

OVERVIEW

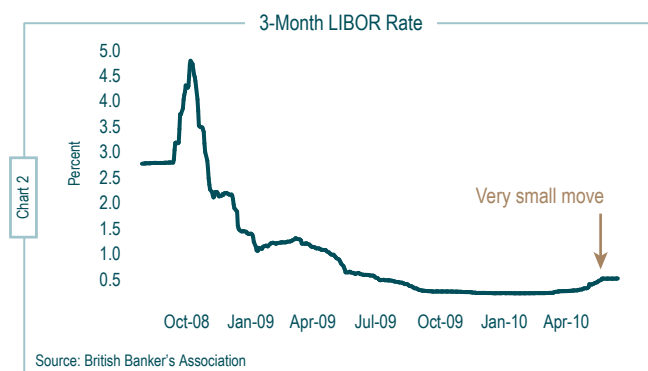
It's déjà vu all over again. Fears over a European sovereign debt default and a contagion spreading from that region to the rest of the world has produced a flight to safety as investors abandoned global equities in April and May in favour of German Bunds and US Treasuries. This pushed yields down by nearly 1%. Investors experienced an unpleasant flashback to the days when Lehman Brothers went under and the ensuing credit crisis precipitated a meltdown in equity markets and a near collapse in the global economy. But it is only that – a flashback. Granted equities have had a gut-wrenching fall with European bourses down 16% on average, the S&P 500 suffering a 12.5% retracement (see Chart 1) and at home the S&P/TSX Composite Index fell close to 1,000 points or some 8% from its recent highs.



While the risk of a spreading contagion is real, we think that the threat of a Greek default, and for that matter any other country within the European periphery, has been kicked down the road because of the massive \$1 trillion European support package and the European Central Bank's (ECB) stealth quantitative easing policy. This is going to give the European Union (EU) time to negotiate new and sustainable fiscal terms while preventing a liquidity and funding crisis for both peripheral countries and European banks. Also, new-found fiscal discipline by so-called Club Med countries and the recent weakness in the euro will ultimately be of help as well.

The scale of the current crisis suggests that the situation is not spinning out of control. Granted the interbank funding markets have been wobbling a bit, which is a clear signal that there

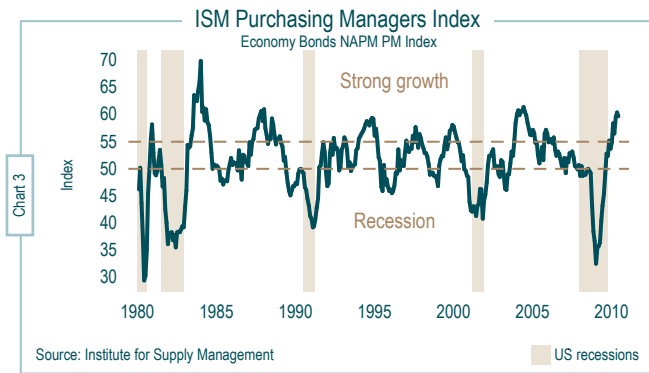
is stress in the system. While the London Interbank Offered Rate (LIBOR) (see Chart 2) has moved up, it has not been at an alarming rate nor has it approached any of the extreme levels seen in the 2008/09 credit crisis. In fact it has recently stabilized, which is a good sign. Going forward an easing in the LIBOR and TED spreads will be the first indicators to signal that the current mini crisis over sovereign debt is starting to abate.



Importantly, from a global perspective, with the EU and the ECB ring-fencing the problem, it has lessened the tail risk of a freezing up of global liquidity. However, the potential for contagion has not entirely dissipated. Rising uncertainty has led to higher funding costs, particularly in Europe, and in some cases a shortage of liquidity at a few institutions. If this were to lead to forced asset sales and substantially lower collateral values then a contagion could be unleashed as banks tighten credit standards and pull back on lending which would heighten global risk aversion. This in turn would further impede the global economic recovery and unsettle financial markets. While this is a possibility, we don't think it is the most probable scenario.

While Europe is definitely going to experience some very anemic growth, on the other side of the Atlantic the Canadian and US economies are expanding at a good pace. Most US leading indicators, while having peaked in many cases, point to a continued expansion (see Chart 3). In addition, coincident indicators are signalling that the expansion has legs. For instance, the capital spending cycle has barely begun, but with

corporations flush with cash there is plenty of firepower yet to be deployed. Also, inventory re-stocking is at a very early stage and has further upside potential as well. There is even some job growth, albeit subdued, and disposable incomes are rising thanks to some modest wage gains accompanied by lower energy and interest costs. Unfortunately, the housing market and lack of credit growth still remain major drags on economic activity.



