



The rally in global equity markets since they bottomed early in March is one of the most spectacular ever seen. It has been almost uninterrupted, with many markets advancing more than 50% in six months. But a more moderate way to look at their performance is to compare this year's increases with the lows reached last year in major markets, as shown by the following table:

	2008	2009 As at Sept. 30
TSX Composite	- 32.4%	+ 19.3%
S&P 500	- 36.6%	+ 30.0%
Europe and Pacific	- 42.0%	+ 29.2%
Emerging markets	- 52.8%	+ 64.1%
World	- 39.7%	+ 25.3%

To summarize, we experienced a liquidity crisis in financial markets, which culminated in March 2009, when the world's main central banks (especially the Federal Reserve in the United States and the Bank of England) intervened massively to inject unprecedented liquidity into the financial system.

We came very close to the point of no return, but the liquidity crisis has now abated: short-term credit conditions have improved significantly, interest rate spreads between the various types of credit have come down to more normal levels and stock markets are up sharply.

It appears that the most severe global recession in 50 years ended in the summer of 2009. We have begun a recovery that will probably be slow in the developed world but fairly robust in developing countries. In any event, it should be strong enough to keep commodity prices at high levels, which will benefit Canada.

ECONOMIC RECOVERY

For those who were wondering whether the global recession was due to weak demand or credit restriction, the answer is now clear: it was a case of severe credit restriction. With the massive injection of liquidity by central banks, international trade has resumed, and delivery volumes of the main exporting countries are up sharply.

Developed countries however are all emerging from the recession with government deficits unprecedented levels as a percentage of GDP. From a financial standpoint, the world is divided into two groups as the recovery gets under way. On the one hand, the developed countries of Europe and North America have heavily indebted consumers, an aging population that insists on maintaining its privileges, a household savings rate close to zero and record government deficits. Developing



LANDRY MORIN
Gestionnaires de portefeuille

Market review

Third quarter 2009

countries, on the other hand, have young populations that are eager to work, personal savings rates that often exceed 20% of income and impressive international liquidity reserves. It is clear that economic growth will be taking place in the second group of countries.

CHARACTERISTICS OF FINANCIAL CRISES

In a study published toward the end of 2008, the International Monetary Fund reviewed all financial crises that were accompanied by falling housing prices since the start of the 1960s. The study concluded that recessions caused by financial crises are more severe than other recessions. They last an average of two and a half years and result in a GDP contraction averaging 5%. A normal recession lasts less than one year, with GDP falling by an average of 2%.

During these periods, the prices of equities and houses behave differently. Equity prices fall by an average of 50% in a bear market lasting two and a half years. The decline of house prices is more gradual but lasts longer. They fall by an average of 30% over four years. The data imply that equity prices begin rising long before house prices start to recover. In fact, researchers have found that stocks begin to rise before the end of a recession, and that house prices start to rise on average one year after a recession ends.

If the recession ended during the summer, as we think it did, it will have been slightly shorter than average but just as severe for many countries. The decline on the stock markets will have been in line with the average but a little shorter: two years versus an average of two and a half years. Lastly, if house prices recently stopped falling, as the indexes are indicating, the decline will have lasted three years in the United States as opposed to the average of four years.

STOCK MARKET CYCLE

We are convinced that we are at the start of a period of global economic growth that will last a minimum of five years. Global growth will be slower, especially in developed countries, but it will not prevent companies from making profits, since profit margins will remain high. For that reason, we believe a bull market in equities has already begun. There may be corrections along the way but the trend will generally be upward.

INTEREST RATE CYCLE

Typically, interest rates rise during an economic growth cycle. For the time being, central banks are keeping short-term rates near zero, but it is inevitable that rates will rise if the economic expansion continues, especially since the bond markets will have to absorb record amounts of government debt. There have been occurrences in the past where a country has run deficits approaching 10% of GDP, as was the case for Japan, but we have never seen all governments in developed countries borrow massively at the same time. In all likelihood, this borrowing will push interest rates up in 2010. The increase could be substantial, for we must keep in mind that such borrowing is not sensitive to interest rates, because governments cannot eliminate their deficits over the short term.

CORPORATE BONDS

Corporate bonds have performed very well recently, returning 15% since the start of the year, which is almost as good as the Canadian stock market during the same period. The Canadian bank bonds that we hold in the portfolios have done particularly well. Have these securities become too expensive? We think not, since they offer an above-average



yield in relation to government bonds. We must also take into account the fact that the bond market will be flooded with government bonds over the next three years and that new corporate offerings will be far less frequent.

INFLATION OR DEFLATION?

Some commentators believe that the unprecedented monetary stimulus that we have experienced will inevitably cause inflation down the road. Others think inflation will remain tame as long as the global economy is operating below capacity. Both arguments have solid economic foundations, and for the time being we can only conclude two things: (1) Inflation is not an immediate danger because the economy is operating well below capacity; and (2) the inflationary trend will depend on central bank policies over the next two years.

REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts are an attractive asset class for investment portfolios. First, they are a tax-efficient vehicle because they do not pay income tax as long as they distribute all their internally generated funds to unit holders. Second, they ensure effective portfolio diversification because they offer higher income than bonds and because, in normal circumstances, their returns have a low correlation with returns on common shares. That being said, there is a period when the correlation between these two asset classes is very high, namely during credit crises such as the one we just experienced. In such periods REIT unit prices decline as much as common share prices, which creates a buying opportunity.

Over the long term, the total return on REITs should be equal to their current yield plus an increase equivalent to nominal GDP. REITs are

appealing just now because they have a current yield of 7%, or 3.5% more than 10-year Government of Canada bonds. This yield spread is far higher than normal because REITs in the United States are having financing problems. But Canada is not the United States. The recession has been much less severe in Canada, and sources of financing are available.

DASHBOARD

September 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 Treasuries	-
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