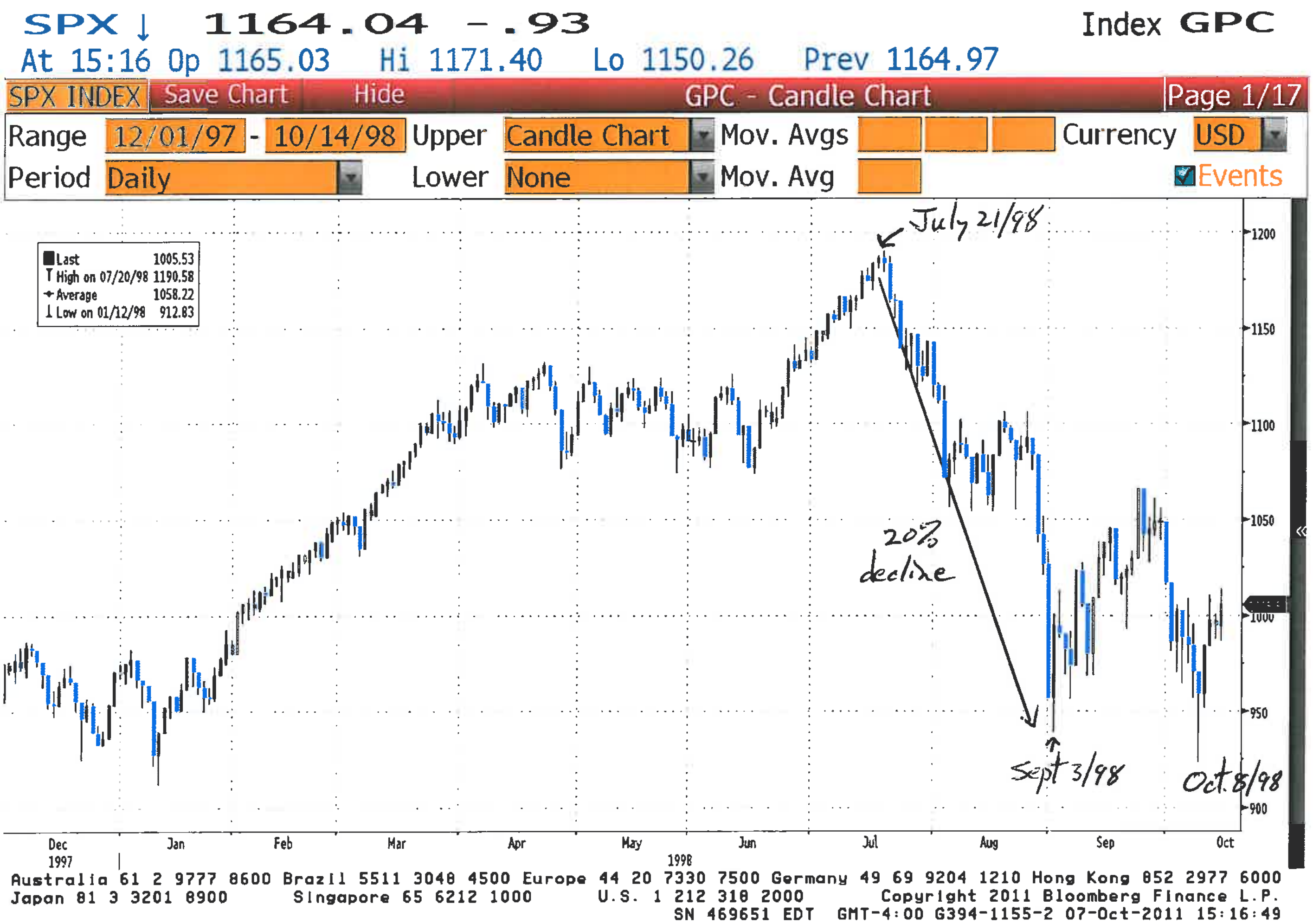
Chart 1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Save Chart
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Currency USD
Period Daily
Lower None
Mov. Avg
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Average 1058.22
Low on 01/12/98 912.83
July 21/98
20% decline
Sept 3/98
Oct. 8/98
1200
1150
1100
1050
1000
950
900
Dec 1997
Jan
Feb
Mar
Apr
May 1998
Jun
Jul
Aug
Sep
Oct
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2011 Bloomberg Finance L.P.
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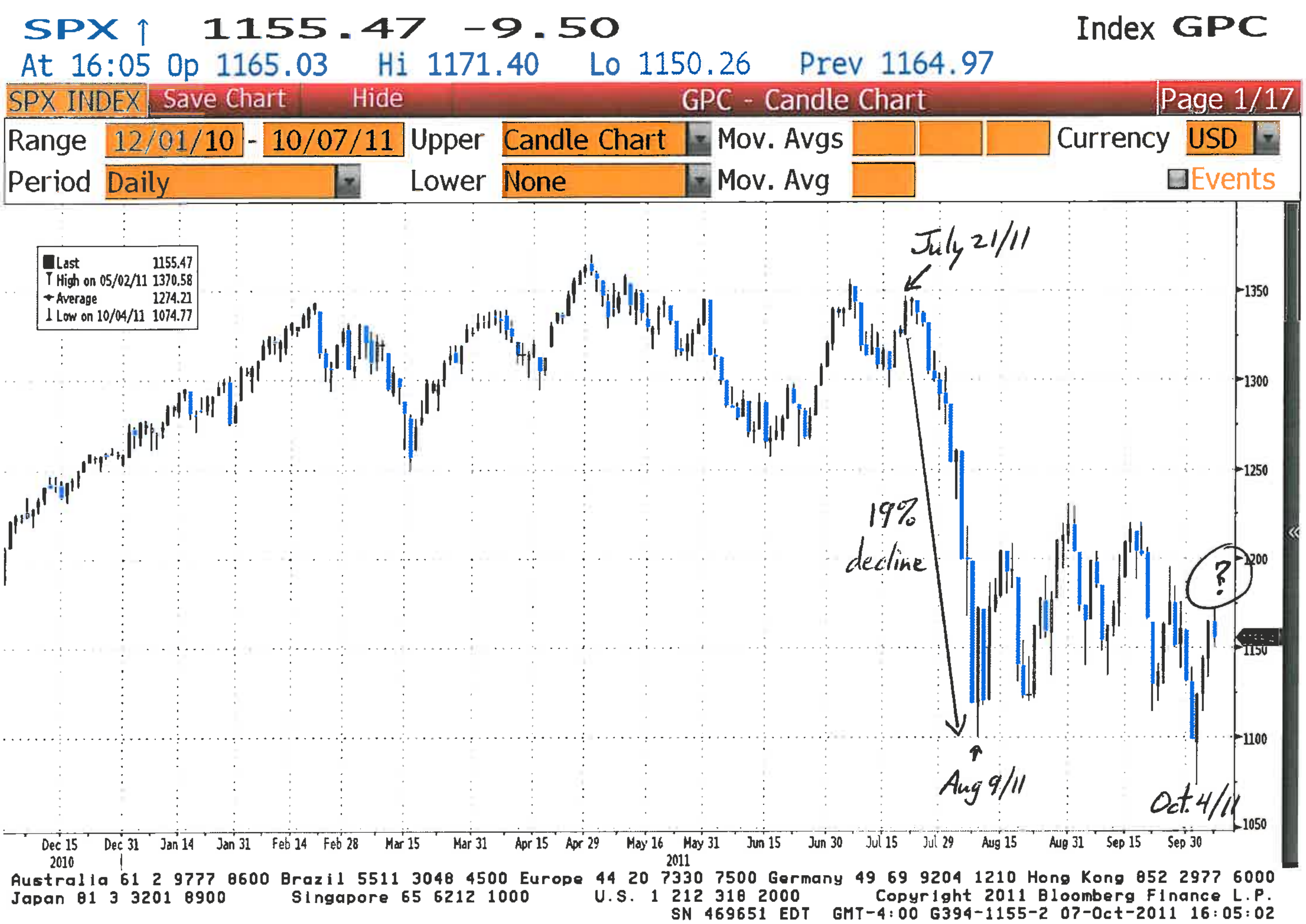
Chart 2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Index GPC
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SPX INDEX
Save Chart
Hide
GPC - Candle Chart
Page 1/17
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Upper Candle Chart
Mov. Avgs
Currency USD
Period Daily
Lower None
Mov. Avg
Events
Last 1155.47
High on 05/02/11 1370.58
Average 1274.21
Low on 10/04/11 1074.77
July 21/11
19% decline
Aug 9/11
Oct. 4/11
?
1350
1300
1250
1200
1150
1100
1050
Dec 15 2010
Dec 31
Jan 14
Jan 31
Feb 14
Feb 28
Mar 15
Mar 31
Apr 15
Apr 29
May 16
May 31 2011
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Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2011 Bloomberg Finance L.P.
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Chart 3

SPX ↓ 1126.62 +2.67 Index GPC

At 10:08 Op 1124.03 Hi 1128.08 Lo 1115.68 Prev 1123.95

SPX INDEX | Save Chart | Hide | GPC - Candle Chart | Page 1/49

Range 01/16/98 - 09/29/00 Upper Candle Chart Mov. Avgs Currency USD

Period Daily Lower None Mov. Avg Events