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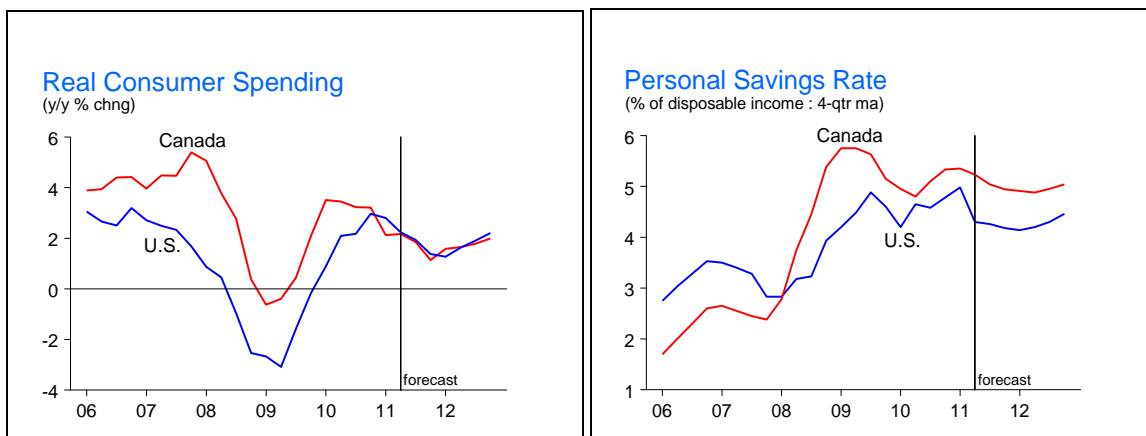
In March 2011, like most of us, I felt quite relieved that Canada had gone through the most threatening financial crisis of modern times with flying colors. Our banking system was praised all over the world and was used as a benchmark in restructuring others. Most banking systems adopted new minimum capital requirement rules under the new Basel III accord, to reflect a more conservative and restrictive use of leverage and related risks. But the level of added regulation doesn't please everyone. In fact, this has become a lightning rod issue for Republicans in the U.S. as it is viewed as a deterrent to efficient lending practices that help to stimulate economic recovery and employment.

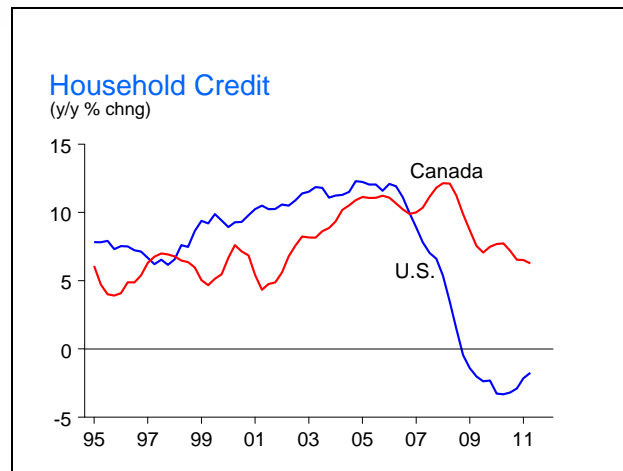
Although we felt more comfortable about the state of the economy last spring, we mentioned in our April 2011 newsletter that we were facing three major stumbling blocks which could test the resiliency of our economic expansion. The first was the end of quantitative easing (QE2) in June 2011. The second was the realignment of the U.S. debt ceiling, something that had been a given during the last decade. And the third was the development of a new financing platform to rescue the troubled nations of the European Union. The question now is: have we struck out?

THE END OF QE2

Barely a month after QE2 ended, economic indicators started to fade again. Many experts linked the slowdown to the earthquake and tsunami that devastated Japan and disrupted the automotive and electronic supply chain worldwide. Although the impact was expected to be short-lived, it couldn't have come at a worse time. The slowdown certainly didn't prompt businesses to hire, build excess inventory and expand operations at a time when consumer spending and borrowing were contracting and saving rates rising. (Chart 1)

Chart 1





Source: BMO Capital Markets

As long as households are cutting back on spending to pay down debt, stimulating the economy using only financial stimulus may not be the answer. As this deleveraging process delays corporations' willingness to expand, corporate cash flows are being used to pay down debt as well, or to buy back stock or for acquisitions rather than for hiring. The Fed's next stimulus program must allow the money to flow directly to consumers, accelerating the deleveraging process, rather than through the banks, who are sitting on a pile of cheap excess reserves they can hardly flow through corporations and individuals, except for speculative purposes that have little or no impact on the economy. As we expressed in our title of newsletter #45, the Fed filled up the banks' tanks with cash, but the demand for loans has dried up. Since QE2 did not yield the expected returns, a new type of stimulus program will have to emerge sooner than later... Strike one.

