

The stock markets turned in a solid performance in the second quarter. In fact, if we include the month of March, the U.S. stock market had one of the strongest rallies over a four-month period in almost a century. Only four other comparable four-month periods have occurred in the past 85 years, in 1933, 1938, 1975 and 1982. In each case, the market rebounded after sharp declines.

The first leg up for a bull market is always very strong and often happens when least expected. For that reason, investors should not try to sell into a decline, hoping to re-enter the market at an opportune time.

We concluded our previous market review by saying that the credit crisis was over, and that it was time to tackle the solvency problems of banks and financial institutions in general. To restore bank solvency, the authorities must address both sides of financial institutions' balance sheets. First, it is essential to strengthen capital and long-term financing – an operation that is for the most part complete. Second, the assets underlying bank loans have to appreciate. That portion of the process is far from over, and that is why the cost of money is still so low.

We believe that the global recession could end by late 2009, and that stock markets will continue to rise in the next few years. Prices of natural resources will remain firm, especially the price of crude oil. We expect Canada's economy to grow and are therefore partial to Canadian equities. As for fixed-income securities, Government of Canada bonds are not appealing, but corporate bonds are attractive.

Stock market performance 2nd quarter 2009

	Local currency	Canadian dollars
Canada	+ 19.9%	+ 19.9%
United States	+ 15.9%	+ 6.6%
Europe	+ 19.0%	+ 16.3%
Japan	+ 22.9%	+ 16.6%
Emerging markets	+ 34.7%	+ 23.9%
Bonds	+ 1.2%	+ 1.2%



ECONOMIC RECOVERY

In the United States, several economic indicators have recently been pointing to a stabilization of activity, and we may see an upturn by year-end. If so, the recession in the United States will have lasted two years, making it one of the most severe of the past 50 years. Most forecasters are calling for a slow recovery because household net worth has been severely affected by falling house and shares prices. Even before the recession, we regularly stated that growth in the United States would be slow and that it would take several years to correct the balance-of-payments deficit.

The situation is different in Canada. In fact, several indicators are pointing to a recovery as early as the fall, except for Ontario, which is grappling with the impact of the collapse of the auto sector.

CAUSES OF THE RECESSION

Economists tend to see recessions as the result of poor economic policy. That was certainly the case from 1950 to 1980, for it has been shown that all the recessions in the United States during those years were caused by restrictive monetary policy. Over the past 20 years, however, it appears that market globalization has been causing rapid changes in industrial cycles.

The recent global recession was due to a liquidity crisis in the financial sector, which then affected two industries that are highly dependent on credit, namely real estate and automobiles. Countries that depend on these sectors have been hit much harder than the others. Canada, for its part, is not as dependent on these industries and has been affected less. The implication is that the country's public finances are in better shape and that consumer spending will hold up better than in the United

States. These factors bode well for Canada's stock market and currency.

STOCK MARKET CYCLE

The major question of the day is whether to interpret the rally of recent months as the first leg of a new bull market or a false start. We believe it is a new bull market because the credit crisis is abating and trade will be able to resume fairly quickly. The stock market is a leading indicator of economic activity, while the unemployment rate is a lagging indicator. There can be a lag of a year between the two indicators. That is why we have to be skeptical of the argument that we should not buy equities because the economy is weak.

STOCK MARKETS OVER THE LONG TERM

The performance of the U.S. stock market over the 10-year period to June 30, 2009, was -4% a year – one of the worst performances for any 10-year period in a century. In fact, a worse performance occurred in only 3% of cases. But it can be shown that periods of poor stock market performance over 10-year periods are followed by periods of positive performance in the 10 years that follow.

Another way to evaluate the performance of the stock markets over the long term is to compare it to the return on bonds. An investor who bought only U.S. equities in 1980 would have had a portfolio worth 2.5 times more in 2007 than if he had purchased only bonds. Today, the value of the two portfolios is the same. It is as if we had gone back to 1980.

EMERGING MARKETS

Generally speaking, emerging markets are more volatile than markets in the developed countries. In the recent decline, however, emerging markets did not perform any worse than the major markets in North America and

Europe. After all, the financial crisis was concentrated mainly in the United States and Great Britain. A few emerging markets were hit hard, such as the Eastern European countries, but the larger markets, such as China, India and Brazil, held up fairly well. We think that this trend will continue and that emerging markets will outperform major markets in the next few years.

CHINA

The Chinese government has adopted a vigorous economic stimulus plan and has the wherewithal to apply it, since it holds the world's largest foreign currency reserves. Despite the collapse of its export sector, China's GDP is forecast to increase this year. The Chinese stock market bottomed in October and has outperformed the other markets in the rally that started in March 2009. We expect this trend to continue for several years.

GOVERNMENT BONDS

Short-term interest rates are still about 0.20% in Canada and the United States, but the rates for U.S. long-term government bonds have gone from 2.5% in March to almost 3.5% recently. Given the tremendous financing needs that the U.S. government will have to meet in the years to come, it is unlikely that the U.S. bond rate will fall below 3.5%. The outlook for Canada bonds is a little better, but not much.

As expected, provincial bonds outperformed federal government bonds; but we must not declare victory yet, since studies are increasingly showing that the new provincial deficits caused by the recession will become almost permanent, owing to the provinces' limited fiscal leeway.

CORPORATE BONDS

Corporate bond prices have exceeded all the other sectors of the bond market since the start of the year, and should continue to rise for two reasons: (1) these bonds still offer a more attractive yield to maturity than government bonds with comparable maturities; and (2) there will be far fewer new offerings in this sector, whereas the government bond sector will be awash with new issues in the years to come.

DASHBOARD

June 30, 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