NEXUS

Portfolio Management & Financial Counsel

# Investment Outlook

January 2010

## The Lost Decade

It is easy to forget what market conditions were like a year ago. To most unnerved investors it probably seemed that conditions could not get much worse than they were in late 2008, but they did. In January and February 2009, economic activity and stock markets around the world continued to decline at an alarming rate. Nothing, however, goes down forever, and markets in both Canada and the U.S. finally found a bottom in early March. Since then, the recovery in markets has been breathtaking, and investors enjoyed excellent returns on both stocks and bonds over the course of the year.

Notwithstanding this vibrant recovery through 2009, stock markets in Canada and the U.S. have struggled for a decade. In the U.S., the S&P 500 Index finished 2009 24.1% *below* the level it traded at 10 years earlier. Fueled by the rise in commodity prices, the Canadian stock market fared significantly better. Still, the rise in the TSX Composite Index amounted to only 39.6%, or less than 3.5% per year. Absent the gains in commodity-related stocks, Canadian equity returns would have been much closer to the experience in the U.S.

Many market pundits have attempted to explain this malaise, typically with the goal of making investors feel optimistic about what lies ahead. While there are many plausible theories, such a period of stagnant stock markets is understandable following two decades of extraordinary returns in the 1980s and 1990s. We would love to say that a new bull market awaits us in the coming decade, but only time will tell whether this is the case. In the near term, it is likely that markets will continue to be volatile as governments and central banks try to wean their economies from monetary and fiscal life support, and guide them to a new period of stability and growth.

## Better Days at Hand

Supporting the recovery in stock prices during 2009 was a clear improvement in economic conditions and the apparent end of the worst recession in a generation. In the U.S., measures of business confidence, particularly the Institute of Supply Management's purchasing manager survey, were first to show improvement. After plunging to unprecedented depths in late 2008, this survey rebounded sharply, reaching levels typically associated with periods of economic expansion by August. As business confidence improved over the spring and summer, so did investors' perception of business risk. Over this same period, credit spreads on corporate bonds[1] narrowed from truly panicked levels early in the year to much more normal levels by late summer.

While improvement in consumer confidence lagged that of businesses, it also improved noticeably over the course of 2009. Starting in June, the U.S. housing market seemed to reach a bottom, and prices have begun to improve slowly on a month-over-month basis. U.S. employment reports also started to show some signs of stability this fall. Since the peak in 2007, the U.S. economy has shed more than 7 million jobs, the greatest loss of jobs in any one period since World War II. Unemployment rates have soared north of 10%. However, over the last several months, the rate of decline in employment has slowed rapidly, and November provided the first positive labour report in almost two years (which, disappointingly, turned negative again in December). Of course, a better tone in housing and in labour markets has translated into greater confidence among U.S. consumers. While surveys such as that conducted by the University of Michigan still show that consumer confidence is weak by historical

[1] The credit yield spread is the premium investors demand to own corporate bonds relative to risk-free government bonds. If risk is higher, spreads will be wider.

standards, it is noticeably improved from earlier in the year. This has positively impacted retail sales, among other things.

In Canada, the improvement in economic conditions has been even more pronounced. House prices not only stabilized, but, quite remarkably, rose substantially over the course of the year. Canada has experienced positive job creation in three of the last five months, and our unemployment rate remains far below that in the U.S. These trends have fueled a significant uptick in consumer confidence which, together with marked improvement in business confidence, has greatly improved the outlook in Canada. The biggest ongoing headwind is the challenge to our exports presented by the strong Canadian dollar.

**A Two-Handed Outlook**

Notwithstanding these improved conditions, our perspective on the investment environment remains very much ‘two-handed’. On the one hand, there is clear evidence of improved economic conditions and the prospect for stronger corporate profits in 2010. On the other hand, it is hardly assured that these improvements will translate into a sustained period of economic growth. Risks remain high.

