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AROUND THE WORLD

Heading for a synchronized recovery

The global economy is back on a growth track after the worst recession in more than 60 years. Over the past year, the world's central banks and governments have pulled out all the stops to loosen up credit markets. Their massive injections of liquidity have had the desired effect. An extreme credit crunch has largely dissipated since the beginning of the year, and renewed appetite for risk has brought lending conditions back closer to normal, allowing ultra-accommodative monetary policies to have more impact. Economic growth resumed this fall in many countries and regions.

Internationally, leading indicators of the OECD economies point unequivocally to recovery over the coming quarters. The indicators of the BRIC countries (Brazil, Russia, India and China) were the first to turn up, and they are now heralding stronger growth than at any time in the previous cycle. Indicators for the OECD economies are also following this trend, bolstering an outlook for

synchronized growth next year.

External demand has been responsible for pulling the euro zone out of recession, however marginally, since domestic demand remains stagnant. Businesses have kept employees on their payrolls despite the economic contraction, but are unlikely to resume hiring anytime soon. The European banking system is still grappling with the aftermath of the financial crisis. For these reasons, domestic demand is likely to recover later in Europe than elsewhere.

Global economic growth of about 4% seems increasingly probable next year. In contrast to previous cycles, this global recovery will be spearheaded by emerging countries. These economies now produce more than half the world's output, and will account for more than two-thirds of the global growth anticipated for 2010. The prevailing winds will blow from Asia and especially from China and India. Emerging Asian economies are expected to expand by almost 8%.

UNITED STATES

Turning the corner

The U.S. economy is finally emerging from its longest contraction since 1929-33. In conjunction with federal stimulus spending, the Federal Reserve's direct intervention in financial markets to fill the void left by private lenders has played a pivotal role in reviving growth. The turnaround required stabilization of the housing market and normalization of financial markets — extraordinary monetary and fiscal measures taken have delivered on both counts.

The U.S. home-resale market is on a clear

and strong recovery path. The index of pending home sales has been on the rise for nine straight months. Existing-home sales now exceed 5.5 million units annually, the fastest pace witnessed since July 2007. Home-price deflation also seems to be a thing of the past — the Shiller price index has been trending upward since May. With homes typically representing a household's biggest investment, an improving U.S. housing market is sure to buoy consumer confidence.

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A year of recovery

2009 has been an eventful year for investors, with markets beginning in a deep slump and moving on to a spectacular rebound. At the beginning of the year, the credit market paralysis and extreme financing rates that followed the Lehman Brothers debacle of September 2008 had given rise to fears of a severe economic downturn that could verge on depression. At the market bottom in March 2009, the major North American stock indexes were down more than 50% from their pre-slump peaks — the worst bear market since the 1930s. In contrast to the Great

Depression, however, governments and central banks were quick to respond. With unprecedented coordination, authorities in many countries launched monetary and fiscal stimulus programs and took action to get credit flowing again.

Investor confidence has been boosted by signs of economic recovery and improved corporate earnings. Equities always rally strongly toward the end of a recession and this cycle has not been any different. As of this writing, the S&P 500 and the S&P/TSX indexes are up more than 50% from their March 9 lows.

After the worst plunge in decades, U.S. profits are about to rebound on the wings of economic recovery. The coming year will be all about a return to earnings growth, and more specifically, about how well companies exploit the budding expansion. For 2010, consensus sees earnings growth of 25.4% in the U.S. and 26.5% in Canada. It should be kept in mind that rebounds of 25% plus are not unheard of in post-recession periods.

We are also keeping an eye on revenue expectations. We have said in the past that it was a good thing U.S. companies were busy cutting costs. This made them more productive. But cost-cutting alone will not sustain a recovery; top-line growth is needed if employment is to increase down the road. Companies are now lean — the aggregate profit margin of non-financial corporations currently stands at 10%, rather high for the end of a recession. An uptick in sales will give bottom lines a big boost. Earnings are expected to start growing again in the fourth quarter of 2009, and the consensus is for average year-over-year revenue growth of 6.8% in the quarters from Q4 2009 to mid-2011. This is lower than the 2005-08 average of 9.6%, a difference consistent with our view that economic expansion will be slower than in the last cycle.

The big challenge of 2010 will be to solidify the budding economic recovery. After a year in which governments reacted swiftly and stepped in as never before, private enterprise will have to put its shoulder to the wheel in 2010. A turnaround in the labour market will be key to consumer confidence and thus to corporate profitability. In any event, equities typically deliver greater returns than other assets in the months preceding and following an economic bottom. The evidence of incipient expansion bodes well for stock market investors in 2010.

CANADA

Recovery under way

While the U.S. recession was the longest since the 1930s, the downturn in Canada was much shorter and somewhat less painful. The global financial crisis left less of a dent here than elsewhere in the world. Domestic demand contracted by a total of 2.8% across two quarters in Canada, compared to about 4% across six quarters in the United States. Thanks to the solvency of our country's banking system and timely easing by the Bank of Canada, the economy is now recovering, spurred by a labour market that is improving more quickly than that of the United States.

The Bank of Canada has pledged not to raise interest rates before mid-2010 if inflation follows its forecast. As the recovery gains momentum, however, the Bank will find it increasingly difficult to justify maintaining real rates so low for so long, particularly given that the financial crisis is over in Canada, and an extended period of monetary accommodation is no longer required.

