

The Guardian

Quarterly Review

Guardian Capital Advisors LP
Private Wealth Management

Q1 - 2010

GREEK TRAGEDY

Quarterly Commentary

Concerns over sovereign debt buckled markets in the middle of February, though most major markets recovered to well over their mid-quarter lows, finishing above their values at the start of the year. Central banks began the process of tightening easy money, though rates remained extremely accommodative. Employment numbers showed a trend towards hiring, though with several years of losses on the books full employment remains a fair way off.

Greek Tragedy

In ancient Greece a festival was held in March, the Dionysia, which celebrated Dionysus, the God of wine, drunken excess, and epiphanies. This festival lasted for five straight days, and central to the celebrations were the presentation of tragic plays. Modern Greece presented a newer version of the tragic play, which held the World in thrall for all of February, and much of March, rather than just five short days.

When Greece joined the European Union in 2001, they dropped the drachma and adopted the standard European currency - the Euro. With euro currency came greater stability, debt could be issued on far more favourable terms, and flush with this easy money the government spending - and debt levels - increased dramatically and the economy of Greece boomed. Profligate spending will do in any perpetual borrower, be they homeowners in the United States, or an entire nation. There are myriad problems plaguing the nation of Greece, underemployment, considerable dependence on tourism, the lowest per capita income of the pre 2005 Eurozone members, and an economy that is estimated to run at roughly one-fourth unreported income. The over-extension of their government's purse is far from unique, making many wonder why one of the smallest nations in the Eurozone could cause massive upheaval in the global markets.

Given the relative ease for capital to cross borders, particularly in a common currency area, the troubles of even the 34th largest economy in the World can come with the potential for contagion. Sovereign debt suddenly looked anything but bulletproof.

Greece was hardly alone in their over-borrowing, joined by other smaller nations in the Eurozone like Ireland, Italy, Spain, and Portugal; the threat of these weaker hands failing to pay their debts caused the value of the Euro to plummet, and increased the associated costs these countries pay in terms of interest to service their deficits. Indeed, the common currency that permitted these nations to borrow at rates closer to that of the economic superpower of Germany became a pitfall. While the US government can, and does, create more US dollars to repay debts, members of the common currency pact cannot print their own Euros, nor can they choose to devalue their currency. These smaller players then are reliant on refinancing their deficits in Eurodollars, which relies on buyers of the debt to step forward; with Portugal having to settle for some three-hundred million Euros sold in a February auction where they had hope to raise the sum of five-hundred million. Many questioned the role of the Euro for Europe, and whether those at either end of the economic spectrum would choose to leave or be forced out.

The Maastricht Treaty, the 1992 treaty governing the creation of the Euro and employment and trade rules inside the Eurozone, makes no allowances for the removal of member nations, nor does it permit the outright bailout of member nations. Germans balked at the idea of a bailout, having not been invited to the party in the first place, they were understandably not keen to assume their share of the hangover. They also reasoned that should Greece be bailed out, the other small nations were sure to come calling cap in hand. It was resolved that these weaker hands would need to heal themselves, with radical surgery required.



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The message to the spenders was physician heal thyself. The strong sought to impose a series of 'Austerity Measures', including large cuts to government spending, potential changes to the retirement age, and additions to sales and income taxes. The concern surrounding the size of borrowing on the balance sheets of nations, from littlest to greatest, came to the fore.

One of the most crucial roles of Western style governments is the collection (taxation) and redeployment of capital (spending), reserving excess when times are good, and borrowing through deficit financing when times are bad. European nations are hardly alone in their excess; budgets with deficits are certainly not a new phenomenon for North Americans, with some of the largest borrowing done in 2009 and 2010 in an attempt to keep banks afloat and the economy as a whole from seizing to a halt. With the creation of Trouble Asset Relief Programs, the backing of teetering banks, outright purchases of mortgage debt, attempts to stimulate economies and employment through debt-financed projects; the taxpayer became the cheque-writer of first resort. With Canadian obligations estimated to be in excess of five hundred billion dollars, and US debt at a staggering \$12.7 trillion, the question could fairly be asked how these debts will be paid? No doubt some version of an austerity plan could serve to reduce government expenditures, coupled with an increase in tax receipts this would provide additional dollars for payment. While austerity presents a viable option, rarely has a nation taxed its way to prosperity, and any savings from program cuts will take time to be realized.

