



# INVESTMENT REVIEW AND ECONOMIC OUTLOOK

## First Quarter 2009

### Overview

World markets during the first quarter of 2009 continued to exhibit a high degree of volatility as investors reacted to the new economic reality, and searched for signs of a recovery. Equity markets performed poorly in the early part of the quarter, but rallied sharply towards the end of the quarter. The MSCI World Index was down -9.22%, the S&P 500 was down -8.42% (both in CDN \$) and the TSX was down -2.00%. The fixed income market fared somewhat better led by high yield and corporate bonds. In Canada, the DEX Universe Bond Index posted a return of 1.52% for the first quarter compared to the corporate bond sub-index return of 3.48%.

In our market commentary last quarter we indicated that we expected the global economy to continue to deteriorate, but felt at the time that the capital markets were already pricing-in a severe economic downturn. We opined that equity market valuations were approaching attractive levels, and strongly believed that in the fixed income area corporate bonds offered above average risk adjusted returns. Economic data released during the past quarter suggests that our thesis remains intact. The U.S. economy has lost 5.1 million jobs since the economy entered the recession in December 2007. Canada started late but has lost 273,000 jobs in the last three months. Governments globally are spending money to slow the decline and stimulate demand. The U.S. deficit could top two trillion dollars in the next year. The Government of Canada is projecting a deficit of \$84 billion over the next year. Even Alberta is projecting a \$4.7 billion deficit, its first in 15 years. The good news is we expect this stimulus to work and the decline in economic activity will slow in the second half of this year and we should see a moderate recovery in 2010.

The economy has indeed gotten worse by almost every measure, but capital markets, in the face of disastrous economic data, have acted better than the previous quarter. Indeed, we have seen corporate bond spreads beginning to narrow and some deals, debt and equity, are being done in the marketplace; for the better companies at least, the capital markets appear to be functioning. However, we continue to expect a turbulent market in the months ahead as stock prices react to earnings disappointments, forced corporate restructurings, and a generally weak economy. Our view calls for an economic rebound to start in late 2009 at the earliest. Additionally, given the strained finances of the American consumer the ensuing rebound is likely to be anemic by historical standards.



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### Canada

In Canada, the early quarter's lower performance can be primarily attributed to energy, in particular companies in the Alberta oil sands, and to the poor performance in the industrial sector. Most of the oil companies have substantial oil reserves, and in a period of rapidly declining oil prices as we have had over the past year, these companies performed poorly in the marketplace. With the recent rebound in oil prices these companies have begun to perform much better. In the industrial sector companies such as Bombardier, and SNC-Lavalin hurt recent performance. Although Bombardier has continued to report earnings above market expectations, their exposure to the business jet market and regional airlines remains a source of concern. SNC is a premier Canadian company involved in building infrastructure around the globe. We believe that the recent price decline is more a function of the market weakness than fundamental issues with the company. Given its leadership position in the marketplace SNC always trades at a premium, and in periods of market uncertainty as we are currently experiencing, the premium tends to diminish.

The portfolio continues to hold some of the better quality energy names in Canada such as Suncor, Encana, and Canadian Natural Resources. Other notable names in the Canadian portfolio include RIM, Shoppers Drug Mart and SNC Lavalin.

We continue to invest with conviction in high quality franchise companies with earnings growth superior to that of the market, and at valuations that are justifiable. As such, we remain consistent with our growth philosophy.

### Debt Markets

Governments around the world continued down the path of doing anything necessary to stop the downward spiral in economic activity. Central banks slashed rates further (U.S. 0.00% to 0.25%, U.K. 0.50%, European 1.25%, Japan 0.10%, Canada 0.50%, etc.). Short rates are now at multi-generational lows. What's next? Quantitative easing. In its simplest version, quantitative easing is when governments print money and buy back longer dated bonds. The idea is to push long rates lower and that in turn, will push other rates, such as mortgage rates, down. To date, major economies, including the U.S., U.K. and Japan have introduced these measures with some success. There is a possibility that Canada could introduce these measures in April.

The first quarter of 2009 began with an improved tone in credit markets. This was initially a U.S. market phenomenon but, by the end of the quarter, new issue deals were brought successfully into the Canadian market as well. Corporate bonds returned 3.48% for the quarter versus 0.57% for Canada's and 0.63% for Provincials. Although this is a nice bounce back there is still a large gap to fill after corporates underperformed Canada's by more than 11% in 2008.



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Returns in the fixed income markets were positive for the quarter led by credit. The portfolio carries a running yield significantly above that of the market, and even if bonds spreads do not narrow further, the portfolio should continue to do better than the market. As outlined above, we believe that corporate bonds offer the best risk adjusted returns in the near term, hence we continue to maintain this overweight position. It should be noted that the portfolio is of a very high quality with a negligible risk of a default in any one security.

### United States

While we remain hopeful that we have passed the trough of the current financial and economic downturn, we remain of the view that the recovery will not be a steep mirror trajectory of the decline. We still expect to see major issues in housing, unemployment and consumption, which will make it difficult for a sustained rally in Financials and other economically sensitive sectors. That said, we are not entirely negative in our outlook. Given the valuation levels of some prize franchises across a number of sectors, we believe stocks with solid balance sheets, lower economic sensitivity and the ability to increase their competitive positioning in the down-turn (through consolidation or competitor attrition) will begin to witness “normalized” multiples from current depressed levels.

Technology (+7.0%), Materials (-0.3%) and Telecommunications (-5.8%) were the best performing sectors over the past quarter in the S&P 500 Index. Financials (-27.2%), Industrials (-19.7%) and Energy (-9.4%) were the worst performing sectors for the quarter. The top and bottom five performers in the portfolio were diversified amongst various different sectors.

Securities selection within the Technology (Intel +15.0% and Google +17.2%) and Industrials (Danaher -0.9%, Roper Industries -6.4% and Union Pacific -6.5%) sectors contributed positively to performance in the quarter. Securities selection primarily within the Financials (Wells Fargo -50.0%, US Bancorp -40.2% and PNC Financial -38.1%) and Consumer Discretionary (Coach -25.9% and Comcast -16.3%) sectors detracted from performance in the quarter.

### Strategy

We believe that equities offer good upside potential given the current period of very accommodative monetary and fiscal policies. Going forward, corporate profits should gain momentum on the back of ongoing cost cutting and productivity advances. It is for these aforementioned reasons, that we remain optimistic on the outlook for the stock market and will continue to cautiously increase the equity allocation going forward. We continue to closely monitor markets and the economy to assess when changes in these allocations may be necessary.