

THE YEAR IN REVIEW

It is our custom at the start of each new year to review our prior year's *Financial Markets Forecast* and the results of our investment strategy, while keeping in mind that the forecast is a point-in-time view and subject to change as events unfold throughout the year.

In our *2009 Financial Markets Forecast* we started out by stating the obvious, that we were in the midst of an unprecedented crisis but the policy responses to the unfolding crisis were equally unprecedented. The US economy appeared broken and credit markets had become dysfunctional resulting in trillions of dollars in asset values having been destroyed. The global economy appeared to be sinking into recession for the first time in 50 years driven by over-leveraged consumers and financial institutions who were caught in a liquidity crisis. In response to the crisis, central bankers swung into full gear by dropping interest rates to near zero while literally printing money through an array of innovative programs to stop the system from hemorrhaging. Fiscal discipline was thrown to the wind as well with governments around the world announcing stimulus programs that dwarfed anything seen in the past.

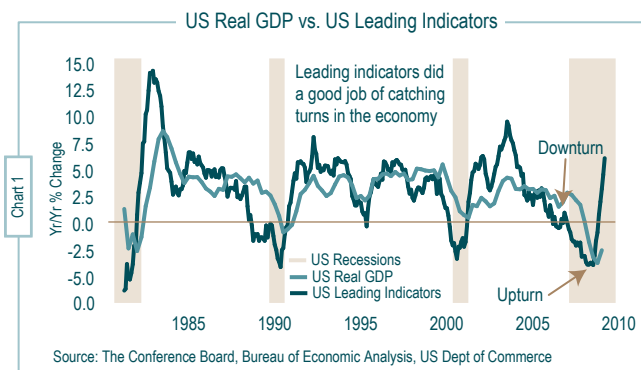
The dilemma that investors faced was whether or not the raft of policy responses would arrest the destructive power of the systemic de-leveraging that was unfolding and what would be the implications for financial markets. We attempted to address this question in our *Forecast*:

ECONOMY

Global growth was forecast to drop to under 1% led by the US, where it was estimated to fall by over 3%, while in Canada we forecast GDP to decline by 1.5%. However, we felt that aggressive monetary policy and the forthcoming massive amount of US fiscal stimulus (\$1.3 trillion) would ultimately arrest the slide with a turnaround possible as early as the fourth quarter of 2009. The turnaround would be preceded by an upturn in credit and equity markets and leading indicators such as the ISM Survey and LEI. We went on to note that debt was the problem and housing was the epicentre of the crisis. Both needed to be addressed and the workout would be a long, slow process with housing prices forecast to drop a further 10% with no real recovery until early 2010.

Our economic forecast missed our precise estimates for growth, but our directional calls were right. Global growth looks like it will come in around -1% for 2009, with the US at -3% and Canada at -2%. An economic turnaround did unfold, but one quarter ahead of forecast.

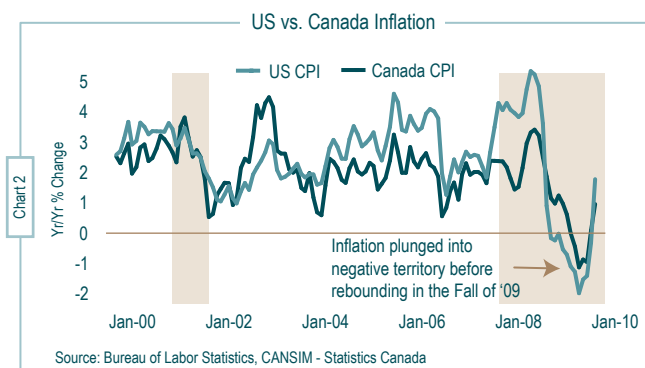
We did get the US housing market right, along with our call that the ISM, LEI, credit and equity markets would lead the turnaround (see Chart 1). The major factors leading to the economic recovery and the passing of the financial crisis were as expected – aggressive monetary policy and fiscal largesse.



INFLATION

Our take on the outlook for inflation was that it would be crushed in 2009 and would even drop into negative territory temporarily before moving back up to around 1% due to very expansive monetary policies and massive fiscal spending programs. A widening global output gap, record low capacity utilization rates and falling commodity prices would be the prime drivers limiting price increases. We noted that inflation-linked bonds were pointing to a deflationary environment but that ultimately the fight against deflation would be won.

