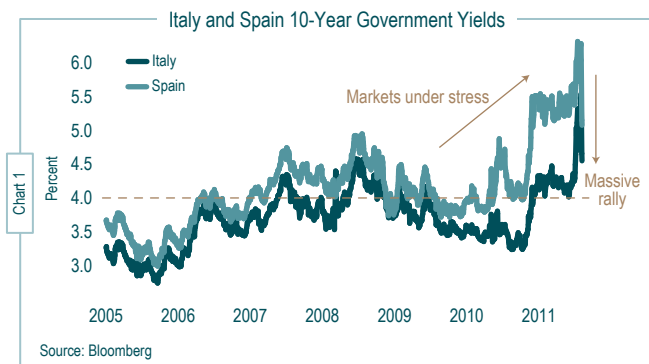


AUGUST 2011

## OVERVIEW

**Panic** – “the sudden onset of intense fear or apprehension, but of relatively brief duration”. There is no question that investors are all of a sudden feeling very apprehensive. The question is will it be of a relatively brief duration?

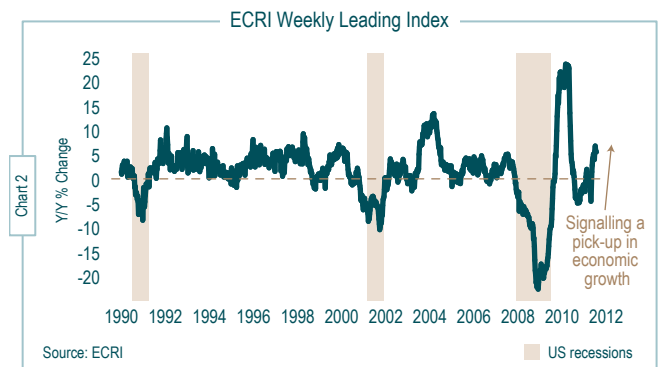
Investors are running scared because they believe that the risk of an adverse financial event has escalated. This could seriously jeopardize the global economic recovery. At the top of the list of concerns is the European debt crisis. Fears continue to mount over a contagion effect that the solvency problems facing Greece, Portugal and Ireland are going to infect Italy and Spain (see Chart 1). This is leading to growing concerns around the ability of European banks to access term funding and the impact that this will have on the European financial system and economic growth. A close second is the concern that US politicians are basically ineffectual and incapable of dealing with the nation’s fiscal problems. The recent downgrade of US Government debt by Standard and Poor’s (S&P) is a case in point because it may lead to a policy mistake (premature spending cuts) which could easily tip the US into recession given how fragile the recovery has been this year. These concerns have arisen at a time when the authorities in emerging markets have been trying to rein in inflation and economic growth, which has led to a global mid-cycle slowdown making the global recovery more vulnerable to external shocks.



While the situation has become more tenuous, not all is lost. Our readings from a series of global leading economic indicators and a composite of global PMIs (Purchasing Managers Indices) are consistent with growth in the neighborhood of 3% to 3.5%. As noted above, the main risk to this forecast lies in Europe where a worsening of the debt crisis and a failure on the part of policy makers to respond forcefully could lead to a further tightening of financial conditions and credit availability. However, we expect the European Central Bank (ECB) to intervene before we get to this state, even

though to date the ECB has continually been behind the curve. A sign that they are starting to change their approach came recently when they dipped into their Securities Market Program (SMP), an 80 billion Euro reserve, to buy Spanish and Italian bonds. This resulted in bonds rallying with yields dropping by 85 basis points, temporarily easing tension in European debt markets (see Chart 1).

The second major risk lies with the US where a lack of political leadership, poor employment numbers and a moribund housing market have heightened fears of a double dip (recession). Forecasters have been scrambling to lower their growth numbers for 2011 after first-half results came in showing a dismal gain in GDP (less than 1%). However, this should not have been all that surprising given that the economy was going through an inventory correction at a time when unemployment was increasing, consumer disposable incomes were weak (rising energy and food prices) and Japanese supply chain disruptions were in full swing. But that was then. Now employment is showing signs of improvement, disposal incomes are forecast to rise 4%, the inventory correction is out of the way and the supply chain disruptions have been rectified. We should also not lose sight of the fact that corporate balance sheets and cash flows are very healthy which points to continued capital spending, rising dividends, share buy-backs and, yes, even some hiring. In addition, because the Federal Reserve’s mandate is to control inflation while promoting employment, we can expect the Fed to weigh in with some soft easing measures. Possibilities here include extending the time line on keeping the funds rate low and their balance sheet large and/or a shift in their reinvestments in the Treasury market towards the longer end of the yield curve. When we take all this into account it suggests to us that US economic growth should pick up in the second half of the year and the economy should not fall back into recession. A number of leading indicators are starting to point to such an outcome (see Chart 2).

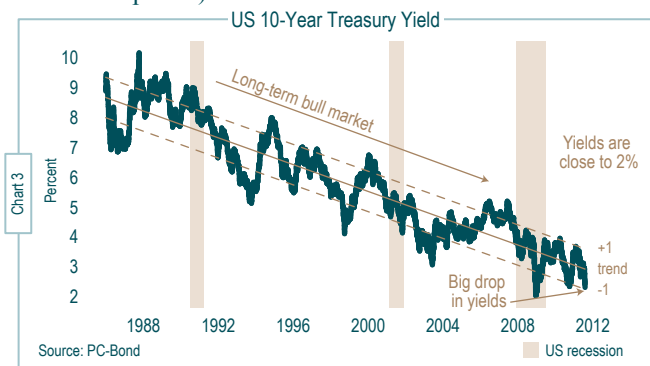


There are of course still risks, including an increase in fiscal drag if Congress institutes additional spending cuts in the short term or if the payroll tax is not extended. But the biggest risk probably comes from the negative feedback loop that could develop from falling markets and investor pessimism. Consumers could lose confidence and retrench due to the negative wealth effect caused by the stock market's plunge and businesses may postpone investment projects and hiring (i.e. declining markets lead to a self-fulfilling prophecy). This will have to be monitored closely.

