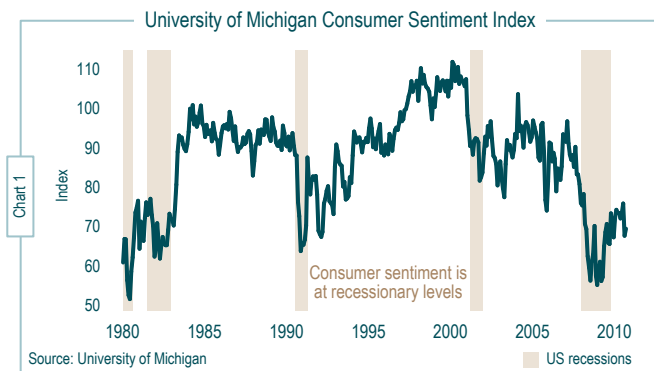


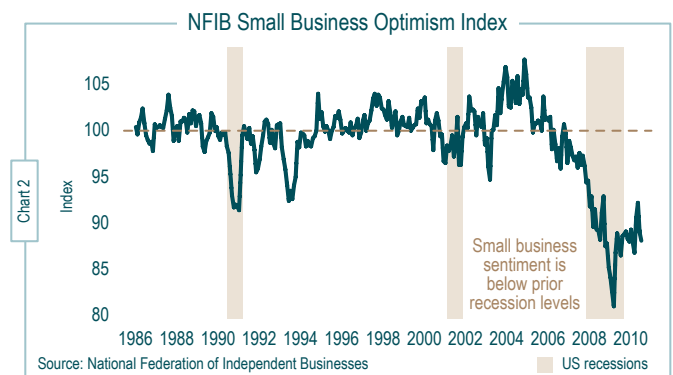
## OVERVIEW

**Confidence is a key factor** when it comes to the outlook for the economy and financial markets. The level of one's confidence can have a material effect on behaviour and action. With this in mind, we recently examined a number of confidence surveys and found some worrisome results. This is particularly the case when it comes to the US, our largest trading partner (75%+ of all trade). Starting with the American consumer we can see that confidence remains at recessionary lows (see Chart 1) largely due to the poor state of the housing market, high unemployment, diminished net worth and tepid income gains.



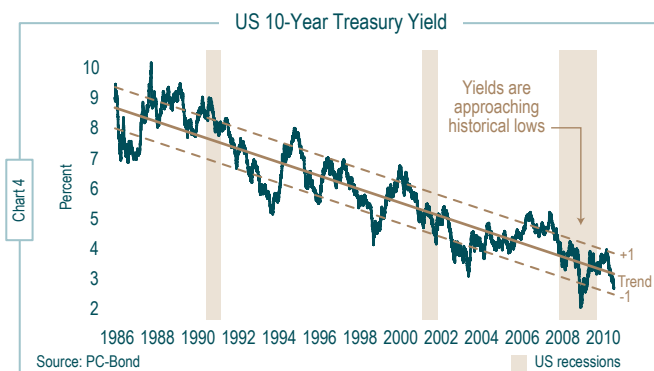
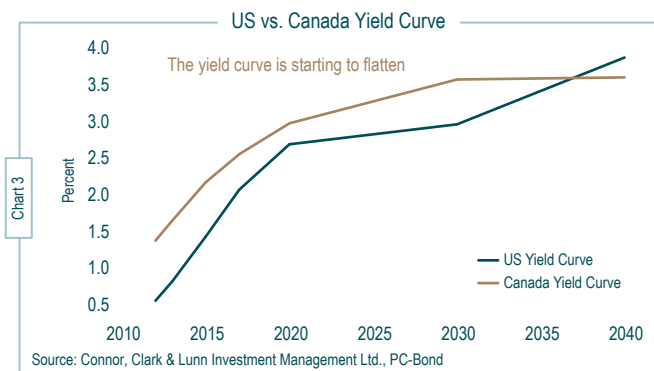
With consumer confidence in the doldrums it is hard to envision that American shoppers will loosen their purse strings anytime soon and increase spending enough to help boost economic activity. On the other hand, business confidence as measured by CEO surveys is strong thanks to continued easy access to cheap credit, high profit margins and strong earnings growth. A high level of confidence on the part of corporate management bodes well for future capital expenditures, which in turn will help lift economic activity. However, it should be noted that these surveys are a reflection of what management of large companies are feeling. This is in contrast to small business owners where sentiment is poor and at levels that are actually lower than previous recessions (see Chart 2). This is largely due to the difficulties that small businesses are having accessing credit at a time when their sales are weak. Poor sentiment is problematic because small businesses account for

around 80% of all employment gains over a typical business cycle. As such, we do not expect to see any material improvement in unemployment rates in the foreseeable future. This creates a bit of a vicious circle because employment conditions have a powerful influence on consumer confidence. In addition, the unemployed find themselves drastically reducing their spending and looking for aid from the public sector, which in turn exacerbates the public sector's dire fiscal position. This is also a vicious circle because governments are not only struggling under a mountain of debt, but they are adding to the unemployment problem as numerous states are shedding employees to help balance budgets.