The Federal Reserve (Fed) remains very committed to the sustainability of the recovery and has continued to send signals that it will remain accommodative for an indefinite period. This stance is supported by the Taylor Rule, which suggests that the Fed should be cutting rates, but given that they are at zero, this is not an option. Taken in aggregate, the cyclical tailwinds of a recovery appear to be overcoming the secular headwinds impeding growth in America.

Canada is in even better shape than the US. The country has a solid recovery going, a strong banking system, moderate credit expansion, sound fiscal policy and something the world wants, namely commodities. However, inflation is higher and the real estate market is a little frothy, which has precipitated an increase in the bank rate by the Bank of Canada (BoC), but rates are not expected to rise to the point that impedes future growth.

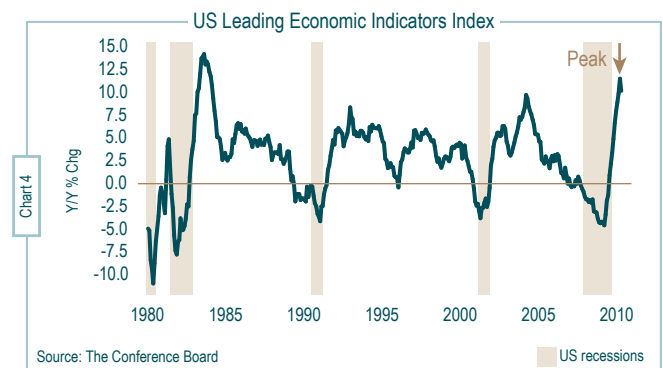
Over in Asia the picture is even brighter with India and China continuing to barrel along even though the Chinese government has put in place a series of policies aimed at slowing down their red-hot real estate market. Growth is still expected to be in the 8 ½% to 9 ½% range this year. Also, even Japan has been showing some glimmers of hope as corporate profits and wages have recently moved up in line with some positive growth in GDP.

The bottom line is that the global expansion remains intact and investors should take some comfort from this, but progress will probably be slow and halting at times. Risks remain including the risk of a contagion spreading out from peripheral Europe,

too early an exit by policy-makers from accommodative fiscal and monetary policies, and the inability of the system to handle exploding government deficits.

CAPITAL MARKETS

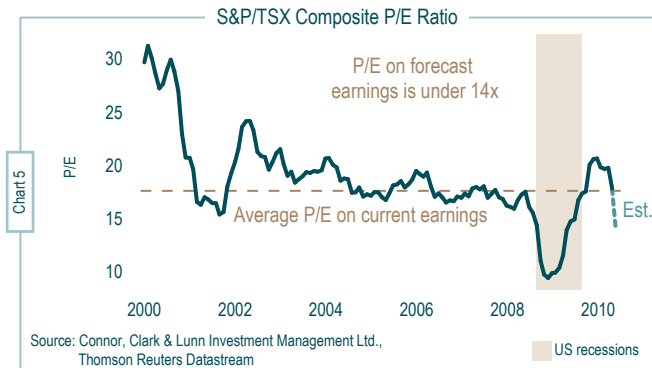
While the Greek sovereign debt crisis was the catalyst for the pull-back in equity markets, it was not the only factor at work. Equity markets typically hit an inflection point when the ISM Manufacturing Index, the Leading Economic Indicators Index (LEI – see Chart 4) and earnings revisions peak simultaneously. This signals that the period of upward revisions to growth and profits has passed. At this point in time, investors typically step back and take some profit which produces a market correction not unlike what we have just experienced. Pull-backs typically are in the magnitude of 10% to 20% and are usually followed by a period of consolidation before a new upward advance can begin. After a period of consolidation there are a number of factors that need to fall into place. As the leading indicators roll over it is important that they stay above average levels, core inflation remains contained and the Fed remains on hold. There also has to be some meaningful gains in employment, and consensus earnings forecasts have to remain positive even though the rate of change has rolled over. Market volatility, a measure of investor risk appetite, after spiking has to subside by moving back towards its long-term average and the smart money (insiders) has to come back into the market because stocks are attractive.



