

## Investment Outlook

April 2010

### Winter Has Come and Gone

As we look back at our comments written in the *Investment Outlook* in January, it is remarkable how little has changed. Winter has come and gone, without much snow, and without much change in the challenges that confront investors. Positive momentum in the economic rebound being enjoyed in Canada, the U.S., and elsewhere in the world continued through the first quarter of 2010. At the same time, there also remains a concern about the sustainability of this recovery. Is it the dawn of a new period of growth and prosperity, or is it a temporary rebound in advance of a 'double dip' recession or a prolonged period of more challenging economic conditions?

Even though the underlying dynamics of the investment environment were little changed during the quarter, that is not to say that nothing interesting happened. Overseas, Greece faced a debt crisis of such magnitude that fears for the stability of the European Union swept the globe. While Greece recently received a tentative commitment for financial backing from its EU partners and the International Monetary Fund, its problems remain unresolved and it faces an extended period of austerity. In the U.S., President Obama finally saw his sweeping health care reform pass through Congress. Depending on one's perspective and political leanings, this landmark legislation will either lead to the most progressive and important improvement in the life of the average American since the introduction of Social Security, or it will be an economic catastrophe. There were also a couple of anniversaries to celebrate. Early in March, newspaper lineage was dominated by retrospectives on two important events: the first anniversary of the stock market low in 2009 (the point at which fear gripped investors more tightly than it has since the 1930s), and the 10<sup>th</sup> anniversary of the high in the NASDAQ in 2000 (the point at which the technology bubble was at its peak). Finally, in Canada, much of our attention was consumed by the spectacular run of the Vancouver Winter Olympics. This has little to do with investments, but it certainly was a highlight of the quarter!

### Economies on the Mend

Throughout the first quarter, a number of economic indicators continued to reflect a strong recovery in the Canadian economy. Fourth quarter 2009 GDP growth (reported in February 2010) surged to a 5.0% annualized rate. This was significantly higher than expectations, as well as the 0.9% growth rate experienced in the previous quarter. The labour market also has been strong, with the unemployment rate continuing to fall, and new hiring stronger than expected. Perhaps reflecting the improved labour market, retail sales also surprised to the upside. Finally, just as this *Outlook* was going to press, a strong reading in the Ivey Purchasing Managers Survey reflects a business sector more confident in the prospect of economic expansion. In sum, Canada remains one of the leading economies in the G8.

Similarly, the U.S. economy has also rebounded smartly. Fourth quarter 2009 GDP grew at a very brisk 5.6% rate, and many other indicators of economic activity improved steadily through the first quarter. As in Canada, the Institute of Supply Management survey of U.S. purchasing managers suggests that businesses see a solid period of economic expansion ahead. Consumer confidence has improved less dramatically, but is still considerably better than it was in 2009. Even those measures that suffered most through the recession – house prices and employment – have stabilized or improved.

### Are Better Times Here to Stay?

As we described in our last *Outlook*, most of the improvement in economic conditions, both in Canada and the U.S., can be directly attributed to the extraordinary measures undertaken by policy makers to intervene in the economy. By slashing interest rates to near zero, buying up private sector debts, increasing spending, and cutting taxes, our governments and central banks perhaps staved off a second Great Depression. However, these measures are by their nature temporary, and many of them will soon be

withdrawn. Over the course of 2010, governments and central banks will have to manage a delicate balance as they move to wean their economies from life support. On one hand, they must act quickly enough that the current stimulus does not ignite inflation, but not so soon that the recovery is snuffed out and we slide back into recession. Time will tell how dependent our economies have become on these extraordinary measures.

In addition to this risk of policy mis-step, we harbour a series of additional concerns about the durability of growth. Avid readers of *Nexus Notes* will have read our recent article on the risk that sovereign debt levels in many countries pose to future economic growth. With gross federal debt in the U.S. forecast to climb to over 100% of GDP, the U.S. has reached levels where its debt load could well choke off future economic growth quite significantly. Moreover, without an improvement in the high level of unemployment, the consumer sector is likely to remain weak. Despite the positive recent 'headline' in the U.S. non-farm payrolls report for March, there are still many worrisome aspects of the labour market. For example, the U-6<sup>1</sup>, a broader measure of unemployment than the 'official' rate, actually rose to 16.9% in March. Average hourly earnings fell for the first time in seven years. The probability of someone who was out of work in February finding a job in March fell to 18.7%, the lowest level since the Bureau of Labor Statistics started tracking this metric in 1948.<sup>2</sup> In short, the sustainability of the current U.S. rebound is hardly assured.

