

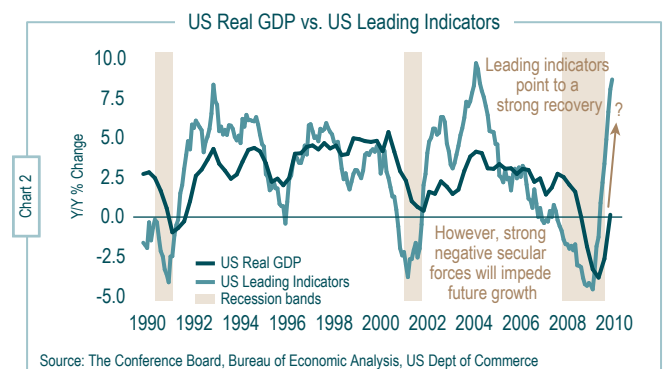
## OVERVIEW

**March is a month of anniversaries.** We have just passed the one year anniversary marking the bottom in North American equity markets. Since March 9, 2009, markets have rapidly clawed back over 60% of their previous bear market losses. While this is impressive from an historical perspective, it still leaves markets 20% below their former highs and technically still in a secular bear market. March also marks the tenth anniversary of the NASDAQ market peak. The bursting of the technology bubble in 2000 sent this index into a tailspin which troughed with the market down by over 80%. Unfortunately, a decade later the NASDAQ Index is still only halfway back to its former highs (see Chart 1). The broader markets have fared somewhat better, if you can call no return for the last twelve years on the S&P 500 and a 4% compounded return on S&P/TSX Composite acceptable. On a cheerier note, March 15 also marked CC&L's 28<sup>th</sup> anniversary.



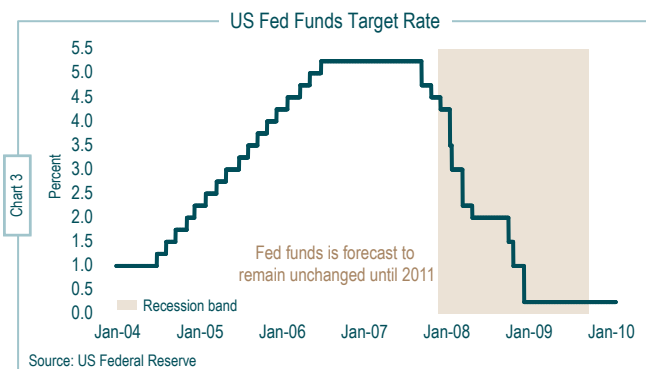
The lost decade in terms of equity investment returns can be laid at the feet of two severe bear markets that were born out of bubbles in asset prices (technology and housing) and too much leverage. The process of de-leveraging is now in full swing, but the healing process will be slow and arduous because of sub-par economic growth. As noted in our 2010 *Forecast*, we are expecting a weak recovery in North America and Europe because of high structural unemployment, out of control government deficits, a dysfunctional monetary transfer mechanism and over-indebted consumers. None

of these issues have gone away, but there are rays of hope. Unemployment rates have stopped moving up and US households over the last year and a half have lifted their savings rate and started to pay down debt. While this later development has come at the expense of growth, it appears that a new equilibrium is forming between saving, debt reduction and spending. The establishment of this new equilibrium has set the stage for personal consumption expenditures to pick up, which they have recently even in the face of weak consumer confidence. An improving employment picture coupled with a modest resumption in consumer spending (makes up 70% of GDP) and the coming lift in capital spending (business intentions surveys) should keep the US economy moving forward at a reasonable pace (see Chart 2). The same situation applies to Canada, but because of our much better fiscal position, employment prospects and strong export sectors, GDP is expected to expand by at least 3.5% for the coming year versus just under 3% in the US.