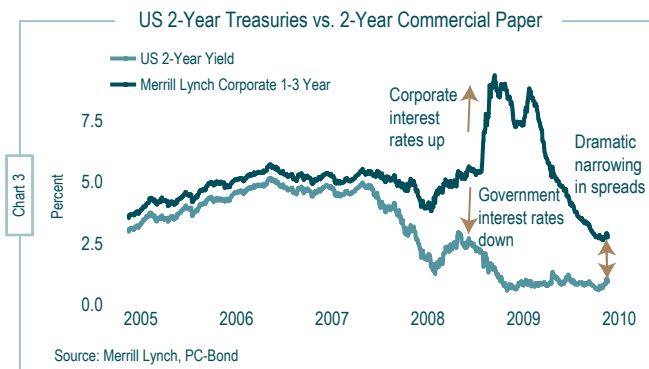
We pretty much nailed the inflation call this past year with US CPI coming in around -0.3% and Canada +0.3% with the most recent numbers pushing back up to around 1%. So far the forces of reflation have been prevailing against the forces of deflation (see Chart 2).



MONETARY POLICY

We felt that monetary policy would ultimately right dysfunctional credit markets where there was a lack of liquidity and price discovery as asset prices were being set by fire sale conditions. Quantitative easing and direct capital investments into banks were expected to help stabilize the economy and ultimately asset markets. We forecast the Bank of Canada would lower rates even further from 1% to 0.25% and that the fall in money velocity would come to an end and this too would help kick-start economic growth and put a bid under asset prices.

We also got this call correct, which was not all that difficult given that central bankers telegraphed their intentions very clearly and very forcefully. We fully bought into the thesis that the magnitude of their intervention and their commitment to right things at all costs would stabilize the economy and be a major boost to credit markets. This can be seen by the dramatic decline in corporate bond yield spreads versus government yields (see Chart 3).



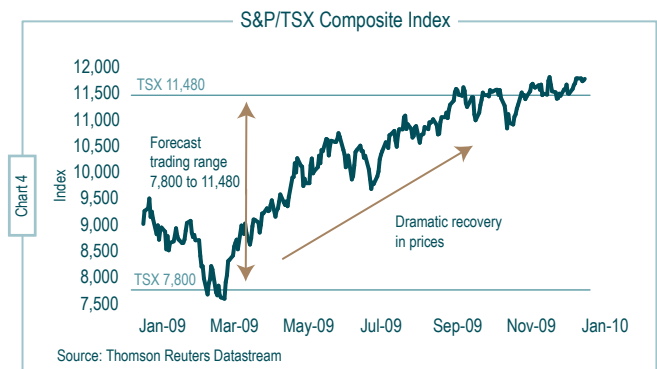
MARKET VALUATIONS

We put forth the thesis that equities looked attractive even though we were in the midst of an economic recession where earnings on the S&P 500 were forecast to drop by at least 20% into the \$48 to \$54 range, while S&P/TSX earnings could sink as low as \$600, but most likely would fall to in and around the \$700 level. Attractive valuation metrics such as low P/E multiples on normalized earnings, high equity risk premiums and compelling dividend yields relative to government bond yields led us to forecast a trading range of 7,800 to 11,480 on the S&P/TSX, or a 10% drop versus 32% on the upside – a fair risk/reward ratio.

Government bonds were deemed to be fair value given the low levels of inflation that were in our forecast and negative growth in the economy. Corporate bonds on the other hand were seen as being highly attractive with real yields through 5%.

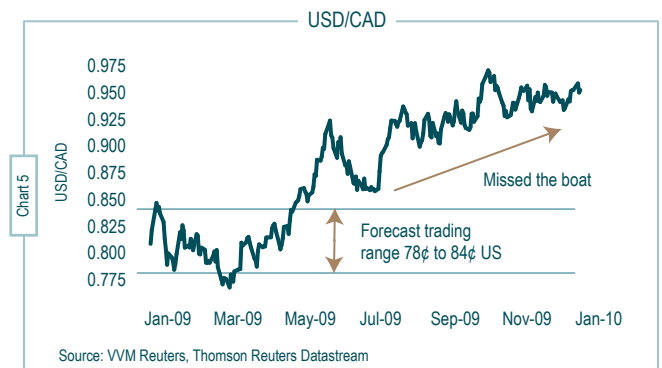
We felt the shine was off the Canadian dollar because the country's current account surpluses were about to disappear, deficit spending for years to come was the order of the day and energy prices were falling. We forecast a trading range of \$0.78 to \$0.84US for the loonie in 2009.