Confidence on the part of central bankers is also not high when it comes to the outlook for the economy. The US Federal Reserve continues to state in its written communiqués that economic growth is tenuous (“unusually uncertain” – Ben Bernanke) and interest rates will remain low for an extended period of time. This has resulted in an extremely steep yield curve (see Chart 3), which normally provides a very positive environment for future economic growth and equity markets. To date, while a steep yield curve has no doubt helped the economy to recover, its impact has not been of the same magnitude as witnessed in the past.

Finally, investor confidence is also a mixed bag with the majority of institutional investors having only a moderately positive view on the economy and financial markets. Retail investors are highly skeptical as they grapple with very low yields on fixed income



securities and very volatile and weak or nonexistent returns particularly for those exposed to equities. A lack of conviction by a wide spectrum of investors is helping to dampen market returns, which in turn leads to a negative feedback loop as consumers react to a lack of progress in wealth formation coupled with a general sense of foreboding because one of their primary barometers for the economy is wobbling.

Normally 14 months into a recovery consumer confidence has been restored, businesses are more upbeat, investors on balance are bullish and the economy is on a roll. Historically this has even been the case after deep recessions, but not this time, suggesting that this cycle is very different. We believe that the primary differences are the deflationary forces that are still stalking global economies and the inability of conventional policy tools to right the situation. It will require a combination of unconventional policy responses, private sector de-leveraging and a re-balancing of the world's structural trade imbalances for economic growth to return to prior levels. In the meantime, there is increased risk that the current recovery in the developed world will be relatively short and anemic.

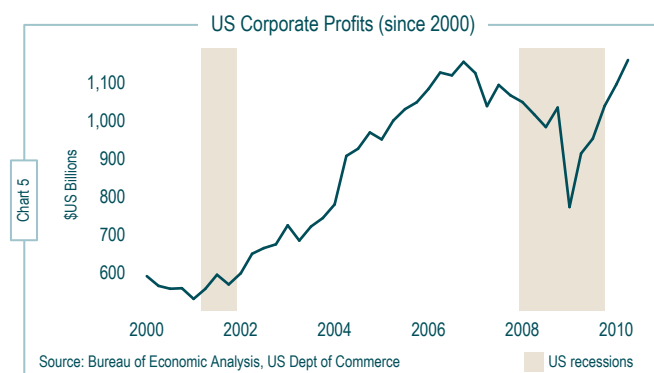
## CAPITAL MARKETS

A steep yield curve has provided one of the primary supports for financial asset prices. Importantly, the shape of the yield curve is never a real problem until it flattens or inverts. Given that short-term interest rates are currently anchored near zero because of central bank policy, there is very little risk of the curve inverting. However, it has been flattening. Long-term interest rates have been steadily declining due to falling inflation and a flight to safety. This is a warning sign that not all is well and it may be foretelling a collapse in the return on capital (see Chart 4).

Another unsettling development in financial markets is the change in the correlation between bond and stock markets. During the last couple of decades when credit was expanding faster than the

economy, interest rates and equity prices were inversely correlated (i.e. falling interest rates led to rising stock prices). Now that credit expansion is basically non-existent, interest rates and stock prices have become correlated, not unlike what has transpired in Japan over the last two decades. This is because falling interest rates are now symptomatic of weak credit formation and sluggish economic growth, which impedes any meaningful advance in stock prices. Ironically, we need to see interest rates rise before stock prices gain any lasting upward momentum.

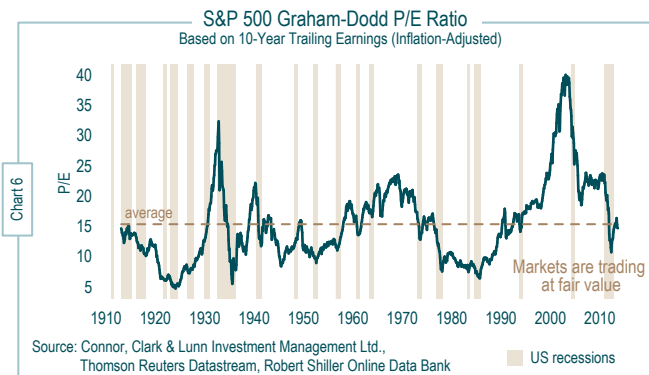
While the bond market has been giving stock investors the jitters, they have been able to take some comfort from a very strong rebound in corporate earnings (see Chart 5). S&P 500 earnings are up 84% over the past year largely led by the financial services sector. Earnings per share for non-financials are still up a very respectable 22% thanks to operating margins that are through 16% (a record high) which is due to labour costs falling to below 62% of total revenue (a record low). The “catch 22” of course is that while profits are great, wage earners have been limited to only a 1% lift in compensation over the past year which is hurting sales and top-line growth.