While consumer and business spending is starting to pick up, the extension of credit to these sectors is going in the opposite direction. Bank lending has contracted by over 12% on an annual basis over the last quarter, pushing loans outstanding as a percentage of total bank assets to their lowest level in history. This is showing up in the collapse in money velocity (GDP divided by M1) and the money multiplier (M2 divided by the monetary base) which underscores the

dysfunctional nature of the monetary transfer mechanism. That is the bad news. The good news is we can expect the US Federal Reserve to stay on hold in terms of shifting towards tighter monetary policy until the lending situation improves (see Chart 3). On the other hand, monetary policy in Canada is moving towards becoming less accommodative. With the economy expanding at a 5% clip in the fourth quarter of 2009, core inflation nudging up through 2%, household credit expanding at a brisk 7.5% rate and real short-term interest rates in negative territory, it is a near certainty that the Bank of Canada (BoC) will begin raising interest rates. We expect up to a 100 basis point (1%) rise in short-term rates over the course of the second half of the year. This change in policy will not be without risk because it will push the Canadian dollar even higher, hurting exporters; it will lift mortgage rates, hurting new construction; and it will flatten the yield curve, hurting retailers and bank earnings. Coming out of the 2002 recession, the BoC's initial moves proved to be premature and dampened an already fragile economic recovery. This will be on the minds of investors and policymakers in the coming months.

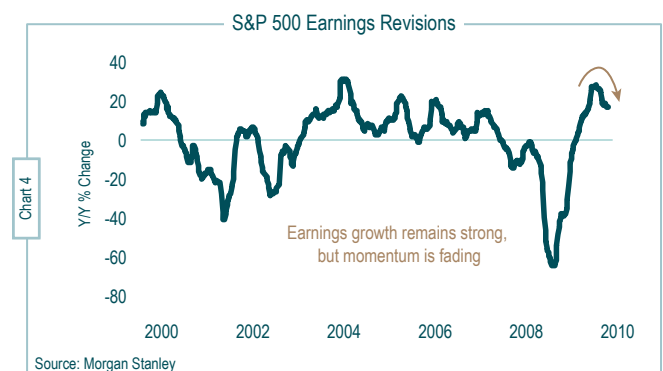


In terms of government deficits, it is fair to say that over the near term government largesse remains a critical factor for ensuring that the economic recovery has legs. However, longer term if deficit spending is left unchecked, it will have a debilitating effect on the future health of many industrialized economies. It will lead to crowding out of the private sector in financial markets, rising inflation and reduced program spending as a percentage of total expenditures because of the rising interest burden. As things stand today, very few governments are in a position to grow themselves out of their structural deficits. This is especially true for the US, Japan and most of Europe – Canada less so. A combination of sustained economic growth (not a certainty), tax increases

and reduced spending will be necessary to right the situation. Unfortunately, there appears to be a lack of political will to deal with the deficit issue which means that it will only become more problematic over time especially in light of a rapidly aging population and entrenched entitlement programs. If history is any sort of guide, it shows that it will probably take a crisis to develop before this issue is fully and properly addressed. In the meantime, risk premiums will remain elevated because of the uncertainty as to how the situation will resolve itself.

## CAPITAL MARKETS

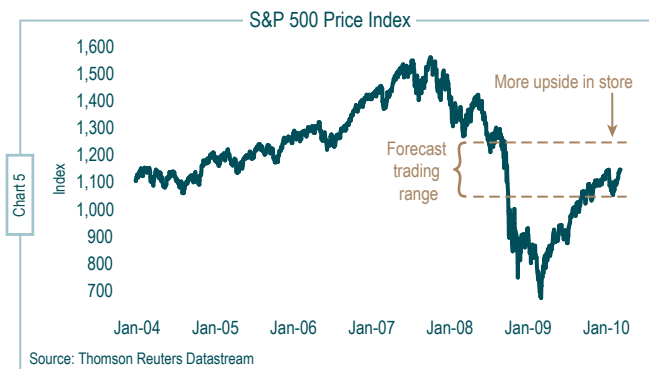
The sweet spot in the current cyclical bull market for stocks has drawn to a close. Equity markets typically move into a consolidation phase nine to twelve months after powerful rallies off bear market bottoms. Corrections in the order of 8% to 10% are the norm during this period. Recent market action seems to have fit this playbook. Since the March 2009 stock market bottom, the MSCI World Index rallied by over 60% before stalling and pulling back some 8% during the month of February. Markets have subsequently recovered and now appear to be entering a consolidation phase characterized by a fairly wide trading range. This type of market action tends to be coincident with a peak in a series of leading indicators such as the ISM New Orders Index, Leading Economic Indicators Index (LEI), investor sentiment and earnings revisions – all of them are now in the process of rolling over (see Chart 4).



