

Investment outlook

MARKET OUTLOOK

FALL 2009

The necessary pre-conditions for a recovery in global growth have fallen into place, and the economy is responding more firmly than expected. Still, important challenges lie ahead. Fallout from the credit crisis is severe and it will shape the recovery for some time ahead. Risky assets have recovered, but our valuation models imply that they are still discounting a significant level of vulnerability, especially in investment grade credit and equity markets. As the obstacles to a self-sustaining recovery fall away, as they have in the past, these markets appear to offer very attractive returns relative to most periods of the post-war era.

ECONOMY STABILIZES, OUTLOOK HINGES ON SELF-SUSTAINING RECOVERY

In the U.S., the fiscal stimulus package is beginning to spread through the economy. The housing market appears to be stabilizing and credit markets are gradually unclogging. A weaker U.S. dollar and revitalized growth in Asia are helping to improve demand for U.S. exports. Final sales are also beginning to show signs of life. Consumer and business confidence are healing and employment declines are beginning to moderate.

However, this business cycle faces unique challenges. The massive monetary and fiscal stimulus must eventually be withdrawn, representing an additional unusual challenge to this cycle. If policymakers are too slow to act, inflation will appear and raise the odds of another truncated boom/bust cycle. If they move too fast, growth could wither before it achieves self-sustaining momentum.

MODEST GROWTH, CONTAINED INFLATION

We anticipate that GDP will remain below trend in the early innings. Our U.S. growth forecast remains at -2.70% for 2009, but we have raised our outlook for 2010 to 1.30%. We have boosted our expectation for growth in Canada to -2.00% in 2009 and 2.00% in 2010.

While we expect to see inflation pick up in the mid- to long-term, we remain hopeful that it will remain within an acceptable range amid a stubbornly large output gap, high unemployment and the deeply depressed velocity of money.

RECENT WEAKNESS, BUT THE U.S. DOLLAR SHOULD NOT BE WRITTEN OFF

The global risk rally has not been kind to the U.S. dollar. The greenback has moved significantly lower since its high in March. We believe that the U.S. dollar weakness may continue in the short term, but several factors support the greenback in the longer term, including valuation and a variety of macro-economic and technical market factors.

CANADIAN DOLLAR (\$US)

Source: Bank of Canada

**CANADIAN INTEREST RATES (%)**

Source: Bank of Canada

**CANADIAN EQUITIES (S&P/TSX COMPOSITE)**

Source: Toronto Stock Exchange

**U.S. EQUITIES (S&P 500)**

Source: Standard & Poor's

**EXPECT SHORT RATES TO REMAIN AT RECORD LOWS**

Given the unique challenges in the current recovery, central banks are likely to continue to hold rates at record lows until there are especially firm signs that the economy has built self-sustaining momentum. We don't expect the world's major central banks to begin hiking rates prior to mid-2010.

NEAR TERM, EXPECT RANGE BOUND YIELDS

Globally, government bond yields are well off their lows, having rebounded from an extremely overbought and overvalued condition early this year. Since April, 10-year U.S. Treasury bonds have traded in a 3% to 4% yield range. As long as the Fed maintains its current policy stance, as we expect, there will be little motivation for the market to broaden the range significantly. We look for U.S. yields to reach 4.25%, while yields in Canada should sit near 3.75%.

EQUITY VALUATIONS STILL EXTREMELY ATTRACTIVE

The recovery in the stock market has been one of the strongest and most impressive reaching all the way back to the 1930s. Moves of this magnitude over such a short period are rare and there is always the risk of a near-term consolidation, or correction, following a rally of such intensity. However, history has shown that trying to time early bull markets has frequently been an unprofitable strategy. The first leg of a new bull market draws its strength from the anticipation of economic recovery. Valuations are a key determinant of returns in this initial stage – the more deeply depressed stocks are relative to fair value at the trough, the greater the bounce. While the move off the bottom has taken out the extreme undervaluation, equities are still discounting earnings and valuations that are well below normalized levels. U.S. stocks are still near their greatest discount in a half-century relative to fair value and a variety of European markets may be even more attractively priced. Even if the next bull market simply moves stocks back to equilibrium, equities are poised to deliver outstanding risk-adjusted returns relative to bonds. So, while it is tempting for investors to become discouraged if they missed the chance to add to equities at the lows, prospective long-term returns for equities from current valuations are still extremely attractive.

Past performance is not indicative of future results.



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