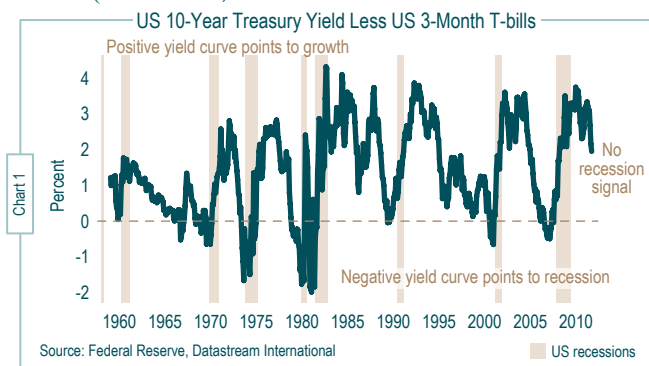


SEPTEMBER 2011

## OVERVIEW

***“The stock market has forecast nine of the last five recessions”***

*(Paul Samuelson – Nobel Economist).* Over the last sixty years the stock market has signalled 15 times that a recession was in the offing and was correct on 8 of those occasions – a bit of a coin toss. Once again Mr. Market is signaling that there is a better than 50% probability that a North American recession is just looming over the horizon and Mr. Market is not alone, he has company. Other leading indicators such as the Philadelphia Fed’s General Business Conditions Index, the Institute of Supply Management (ISM) and the University of Michigan’s Consumer Sentiment Index are all pointing to a slump in economic activity. Even though their records are not any better than Mr. Market’s, in aggregate these indicators are worth paying attention to. But, so too are a variety of other leading indicators that are signaling further expansion. The ECRI Weekly Leading Index, Initial Jobless Claims, corporate credit spreads and the yield curve are all in the positive column. Of particular note is the yield curve, which predicted 7 out of the last 8 recessions, because it is signaling close to a zero chance of recession (see Chart 1).

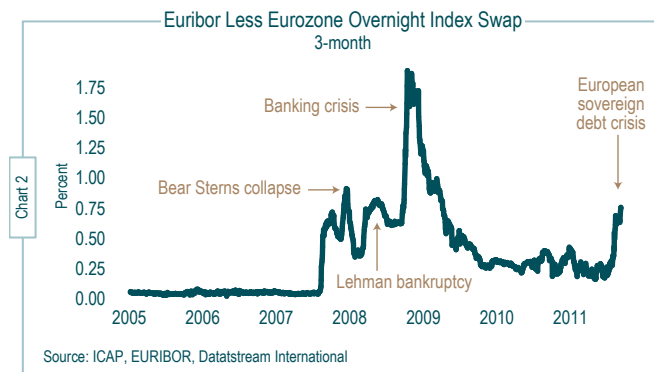


In examining this broad and varied series of leading indicators it is apparent that the odds of a recession unfolding have risen, which we now estimate to be around 40%. However, even though the odds have doubled since the beginning of the year we are still sticking with our base case of “modest growth and no recession”. We are also sticking with our forecast that equity markets will end the year in positive territory while bonds should give back some of their recent strong performance.

As noted above, we remain committed to our base case scenario because monetary policy remains accommodative, the banking sector is better capitalized, consumers have come a long way in restoring their balance sheets (consumer debt service ratio is at a 15 year low) and there is pent up demand across the cyclically

sensitive parts of the economy. In addition, corporations are in good shape with strong balance sheets, robust cash flows and financing rates are near record lows. Importantly, the factors that have pushed the economy perilously close to recession are fading. The supply chain disruptions coming out of Japan have been largely rectified, the draw down in global inventories has abated, energy prices have eased and consumer incomes are starting to grow. Down the road we can expect that President Obama’s program to tackle the job market and sluggish economic growth will probably do more good than harm while the US Federal Reserve’s (Fed) next policy meeting will be extended so as to explore all the options available to promote economic growth. Across the Atlantic, the European Central Bank (ECB) has been lending more support to the European debt markets and is prepared to provide unlimited term funding for the banking industry. The ECB also appears to be willing to lower interest rates. Finally, emerging markets, which remain in relatively good shape and make-up 49% of global GDP, continue to power global growth. Our bottom line is that Mr. Market will be 8 for 16 after the current scare passes.

If we are wrong in our assertion that a recession will be avoided then markets will test their recent lows and may even drop further. However, we do not think the downdraft will be all that severe because a recession has been largely discounted with the market’s recent 20% plunge. The bigger risk lies with a collapse in the European banking system. European bank balance sheets are under duress due to their exposure to peripheral European debt (PIIGS) and the lingering effects of the collapse in the housing market. The recent increase in the Euribor/OIS spread (see Chart 2), rising credit default swap rates (CDS) and the doubling in reserve funds on deposit at the Federal Reserve from official foreign accounts point to stresses in the European banking system and a growing loss of confidence. These “canaries in the coal mine” will have to be monitored closely to see if the situation continues to deteriorate.