Earnings for both the S&P 500 and the S&P/TSX collapsed as forecast hitting our target ranges for the year. Equity markets rallied as well and for most of the year fell within our forecast range of 7,800 to 11,480 on the S&P/TSX (see Chart 4). However, equity markets did close out the year stronger than we expected, but we'll take that kind of miss anytime!



The unfreezing of credit markets led to a dramatic reversal in the flight to safety that had pushed government bond yields to record lows leading government bonds to produce a small negative return for the year while corporates were a standout with double-digit returns due to the dramatic decline in yields. High yield bond returns fared the best with returns matching those of equities in the 30%+ range.

In terms of the Canadian dollar – this was a complete miss on our part as investors piled into a reflation trade after the turning point in March, bidding up commodities and currencies with high commodity exposure based on the stronger outlook for emerging market demand. Our sound banking system, better fiscal position and a wounded US dollar also helped propel the loonie higher (see Chart 5).

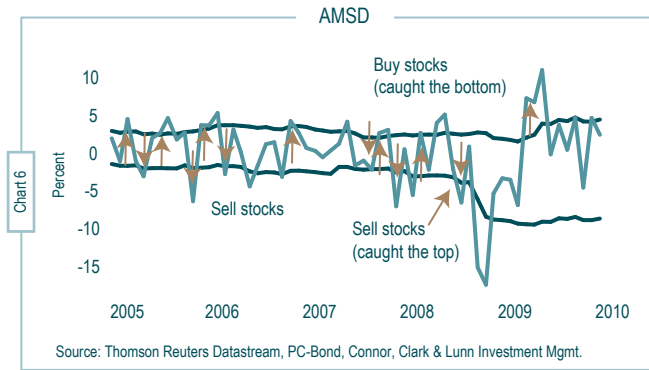


TECHNICAL CONDITIONS

As we entered 2009 our equity technical indicators were at extreme negative readings suggesting further market weakness. However, we felt that the time was fast approaching when the signals would reverse, and coupled with extreme investor sentiment, a bottom in markets could be expected in the next few months.

While bond yields were in a major downtrend, we felt that they were nearing a bottom because of changing momentum and sentiment factors. However, we noted that risk-averse investors could keep yields depressed for a quarter or two before rising back up to their long-term trend line.

Our technical models did a fairly good job of catching the bottom in stock prices (see Chart 6) and the directional moves in fixed income markets.



Now we get to do it all over again – our *2010 Financial Markets Forecast* will be out in the next few weeks, and while the economic climate has improved markedly and the financial crisis has past, garnering returns will be much more challenging in the year ahead.

PORTFOLIO STRATEGY AND STRUCTURE

We forecast that 2009 would be a pivotal year as the deflationary forces of the recession and dysfunctional credit markets were pitted against an array of unprecedented policy response. Our sense was that the forces of reflation would carry the day and that stocks and corporate bonds would prove to be winners while government bonds would provide coupon-like returns and cash was totally unappealing. We also felt that corporate spreads had to narrow before stocks could advance, and on a risk-adjusted basis corporate bonds were the better investment. The yield curve was expected to remain anchored at the short end and would not flatten because central banks would keep rates near zero. In terms of the stock market, energy, technology and industrials were expected to lead the advance while financials and consumer discretionary (traditional leaders) would lag. Quality was expected to outperform and small cap would outperform their large cap brethren. Finally, we felt that stocks would outperform fixed income and that excesses in one direction could lead to excesses in the opposite direction – bonds had outperformed stocks over the last year by the widest margin in history (5 standard deviations) and this was about to reverse.

Our call in terms of portfolio strategy this past year was one of the better forecasts we made. So far the forces of reflation are prevailing over the forces of deflation, but we are not entirely out of the woods on this one. Corporate spreads narrowed, the yield curve remained very steep and equities outperformed bonds by a wide margin (S&P/TSX +31%, MSCI World +23% versus DEX Universe of +5.4%). Technology and energy stocks outperformed as expected while consumer discretionary underperformed by a wide margin. Financials did better than we forecast and industrials underperformed relative to expectations. Quality did not outperform as we had expected while small cap beat their large cap brethren by a wide margin. On balance these calls resulted in added value for portfolios.