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AROUND THE WORLD

First contraction of global GDP since World War II

Credit woes have spread from developed countries to all regions of the world. The global economy stalled with astonishing swiftness in the fourth quarter and the outlook for the very short term remains gloomy. The leading economic indicators of the OECD countries and BRIC (Brazil, Russia, India, China) turned more negative recently, pointing to severe global downturn.

Asian economies are being battered by the combined effect on world trade of a recession in developed countries and a global financial crisis. Asian trade has taken an unprecedented pounding. China, the pivotal player among Asian trading partners, is importing 40% less than a year ago. Exports of China's Asian neighbours have been knocked for a loop as a result - witness a 35% drop in Japan and about the same in Singapore. South Korea has a current-account deficit for the first time in 11 years.

Europe is hardly in better shape. German GDP contracted more sharply in Q4 than in any quarter since 1987. For the OECD countries as a whole the downturn will be the sharpest since World War II.

Fortunately, although the global economy faces exceptional difficulties, the response of governments has seemed up to the challenge. Virtually all major economic players have launched fiscal stimulus plans of unprecedented magnitude. The major central banks have cut interest rates drastically and most are now deploying quantitative measures to revive credit and bring down market interest rates. Also without precedent is the synchronization of fiscal and monetary policies. So although the world economy is in a parlous state, this large dose of global stimulus is likely to make itself felt later this year.

UNITED STATES

U.S. authorities go all out

Times are also tough south of the border. The U.S. labour market continues to deteriorate. More than 650,000 payroll jobs were cut in February, bringing the cumulative loss for this recession to 4.4 million. Fourteen months into the downturn, the percentage contraction of employment is higher than in the 1981-82 recession, which pushed the unemployment rate to a post-WWII record of 10.8%.

Sales of motor vehicles recently plunged to an annual rate of 9 million units, the lowest since 1981. At that rate it would take 25 years to replace the existing stock of motor vehicles. Yet consumer spending on goods and services other than motor vehicles has surprised on the upside lately. Retail sales excluding autos and parts recently posted the first back-to-back increase in eight months. The big picture is still one of very fragile U.S. consumers struggling with severe job losses. Yet despite record-low confidence

and balance sheets shaken by the slump of both home prices and stock prices, U.S. consumers are still spending. Retail sales suggest that the growth of consumer spending as a whole will be much less negative in the first quarter than it was in the fourth. The recession is hardly over, but the dismal slide of retail sales in Q4 will not recur in Q1.

Meanwhile, Washington is not sitting on its hands. The U.S. central bank and government are doing everything in their power to revive the economy. The Obama administration and Congress have enacted a \$789.5-billion recovery package that includes both tax cuts and infrastructure spending. This stimulus, to be spread over two years, amounts to a substantial 5.7% of annual GDP.

And in light of increasing slack in the economy, the Federal Reserve has shifted into

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Where will all the sidelined cash go?

Volatility has been high over the last six months. With U.S. equity markets down 47% from peak at this writing, one of the worst pullbacks since the great depression, risk aversion has been almost unprecedented. The difference between the 1930s and today, however, is that 80 years ago the authorities were slow to act (some recovery measures had to wait for years after the stock market peak). This time around they have moved much more quickly and forcefully. Downside risk is limited at this point because the market has now factored in much of the bad news and the effect of massive government programs will soon be felt.

Of course a rebound in equities will prove sustainable only if it builds on solid ground. In the current environment, this implies stabilization of the U.S. housing market and of the financial system. We are much encouraged by recent developments on both fronts.

With regard to the housing market, we welcome the Obama administration's Foreclosure Prevention Program, which aims to help nine million homeowners avoid foreclosure. The total cost is estimated at \$275 billion. The first \$200 billion will go to help as many as five million owners who have little equity in their homes - or even owe slightly more than their homes are worth - to refinance mortgages through the government-controlled giants

Fannie Mae and Freddie Mac. The other \$75 billion will be used to encourage lenders to modify loan terms for people at risk of foreclosure or already in foreclosure proceedings. Lenders and government would jointly lower monthly payments to 31% of a homeowner's income. To encourage servicers, the plan includes incentives such as a \$1,000-a-year "pay for success" fee if a borrower stays current on the loan.

This measure is aimed at avoiding a new glut on the market from foreclosed homes. Taken alone, it would probably not be enough to reduce inventories. But the number of homes on the market is now falling fast. The pace of housing starts recently plunged to the lowest since the Commerce Department began keeping records on starts in 1959. That's bad news for homebuilders but good news for the economy, because it means fewer homes on the market. Moreover, the number of homes on the resale market (single-family and condos) has also receded to the lowest since May 2003. With the affordability index now at an all-time high, home inventories down considerably and starts all but stalled, our confidence that U.S. home prices will stabilize in 2009 is quite high.

Second, equity markets will not find solid footing until the financial system stabilizes. The financial industry is the

transmission belt between monetary policy and the economy.

