



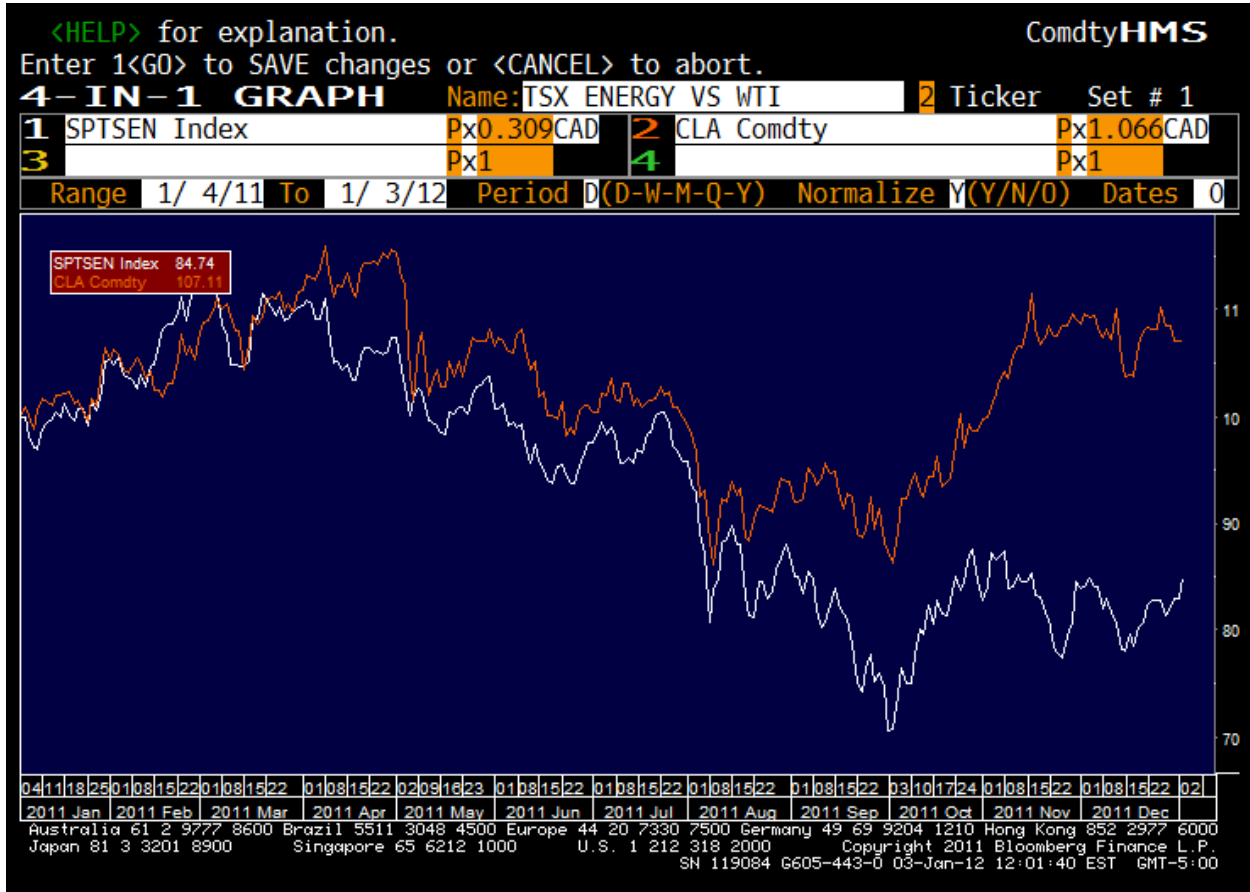
**GALILEO Q4 2011 COMMENTARY**  
**'The Year of the Black Swan'**  
**By Michael Waring**

This last year is best described as the Year of the Black Swan. From the Tohoku region earthquake in Japan to the Arab Spring, hefty geopolitical premiums on oil prices, sovereign debt crises and political brinksmanship in the West, we would say that unforeseen catastrophes won and the markets lost in 2011. We would however maintain that signs are in our midst that the global economy has stabilized and that certain areas of the market (notably former energy trusts) held up very well in 2011. Volatility will continue to haunt the capital markets driven by headline risk. Market ebbs and flows will continue to be a function of investor psychology and the paralysis of fear and greed. It has always been said that markets climb a wall of worry. As a growth manager focused on fundamentals, we believe that investing should be about the discovery of value and compelling investment stories rather than macroeconomic pontification.

The macro doom and gloom of 2011 has served to obscure some very compelling realities. Profit margins are at 20 year highs, corporate debt is at multi-decade lows. The earnings yield of the S&P currently sits at 8.2% while 10-year Treasuries yield 1.85%. US unemployment has begun to abate with 200,000 jobs added in December. Further, recent PMI numbers out of China (50.3%) and the United States (53.9%) point towards expansion, not contraction. European growth will continue to be soft and heavy borrowing for deficit refinancing will persist in 2012. In China, GDP growth slowed in Q4 to 8.7% from 9.1% in Q3 but this is arguably from monetary tightening on the part of the central authorities aimed at curbing inflation. Growth in Chinese GDP for 2012 is expected to be comfortably over 8.0% as the PBOC embarks in the other direction of policy easing over the coming months. This bodes well for our overall investment thesis. While we are aware of the threat that sovereign default in Europe represents, we believe it more constructive to focus on compelling valuations in the market.

During 2011, Energy (-12.28%) and Materials (-21.81%) led an 11% decline for the TSX despite firmness in commodity prices throughout the course of the year. This could be understood in one of two ways: either the economy is stronger or resources are more scarce than the market believes. Ostensibly it is a combination of both. Either way, valuations look attractive. Oil proved remarkably resilient ending the year up 4.4% at \$94.70/barrel. This is in stark contrast to 2008 when oil hit a high of \$147 and then plummeted to \$30. Evidence of value in the energy complex abounds not only from the underlying cash flow of the group but also in numerous acquisitions such as PetroChina's acquisition of Athabasca's 40% stake in the Mackay River project, China Petroleum's \$2.5B venture with Devon Energy to develop shale oil and gas fields in North Dakota, and Teck Resources' purchase of its oil sands partner Silverbirch for \$435M. Across the board in the commodities complex, net long positions have increased 18% since October across 18 U.S. futures and options according to the Commodity Futures Trading Commission.

The divergence between commodity prices and the underlying stocks in addition to robust M&A activity at the outset of this year signal to us that the economy is in better shape than most investors think and that there is continued opportunity in the market. Despite the current high levels of uncertainty among investors, we remain constructive on the overall outlook.



The orange line represents oil prices over 2011 while the white line represents underlying stock valuations. Note the widening divergence that starts in Q4/2011.

Source: Bloomberg, January 5, 2012.