

After posting gains of 60% to 100% from March 2009 to March 2010, stock markets pulled back in the second quarter of the year. Thus far the declines can be characterized as "corrections" in a bull market, since corrections are defined as average declines of 10%. In the second quarter, the declines were about 5% for Canada and as much as 15% for Europe.

Markets are concerned about Greece's creditworthiness, since analyses are showing that it will be very difficult for the country to pull through without substantial financial support. It will probably have to restructure its debt. For that reason, European authorities have offered financial support to members of the euro zone, especially the Club Med countries, such as Italy, Spain and Portugal.

At the same time, economic activity has continued to improve around the world. Global industrial production is almost back to the last peak recorded in 2008. What is even more interesting is that global trade is up sharply over the past year and at the current rate will exceed its previous peak before the end of the year. Moreover, the recovery has taken place without inflation. In fact, inflation has gone down for the past two years in most developed countries, even though central banks have maintained highly expansionary monetary policies and the cost of money is still at a 50-year low.

In these conditions, short-term interest rates should remain low for at least another six months because central banks will not raise rates until they are sure of two things: (1) the economy no longer needs stimulus; and (2) the risk of deflation has been eliminated (see "Japan's economic malaise" below).

	<b>2009</b>	<b>2010</b>
	<b>In Canadian \$</b>	
S&P/TSX Composite	+34%	- 3%
S&P 500	+8%	- 5%
Europe & Pacific	+13%	-11%
Emerging markets	+53%	- 5%
World	+12%	- 8%

### JAPAN'S ECONOMIC MALAISE

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Early in the 1990s, the stock market and house prices declined at the same time in Japan. The country's banking system came close to bankruptcy and the economy plunged into a deep recession followed by a timid recovery. Since then, Japan has experienced slow economic growth accompanied by mild deflation, along with a continuing decline in equity and house prices. Moreover, consumer prices have fallen by 1% to 2% a year. The government and the Bank of Japan have been trying unsuccessfully to kick-start the economy for almost 20 years.

The United States and Western Europe have also recently seen equity and house prices decline at the same time, their banking systems have come close to bankruptcy and their economies have entered a recession. The fiscal and monetary authorities have responded with expansionary economic policies, as was done in Japan, but governments in Western countries have tried to intervene as little as possible in private-sector decision making.

We do not know whether Western countries will go in the same direction as Japan, but their central banks are very much aware of the risk. It is important for investors to monitor house prices, especially in the United States, as well as the prices of consumer goods, to detect the first signs of deflation.

### RECOVERY IN THE UNITED STATES

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The debate surrounding the economic recovery in the United States is mostly about employment. In recent months, employment has stopped falling but it is still not increasing, at a time - six to nine months after the end of a recession - when we should be seeing it rise. Pessimists are saying the economy will go into a double-dip recession as soon as the government stimulus programs end. There is an

explanation for the current situation, however: productivity is so strong that companies do not need to hire additional employees to increase their earnings. This assumption is also supported by the fact that corporate earnings are beating expectations and new equipment orders from businesses are at a record level.

Nevertheless, the U.S. economy still has problems. Despite home-ownership assistance programs, housing prices have not yet begun to rise and the inventory of unsold houses is still large. It is clear that employment will eventually have to increase so that people can buy houses. Moreover, banks have not yet resumed lending even though their liquidities are at an unprecedented level.

### GLOBAL GROWTH

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GDP growth in the United States should be in the range of 2% to 2.5% in 2010-11, or half the average rate during a U.S. economic recovery. In Europe, growth will be even more lacklustre. Even so, global growth should average 4% during this period because Asia should keep expanding at 6% to 8% while Latin America should grow at 3% to 4%. Developed countries have aging populations and are riddled with debt, so they will not serve as the engine of growth. They may account for 50% of the global economy, but growth will take place in the other 50%.

### GOVERNMENT BONDS

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Long-term interest rates have declined for notes with the best credit ratings but have risen for secondary debt. For top-rated debt, the prize unquestionably goes to German bonds (10-year bunds), which recently yielded as little as 2.5%. For Canada and the United States, the 10-year bond yield has held steady at 3¼% to 3¾% over the past year. It is currently at the low end of this range.

In an environment in which inflation is holding steady at 1½% to 2%, federal bonds have little appeal except as an insurance policy against possible deflation in the years to come. Deflation is an extreme scenario but it is quite possible that inflationary trends will go from the 2% that we have been experiencing since 1990 to 1%. In such conditions, government bonds would once again become attractive.

### CORPORATE BONDS

Corporate bonds are still attractive in the current context for several reasons. First, they offer a much higher yield than government bonds. Second, we do not foresee a high volume of new offerings in the years to come in the corporate sector, whereas governments will have to finance record deficits. Lastly, businesses represent the sector of the economy that currently has the greatest liquidity, and this situation should continue, because corporate earnings are solid and the benefits of productivity gains seem to be accruing far more to businesses than to individuals or to governments.

### HOUSE PRICES

In the United States, house prices have stopped falling over the past year but are still 35% below their 2007 peak and show no signs of rising. The statistics on the market provide a picture that is far from clear. On the one hand, the number of homeowners in default continues to rise, which suggests there will be more foreclosures in the months to come. On the other hand, houses are far more affordable, the rate of sales is picking up a little and it appears that speculators are not the only ones buying, since household formation has begun to rise once again in recent months.

It is estimated that 14% of the mortgages in the United States are in arrears and that this percentage is still rising. The available supply

totals more than seven million houses, or about 18 months' worth of sales at the current rate.

The outlook in this area is therefore still uncertain.

### DASHBOARD

June 30, 2010	
<b>Canada</b>	
Canadian dollar vs. U.S. dollar	+
Corporate bonds	+
Long-term government bonds	-
S&P/TSX 60	++
Small caps	+
REITs	++
<b>United States</b>	
U.S. dollar vs. euro	0
Long-term treasury bonds	-
S&P 500	+
Nasdaq	+
Small caps	+
<b>Europe</b>	
Euro vs. U.S. dollar	0
MSCI EMU	+
<b>Asia</b>	
Yen vs. U.S. dollar	--
MSCI Japan Index	0
<b>Emerging markets</b>	
MSCI Emerging Markets	++

0: neutral      +: overweighted      -: underweighted