

Investment Outlook

October 2009

Sell in May and Go Away?

So much for the old seasonal investing adage that one should “sell in May and go away.” If that strategy had been pursued over this summer, an investor would have missed sparkling stock and bond market returns. From May 1 through August 31 the TSX Composite provided a return of 17.7%.¹ Amazingly, the TSX Composite now shows a small positive return for the 12 months ended September 30th. In the U.S., the S&P 500 rallied 17.9% during this period. Thinking in more traditional calendar quarter terms, the S&P 500's 15.6% Q3 return is the best quarterly return for the index since Q4 of 1998. It is the best Q3 return since 1939. Internationally, returns were also impressive. The EAFE Index was up 27.9% over the May through August period.² Even the bond market benefited as the ongoing normalization of risk aversion led to a further contraction in credit spreads.

The basis for this market recovery lies in a stabilization and improvement in many economic indicators after the worst economic downturn since the Depression. Last quarter, we talked about ‘green shoots’ and economic conditions that had become ‘less bad’. Investors even enlisted high school calculus to talk about the ‘second derivative’ of the economic decline – while economic conditions were still getting worse, the rate of deterioration was slowing. You may recall from our last *Outlook* that we used the example of Ford's June sales decline of 11%. While that hardly seemed a happy result to the conventional thinking at Nexus, it was greeted enthusiastically by investors. An 11% decline was, indeed, not quite as bad as expected, and it was not as bad as the previous month. Hope was in the air.

During the last three months, we have moved beyond the second derivative and conditions that are ‘less bad’, and actually have seen a number of measures improve on an outright basis. In the U.S., consumer confidence, while still low by historic standards, has improved noticeably from its worst levels. The Institute of Supply Management survey of U.S. purchasing managers has improved sharply to a level normally associated with economic expansion. Even U.S house prices, whose dramatic decline has been one of the significant drivers of the recession, appear to have stabilized and moved slightly higher on a month-over-month basis. A growing number of economists are bravely declaring that the worst recession in a lifetime may, in fact, be over.

In Canada, conditions have also improved. Just as this commentary was going to press, the September employment report was released and it painted a surprisingly strong picture. During the month, 36,400 new jobs were created and the unemployment rate actually dropped to 8.4%. There was a big shift to full-time from part-time jobs and the length of the workweek was up strongly. Additionally, the Canadian economy has been helped by the renewed strength in commodity prices, as demand from many emerging economies has bounced back strongly. While retail sales have remained weak, the Bank of Canada's Business Outlook Survey has had a remarkable recovery. Clearly, businesses are feeling quite good about the near-term outlook. Real estate prices have also remained remarkably resilient in many parts of the country, and our banks have weathered the storm well. There are lots of reasons to feel good about what is going on in Canada.

¹ All returns in this paragraph are total returns expressed in local currency.

² EAFE is an acronym for Europe, Australasia and the Far East.

Raining on the Parade

It is undeniable that economies in North America and around the world have recovered nicely from their worst. The '\$64,000 question' is the sustainability of this recovery. Many commentators have enlisted the alphabet to describe their expectations for the nature of the recovery. Some see a robust 'V'-shaped recovery. Others think it will be more moderate and resemble a 'U'. The most pessimistic see a 'W'. We don't know if any letter of the alphabet will properly describe the economic recovery when it happens; however, we are pretty certain that talk of a 'V'-shaped recovery seems more hopeful than realistic.

The U.S., in particular, continues to face a number of well-documented challenges. One of the most notable is its terribly weak labour market. The U.S. economy has now lost 7.2 million jobs from its peak in 2007, the greatest aggregate number of job losses in a downturn during the post-World War II period. The current unemployment rate, 9.8%, is at a 26-year high and is expected to trend higher. The median length of unemployment, 17.3 weeks, is the longest on record. The length of the workweek, now 33 hours, is at a post-war low. The U-6³, a broad measure of Americans not properly employed, has hit 17%, the highest on record.