THE U.S. DEBT CEILING

Meanwhile, U.S. deficits are mounting and politicians as well as economists and financial experts are debating how they can manage to cut the deficit while simultaneously stimulating a stalling economy. The endless bickering between Republicans and Democrats went down to the wire and resulted in an enormous loss of credibility as each side put their own political agenda before the future of their country. Accordingly, Standard & Poor's, the rating agency, cut the country's credit rating to AA+ from AAA, causing another confidence crisis. The response was swift and deep as markets shed some 600 points in a single day followed by the most volatile week in market history. Economic indicators continued to slowly deteriorate in August and September. Strike 2...

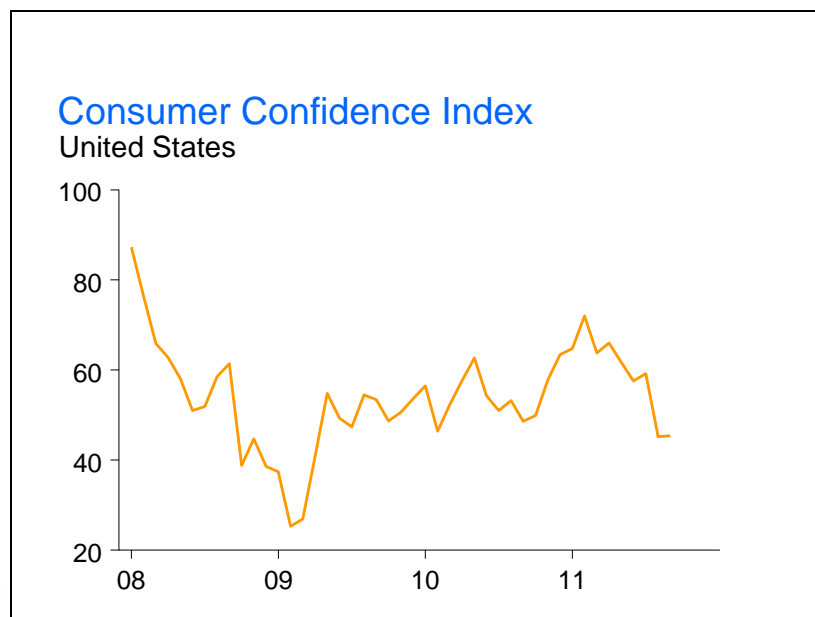
THE EUROPEAN CRISIS

Lagging Greece refinancing problems and that country's inability to restore adequate fiscal policies have started to spill over onto other financially weak countries. Italy's bond yields, as well as those of Spain, started to be targeted as riskier assets, pushing prices down and yields up. What this means is that it is becoming more expensive for these countries to refinance their debts. This, in turn, deepens the deficit, bringing about the need for further financing. This negative spiral has to stop. The contagion effect can be disastrous. But how? The European Union includes 17 nations and although it has standardized its monetary policies through the European Central Bank (ECB), it has never done so with fiscal policies. To illustrate the situation, take Germany, for example, where the economy is doing well. Germany may have to tighten its monetary policy (i.e. raise interest rates) to avoid overheating and inflation. On the other hand, Greece is in an economic slowdown and needs more easing (i.e. lower rates). To adjust regionally, one country can make fiscal adjustments, in other words cut or raise taxes when need be. Then we have Portugal, Italy, Ireland, Greece and Spain – the so-called PIGS. These countries generally have a poor track record with respect to their fiscal commitments. Where underground economies and corruption are more common, tax revenues are usually hard to come by. So unless a centralized fiscal policy with minimum guidelines can be implemented – and followed – the very survival of the European Union and the Euro is increasingly uncertain. While economic indicators are showing virtually no growth in Europe in the current quarter, they are still working on additional financing for Greece. We are victims of a lack of leadership and a dysfunctional political environment both in the U.S. and Europe... Strike 3.

