

The financial markets provided good returns in 2009, as shown by the following table. All the results are in Canadian currency to facilitate comparisons but it is important to note that the Canadian dollar was up 15.9% in 2009 against the U.S. dollar, which had an adverse impact on the returns earned by Canadian investors on foreign indexes.

	2009	2008
S&P/TSX Composite	+34%	- 32%
S&P 500	+27%	-37%
Europe & Pacific	+31%	-42%
Emerging markets	+77%	-53%
World	+30%	-40%

High-yield bonds also recorded a very strong performance after having been downgraded substantially during the financial crisis.

The financial crisis is therefore over, as is the global recession. Two questions now arise: (1) Is the incipient recovery strong enough to ensure the expansionary cycle can continue without the massive support of government deficits; and (2) What will happen when the central banks start to withdraw the tremendous amounts of liquidity they have injected into the markets over the past two years?

As regards the strength of the recovery, we have at least part of the answer, because developing countries were among the first to show signs of strength, especially China. A large number of analysts were doubtful that developing countries could emerge from the recession without the impetus of demand from developed countries, particularly the United States. Conversely, proponents of the decoupling theory argued that developing countries now hold most of the world's savings and that domestic demand can sustain their economies. Most forecasters now agree that growth will be stronger in developing countries over the next few years.

But should we expect the U.S. economy to slide back into recession in 2010? This will depend on the policy of the U.S. Federal Reserve: if it tightens credit too quickly, it could cause a spike in interest rates that would put an end to the recovery, as was the case during the recession of 1981-1982 in the United States and early in the 1990s in Japan. The monetary authorities are well aware of this risk and have therefore repeatedly said that monetary conditions will remain accommodative as long as necessary.

We have concluded that the global economy is starting a new expansionary cycle that will last four or five years.



STOCK MARKETS OVER THE LONG TERM

If we take the U.S. stock market as an indicator, investors have received no return on their equity investments over the past decade. It was one of the worst 10-year periods since statistics on the U.S. stock market have been compiled. Does this mean that stock markets will perform poorly over the next decade? Judging by historical returns, the opposite is likely to occur, since the worst 10-year periods are usually followed by positive 10-year periods.

This is simply a statistical phenomenon called regression toward the mean: if a series of points follow a trend, then depart from the trend, the probability of a reversion will be high. In 2000, the U.S. stock market was far above the trend and did not generate positive results in the 10 years that followed. Currently the U.S. stock market is well below the trend line.

One essential condition for a high probability of positive returns over 10 years is a low price-earnings ratio.

The current ratio is not the lowest we have ever seen but it is perfectly reasonable, if not attractive, taking into account the level of interest rates. Twelve months from now, the earnings of the U.S. companies in the S&P 500 Index should exceed \$70, which implies a price-earnings ratio of less than 16. If we add to that the fact that earnings will continue to rise for several years, it is not difficult to forecast that the markets will exceed their previous peak before the current cycle ends.

There is no consensus regarding this forecast but we would like to point out that there was even less of a consensus in 2003 when we said the same thing in our Market Review.

U.S. PRODUCTIVITY

A society's only true source of wealth is its productivity. In this respect, something unusual happened during the past recession: productivity continued to rise. The normal phenomenon during a recession is as follows: companies see their sales decrease but hesitate to lay off employees because they can't be sure the slowdown will be lengthy. A decrease in output per hour worked then occurs. But this time companies responded quickly, which enabled them to maintain their productivity and to offset a portion of their drop in earnings.

As the recovery takes hold, companies should start rehiring sooner than they did in previous recoveries and since productivity has continued to rise, it is likely that their profitability will be maintained at a higher level than during previous cycles. The United States continues to be the most productive economy in the world, and its high productivity will help it get through the crisis.

ECONOMIC GROWTH

Most observers are expecting a slow economic recovery. Some even believe that the economies of the developed countries are fragile and that it wouldn't take much for them to fall back into recession. First, it is important to note that the economy always seems fragile at the end of a recession. That is why we should not rely on an analysis of problems in individual sectors of the economy but instead look at the history of economic cycles.

From this standpoint, cycles are remarkably similar. All recessions in the United States have been caused by a tightening of credit and more recently by a combination of tight credit and rising oil prices. The credit crunch is affecting mostly those areas that most dependant on credit, namely construction, sales of durable

goods and business investment. During a recession, interest rates fall, indicating that credit has returned, the price of oil goes down and six to 12 months later, the economy starts to grow again.

An analysis of cycles shows that recoveries are almost always strong. This time, analysts are arguing that the U.S. recovery will be weak because consumers are carrying too much debt. And yet the individual savings rate has already increased from 0% to 4% in a period of rising unemployment. It is possible that the savings rate will continue to increase. This could shave 1% a year off growth in the years to come but probably not much more.

PRICE OF OIL

All sharp increases in the price of oil since 1973 have caused the global economy to slow and have often caused a recession. An increase in the price of crude acts like a heavy tax in developed countries. If the economy has already started to stumble, for example when credit is tight, a recession will occur.

Seen from this standpoint, the increase in the price of oil over the past year is worrisome. The price of a barrel of crude was as low as \$35 in 2008 but it is now trading above \$70. From this level, price increases could be detrimental because it appears that our industrial structure is fairly well adapted to a price of \$50 to \$70. If the price of oil exceeds \$100 this year, it will be cause for concern in 2011 because at that time credit restrictions will begin to come into play.

INTEREST RATES

Short-term interest rates are now 0.25% for treasury bills in the United States and Canada. Central banks have injected so much liquidity into the markets that U.S. treasury bills traded at a negative return only recently.

It is certain that short-term interest rates will go back up at some point but we do not know when. In the United States, the Federal Reserve has stated several times that it is not in a hurry because the biggest risk would be to tighten credit too soon. The Bank of Canada, for its part, has said that mid-2010 would be an opportune time.

BONDS

Federal 10-year bonds were yielding as little as 2.8% during the financial crisis. They are now yielding 3.6%. This return may represent paltry compensation for the risk involved because the bond market is confronted by two challenges: the tightening of credit by central banks and an unprecedented volume of new government issues by developed countries with chronic deficits.

We must therefore be cautious with government bonds. Corporate bonds are more attractive, however, since their yields are much higher and the financial situation of issuers is improving. It would not be surprising to see corporate bonds offering the same yields as some government bonds two years from now.

DASHBOARD

December 2009	
Canada	
Canadian dollar vs. U.S. dollar	+
Corporate bonds	+
Long-term government bonds	-
S&P/TSX 60	++
Small caps	+
REITs	+
United States	
U.S. dollar vs. euro	0
Long-term treasury bonds	-
S&P 500	+
Nasdaq	+
Small caps	+
Europe	
Euro vs. U.S. dollar	0
MSCI EMU	+
Asia	
Yen vs. U.S. dollar	--
MSCI Japan Index	0
Emerging markets	
MSCI Emerging Markets	++

0: neutral

+: overweighted

--: underweighted