

North American Equity markets got off to a very strong start in 2012. The S&P/TSX Total Return Index increased 4.4% during the first quarter. The S & P 500® index performed even better and increased by 12.6% in the quarter.

The worries that dominated equity markets for most of last year gave way to more optimism regarding potential growth for global economy. However, we believe that the market rally that began last October and continued into this year's first quarter seems to be ignoring continuing risks and that global economic growth will be moderate over the foreseeable future.

Although business and consumer confidence has been improving in the United States both remain weak in Europe. Similarly, while the unemployment rate in the U.S. has been declining Europe's unemployment is well over 10%. Even though the sovereign debt crisis seemed to have been abated with the completion of the Greek debt swap, the IMF bailout and large liquidity injections into the European banking system, recent elections in France and Greece have once again undermined confidence in Europe's ability to deal with its financial problems. The probability that Greece will leave the European Union is high. Should Greece exit the E.U. there will likely be short term volatility but we don't believe that the long term effects will be serious.

While global economic growth conditions have improved over the past few months there are still headwinds that should keep growth at moderate levels, namely debt and deficit levels in most of the developed world. The European Union still needs to turn its attention to very high levels of sovereign debt in Spain, Italy, Ireland and Portugal. The planned cuts in debt-to-GDP ratios can only be accomplished with severe austerity measures. These policies will be a drag on economic recovery in the region for the next eighteen to twenty four months.

---

While the U.S. economy is expected to grow by about 3% for this year, further growth next year could be hampered by cuts to government spending when the federal government finally reigns in its spending. The housing market shows little sign of recovering and employment growth is sporadic.

Despite the above noted issues Canada seems to be on top of the world. Canada avoided many of the serious problems arising from the financial crisis of 2008 and 2009. In addition, our financial system has been heralded as a model of prudence and good management. The Canadian economy buoyed by the developing world's need for commodities has been relatively strong and resilient. Canadian consumers are continuing to spend and our housing markets are strong right across the country. Canadian equity markets and the Canadian dollar have also performed well. Foreign investors are flocking to Canada as an opportunity for growth and as a safe haven. All appears to be well in the land of the Great White North!

But we are getting nervous! We think that the Canadian economy and Canadian equity markets may be headed for some serious pullbacks. We have three serious concerns:

- Our economy is based on a commodity boom essentially fuelled by China
- Canada's residential real estate market is overheated
- The composition of TSX over exposes Canadian equity investors to the above risks

Our major concern is that Canada's boom is essentially based on the growth of emerging markets; particularly China. An historical analysis of every emerging market shows that while the long term growth trend is positive there are many "boom and bust" cycles along the way. We fear that China may be heading towards an economic slowdown if not outright hard landing.

---

Recent reports indicate that China is indeed posting slower growth than anticipated. Exports, the engine of the nation's incredible growth, are slowing; in April, they edged up a mere 4.9%, approximately half of what had been predicted. Imports meanwhile managed to rise a modest 0.3%, far below the 11% anticipated. Moreover, factory output came in at 9.3%, the smallest increase since May 2009.

Just as worrisome is China's real estate market. Several visitors to China have commented on the large number of empty residential and commercial buildings throughout the country. Not surprisingly, there are widespread reports that Chinese commercial and residential real estate prices have declined by as much as thirty per cent. Such a decline could prove to be problematic as banks, investors and speculators have invested a substantial amount of their capital in the Chinese real estate market. As we have seen in other economies, problems in the real estate market eventually lead to significant consequences in the broader economy.

Although a slowing Chinese economy will affect the global economy, Canada will bear a disproportionate brunt of the economic fallout. Canada's commodity boom will certainly recede as the major driver for most of Canada's resources have been either directly or indirectly driven by growth in China. As a result, the entire Canadian economy will slow down.

Canada's residential real estate market is quite vulnerable. A strong economy, low interest rates and foreign buyers have resulted in prices that are dangerously high as evidenced by the following facts:

The ratio of house prices to rent is now higher in Canada than in any other developed country.

