

Investment Outlook

April 2009

What a Relief

Things didn't start off so well this quarter. As if the bear market of 2008 was not enough, stock market conditions deteriorated further in the first two months of 2009. More specifically, the U.S. stock market posted its worst January performance ever, and its worst February performance since 1933. March, however, has been a different story. Since the low on March 9th, stock markets around the world have rallied strongly. The benchmark U.S. index, the S&P 500, has rallied 25% since then, and continues to be strong in early April. The NASDAQ is up more than 25%, its best four-week rise ever. In Canada, the TSX Composite also has bounced impressively. People are smiling again on Wall Street and Bay Street.

Of course, nothing goes straight down forever, and a reversal of some kind was to be expected. However, a number of important catalysts have fueled the rally and given even the most dour forecasters reason to question whether the worst is behind us. Over the month, commodity prices have stabilized and even started to recover in some cases (which is particularly helpful in Canada). While March auto sales were dreadful on the surface – GM's sales were down 45% year-over-year in the U.S. – they were not as bad as expected and suggest some signs of stabilization. Some important U.S. economic data, such as the ISM Manufacturing survey, have hinted at improvement. Surprisingly, even U.S. retail sales have proven to be remarkably resilient and companies such as Best Buy have surprised investors with their performance. Clearly, low energy prices and low interest rates are helping to mitigate the slowdown.

The financial crisis also continues to abate as governments around the world pull out all the stops. In the U.S., the new Obama administration has launched a myriad of aggressive new policies and spending initiatives – each with a new acronym – all of which are designed to grease the wheels of the financial system. Moreover, the U.S. is exhorting others around the world to do the same, as manifest in the enormous \$1 trillion stimulus announced at the recent G20 meeting in London. In the U.S. and abroad, the speed and size of this government intervention is without historical precedent. Whether it is because of, or in spite of, these government actions, Citigroup and several of the largest U.S. banks have surprised investors with announcements that they are likely to return to profitability in the first quarter of 2009.

Is the Rally For Real?

Of course, the question on every investor's mind is whether this rally is for real? Is it the beginning of the hoped-for recovery? Did the bear market bottom for good on March 9th, or is this another bear market rally similar to the 17% bounce off the November 20th low?

Despite our hopes to the contrary, many of the stock market dynamics would lead one to question the sustainability of the rally. The current rally is being led by the most heavily shorted sectors: financials, consumer discretionary, and materials stocks. These are the sectors that led us into this mess and it would be highly unusual for them to lead us out. The market does not often work that way. Moreover, the basic economic backdrop remains challenged, and it is unlikely a sustainable recovery can occur without more fundamental improvements. Specifically, housing and employment, the bedrock of the economy, continue to deteriorate.

The most widely-watched measure of house prices in the U.S. – the Case-Shiller Home Price Index – was recently updated with January data. It revealed that house price declines have not abated. Prices are down 19% year-over-year, and the rate of decline has not slowed. Prices are down 29% from their peak in July 2006. There is not yet a light at the end of the tunnel on the housing front.

Similarly, U.S. employment statistics for March were released in early April. A further 663,000 jobs were lost in March, driving the total number of jobs lost above the 5 million mark since the recession began in 2007. The official unemployment rate rose to 8.5%, the highest in a quarter century. Moreover, the Bureau of Labor Statistics also tracks a number of other statistics that one could argue give a more complete picture of the employment situation. If one includes people working part-time because they cannot find full-time work, and those who have given up looking for work, the unemployment rate balloons to an estimated 15.6%.

Despite the emergence of a few rays of hope in the U.S. economic data, we remain skeptical of the sustainability of the stock market rally. Consumers drive 70% of the U.S. economy. In our view, the final cyclical bottom can only be made once housing stabilizes and the outlook for employment improves.

Canada: Land of Milk and Honey?

There has been discussion in the financial press in recent months about how Canada has been a “safe haven” in the global financial and economic meltdown. At the recent G20 meeting in London, Prime Minister Harper seemed to happily oblige the international media with tales of Canada’s great recipe for success: the prudent fiscal policies pursued by our governments, and the conservative lending practices to which our financial institutions adhered. While we heartily agree with the proposition that Canada should be less prone to complete financial system failure than other countries, Canada is fully exposed to the real business cycle effects of the global recession. In fact, a key mistake many investors have made over the past year is to have believed Canada would be immune from many of the worst effects of the global downturn.