CONFIDENCE IS THE KEY

At this point in time, investment confidence is at the lowest level since March of 2009, although U.S. stock markets are up more than 4000 points. (Chart 2)

Chart 2



Source: BMO Capital Markets

Yet U.S. market performance has remained in negative territory for the past 10 years. Thinking back, I wonder, did investor confidence have anything to do with the past decade's poor performance? The decade began with the tech bubble burst and the uncovering of some of the largest corporate frauds in history. World Com, Nortel, Enron, to name but a few, skewed valuations and hurt investors at large. People pushed back retirement or had to go back to work as pension plans became significantly underfunded. The terrorist attacks on the World Trade Center and consequent war on terror did nothing to encourage investors. Subsequently, the invasion of Iraq to seek out and destroy alleged weapons of mass destruction further tested our confidence in our leaders. The Fed acted to restore confidence with monetary stimulus by cutting interest rates to the lowest level in 50 years. Maintaining these rates artificially low for too long and granting mortgages to anyone with a pulse through government-sponsored agencies (Fannie Mae and Freddie Mac) created a mirage of wealth for Americans, and sharpened the appetite and greed of a select few. Victims once again, many ordinary American citizens were left holding the bag. Meanwhile, financial institutions repackaged riskier loan portfolios and sold them in the form of a debt financing called CDOs (collateral debt obligations) to the rest of world, spreading the contamination. The trusted rating agencies gave these CDOs a AAA rating...

After the real estate market collapsed, drawing the stock market with it, new banking regulations were introduced, as mentioned earlier, but little if nothing was done about hedge funds. Hedge funds are known for their excessive use leverage to implement their strategies, and are largely responsible for the widely volatile markets, which has done nothing to ease investors' anxiety or rebuild confidence. As for a fitting ending to this wonderful decade, U.S. financial institutions voted themselves the largest bonuses on record in 2010. No wonder so many conspiracy theories are floating around out there, reflecting the mindset of investors today. These days, some corporations pay an interest rate to their bank to keep cash in their account and not lend against it. How low can confidence and trust go?

As a comparison, back in the early 80s, we were also going through hellish times. Unemployment was at nearly 10%, inflation at 11% and interest rates at 20%. These unbearable conditions made us believe that everybody was going to go bankrupt. With leadership and a proper plan (called Reaganomics in those days), confidence returned and opened the way for us to enjoy one of the largest economic expansion and bull markets ever (1982-2000). Today, one in seven Americans lives below the poverty line (an annual income of less than \$22,000 for a family of 4) and relies on food stamps. One out of four can't meet or has fallen behind in their mortgage payments. Is there a solution? JOBS! JOBS! JOBS! But to create jobs, we need a strong foundation (banking system), combined with an extensive financial development plan that would have long-term economic impacts on research and development, intellectual property and technology. This would put America back on track in a globalized world. With a credible plan, the simple belief that it can be done would restore confidence, slowly but surely.

Globalization

Every era is different and this is what creates opportunities. Globalization is the main difference this time. Free trade in major markets all over the world has brought extensive growth, but it has also linked countries together. Today, when one country sneezes, the others catch a cold. This interdependence is convenient to control costs, attract investments etc., in good times. But remember, a chain is only as strong as its weakest link. Companies can hedge themselves against risks using modern financial instruments (credit default swaps, etc). They too work well, as long as the banking system is sound and financial institutions are solvent.

Practical Ideas

A new energy policy

Obviously, austerity measures are not welcome as they are counterproductive to the much needed economic growth. By putting people back to work you enlarge your tax base therefore increasing revenues. But creating temporary jobs will not fulfill the long term need for tax revenues. We need to develop the technologies of tomorrow. Over time, energy costs have always impacted economic growth. If we could become less dependent on foreign energy, we could have better control over costs. Reducing our dependence on fossil fuels with tomorrow's more environmentally-friendly and renewable energy sources can provide opportunities both for investment and for long-term well being.