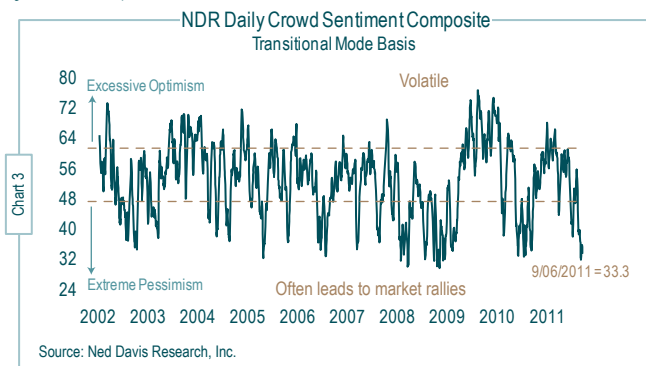


A fresh banking crisis in Europe would set off a whole chain reaction (contagion) that could lead to both an economic and market meltdown. Fortunately, we are not at that point. The odds are still on the side of muddling through the current crisis because of the numerous policy options and actions the ECB and European governments can take to avert a crisis – think European style TARP and quantitative easing.

## CAPITAL MARKETS

Our concerns over Europe come at a time of year (late summer/early fall) when great upheaval tends to occur in financial markets. For instance, the great crash of 1929, the collapse of the Bretton Woods agreement in 1971, the Mexican default in 1982, the stock market crash of 1987, the Russian default in 1998 and most recently the bankruptcy of Lehman Brothers in 2008 are all examples of severe financial events that unfolded after a buildup of pressures throughout the year. While we do not think that is in store for us this year, we are cognizant that the European debt/ banking situation is still very tenuous and could precipitate a fat-tail event (market collapse). Thus the need, as before, to carefully monitor the “canaries in the coal mine”.

That aside, there are still other concerns weighing heavily on investors’ minds, such as the recent talk of recession, the collapse in US consumer confidence, the ineptitude of American politicians, the downgrade of US government debt and the diminishing arsenal of policy options for central bankers and government authorities. As such, we can expect investors to juxtapose these concerns against a variety of previously noted positive factors which will make for fairly volatile investor sentiment (see Chart 3) and in turn financial markets. This will likely continue until there is more clarity as to whether or not the economy will fall into a recession and how the European debt/banking situation starts to resolve itself. In the meantime financial markets will be range bound as investors vacillate between a “risk on or risk off” mentality (see July Outlook).



Putting macro concerns aside, equity markets look compelling from a valuation perspective with price/earnings multiples (P/Es) at historically low levels when compared to core inflation, dividend yields through 10-year Treasury yields (a phenomenon not seen in the last 60 years) and earnings yields relative to bond yields at historically wide levels. In other words, equity risk premiums are very elevated, which normally would be a signal that from a risk/

reward perspective stocks are a compelling investment. However, the situation is more complicated than normal because investors are not only facing the usual uncertainties around the economy, but there is an elevated level of uncertainty around government action and/or inaction. Political risks have increased because of an increasingly dysfunctional US government, the tepid response by European leaders to the European debt crisis and political unrest and upheaval in the Middle East. As such, equity risk premiums will probably remain elevated. For equity markets to really gain any traction to the upside not only will the threat of recession have to subside, but there will also need to be some progress on the political front as well. As such, macro factors will continue to be the primary driver of stocks prices versus company specific factors, making for a very uncertain environment for investors to operate in.

At some point interest rates will drift higher as macro risks subside and investors start to demand a real return on their money. However, the rise in interest rates will probably be subdued because the developed world is still over leveraged and the easiest way to de-leverage is via negative real interest rates, which central banks and their respective governments seem committed to. Of course this means there will be a transfer of wealth from creditors to debtors.

## PORTFOLIO STRATEGY

While developed world economies are facing some severe headwinds, there is enough underlying strength in the global economy to keep most of the world’s economies out of recession, which should help alleviate some of the negative sentiment that is currently roiling financial markets. The recent stock market correction and bond market rally has largely discounted a mild recession, but not a full blown one. A typical recession in the US produces on average a 29% drop in earnings and a 33% decline in equity prices. We do not think this is in the cards and therefore from a risk/return and relative valuation perspective stocks look more attractive than fixed income investments. As noted in our August Outlook, we increased our exposure to equities to an overweight position with the intention of buying more if recent index lows are breached (see Chart 4). Subsequently, we reduced our fixed income weighting below benchmark weight. Further asset mix shifts in favour of stocks will be contemplated given some improvement in the outlook for the economy, the European debt/banking problem and some favourable developments on the political front.