The sick U.S. labour market continues to sap consumer spending and is clearly weighing on the economy. With record numbers unemployed, and those remaining employed nervous about their prospects, consumers have kept their wallets shut. U.S. consumer credit is down 4.4% over the last year, largely driven by the 13.1% decline in revolving credit. Revolving credit is primarily credit card debt. While a reduction in consumer indebtedness is essential for the long-term health of the economy, the short-term impact has been pronounced. Retail sales have languished. Since the consumer represents 70% of the U.S. economy, times are tough and likely will remain so for some time.

A second major threat to sustained recovery in the U.S. relates to international confidence in the value of the U.S. dollar. Massive deficits, as have been planned in the U.S., must be financed with foreign savings. There is a growing suspicion that future economic growth and/or increased taxes will be insufficient to pay down the debt burden that is currently planned. In such a case, servicing the debt and paying it off may require a devaluation of the U.S. dollar or a rise in inflation. The current administration seems much less concerned with a devaluation of the U.S. dollar and the risks that come with it than some international investors are comfortable with. Recent U.S. dollar weakness and commodity price strength could yet flare up into more serious problems.

While the Canadian economy continues to be one of the soundest in the OECD, we face our own challenges. In particular, the rapid rise of our currency over the last several months has once again weighed on our export sector. After posting surpluses for three decades, the rising Loonie, together with weak demand from the U.S., has dramatically affected our ability to sell goods abroad. In August, the Canadian trade deficit reached \$2 billion, reflecting a sharp decline in our many exports. The Loonie has gained almost 15% against the U.S. dollar over the course of 2009, largely reflecting the recovery in commodity prices as well as the relative strength of our economy. While a strong currency is positive over the long term, the dollar's sharp rise over the course of 2009 has led to considerable concern regarding our international competitive position and the durability of our recovery.

A Tricky Situation

As investors, we face a tricky situation. A recent headline in Barron's declared that "The bull market in puzzlement continues."⁴ Investment returns over the last seven months provided a pleasant respite from the anguish felt in 2008. As we have detailed above, there are many positive developments that give one hope that the recovery is for real and that the worst is past. Yet the easy returns in stocks and bonds may be behind us. Many worrisome issues remain that we believe provide a real challenge for investors and lead one to a more cautious stance.

³ The U-6 is a broad measure of unemployment published by the U.S. Bureau of Labour Statistics. It adds to the ranks of the officially unemployed those who have given up looking because they can't find a job and those who have accepted part-time work because they can't find full-time work.

⁴ *Barron's*, September 14, 2009.

How have we positioned portfolios in this uncertain time? Over the last six months, we have modestly increased our exposure to equities in order to take advantage of some extraordinary values that became available. However, we don't feel an urgent need to catch the very bottom of the market. We believe that patience in a risky world is both prudent and desirable. The stocks in which we are invested emphasize quality and have a strong defensive bias. If the current path of recovery proves sustainable, our investments will benefit, albeit not quite as dramatically as more economically sensitive ones. If, instead, the path isn't quite as smooth as many hope, then the more cautious approach we have adopted will be well rewarded.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>September 30, 2009</u>	<u>December 31, 2008</u>
TSX Composite Index	11,395	8,988
91-Day T-Bill Yield	0.23%	0.89%
30-Year Gov't of Canada Bond Yield	3.84%	3.44%
Prime Rate	2.25%	3.50%
Exchange Rate (1\$ Cdn. = US\$)	\$0.9327	\$0.8166
<u>United States</u>		
Dow Jones Industrial Average	9,712	8,776
Standard & Poor's 500 Index	1,057	903
30-Year U.S. Treasury Yield	4.05%	2.68%

Market Returns For Periods Ended September 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%	1.3%	3.1%	3.4%
DEX Universe Bond Index	2.7%	10.3%	5.9%	6.6%
TSX Composite Index	10.6%	0.5%	8.3%	7.3%
S&P 500 Index (C\$)	6.6%	-5.8%	-2.3%	-3.3%
MSCI EAFE (C\$)	10.2%	4.4%	2.6%	-0.6%

Footnotes:

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

(2) Compound average annual return.

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