---

---

**Average house prices are now 12 times personal disposable income, substantially above historical averages.**

**Housing investment as a share of GDP is at 7 per cent and climbing towards a record high.**

**Home ownership has reached 70 per cent in Canada; surpassing the level in the U.S. at the peak of the American housing bubble.**

**The increase in house prices and low interest rates has encouraged Canadians to borrow. Household debt as a per cent of disposable income has risen to over 153 per cent in Canada, reaching record levels and coming close to the levels reached in the U.S. before the housing crash. This high debt load comes at a time when the economy appears to be slowing and unemployment rising.**

**Historical evidence across several global real estate markets suggests that the combination of the overvaluation described above, leverage and a slowing economy results in a very serious correction. The resultant fallout will be very painful for the Canadian economy.**

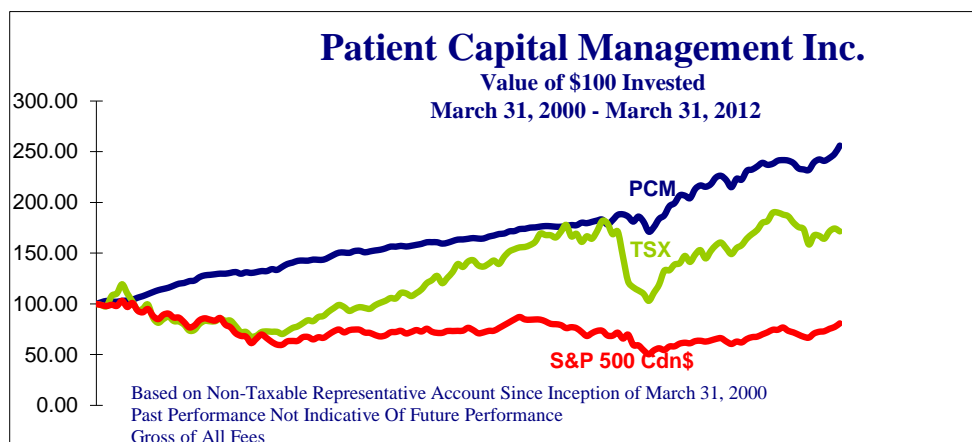
**As we have discussed on several previous occasions the Canadian market is not well diversified. Seventy five per cent of the S&P/TSX Composite Index is composed of commodity based companies and financial institutions. Commodity businesses are particularly vulnerable to an economic slowdown and the financial sector will be affected by a serious correction in the real estate market. As well, most of the high quality businesses listed on the Canadian market are far more expensive than their global peers. For example, the shares of companies such as CN Rail, Tim Horton's, Shoppers Drug Mart and the Canadian banks all trade at substantially higher valuations than similar companies listed in the U.S. The large exposure to commodities, financial companies and higher relative valuations pose substantial downside risk to Canadian equity markets.**

---

While we remain cautious and see serious potential risks ahead we want to remind all of you that macro-economic risks are often present in one form or another. Since our inception in March of 2000 equity investors have experienced what at the time seemed like very serious impediments to the creation of long term wealth:

- The implosion of the dot.com bubble
- The destruction of thirty five per cent of the TSX's market value through the bankruptcy of Nortel
- The terrorist attacks of 2001
- The wars in Iraq and Afghanistan
- The outbreak of SARS in Canada
- The collapse of the U.S. housing market & subsequent financial crisis in the U.S.
- The Great Recession of 2008 and 2009
- The European sovereign debt crisis

As the Graph below illustrates, Patient Capital has managed to protect and grow your assets through these “crisis.”



**Over the long term macro-economic problems resolve themselves and well managed companies survive and prosper through all sorts of circumstances. Capital employed in attractive businesses purchased at attractive prices grows and compounds in value. We are quite confident that our philosophy and process will steadfastly guide us through the next several years irrespective of the headwinds that may lie ahead. Investors who are prepared, have conviction and are patient will prosper through such periods.**

**PCM's business continues to grow. Our assets under management now approximate \$300 million. We recently added Eugène Ehren to our team. Eugène will help Domenic with portfolio administration duties and is already starting to make a positive contribution.**

**The last half of 2011 was a difficult time for my family and I. We lost both of my parents within the span of six months. I want to thank Domenic and Bob for their support and dedication; I can confidently say that we didn't miss a beat during this time.**

**Serving you through Patient Capital has helped me to deal with their loss and honour their memory. The values of integrity, hard work and "doing the right thing" are the principles that they instilled in our family. They are the foundation which Patient Capital is built on.**

**Thank you for continuing confidence and support. It is very much appreciated!**

**Vito Maida**

**May 21, 2012**

---