

In this issue ...

Page 1

- Around the world: The green shoots put down roots
- United States: The recession ends

Page 2

- Capital Markets: Higher risk tolerance leads investors to growth
- Canada: Set for growth

Page 3

- Asset Mix: A Quest for the elusive entry point
- Our Forecast

Page 4

- Model Portfolios: asset mix, geographic diversification and duration for five individual investor profiles

AROUND THE WORLD

The green shoots put down roots

After months of surprising on the downside, the tide of the global economy has turned to upside surprises. The shift reflects the pass-through from a very significant improvement in the credit markets of both developed and developing nations. Economic activity is still well below the pre-crisis level, but the government backstops put in place earlier this year have allowed commercial banks to resume their role as the transmission belt for monetary policy.

In the main industrialized countries, the OECD leading economic indicator (LEI) surged 1.4% in July, the largest monthly increase in 34 years. As a result, the six-month change in the indicator (our preferred gauge of momentum) jumped into positive territory for the first time since 2007. July was the first month in more than two years in which the LEIs of both the OECD and the BRIC (Brazil, Russia, India, China) economies were positive. The six-month change of our global composite LEI (70% OECD,

30% BRIC) is now running at 7% annualized, suggesting a very strong possibility of above-trend global growth through early 2010.

Emerging economies will play an important role in sustaining the global recovery. In China, strong domestic demand, buoyed by very sizeable fiscal stimulus and a surge in lending by domestic commercial banks, propelled the country's GDP to a Q2 rebound from the worst performance in a decade. Chinese auto output was up a staggering 50% year-over-year. The four emerging Asian economies that have reported second-quarter GDP (China, Indonesia, South Korea, Singapore) expanded during the quarter at an annual rate averaging more than 10%. Since manufacturing weighs heavily in these economies, they are well-positioned to benefit from inventory rebuilding in the more mature economies over the coming months. This will limit the downside of many industrial commodity prices.

UNITED STATES

The recession ends

The U.S. economic backdrop has improved markedly in recent months, so much so that GDP is poised to expand in the third quarter as producers start rebuilding inventories.

The vigour of the recovery will depend greatly on how fast the job market returns to normal. At this point the U.S. is still shedding jobs, but at a much slower pace. The August payroll contraction of 216,000 was the smallest in 12 months (earlier this year the monthly loss topped 700,000). The most encouraging number in the report was total hours worked, which rose for the first time in about a year. At this point in the cycle, companies are responding to a pickup in orders by asking their current staff to work longer hours. Such an increase in labour intensity normally precedes rehiring.

Of course, the economic benefit of a rise in take-home pay will be impaired if homes continue to lose value. However, the most recent evidence suggests that home prices are finally stabilizing.

The Case-Shiller index shows a rise of 0.7% in June, the largest since December 2005. This is welcome news for highly leveraged U.S. homeowners, since it is hard to be confident about the future when the market value of one's largest asset (or liability) continues to fall. With home prices stabilizing and the wage bill no longer shrinking, a sustainable recovery appears likely.

But debate continues about the reliability of the signals from leading economic indicators. For some pundits, the predominance of financial variables (stock market, money supply, interest-rate spread) in the rise of the composite LEI since the end of March means that the recovery signal could prove fleeting unless it is soon confirmed by nonfinancial indicators. Data recently released by the Conference Board are very encouraging in this regard: the contribution of nonfinancial components to the six-month change in the LEI turned positive in July for the first time since the onset of the U.S. recession.

Higher risk tolerance leads investors to growth

Global equity markets have been on a wild upswing since March. Equities always rally strongly toward the end of a recession, and this time around is no exception. At this writing, both the S&P 500 and the S&P/TSX show cumulative gains of more than 50% since March 9.

Valuation measures are up sharply as a result of the rally. Last March the S&P 500 was trading at about 10.7 times 12-month forward earnings and the S&P/TSX at 10.2 times. At this writing, the forward P/E of both indexes have increased to almost 14.

Despite the huge rebound, we cannot say the rally is overdone. Such increases in valuation are not abnormal at the end of a recession. In the last 14 U.S. recessions, the forward P/E of the S&P 500 climbed on average from 11.2 at market bottom to 13.4

at economic bottom. A year later, the multiple was above 16.

In the last five U.S. recessions, the Canadian (S&P/TSX) ratio of price to reported earnings, after declining from an average 12.9 at onset of recession to 10.5 at market trough, climbed back to 12.7 at the economic bottom and to 15.1 a year later.

Thus the recent expansion of multiples has followed the historical pattern for the latter part of a recession. If history is a guide, there is room for further P/E expansion over the next few months. We do not see current valuations as overstretched in the current low-interest environment.

Investors are keeping an eye on earnings as well as valuation. Q2 earnings of the S&P 500 companies came in 10.0% above expectations, more than the Q1 surprise of

7.5% and much more than the post-1994 average of 1.6%. The Canadian surprise was almost as substantial at 9.4% above expectations. But investor attention is now turning to the third quarter. Is there another earnings surprise in store?