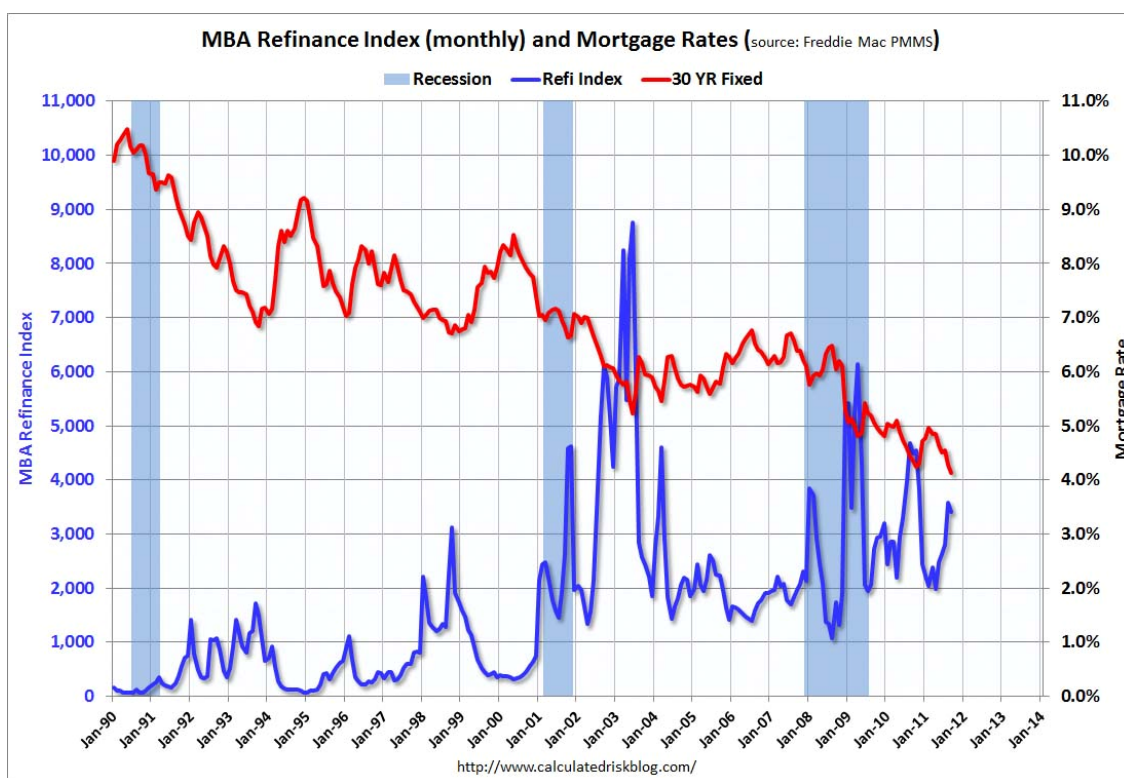
Naturally, when oil prices are kept in check in a lower range, economic activity seems to grow at a faster pace. Corporate margins are enhanced and more cash is made available for business expansion, creating more jobs and/or dividend increases, in turn increasing investment income and, ultimately, tax revenues. Conversely, when oil prices are kept in a higher range, consumers limit their spending which negatively affects economic growth. Ideally, oil prices would be in the \$50 range, giving consumers more disposable income to spend or reduce debt. Both would be favourable to economic activity as foreclosures and mortgage defaults would decline and, eventually, house prices would firm up. Oil prices actually act like a tax on consumers. When government cuts income taxes, it directly reduces its income, but lower oil prices are less costly. A new energy policy could be a great way to achieve many goals at once. But how can we reduce our dependency on foreign oil? The answer is to consume less and to use other, more accessible and cheaper means like natural gas!

Of course, natural gas is still a fossil fuel, but it is 25% less pollutant, it is locally available with more than 100 years in reserves. And it is cheap. Although not perfect, it could definitely bridge the gap until new renewable energy sources have proven efficient and affordable. A well-known oil and gas tycoon called T. Boone Pickens has been relentlessly lobbying the U.S. government to convert some 8 million trucks to natural gas, a move that would reduce costs and pollute less, natural gas being much cleaner than diesel. Consuming less oil could have a negative impact on oil prices and help economic expansion...

Real estate policy

Some specialists are looking into ways to get the real estate market back on its feet as it is the backbone of economic wealth. The goal of the Fed’s so-called “Operation Twist” is to flatten the yield curve. In short, the Fed is buying back long-term bonds and issuing shorter term paper against them, hoping to reduce long-term rates. The actions should trigger a new wave of mortgage refinancing at extremely low rates for the long-term. (Chart 3)

Chart 3



Source: Freddie Mac PMMS

While helping homeowners reduce their mortgage payments, it may stimulate the housing market and reduce both oversupply and foreclosures. It would also allow good mortgage payers to accelerate the deleveraging process while strengthening banks’ balance sheets as well.