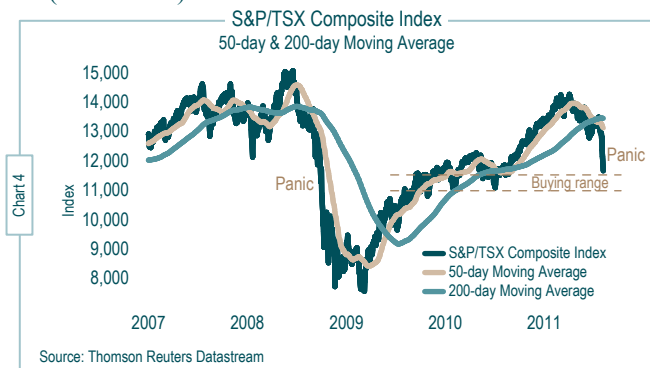
Finally, the third major concern for investors is the fight against inflation in emerging economies. With the recent declines in food and energy prices, we expect to see some progress on the inflation front, and given the current meltdown in financial markets and the increased threat of recession, we can expect that any further tightening in monetary and fiscal policy will probably be put on hold. This should help global growth and act as an offset to the economic drag coming from developed markets.

## CAPITAL MARKETS

As stock markets collapsed, bond markets rallied as investors fled to the safety of US Treasuries even in the face of a downgrade (see Chart 3). European debt markets also rallied thanks to the ECB stepping into the market in response to the previous dramatic rise in Italian and Spanish bond yields and growing signs that inter-bank risk was rising (the Euribor/OIS spread widened to 55 basis points from 30 basis points).

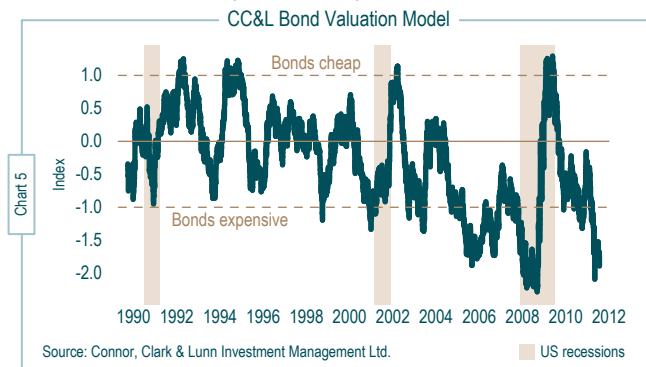


Stock prices have collapsed and from a technical perspective they have broken down and are on the cusp of entering a bear market phase (see Chart 4).



However, sentiment indicators showing extreme bearishness on the part of investors (contrarian indicator) point to at least a relief rally. Insiders have stepped up their buying, as have corporations where

net buying is running at three times its normal rate. In addition, the Citigroup Economic Surprise Index is near record lows which historically signals a market bottom. Valuation metrics look terrific with equity risk premiums hitting new highs, P/E multiples at new lows for this cycle and dividend yields through Treasury yields. The picture for bonds is just the opposite. Technically they remain in a bull market (see Chart 3), but risk premiums are low and valuation metrics look extended (see Chart 5).



It is apparent that because of all the uncertainties and the fear of a looming recession, investors are now demanding a higher risk premium for equities, as indicated by the current price-earnings ratio of 11 times which translates into an earnings yield of 9.3% for the S&P 500 index compared to a 2.1% yield for Treasuries (see Chart 3). This is one of the widest valuation spreads in history. Nonetheless, given the structural damage to equity markets, prices could fall further before finding a bottom somewhere in the neighbourhood of 1050 to 1100 for the S&P 500 index and 11,000 to 11,500 for the S&P/TSX Composite index (see Chart 4).

## PORTFOLIO STRATEGY

Going forward we believe it will take two key developments for equity markets to rebound and produce a sustained advance into year-end. The first is definitive and bold action on the part of the ECB and the second is a healthier US consumer. Consumers are in better shape with household debt to GDP back in line and debt service ratios at 20-year lows. Energy and food prices are in full retreat and there are even some early signs that the housing market is forming a bottom. A healthy consumer leads to good equity markets. Following the market collapses in October of 1987, in 1998 after the demise of the hedge fund Long Term Capital Management and in 2001 after the 9/11 tragedy, the consumer rebounded, and so did equity prices. The panic proved to be a buying opportunity.

Just as forecasters underestimated the slowdown in the first half of this year, we fully expect them to underestimate the pick up in the second half because of the factors noted above. As such, we have started a gradual buying program that will be staged in as target price levels are met. We have recently increased our exposure to equities and are now slightly overweight the benchmark – up from a neutral position. We expect equity markets to trace out a bottom formation (11,000 to 11,500 on the S&P/TSX and 1050 to 1100 on the S&P 500) over the next month or so which will provide an opportunity to add to stock positions (see Chart 4).