Market Outlook

JANUARY 2010

Peter Drake, ***VP, Retirement and Economic Research***

- We expect to see approximately 4% in global GDP growth in 2010, consistent with the consensus forecast. This is below the long-term trend, but is still decent, given where markets have come from, and considering some of the challenges we've faced.
- In developed nations, stimulus-driven economic activity will continue to be a significant contributor to growth. However, in developing nations, growth will be more robust and more fundamentally driven. Coming out of the crisis, many developing nations have stronger economic fundamentals than developed nations, because they are not suffering the same degree of forced de-leveraging.
- Risks continue to be on the policy side, and focused on when and how policy makers will adjust stimulative monetary policies so as to not derail a still-fragile economy.

Andrew Marchese, ***Head of Canadian Equities, Director of Research, Portfolio Manager***

- For risk-asset investors, a lot of the easy money was made during the last three quarters of 2009.
- 2009 saw massive reflation trade, which is typical of the first phase of a cyclical bull market recovery. However, the magnitude of the trade was certainly impressive by historical standards, particularly given where markets had come from.
- We believe we have now entered a normalization phase. We expect growth to be more subdued, and multiple expansion potential will probably be more limited on the upside.
- Valuations are at fair levels, given the fundamental outlook; risk premiums have pulled back dramatically.
- Monetary policy global is extremely accommodating, and this remains a good backdrop for stocks.

Brian Miron, ***Portfolio Manager, Fixed Income***

- Government bonds had negative returns in 2009; corporates returned in excess of 16% as spreads tightened dramatically from historically wide levels to still-wide levels.
- Spreads are pricing in a 2.5% to 3.0% default rate for investment-grade corporate issuers for 2010; however, at the height of the crisis, they were pricing in a 10% to 12% default rate. Conditions have clearly improved.
- Investment opportunities are to be found down in the capital structure, among tier-one securities and subordinated debt, where there is still good value on a selective basis. In addition, opportunities exist among structured securities, including commercial mortgage-backed securities, which have not seen the same degree of spread-tightening as higher quality corporates.
- We also have a very steep credit yield curve: investors are being well paid to invest further out along the credit curve.

The Case for Canadian equities

Andrew Marchese

- The case for Canada is still intact. The Canadian market is highly weighted to resources, approximately 45%. The growth in Asia and other developing markets continues to fuel demand for oil and other hard assets. Asian economies have higher industrial production than the west, and these economies need the input resources that Canada has in relative abundance.
- This fundamental demand, coupled with very accommodative monetary policy and competitive devaluation of currencies globally, will drive demand for hard assets over paper assets in the near and medium terms.
- The risks are largely financial at present. For example, this week China raised reserve ratios, and that spooked markets. However, we actually view this more as a bullish signal, because the country is showing that it's being responsible about how it's growing.

Market Outlook *continued*

Outlook on the U.S.

Andrew Marchese

- The U.S. economic situation remains fragile, but significant stabilization has occurred since the depths of the crisis less than a year ago. Longer-term, the country's balance sheet and the effects of a long period of consumer, corporate and government de-leveraging will not be conducive to growth.
- The situation does not support a strong U.S. dollar, so we remain bullish on the Canadian dollar, especially in light of the growth potential advantage Canada has, with its resource exports leveraged to rapid industrial growth in emerging markets.

Brian Miron

- We see the U.S. market as fundamentally challenged on many levels: consumer de-leveraging and business and corporate de-leveraging need to occur. And economic stability is still highly dependent on unprecedented monetary accommodation: these factors are never conducive to growth. The good news is that things continue to improve, and in 2010, we see moderate (but still sub-par) growth of 2% to 3%.
- The issue now is market fear of a double-dip recession. Policy moves are being watched closely by everyone, and any surprises will likely have negative results.
- Longer-term, with the rise of Asia, the U.S. dollar will continue to be under pressure. However, in the short term, if a double-dip scenario does emerge, we could see the U.S. dollar strengthen in a global flight to quality.

Earnings

Andrew Marchese

- The earnings resilience in 2009 surprised everyone. Companies were able to cut costs dramatically and moved quickly to protect the bottom line.
- We are looking for top-line earnings growth to start to reappear. The cost-cutting measures of 2009 have set up many companies to have enormous operating leverage, and even a modest increase in the top line could have a significant impact on cash flow and the bottom line.

Interest Rates and Corporate Spreads

Brian Miron

- Interest rates set effectively at zero in Canada and the U.S. do not make for an appropriate monetary policy when the economy is expected to deliver 2% to 3% growth. Even to be low, rates have to come up somewhat.
- There is some risk that the Bank of Canada will change its tack, but this risk is low. The Federal Reserve in the U.S. is on hold for longer, we believe. The situations in Canada and the U.S. are quite different. In the U.S., a de-leveraging process is underway at both the consumer and corporate level, whereas in Canada, private spending and debt are still growing. We expect the Bank of Canada to hike rates in the second half of the year, and we expect the hikes to be relatively rapid, raising the rate by 1% to 1.25% by year-end. But this is just to get away from zero.
- The biggest risk we see at present is in surprises in policy communication and/or implementation.
- We need to see sustainable revenue growth to bring spreads in further from current levels; they remain wide by historical standards.
- I also see the possibility of corporate event risk for bond investors, in the form of shareholder-friendly activity, such as M&As and share buybacks.

Market Outlook *continued*

In Summary

Brian Miron

- The year 2010 will mark something of a turning point as we move from economic weakness to economic stability, and from accommodative monetary policy to a more neutral policy.
- It will be very important to stay on top of policy developments, and security selection will be much more important in making good returns in 2010 than it was in 2009.
- Policy surprises and corporate event risk remain the biggest risks for bond investors.
- Depending on how quickly rates rise, bonds will earn their coupon, plus some likely capital appreciation from spread tightening, but returns will be moderated if rates rise faster than expected. Bond markets have already priced in a 1% to 1.25% increase for the latter half of 2010; however, if rates rise faster, total returns will be more subdued.

Andrew Marchese

- The year 2010 will see a normalized path of growth among global equity markets, earnings and valuations.
- We believe that Canada will continue to be a very attractive place to invest, given the nature and pace of growth in emerging markets.
- Accommodative monetary policy will continue to provide a very positive backdrop for the stock market. Policy surprises remain one of the key risks.