Many hopes are invested not only in the stimulus bill recently passed by Congress but also in the Financial Stability Plan recently unveiled by Treasury Secretary Timothy Geithner. The three key initiatives of the stability plan are: (1) to test the ability of big banks to weather an even deeper economic downturn; (2) to make credit more available to consumers and businesses, with the Treasury pledging to extend the Federal Reserve's Term Asset-Backed Securities Loan Facility to existing loans; (3) to create a public-private partnership to take toxic assets off bank balance sheets. Mr. Geithner said the plan will initially aim to use public financing to create a Financial Stability Trust disposing of as much as \$500 billion in public- and private-sector buying power, with the prospect of an expansion to \$1 trillion down the road.

One thing we have noticed is that the latest market rally is different from previous ones. In the first bear-market rallies of this recession, investors primarily went after resource companies, the beneficiaries of the commodity price bubble. This time around, investors have bought into financials. This is good news to us, because equities have never rebounded from a recession without a strong

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CANADA

First recession in 17 years

Canada officially slipped into recession in the fourth quarter of 2008. The downturn is weighing ever more heavily on the labour market. At this writing Canadian employment is down 295,000, or 1.7%, from peak. Ontario has borne the brunt so far, accounting for 54% of all job losses although its share of the working-age population is only 39%. The labour market entered a new phase of weakness in February when service industries, employing 77% of all workers, shed jobs for the first time in this recession. The labour market pain is slowly but surely spreading, and Canadian employers seem to be reacting faster to darkening skies than

they did in the last two recessions. Though a 1.7% contraction of employment is far from the 3.5% of 1990-91 and the 5% of 1981-82, the current deterioration has been swifter. Since we expect the recession to last at least until midyear, we see the unemployment rate rising to about 9%. The good news, if there is any, is that the current rate of 7.7% is not that high by historical standards and workers who have kept their jobs have enjoyed an increase in purchasing power. Average hourly earnings are up 3.9% from a year ago while prices are up just 1.1%.

As in the U.S., governments have put in

place tremendous efforts to help the economy. The January 27 federal budget, together with provincial measures, will provide fiscal stimulus amounting to 1.6% of GDP. The effects - especially the effect of infrastructure building on employment - are likely to be felt in the second half of the year.

In March the Bank of Canada lowered its target for the overnight rate by half a percentage point to 0.5%, and said it did not exclude the possibility of lowering it further. One obvious key factor in this regard is stabilization of the global financial system, a precondition for economic recovery.

Neutral ... for now

For some time, analysts, institutional investors and the media have been dissecting markets under a microscope. Is a down day the sign of a new resistance point being breached? Does a day where the market rises signal the beginning of a durable rally? Of course, while hindsight is infallible, but foresight in such matters is at best an educated guess. Has the bottom been reached? No one knows for sure, but we are without a doubt an awful lot closer to it than was the case six months ago. Will markets recover and move on to post new highs? Undoubtedly, but no one really knows exactly when.

We suggest that our clients adopt a cautious stance while avoiding a "bunker mentality". It is not a time to be making big bets despite the attractive valuations we see beginning to emerge. On the other hand, unless you really can't sleep at night, avoiding the stock market altogether isn't the right approach either. We'll let our actions do the talking. The asset mix for our balanced

portfolio, which remains unchanged compared to the last quarter, shows no strong conviction with regard to any asset class in particular. We are very close to being at neutral weightings across the board.

We are very slightly underweight (-1%) in equities, with this amount parked in cash for the moment. The catalyst that will prompt us to become more positive on stocks would be more concrete signs that the health of the financial sector south of the border is improving. From a geographic perspective, we have a neutral stance with regard to the U.S. and Canada, and are slightly underweight in international stocks (-1%) - where our least favorite places to invest at this stage of the cycle is Japan.

Generally speaking, we favor companies with solid balance sheets and proven business models. A good dividend yield also gives the investor a paycheque while he or she is waiting for the equity markets to recover. At this point, we favor "early cyclicals" - sectors such

as consumer discretionary, transportation and financials - that typically do well at the beginning of an economic recovery. For the moment we are careful with regard to "deep cyclicals" such as materials, because of the softening impact the economic slowdown is having on commodity prices.

Our neutral weighting for fixed-income is more a reflection of the risk management that this asset class provides than the potential returns we expect from it. For all intents and purposes, we also maintain a neutral duration (5.5 years). Government credits (federal and provincial bonds) currently account for two thirds of our portfolio's fixed-income component. We have moved to a slight overweight position in corporate debt issued by solid companies with visible earnings (33% of our fixed-income investments versus a benchmark weighting of 28%). While we are not there yet, we see an inflection point approaching where we will want to shorten the duration of our bond portfolio because of the threat of rising interest rates.

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contribution from financials. This sector has always outperformed the rest of the market in end-of-recession rallies.

There are currently vast amounts of liquidity on the sidelines. The assets of money market funds now amount to 40% of all mutual fund assets, a 17-year high. When investor confidence returns, we expect this cash to flood back into equities. At some point in a recession - typically two-thirds of the way from economic peak to economic trough - investors stop focusing on bad news and start anticipating a recovery. We are now 15 months into a U.S. downturn that began in December 2007 and that we expect to last 20 to 22 months. In other words, we may be close to the point

at which investors start anticipating a recovery and bid equities up again. End-of-recession rallies tend to be very steep. In the last five U.S. recessions, the S&P/TSX rebounded an average 19.7% in the period from market bottom to economic bottom, then gained an average 10.9% more in the following six months.