By all accounts, the economic environment in Canada is widely considered to be much more attractive than that in the U.S. Economists forecast Canadian economic growth over the next several years to be the strongest of any G8 country. Nevertheless, risks persist to our own recovery. The Canadian dollar's recent surge to parity with the U.S. dollar makes cross-border shopping attractive, but is a serious headwind for the competitiveness of our export sector. While the impact of a currency move takes time to work its way through the system, the current strength of the loonie is a concern for future growth. Additionally, as an export-oriented country, we depend on demand from abroad. The U.S. remains our largest trading partner by far, and we have documented its current and future challenges. However, the Canadian economy has become increasingly driven by non-U.S. demand, particularly that from China. While China's growth remains exceptionally robust at present, it is not without risk. A growing number of observers worry that China's economy is about to bubble over, fueled by aggressive credit expansion, excessive real estate speculation, and frenzied new construction. While China's vast foreign reserves give many bulls confidence, somewhat ominously, others point out that the only two countries which previously acquired such large reserves relative to global GDP were the U.S. in 1929 and Japan in 1989. China could well continue to provide insatiable demand for all that Canadian exporters have to offer, but there is also a scenario where China's economy suffers a substantial set-back.

## Staying Conservative

Just as our outlook is relatively unchanged from three months ago, so is our investment posture. Given the strong stock market rebound, and the many challenges to economic growth which lie ahead, we continue to expect volatility and uncertainty in the financial markets. Traditionally, faced with such uncertainties, one might favour investments in the safety of bonds. At the present time, however, the appeal of bonds is reduced. There still remains a very important role for bonds in the portfolios of most investors, but after decades of exceptional returns from bonds, our expectation for fixed income returns in the next decade is modest. Accordingly, we have gradually increased our equity weightings over the last year and in the last quarter. A year ago, most clients were significantly under-weight their long-term targets for equities. Today, client portfolios are typically pretty close to their long-term asset mix objectives. As we have added to equities, however, we have been careful to maintain a conservative bias. For some time, we have favoured companies with strong businesses and defensive characteristics, conservative balance sheets, and attractive dividends. In fact, the dividend yields on a number of our equities are higher than the coupons on some of our bonds! Over the course of history, such companies have performed better than more economically sensitive or more 'exciting' ones. In the period ahead, we are confident that our stock selections will provide clients with the stability they require in a challenging environment, but also the opportunity for growth as the businesses expand and prosper.

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<sup>1</sup> The U-6 is a broader measure of unemployment that adds to the "officially" unemployed those who have stopped looking because they can't find a job and those that have accepted a part-time job because they can't find a full-time job.

<sup>2</sup> Quoted in *Barron's* April 5, 2010.

## FINANCIAL MARKET SUMMARY

### Market Levels

<u>Canada</u>	<u>March 31, 2010</u>	<u>December 31, 2009</u>
TSX Composite Index	12,038	11,746
91-Day T-Bill Yield	0.30%	0.34%
30-Year Gov't of Canada Bond Yield	4.07%	4.08%
Prime Rate	2.25%	2.25%
Exchange Rate (1\$ Cdn. = US\$)	\$0.9849	\$0.9555

### United States

Dow Jones Industrial Average	10,857	10,428
Standard & Poor's 500 Index	1,169	1,115
30-Year U.S. Treasury Yield	4.71%	4.64%

### Market Returns For Periods Ended March 31, 2010 <sup>(1)</sup>

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years <sup>(2)</sup></u>	<u>Last 10 Years <sup>(2)</sup></u>
DEX 91-Day T-Bill Index	0.1%	0.3%	2.9%	3.2%
DEX Universe Bond Index	1.3%	5.1%	5.2%	6.5%
TSX Composite Index	3.1%	42.1%	7.4%	4.7%
S&P 500 Index (C\$)	2.3%	20.7%	-1.6%	-4.2%
MSCI EAFE (C\$)	-2.1%	24.5%	0.2%	-2.3%

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#### Footnotes:

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

(2) Compound average annual return.