The much-better-than-expected earnings of Q2 were a product of substantial cost cutting. In top-line growth the surprise was less than the historical average. With cost-cutting pushed to the limit, we expect that the focus of attention in Q3 will turn to revenue growth. If economic growth resumes in Q3 and if households - at least the 90% of households whose members still have jobs - are comfortable with their new, higher savings rate, consumption will grow in line with disposable income.

Bracing for a shift in growth vectors

The financial sector of North American equity markets (especially banks) has had a great ride since the March 9 market trough. The U.S. banking index has shot up more than 150% and the Canadian bank index has doubled.

While we think financials are poised to continue doing well in the first phase of economic recovery, their recent rise has greatly reduced their potential to outperform the market. The Canadian banking index is now trading only 17% below its 2007 peak. By comparison, the global banking index is still 49% below its previous peak.

Moreover, Canadian banks are not as cheap as they used to be. The rally has pushed their price-to-book ratio to 2.1, roughly twice that of most developed countries. In all fairness, Canadian banks still offer a much better dividend yield than banks of other major countries - 4.4%, versus 2.7% for the world banking index. At this point, we would advise prudence with regard to the financial sector. After all, nobody ever got poor taking profits.

Since the March 9 trough, investors have been shunning defensive plays and buying

CANADA

Set for growth

In Canada, the labour market is not yet out of the woods but recent data suggest that the economy turned the corner this summer. The private sector, having lost a cumulative 462,000 jobs since the onset of the recession, added jobs in August for the first time in 11 months. The gain was the largest since January 2008, months before the recession began. New hiring by business employers is a sign of economic recovery under way in Canada.

There is also good news on the housing front. The Canadian Real Estate Association reports a sixth monthly increase in existing-home sales in July (2.5%). Moreover, new listings have continued to trend down as sales have risen, turning the buyer's market of January into a balanced market. This development is likely to keep home-price deflation in check.

One factor that helped put the housing market back on track was accommodative monetary policy. The resulting easy access to credit has also fostered a rebirth of consumer spending. Though factory output remains

extremely depressed, significant improvement is likely in the next few months as growth resumes in the economies of our trading partners. We expect an expansion of Canadian real GDP in Q3.

Though the outlook is improving, the Canadian dollar continues to challenge exporters. The loonie's recent appreciation to 94 cents US seems slightly overdone, since the prices of natural gas and other key commodities exported by Canada are under pressure. Moreover, part of the Canadian dollar's strength is due to weakness of the greenback. With the end of the financial crisis near, we think the USD will soon cease to trade on risk aversion vs. risk appetite and return to basics, with a focus on the U.S. economic cycle. The keystone of our currency scenario is the imminent return of employment growth south of the border, forcing markets to price in Fed rate hikes. In the short term at least, these cyclical forces are likely to give the USD a second wind.

A Quest for the Elusive Entry Point

The summer months have tended to confirm that this spring's "green shoots" did in fact herald the start of an economic recovery, and major market indices are up by close to 50% over the last six months. This begs an important question: is it too late to increase one's exposure to equities in order to capture the upswing stocks usually offer once the end of a recession is in sight? Many investors look for an "entry point" before investing - a dip that brings stock prices momentarily lower once the overall upward trend is confirmed. The risk with this approach is that the dip never happens, the entry point fails to materialize, and you are stuck buying back into the market when the "easy gains" have already been harvested. We think this could well be the case today.

While warning about the danger of throwing caution to the wind following the emergence of green shoots, in our last issue of *Investment Strategy* we moved from a neutral to an overweight position in equities. Looking forward to the final quarter of 2009, we are very comfortable maintaining this overweight position in equities, even with the strength of the market rebound we have

(CONTINUED PAGE 2 « Capital Markets »)

the stocks that declined most in the bear market. Low-beta stocks are out and higher-beta stocks are in. These are also the stocks whose earnings have rebounded the most in 2009 - mainly financials and IT. As is usual in end-of-recession rallies, these two sectors have shown both the best earnings growth and the best stock price performance of S&P/TSX sectors in 2009.

Over the next few weeks, investor attention can be expected to shift from 2009 to 2010 earnings. As economic expansion gets under way, the baton of growth will pass to different sectors. The consensus of analysts sees next year's strongest earnings growth in energy, materials and consumer discretionary stocks.

We see resource producers attracting investor attention. True, resource stocks are up 46% from the trough, but forward-looking

experienced over the last six months. Our fourth quarter asset mix remains unchanged compared to that for Q3. To reiterate, for our balanced model portfolio, we are overweight our benchmark for equities (+3%), underweight cash (-1%) and bonds (-2%). The table on the following page will give you the current recommended asset mixes for our four other model portfolios.