In the shorter term, most sovereign debt will likely be rolled over. The case for debt rollover is far from bleak. In the zero-sum game of debt, there are savers too. Germany, Japan, China all have considerable foreign reserves, and growth continues in the BRIC nations, Brazil, Russia, India, and China.

These nations continue to experience real expansion in their economies, projected in the mid-single digits for the first three, to over nine percent for China; the Bank of Canada noted in January *"Economic activity in emerging-market countries-most notably China-is growing at a rapid pace, and the recovery has now extended to most of the advanced economies, with positive output growth recorded in both North America and the Euro area in the third quarter"*. With roughly half of the population of the planet, even small gains in real growth serve to bolster the global economy, which is expected to grow at 3.7 percent in 2010 and 4.1 percent in 2011. In turn this provides the base for employment and economic gains both in and outside those developing nations.

With continued strength from these second-World countries, commodity based economies such as Australia, Chile, and Canada are likely to continue to prosper. The appreciation of the Canadian dollar has served to increase our purchasing power abroad, while exporting some inflationary pressures over our border. Growth of the second-World economies should also lead to rising input costs - oil, nickel, lithium, steel, and other commodities will continue to appreciate as they remain in shorter supply. While readings have not yet begun to show inflation, mild amounts of inflation are likely to enter the system. The Royal Bank of Australia have already begun a cycle of rate hikes, and the Bank of Canada confirming that rates will remain on hold *"until the end of the second quarter of 2010"* in their January 2010 Monetary Policy Report, intimating that a tightening cycle is soon to begin. As inflation serves to devalue currency over time, it serves to devalue the total cost of the debt that has been pushed down the line, making it cheaper to repay in terms of 2010 dollars. While anticipated inflation may soften the blow for future generations, the recipients of our fiscal mismanagement, surely inflation cannot be relied upon to provide the sole solution to the fallout from bubbles and excesses of the past decade and a half.



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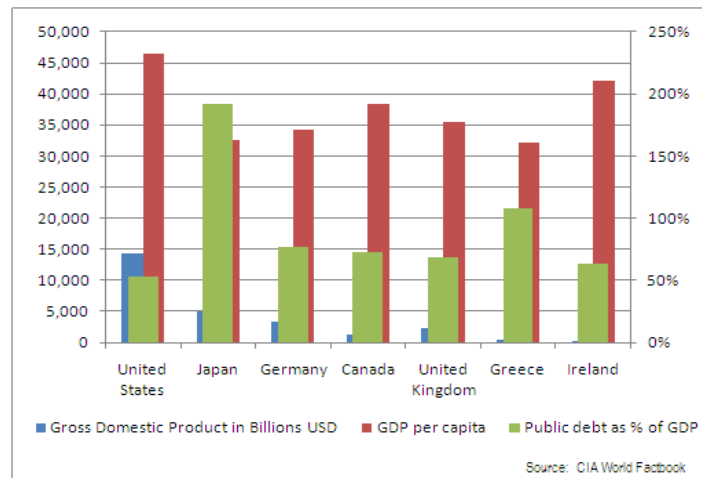
GREEK TRAGEDY

Despite the size and scale of the program, the news is not all bleak. The US dollar remains the reserve currency of the World, which permits the largest economy wiggle room. In Europe, presuming these troubled nations agree to large-scale systemic changes, they are likely to be helped. The form of help is likely to be provided not through an outright bailout, but through their Euro partners purchasing government bonds on a large scale. Closer to home, it is not unreasonable to assume that Canada could prosper, being enviably positioned with low relative levels of federal and personal debt, considerable resource wealth, strong currency, and the health of our banking sector all providing reasons to believe in growth prospects.

Declaring the all concerns over sovereign debt to be behind us is surely premature. With so many moving parts, definitive declarations simply cannot be made.

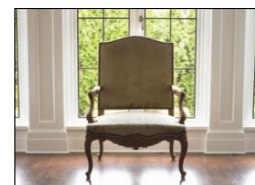
With the potential for a modern day Greek Tragedy moved to the back burner for now, the festival of Dionysus can shift from celebrating excess to celebrating an epiphany - maybe a little austerity here and there is a good thing.

Guardian Capital Advisors Investment Committee



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