To this end, equity risk premiums look attractive once again after the market pull-back, and P/E ratios on forward earnings remain compelling especially if inflation remains muted (see Chart 5). Given low capacity utilization rates and high unemployment (wide negative output gap) there appears to be little risk in the short to medium term for any meaningful lift in inflation rates. P/Es also look attractive when compared to corporate bond yields. Any further narrowing of corporate spreads, which we suspect will happen, will make stocks that much more compelling. Equities are also under-owned by

the household sector, including direct and indirect holdings through mutual and pension funds (excess buying power). Sentiment, which is a good contrary indicator, is negative.

From a cyclical perspective, there is a good case to be made that stocks can still move higher; however, there are still plenty of uncertainties and issues that need resolving. As such, P/E multiples will be constrained from moving up and producing a powerful bull market while market volatility will remain a fact of life.

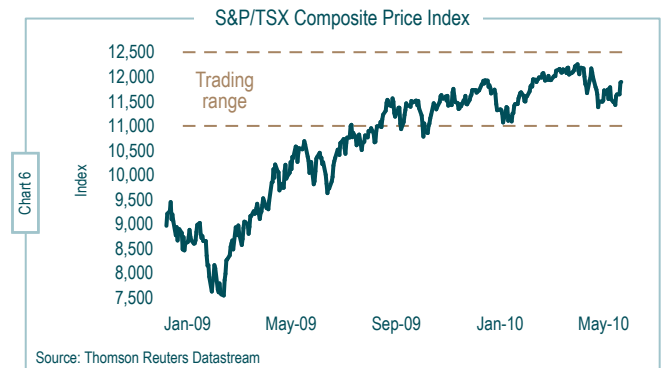


On the flip side we have the bond market, which has been a refuge for investors. Volatility has been low, but returns have been modest. Investors have been just fine with this kind of outcome because they can sleep at night. This will probably not change in the near future. Furthermore, there is a strong movement to de-risk investment portfolios, particularly among corporate pension funds, which will lead to ongoing support for bonds. The bond market will likely remain range bound as the forces of deflation keep inflation in check. Longer term a supply problem may emerge as corporations slowly come back into the market at a time when high government deficit financing may surface and disrupt markets. Ultimately a rise in real yields versus inflation premiums will push nominal bond yields up and prices down. Bond yields are at the lower end of our forecast trading range, and given any resolution to the European debt crisis, yields can be expected to rise as investors start to worry about a pick-up in economic growth and increasing supply.

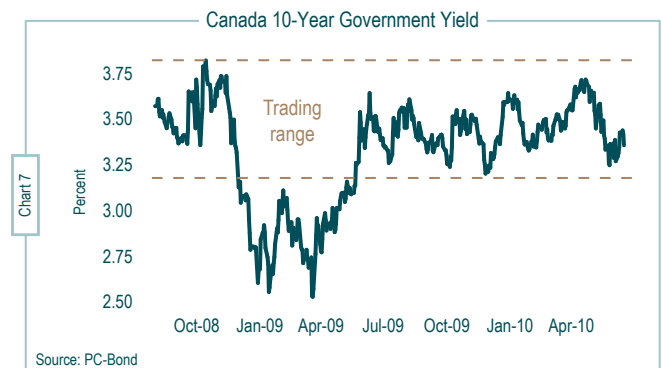
PORTFOLIO STRATEGY

At the beginning of the quarter, we became more defensive and brought our equity overweight down to neutral with portfolio benchmarks. Markets subsequently retreated and, given lower

price levels and some improvement in the outlook, we re-established our overweight positions. This trading stance is consistent with our stated goals and forecast of being tactical in our approach to financial markets this year given that they were expected to be trapped within a broad trading range (see Chart 6).



Within equity portfolios we have become a little more defensive and continue to search for good quality companies with sound balance sheets and visible earnings growth. Our approach to credit selection within the bond market is fairly similar. From an interest rate perspective, we expect fixed income markets to be range bound as well (see Chart 7), providing trading opportunities from both a duration and a yield curve perspective. We still like corporate credit but continue to reduce portfolio exposure as spreads narrow. We recently increased exposure to the provincial sector at the expense of corporates given improving relative valuations.



Our strategy for both asset classes (bonds and stocks) is to remain tactical over the short term until there is more clarity as to the level of sustainable economic activity and how the cycle is going to play out in terms of the two major countervailing forces – secular de-leveraging versus cyclical stimulation.