A “Victory Bond” or “Recovery Bond”

The issuance of a special bond similar to those issued after the war to finance the recovery could be useful although costly. As you know, the baby boom began in 1946 and lasted until the early 60s. The first of the baby boomers are now reaching 65 years old and this group will grow rapidly over the next 15 years. If 70% of the U.S. economy is driven by consumers, when they reach retirement years, should their pension income be lower than expected, they will rely on investment income to close the gap. Given their risk profile, fixed income investments should become a larger weight in their portfolio. However, with rates at nearly 0%, this growing group is likely to cut their spending if they don't want to go broke. How is that helping economic growth? Rates at or near 0% are great for borrowing, but this group is unlikely to do so in a significant manner. Perhaps the limited issuance of “Recovery Bonds” would allow savers to collect, say, a 5% coupon rate for a maximum limit of \$100k per individual (not for corporations). The rate could be reset on an annual basis by the Treasury and, while the bond's term may be 10 years, it could be cash in at anytime (something similar to Canada Savings Bonds). Such a product, accessible to residents only, may be criticized as it would appeal to the rich only. Perhaps for those saddled with a huge mortgage and no savings, something like a 5% interest credit on the first \$100k in mortgage loans could be offered, thus helping some homeowners stay afloat. Obviously, such a structure would need fine tuning to prevent abuses.

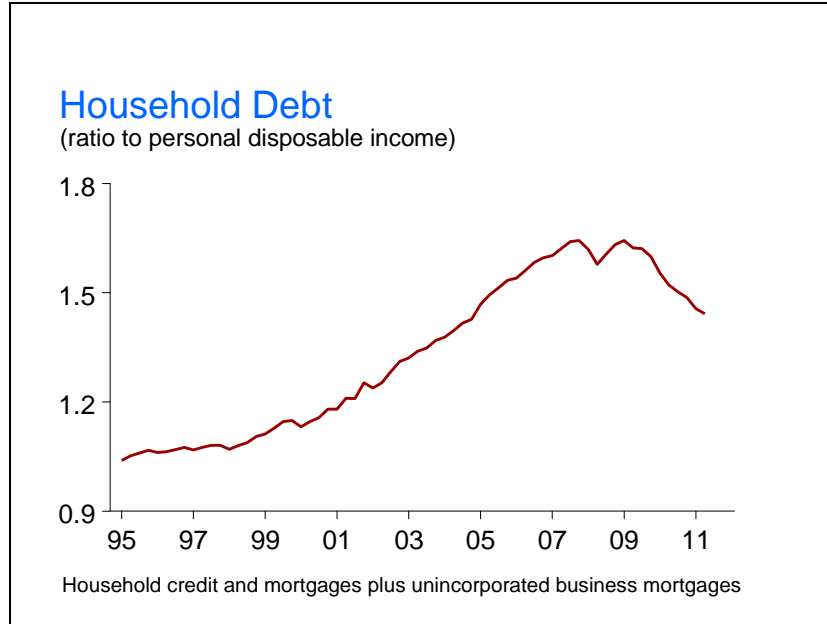
The great challenge for our leaders will be to decide if job creation should be encouraged to stimulate consumption, or if consumption should be stimulated in order to warrant job creation...(a game of what comes first, the chicken or the egg...)

Conclusion and recommendations

Unprecedented pressures (financial, economic, political) coming from all directions and regions carry the risk of destabilizing democracies, leading to social unrest. World leaders must make today's tough decisions for a better tomorrow. China, one of the most relied upon economic engine is showing signs of weakening. In our last letter, we noted that China and India were fighting overheating economies by tightening monetary policy (raising interest rates) and increasing margin requirements. Mortgage loans have become much more restrictive in order to cool down a speculative real estate bubble. Recent reports show that a whopping 64 million in uninhabited apartments in ghost cities are awaiting owners... The expected soft landing of China and India's economies may turn into a recession, at the very worst possible time.