Nevertheless, on the surface the future appears bright with the consensus forecast predicting a further 24% increase in US

corporate profits in 2011 and an even slightly larger increase here in Canada. The issue confronting investors is whether or not this forecast is reasonable given the uncertainty surrounding the outlook for economic growth and the negative signals emanating from the bond market. Our own take is that the consensus forecast is a stretch given that it would mean that corporate profits would be some 25% above their 2007 record highs (see Chart 5). 2007's record levels were achieved when unemployment was hovering around 4.5% (currently 9.6%), capacity utilization rates were through 80% (currently 74%) and credit was expanding at a 16% rate (zero today). This would be quite an achievement following on the heels of the worst recession since the Great Depression and all the structural problems we are still facing.

Equity markets are driven by both the growth in earnings and by the discount rate applied to them. From this perspective, equity markets look reasonably priced. Price-to-earnings (P/E) multiples on a forward basis are very attractive, as you might expect given the rosy forecasts emanating from most analysts, with both the S&P/TSX Composite and S&P 500 trading under 14 times estimated earnings. However, on a trailing basis, stock markets only represent fair value with the S&P/TSX Composite trading at 16.5 times earnings and the S&P 500 at 15.5 times earnings, which is in line with the historical long-term average as measured by the Graham-Dodd P/E ratio (see Chart 6).

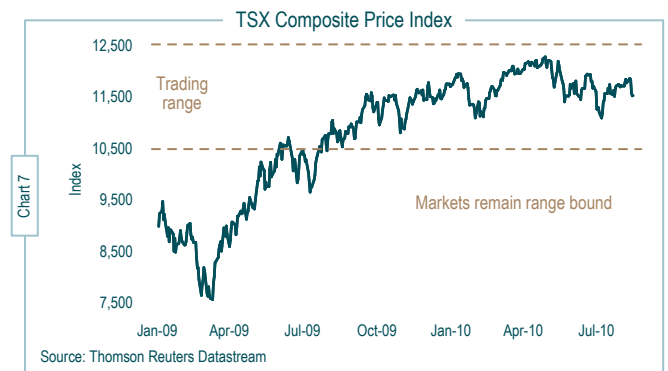


## PORTFOLIO STRATEGY

As noted above, the bond market and the stock market have become positively correlated because they view the world differently. The bond market is looking for a double-dip recession (5-year Treasury yields less inflation are zero and 2-year Treasury yields less inflation are negative) while the stock market is looking for a

more normal cyclical recovery accompanied by a typical mid-cycle slowdown. One of these two markets is wrong. This has set the stage for ongoing market volatility and the potential for an explosive move in stocks one way or the other depending on which set of investors is right. A double-dip scenario could lead to a further 25% sell-off in the stock market whereas a more steady outcome could see a 25% move but on the upside as earnings gains come through accompanied by some expansion in P/E multiples. Bonds on the other hand, even under the double-dip scenario, appear to have limited upside potential given how low nominal yields are already. Whereas something approaching a more normal cyclical recovery could see yields move higher, not unlike what we saw in the 1993-94 bear market when capital values fell by nearly 20% before a long slow recovery ensued.

While we currently place the odds of a double-dip scenario at around 25%, the potential for a substantial down draft in equity prices and a lack of any real upside from fixed income markets has led us to position balanced portfolios close to their benchmark asset mixes. This will be maintained until there is more clarity as to how the economy is going to perform over the next 12 months. In the meantime, we expect that both bond and equity markets will remain range bound. Ten-year Government of Canada bonds are forecast to trade between 2.85% and 3.50% with US 10-year Treasuries 15 basis points lower. The S&P 500 is forecast to remain within the 960 to 1250 range while the S&P/TSX Composite is forecast to trade between 10,500 and 12,500 (see Chart 7).



In this type of environment our investment strategy for both asset classes (bonds and stocks) will remain tactical in nature with a defensive bias until there is more clarity as to whether or not we have achieved “escape velocity” (see July *Outlook*) accompanied by a meaningful pick-up in confidence across the board.