

Investment Outlook

July 2009

What a Year it has Been

When we wrote our *Outlook* a year ago, stock market indexes were near their highs. Oil was trading at US\$145 per barrel and many believed it was only a matter of time before it crossed the US\$200 mark. Of course, the burden of high energy prices was weighing on consumers, and growth was slowing in the U.S. and many other economies. Credit markets were nervous, but had improved noticeably from the tense period around the collapse of Bear Stearns earlier in the year. We worried that the U.S. could slide into recession, but this was far from certain. Canada, although not immune from the slowdown in global growth, seemed to be holding up relatively well. Almost no one foresaw the magnitude of the crisis that lay ahead.

As we look back at the last twelve months it is remarkable to consider that we have endured the most difficult economic and stock market conditions since the Great Depression. Thankfully, the most recent quarter has been a period of recovery. Stock markets in Canada and the U.S. bottomed on March 9th and have rebounded dramatically since then – many indexes have bounced 40% from their lows. Given the massive stimulus and market intervention initiated by governments and central banks around the world, it is perfectly normal that we should experience a significant rally in financial markets as they anticipate the possible success of these measures. The question remains, however, whether the stimulus will be effective and, accordingly, whether the market recovery is sustainable.

Less Bad is the New Good

There is no doubt that the financial crisis has subsided and economic conditions have improved from their worst levels. We no longer fear a complete failure in the global financial system that seemed possible in the fall and winter. The rally we have enjoyed in stock markets reflects renewed enthusiasm among investors that economic conditions are improving. Optimists see the 'green shoots' of renewed economic growth in almost every report. In reality, recent data indicate that the economy is 'less bad' than it was, but still struggling. We worry that optimism for a solid recovery is based more on hope than on reality.

A good example of this phenomenon can be seen in the June U.S. manufacturing survey completed by the Institute of Supply Management. This survey of purchasing managers offers a useful perspective on manufacturing activity in the U.S. The June number came in at 44.8, which was a bit better than expected and certainly much better than the 32.9 reading in December. While this was treated as good news, any reading less than 50 suggests that the economy is contracting. We may be old fashioned, but a weak economy deteriorating further does not seem like something to celebrate. Similarly, Ford's June sales decline of 11% was better than the 17% decline that was expected. Good news? We would argue that a further 11% decline in sales for a company that is already in crisis mode, is hardly good news. Yet investors seemed encouraged.

While the economy may be showing signs of stability, it is doing so at very low levels of activity. Moreover, one of the key building blocks of economic strength – employment – continues to be very fragile. In contrast with some of these 'less bad' economic releases, the June employment report in the U.S. was discouraging. Average hourly earnings rose at the weakest rate since 1964. The U.S. lost jobs for the 18th consecutive month in June, and the official unemployment rate rose to 9.5%, a 28-year high. Every single job that has been created since 2000 (about 6.5 million) has now been lost. This is the first recession since the Great Depression to wipe out all of the job growth from the previous business cycle. Moreover, if one looks at a measure the Bureau of Labor Statistics calls U-6, the situation becomes even

more worrisome. In addition to the official number of unemployed, the U-6 also includes those who are discouraged and stopped looking for work and those who have taken part-time jobs because they cannot find full-time jobs. The U-6 unemployment rate is 16.5%, not a good environment for a consumer-driven recovery.

When Good is the New Bad

As part of the borrowing and spending spree that got us into the predicament we are in, the U.S. savings rate fell below zero. Americans spent more than they earned (and then some, it turned out). In recent months, however, the savings rate has sharply increased, rising to 6.9% in May. Saving is good for the long-term health of consumers and the economy, but if consumers are saving more they are spending less. Perversely, by doing the right thing and saving, consumers will slow the recovery.

As economists ponder the impact of a rising savings rate, all of a sudden, 19th century British economist David Ricardo has come back into vogue. In 1820, Ricardo offered a theory that has since become known as the ‘Ricardian Equivalence’. The theory argues that a fiscal stimulus, such as is now being pursued around the world, will not work because consumers will save as much extra money as the government spends. Why? Because consumers know that the extra government spending eventually will result in higher taxes as the government needs to fund the stimulus. Most economists have been skeptical of Ricardo's theory, but no one has yet proved it wrong. In May, the Obama administration started to inject stimulus funds at a \$163 billion annual rate. Consumer spending only increased at a \$25 billion annual rate. Whether it is Ricardian Equivalence, or simply worries about job security or the security of their pensions, Americans (and Canadians) are limiting their spending. With consumers representing 70% of the economy, in all likelihood, economic growth will remain subdued for some time to come.

Canada Remains a Less Bad Place to Be

Canada continues to suffer through a significant and prolonged recession. Our economy has been more affected by the deep global slowdown than many expected. Nevertheless, we retain many structural advantages that cause us to think that our recovery might be a little sooner and a little more robust than in other countries. A decade of responsible fiscal management at all levels of government means that our government finances are not nearly as precarious as in many other countries. Consumers have over-borrowed and over-consumed, but not nearly to the extent that our southern neighbours have. Real estate is soft, but it should be much more resilient than in many more inflated locales. Finally, as growth resumes around the world, particularly in emerging markets, demand for commodities of all description will benefit our resource-rich country. We have our challenges, but they are not nearly as daunting as those faced by others in many parts of the world.

Patience Will Be Rewarded

This is an environment in which it is far easier to be pessimistic than it is to be optimistic. We have outlined many of the concerns that keep us awake at night as we try to prudently manage client portfolios. It seems likely to us that the recovery, when it comes (and it will come), will be more subdued and prolonged than many hope. Still, we think that the greatest investment opportunity lies in high quality stocks that will prosper over time. Our bond holdings have performed exceedingly well over the last year and mitigated the sharp decline in the stock market as the financial crisis unfolded. Realistically, however, bonds will continue to serve the useful purpose of preserving capital, but with very low interest rates their contribution to investment returns will be minimal. In order to achieve an objective of portfolio growth, investors will need to maintain an appropriate weighting in common stocks. As Warren Buffett is fond of saying, “It is quite easy to know what stocks will do, it is just impossible to know when.” Now, more than ever, investment success will accrue to those who are diligent, disciplined and patient.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>June 30, 2009</u>	<u>December 31, 2008</u>
TSX Composite Index	10,375	8,988
91-Day T-Bill Yield	0.29%	0.89%
30-Year Gov't of Canada Bond Yield	3.86%	3.44%
Prime Rate	2.25%	3.50%
Exchange Rate (1\$ Cdn. = US\$)	\$0.8602	\$0.8166
<u>United States</u>		
Dow Jones Industrial Average	8,447	8,776
Standard & Poor's 500 Index	919	903
30-Year U.S. Treasury Yield	4.30%	2.68%

Market Returns For Periods Ended June 30, 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	0.1%	2.0%	3.2%	3.5%
DEX Universe Bond Index	1.3%	7.0%	5.9%	6.3%
TSX Composite Index	20.0%	-25.7%	6.6%	6.2%
S&P 500 Index (C\$)	6.9%	-15.8%	-5.0%	-4.5%
MSCI EAFE (C\$)	15.7%	-21.7%	-0.6%	-1.2%

Footnotes:

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

(2) Compound average annual return.

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