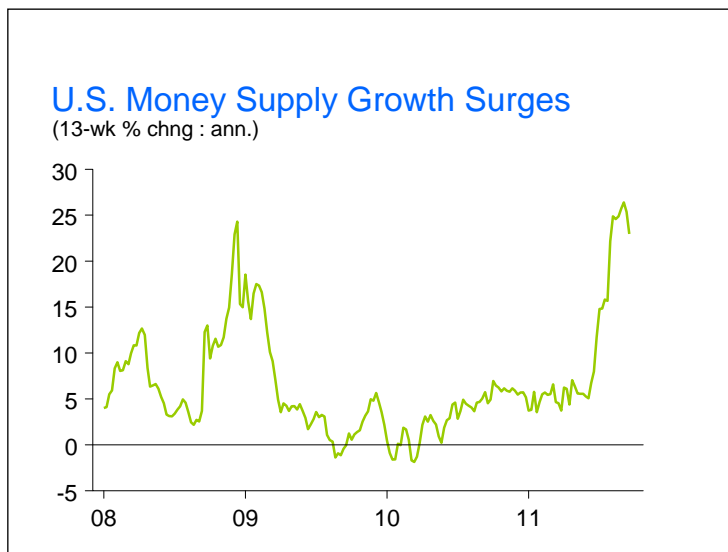
According to well-known economist Kenneth Rogoff, a recession is defined as a contraction of output and employment. When the contraction spreads significantly to debt and credit, then the risk of deflation and depression is enhanced and it will last as long as it takes to complete the deleveraging process. Typically, this process takes as long as it took to build up the leverage in the first place. (Chart 4)

Chart 4



Source: BMO Capital Markets

The solution therefore, is to provide the necessary stimulus to accelerate the deleveraging process. Increasing money supply further is not the solution. (Chart 5)



Source: BMO Capital Markets

Liquidities are available but to help consumers, governments must find ways to facilitate debt workouts and write-downs as quickly as possible. All this uncertainty will keep equity markets wildly volatile for the foreseeable future. You must be prepared to accept these market swings and, to do so, you must make sure of your equity exposure. Obviously, the lower your exposure to equities, the lesser the volatility and anxiety you will experience. However, given this environment, we believe the investment strategy we have implemented for your portfolio is appropriate as it focuses on revenues and income-generating equities with strong balance sheets. Any holding that does not fit that description will be more volatile. The recent manufacturing slowdown in China is not good news for Canadian commodity stocks. Aside from gold stocks, for which I would maintain a 3% to 5% exposure, given your asset mix, I would reduce your oil and gas exposure from 10% to 8%. We would first reduce low income and higher cost producers in order to reach our target weight. As for base metals and agriculture, we would maintain a very low exposure, with a preference towards agriculture (2 to 3%).

In the financial sector, Canadian banks are solid and very well capitalized but are facing some restructuring changes to their capital bases to be in line with Basel III requirements. More specifically, most bank-issued preferred shares will be refinanced through a new, yet to be reveal, structure over the coming years. This change will become more obvious in 2013 and 2014. This refinancing may create new buying opportunities in the future for the fixed income component of your portfolio. The low interest rate environment is more of a challenge for insurance companies, as they invest premiums at much lower than expected returns. Industrial stocks also face a challenge since they are highly correlated with the economic pulse. Look for reducing your exposure from 8% to 5% by keeping the core players and the best dividend payers.

Your safety net remains your consumer staples, utilities, telcos and pharmaceuticals. While the U.S. went through their financial crisis three years ago, Europe is facing the music today. Although U.S. banks are re-capitalized and on much stronger footing than European banks, they will still feel the effects of a restructuration in the Euro zone. Accordingly, earnings growth may be more difficult to achieve in the U.S., hobbled as it is by a major trading partner trying to heal some wounds. As a result, we will continue to accumulate shares of two U.S. companies with little or no debt and a huge cash position, a situation that allows them to raise dividends – as they both did recently – and to take advantage of opportunities as they arise.

Professor Rogoff calls the financial crisis the “Great Contraction”, which he feels may take several years to complete. We believe caution and patience will be required throughout this perhaps lengthy roller coaster ride...

RECOMMENDED ASSET MIXINCOME PORTFOLIO

Oct 2011	Apr 2011	
20%	15%	CASH (CSB, QSB, T-BILLS)
50%	50%	FIXED INCOME (BONDS)
15%	15%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES
10%	15%	EQUITIES
5%	5%	FOREIGN

BALANCED PORTFOLIO

Oct 2011	Apr 2011
15%	5%
35%	35%
15%	15%
25%	35%
10%	10%

Sources:

Canadian Equities Guided Portfolio – September 2011
 US Equities Guided Portfolio – September 2011
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