We are encouraged by the policy announcements of recent weeks and remain confident that successful implementation of these programs will pave the way for an economic recovery later this year. In these circumstances, we believe that the massive pull-back of the past year presents an opportunity to build a well-diversified portfolio focused on value.

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overdrive. It has reiterated its intention to use all available tools to promote economic growth and has now launched a quantitative easing campaign. The U.S. central bank has announced it will buy up to \$300 billion in long-term Treasuries. To provide greater

support to the mortgage market, the Fed is boosting its purchases of mortgage-backed securities by another \$750 billion and its purchases of agency debt by another \$100 billion. Further, it will extend the range of collateral eligible for the Term Asset-Backed Securities Loan Facility.

OUR FORECAST

	2006	2007	2008	FORECAST 2009
Gross Domestic Product (%)				
Canada	3.1	2.7	0.5	-1.4
U.S.	2.8	2.0	1.1	-2.0
Inflation (%)				
Canada	2.0	2.2	2.4	0.0
U.S.	3.2	2.9	3.8	(0.1)
	March 23, 09		Dec. 09	
Short-term rates (T-Bills, 91-Day) (%)				
Canada	0.39		1.00	
U.S.	0.20		0.65	
10-year bond yields (%)				
Canada	2.66		3.33	
U.S.	2.77		3.39	
30-year bond yields (%)				
Canada	3.61		3.87	
U.S.	3.69		3.98	
Canadian dollar	U.S.\$0.82		U.S.\$0.85	
S&P / TSX Sector Rotation				
	Overweight		Underweight	
	Financials		Energy	
	Transportation		Materials	
	Consumer Discretionary		Utilities	

MODEL PORTFOLIOS

Income Portfolio

Investor Profile : You want to preserve your capital or establish a source of periodic income to finance ongoing expenses. You do not find the stock market very attractive because of its volatility, but you are not against the idea of investing a small part of your portfolio in stocks, mainly to counteract the effects of inflation. Your tolerance for risk is very low.

Asset Class	Minimum/Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 20%	10%	11%	—
Fixed-income (duration: 5.5 years) ¹	60% to 100%	70%	70%	—
Canadian equities	0% to 30%	10%	10%	—
U.S. equities		5%	5%	—
Foreign equities		5%	4%	—

Conservative Portfolio

Investor Profile : On the whole, you want your portfolio invested in fixed-income securities. Although you can tolerate limited volatility to ensure that your assets will grow, you prefer having a portfolio consisting mainly of fixed-income investments for reasons of stability. Your tolerance for risk is low.

Cash equivalents	0% to 15%	5%	7%	—
Fixed-income (duration: 5.5 years) ¹	50% to 80%	60%	60%	—
Canadian equities	20% to 45%	10%	10%	—
U.S. equities		10%	10%	—
Foreign equities		10%	9%	—
Alternative investments ²	0% to 10%	5%	4%	—

Balanced Portfolio

Investor Profile : You give equal weight to income and capital growth. You can tolerate moderate volatility to ensure the growth of your capital, but you prefer having a portfolio with a significant exposure to fixed-income securities for reasons of stability. Your tolerance for risk is average.

Cash equivalents	0% to 20%	0%	3%	—
Fixed-income (duration: 5.5 years) ¹	30% to 65%	50%	50%	—
Canadian equities	30% to 65%	15%	15%	—
U.S. equities		15%	15%	—
Foreign equities		10%	9%	—
Alternative investments ²	0% to 15%	10%	8%	—

Growth Portfolio

Investor Profile : Your main goal is capital growth. Although you can tolerate greater volatility in order to increase the value of your assets, you are not prepared to invest your entire portfolio in stocks. Your tolerance for risk is high.

Cash equivalents	0% to 25%	0%	4%	—
Fixed-income (duration: 5.5 years) ¹	25% to 45%	35%	35%	—
Canadian equities	40% to 75%	20%	20%	—
U.S. equities		15%	15%	—
Foreign equities		15%	14%	—
Alternative investments ²	0% to 20%	15%	12%	—

Maximum Growth

Investor Profile : You want to maximize the eventual return on your capital by investing all or most of your portfolio in the stock market. In doing so, you accept higher volatility of your investment returns in the hope that these returns will ultimately be higher. Your tolerance for risk is very high.

Cash equivalents	0% to 30%	0%	5%	—
Fixed-income (duration: 5.5 years) ¹	0% to 30%	20%	20%	—
Canadian equities	55% to 100%	20%	20%	—
U.S. equities		20%	20%	—
Foreign equities		20%	19%	—
Alternative investments ²	0% to 25%	20%	16%	—

1) Includes conventional and real return bonds. Benchmark = 75% SC Universe Index, 25% SC RRB Index

2) Includes hedge funds and real estate. Benchmark = 50% Tremont Hedge Fund Index, 50% S&P TSX Cap REIT Index

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