In terms of geographic allocation, we are positive on the U.S. since we think our neighbours to the south will benefit most from the abatement of the credit crunch. With its concentration in energy, materials and financial services, the Canadian market still attracts us, although as mentioned earlier, we think that a lot of the upside from Canadian financial stocks has already been delivered. We are generally less positive on Europe and the Far East at this point, although we think that emerging markets continue to offer good potential. Earlier this year we adopted an "end of recession" strategy favouring early cyclicals and Financials, which typically do well at that stage of the cycle. As mentioned below, we think the time has come to look to sectors that stand a good chance of outperforming in

indicators suggest considerable remaining upside. As noted above, global leading indicators are pointing up and many countries (Germany, France, Japan) surprised the market by reporting GDP growth in Q2.

Moreover, global industrial production surged 2% in June, the strongest monthly increase in at least 18 years. A key concern in recent months has been that a pickup in production due to fiscal stimulus and/or the vain hope of inventory rebuilding would soon wane unless it were accompanied by a resumption of global trade flows. Fortunately, the goods being produced seem to be moving again. Global trade rose 2.5% in June. Its revival suggests that the recovery is taking hold. At this juncture, we think the ample liquidity still being provided by central banks and governments in various parts of the world will make for a sustainable global recovery that will support demand for resources.

the next leg of the rally. At this point we are overweight in the Energy, Information Technology and Consumer Discretionary sectors, market weight in Industrials, Materials and Financials, and underweight in Consumer Staples, Telecommunication Services and Utilities.

For our model portfolio's fixed-income component, our slight underweight position is combined with a duration that is neutral compared to the DEX Universe Index duration of 5.9 years. For some time now, we have been overweight corporate bonds and underweight federal issues, a strategy that has served us well to date. While intending to maintain an overweighting in corporate debt, we think the time has come to reduce the beta of our bond exposure take some profits in these securities and deploy these amounts towards provincial issues.

OUR FORECAST

| | 2007 | 2008 | FORECAST | |
|---|--------|------------------------|-------------------|------------------|
| | | | 2009 | 2010 |
| Gross Domestic Product (%) | | | | |
| Canada | 2.7 | 0.5 | (2.1) | 2.9 |
| U.S. | 2.0 | 1.1 | (2.3) | 3.0 |
| Inflation (%) | | | | |
| Canada | 2.2 | 2.4 | 0.4 | 1.9 |
| U.S. | 2.9 | 3.8 | (0.4) | 2.2 |
| Sept. 23, 2009 Sept. 2010 | | | | |
| Short-term rates (T-Bills, 91-Day) (%) | | | | |
| Canada | | 0.26 | | 1.92 |
| U.S. | | 0.10 | | 1.92 |
| 10-year bond yields (%) | | | | |
| Canada | | 3.42 | | 4.24 |
| U.S. | | 3.42 | | 4.29 |
| 30-year bond yields (%) | | | | |
| Canada | | 3.93 | | 4.47 |
| U.S. | | 4.20 | | 4.53 |
| Canadian dollar | | U.S.\$0.92 | | U.S.\$0.92 |
| S&P / TSX Sector Rotation | | | | |
| Overweight | | Underweight | | |
| Consumer Discretionary | Energy | Information Technology | Telecommunication | Consumer Staples |
| | | | 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 |
|---|-----------------|-----------|-----------------------|
| Cash equivalents | 0% to 20% | 10% | 10% |
| Fixed-income (duration: 5.9 years) ¹ | 60% to 100% | 70% | 68% |
| Canadian equities | 0% to 30% | 10% | 11% |
| U.S. equities | | 5% | 6% |
| Foreign equities | | 5% | 5% |

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% | 4% |
| Fixed-income (duration: 5.9 years) ¹ | 50% to 80% | 60% | 58% |
| Canadian equities | 20% to 45% | 20% | 22% |
| U.S. equities | | 7.5% | 10% |
| Foreign equities | | 7.5% | 6% |

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% | 5% | 4% |
| Fixed-income (duration: 5.9 years) ¹ | 30% to 65% | 45% | 43% |
| Canadian equities | 30% to 65% | 25% | 28% |
| U.S. equities | | 10% | 12% |
| Foreign equities | | 10% | 8% |
| Alternative investments ² | 0% to 15% | 5% | 5% |

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% | 0% |
| Fixed-income (duration: 5.9 years) ¹ | 25% to 45% | 35% | 30% |
| Canadian equities | 40% to 75% | 25% | 30% |
| U.S. equities | | 15% | 18% |
| Foreign equities | | 15% | 12% |
| Alternative investments ² | 0% to 20% | 10% | 10% |

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% | 0% |
| Fixed-income (duration: 5.9 years) ¹ | 0% to 30% | 20% | 15% |
| Canadian equities | 55% to 100% | 25% | 29% |
| U.S. equities | | 20% | 23% |
| Foreign equities | | 20% | 18% |
| Alternative investments ² | 0% to 25% | 15% | 15% |

1) Includes conventional and real return bonds. Benchmark = 75% DEX 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