Countries around the world have adopted extraordinarily stimulative monetary and fiscal policies in order to stabilize their economies. More specifically, this means that short-term interest rates have dropped to near zero, and government spending has risen to unsustainable levels. The U.S. federal deficit is officially forecast to rise as high as 14% of GDP, an alarming level. While these extreme measures most likely have been necessary and appropriate to avert a major global catastrophe, they present serious risks going forward.

A consequence of low interest rates is that consumer debt levels have remained high. In fact, during December Bank of Canada Governor Mark Carney and Finance Minister Jim Flaherty each warned Canadians about the growing level of consumer debt. With interest rates almost at zero it should not be surprising that consumers have actually accumulated more credit card and mortgage debt over the last year. When interest rates inevitably rise to more normal levels, the impact on over-leveraged consumers could derail any hope of a sustained recovery, particularly if the labour market remains weak.

Of course, the extraordinary levels of government spending we have described have also resulted in governments piling up debt at an unprecedented rate. In a number of countries, including Japan and the U.S., serious concerns exist about how this debt will ever be repaid other than as a result of allowing much higher rates of inflation or debasing the currency. In certain smaller countries, such as Greece, a debt default is not out of the question.

The great challenge facing policy makers during 2010, therefore, will be the success with which they engineer ‘exit strategies’ from these emergency measures. The signs of recovery we have enjoyed have been predicated on near-zero interest rates and massive fiscal intervention in the economy. There remains a great risk that as interest rates rise and government spending falls our fragile recovery will falter and we will slip back into recession. In our view, it is too early to declare victory.

**Caution Remains Appropriate**

As we look forward, investors face a significant conundrum. Bonds provided great returns in 2009 and have provided above-normal returns for the last 30 years. They continue to provide the important attributes of income generation and capital preservation, but they are unlikely to provide meaningful real returns over the next decade. Accordingly, despite many near-term uncertainties, we believe clients should emphasize equities to the extent their financial circumstances permit.

While we clearly favour equities for long-term investors, we anticipate volatile markets given the uncertainties we have described. Accordingly, we believe that it is appropriate to maintain a cautious bias. Over the course of 2009 our equity weightings crept steadily higher as we identified several new investment opportunities. In each case, these companies exhibited the dual characteristics of growth as well as financial strength and stability to weather challenging times. We continue to believe that success will accrue to those who are patient and disciplined, and our emphasis on defensive and high quality companies will remain unchanged.

# FINANCIAL MARKET SUMMARY

## Market Levels

| Canada | December 31, 2009 | December 31, 2008 |
|---|---|---|
| TSX Composite Index | 11,746 | 8,988 |
| 91-Day T-Bill Yield | 0.34% | 0.89% |
| 30-Year Gov't of Canada Bond Yield | 4.08% | 3.44% |
| Prime Rate | 2.25% | 3.50% |
| Exchange Rate (1$ Cdn. = US$) | $0.9555 | $0.8166 |

| United States | | |
|---|---|---|
| Dow Jones Industrial Average | 10,428 | 8,776 |
| Standard & Poor's 500 Index | 1,115 | 903 |
| 30-Year U.S. Treasury Yield | 4.64% | 2.68% |

## Market Returns For Periods Ended December 31, 2009 (1)

| | Last Quarter | Last 12 Months | Last 5 Years (2) | Last 10 Years (2) |
|---|---|---|---|---|
| DEX 91-Day T-Bill Index | 0.1% | 0.6% | 3.0% | 3.3% |
| DEX Universe Bond Index | -0.2% | 5.4% | 5.2% | 6.7% |
| TSX Composite Index | 3.9% | 35.1% | 7.7% | 5.6% |
| S&P 500 Index (C$) | 3.5% | 8.1% | -2.4% | -4.1% |
| MSCI EAFE (C$) | -0.3% | 12.6% | 0.7% | -2.0% |

Footnotes:
(1) Represent total returns, including income and capital appreciation (or depreciation).
(2) Compound average annual return.