Going forward we expect further gains will be more laboured and highly dependent on earnings growth, interest rates and liquidity. A powerful lift in earnings appears to be in the cards, but the outlook for interest rates and liquidity, while currently supportive of further market advances, is more of a question mark down the road. As such, the next meaningful

correction will probably come around the first signs of a withdrawal of monetary stimulus, which often manifests itself in a compression in P/E multiples putting downward pressure on prices.

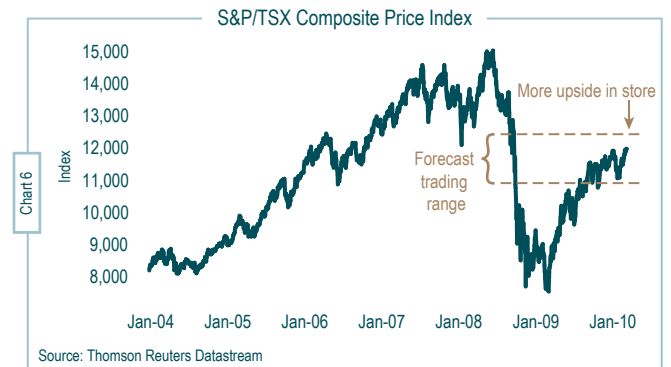
Other factors pointing to range bound markets include investor worries over the risk of a contagion spreading from the instability in Greece to other weak Eurozone countries, precipitating another banking crisis. The threat of a contagion spreading would severely weaken the Euro against the US dollar, which in turn would damage the fragile recovery that is unfolding in America through a slowing in growth for exports and an inadvertent tightening in monetary policy. Other risks remain as well including ongoing issues in the US housing market with the huge number of reset mortgages (ARMs) coming due in the next several months. Fully one in four households has negative equity in their homes. This is obviously problematic, not only for the housing market, but for the banking sector as well. Until there is some clarity as to how these issues will resolve themselves, equity markets will oscillate within a broad trading range (see Chart 5).



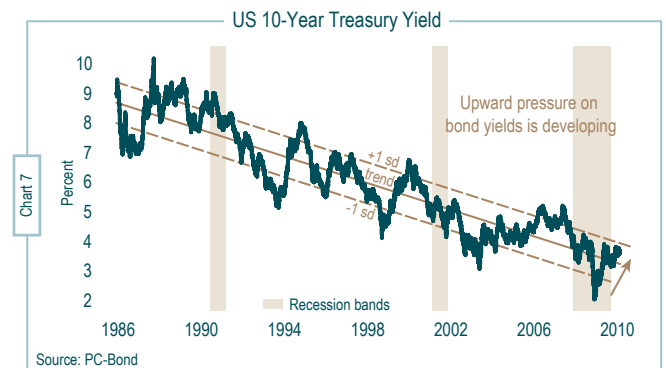
## PORTFOLIO STRATEGY

While equity markets will be range bound over the balance of the year (see Charts 5 & 6), in the near term they should continue to grind higher because the global economy is expanding, inflation is low, the yield curve remains steep, valuation levels are reasonable and the outlook for rising earnings is solid. Good companies with improving prospects are attracting capital and investor interest. From a technical perspective, markets are no longer overbought nor are they oversold. Insider buying is absent, and merger and acquisition activity is muted. Broad price momentum is fading with some divergence on the part of financial stocks relative to trend. Also, monetary conditions are neutral at best. The outlook is definitely more mixed than it has been

for awhile, but the weight of the evidence, as noted above, suggests that a moderately bullish stance towards equities is still warranted.



Bond prices, on the other hand, have come under some downward pressure as yields have started to move up (see Chart 7) due to some strengthening in the economy and rising supply because of the huge financing needs of governments. The bond market is also facing the withdrawal of central bank quantitative easing and asset-backed support programs from the system. Inflation expectations have also increased as of late. The interest rate spread between corporate issuers and governments has continued to narrow, which has lessened the attractiveness of credit somewhat but not to the extent that an overweight to this sector of the bond market is no longer warranted. Rising government supply and low issuance on the part of corporations also continues to make investment-grade corporate credit an appealing alternative to government bonds.



Given the foregoing, our asset mix strategy remains unchanged. Balanced portfolios remain overweight stocks versus bonds with an emphasis on Canadian equities versus foreign, and within the foreign component, US equities are favoured over EAFE markets.