Unlike the U.S., where so much of the economy is tied to domestic consumption, Canada’s economy relies much more on open trade with other nations, and particularly on U.S. final demand. Accordingly, the U.S. and Canadian business cycles are very closely related, with U.S. economic trends typically leading those in Canada by one or two quarters. Given what we have observed in the U.S., therefore, one would naturally expect that economic conditions would be deteriorating noticeably in Canada at the present time. Indeed, that seems to be the case. Whether one looks at the recent Ivey manufacturing survey, or the rapid decline in railroad traffic, the Canadian economy is undoubtedly in decline. While we in Canada don’t face the same crisis in our housing sector, or within our banking system, it may be that our derivative economy feels the impact of the global recession even more acutely than does the U.S.

Portfolio Positioning

Investors are wrestling with two fundamental questions at the present time: Is the worst of the bear market behind us? Will the enormous stimulus packages implemented around the world ultimately lead to a period of troublesome inflation?

With respect to the first of these issues, we have outlined above the reasons for our skepticism. Throughout the past year, we have positioned client portfolios conservatively and we believe that positioning remains appropriate. As we talked with clients over the past quarter, we expressed the view that it is too late to be pessimistic and too early to be optimistic. Stock prices have discounted an enormous amount of bad news, and many stocks represent values not seen in a generation. We don’t think it makes sense to become more conservative in this environment. On the

other hand, we believe sufficient risk persists that prudence dictates further patience. If we are going to be wrong, we would rather it be because we stay cautious too long and miss some of the upside in the recovery. It would be worse to be wrong by being early in committing more to equities and have clients suffer further declines. We're comfortable with our current cautious stance.

Without doubt, the issue of inflation is one of the most pressing topics among investors. Governments around the world are intervening in their economies with levels of monetary and fiscal stimulus never before imagined. In the U.S., this stimulus is expected to amount to as much as 12% of GDP in the coming year. Investors are worried that the flood of U.S. Treasuries needed to finance this spending will lead to a debasement of the U.S. dollar, an increase in interest rates, and a sharp uptick in inflationary pressures. While Canada does not face these same pressures directly, an increase in U.S. inflation and interest rates would likely find its way into our own economy.

We have been gradually positioning our fixed income portfolio to reflect this concern. Because of the enormous economic slack brought upon us by the recession, inflationary pressures are well-contained at present. Anticipating that this state of affairs might gradually give way to a period of rising interest rates, however, we have significantly shortened the duration of our fixed income holdings over the last quarter such that portfolios have noticeably shorter maturities than the standard market benchmark.

In sum, this has been a very difficult time for all investors. Despite some improving economic signs over the past quarter, there remains much to be concerned about in the current environment. There could be several more months of turbulent market conditions before a lasting recovery takes hold. Having said that, it is in times like the present that the foundation is built for truly superior returns in the years ahead. Many stocks have been beaten down to incredibly low levels and represent tremendous long-term value. We believe more than ever that great rewards exist for those with the patience and discipline to take advantage of such an environment.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>March 31, 2009</u>	<u>December 31, 2008</u>
TSX Composite Index	8,720	8,988
91-Day T-Bill Yield	0.40%	0.89%
30-Year Gov't of Canada Bond Yield	3.56%	3.44%
Prime Rate	2.50%	3.50%
Exchange Rate (1\$ Cdn. = US\$)	\$0.7932	\$0.8166

United States

Dow Jones Industrial Average	7,609	8,776
Standard & Poor's 500 Index	798	903
30-Year U.S. Treasury Yield	3.53%	2.68%

Market Returns For Periods Ended March 31, 2009 ⁽¹⁾

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years ⁽²⁾</u>	<u>Last 10 Years ⁽²⁾</u>
DEX 91-Day T-Bill Index	0.3%	2.4%	3.2%	3.6%
DEX Universe Bond Index	1.5%	4.9%	5.2%	6.1%
TSX Composite Index	-2.0%	-32.4%	2.8%	4.9%
S&P 500 Index (C\$)	-8.4%	-24.1%	-5.5%	-4.7%
MSCI EAFE (C\$)	-11.4%	-34.4%	-2.9%	-2.6%

Footnotes:

(1) Represent total returns, including income and capital appreciation (or depreciation).

(2) Compound average annual return.