Depreciation of the U.S. dollar has no doubt been a factor in the recent

strength of the Canadian currency, but keen foreign demand for Canadian financial assets has also had an impact. Federal public finances — notably a debt-to-GDP ratio in the neighbourhood of 30% — are the envy of the G 7 countries. The loonie has consequently become a prized currency among foreign investors, all the more so in a time of global recovery.

A faster U.S. employment rebound than anticipated by financial markets and a concomitant rise in interest rates are likely to buoy the U.S. dollar against a wide range of currencies. This development should dampen upward pressure on the loonie in the coming quarters, but the resulting shot in the arm to manufacturers promises to be short-lived. We expect the loonie to pick up strength again in the second half of the year, finishing 2010 in the vicinity of 94 cents U.S.

All things considered, we expect Canada's GDP to grow by almost 3% in 2010. After the cyclical rebound, growth is likely to cool in 2011 to a cruising speed of about 2%.

Steady as she goes — We maintain our overweight position in stocks

With indications of an economic recovery multiplying, we see no reason not to maintain the overweight position in equities our reference portfolios have had for the past two quarters. This decision is essentially prompted by two considerations. First, while stock markets have rewarded investors with returns of 50% or more since the lows of March 2009, we still feel there is still good potential remaining for this asset class. Second, we see little to be excited about with regard to the returns expected from cash and fixed income.

There is still plenty of cash sitting on the sidelines waiting to be moved back into the stock market, and eventually investors will tire of historically low yields and regain appetite for assets that are riskier, but offer the potential for higher returns. Economies are growing again, risk aversion is abating, and we anticipate that the world's equity markets will gain lift from earnings growth that should exceed expectations. As in the previous quarter, we have overweight positions in Canada and

the U.S. with a corresponding underweight in Europe. We also think emerging markets are an attractive proposition for investors who are willing to accept the higher volatility that goes with the stronger growth expected from these markets.

As economic expansion gathers momentum, the torch will pass from one group of industries to another. Analysts expect the strongest earnings improvements to come from the energy, materials and consumer discretionary sectors. With the exception of the gold mining industry (71% of the materials sector in Canada), these are our preferred sectors. We have doubts about the viability of the recent bullion rally. Since we think U.S. employment may soon start growing again and interest rates could start rising sooner than the market expects, we believe the U.S. dollar will gain support at the expense of bullion.

We also reiterate our recommendation to underweight defensive and interest-sensitive sectors such as consumer staples and

utilities. In an environment of stronger economic growth and rising interest rates, these two sectors are poised to lag the market. We would also underweight telecommunications services. Telecommunications is expected to post the slowest growth of the 10 S&P/TSX sectors.

On the fixed income side, we remain underweight federal bonds — in our opinion the increased yields offered by provincial bonds more than compensate the slight increase in risk. With spreads narrowing, we have trimmed our exposure to corporate bonds a little. We remain positive on the outlook for carefully selected high-yield bonds. Finally, as a defensive move in anticipation of interest rate increases that should be in the cards some time in 2010, we have slightly reduced our duration.

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However, the U.S. labour market was hit hard by the recession. From the economic contraction's onset in December 2007 to its bottom in the third quarter of 2009, employment shrank by more than 7.2 million. Employers acted more quickly to lay off workers than in previous recessions. Faced with an adverse financing environment, companies feared that the downturn would be much worse than it actually turned out to be. Since these companies' labour forces are now overextended, stronger demand should translate quickly into rehiring.

Payroll employment stabilized in late 2009. We have been especially encouraged by the first increase in service jobs since the onset of recession, and the first

notable lengthening of the workweek in a very long time. Increased worker intensity and a continuing rise in hourly earnings translate into a rising aggregate wage bill — a key development because it puts households in a position to sustain their spending, which in turn exerts a beneficial impact on the economy. In our view, a return to lasting employment growth is just around the corner. The latest employment report should reassure investors about the outlook for U.S. profits.

With fiscal and monetary policy providing strong support for the economy and with financial markets now stabilized, the outlook for 2010 is positive. We expect the U.S. economy to grow 3.4% next year, and core inflation to remain subdued.

OUR FORECAST

	2008	2009	FORECAST	
			2010	2011
Gross Domestic Product (%)				
Canada	0.4	(2.5)	2.9	2.2
U.S.	0.4	(2.5)	3.4	2.2
Inflation (%)				
Canada	2.4	0.3	1.6	2.0
U.S.	3.8	(0.3)	2.3	2.5
Dec. 14, 2010 Dec. 2010				
Short-term rates (T-Bills, 91-Day) (%)				
Canada	0.35		1.46	
U.S.	0.07		1.43	
10-year bond yields (%)				
Canada	3.40		4.10	
U.S.	3.63		4.23	
30-year bond yields (%)				
Canada	4.01		4.36	
U.S.	4.54		4.79	
Canadian dollar	U.S.\$0.94		U.S.\$0.90	
S&P / TSX Sector Rotation				
Overweight		Underweight		
Consumer Discretionary	Energy		Consumer Staples	Telecommunication
Information Technology			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: 5.8 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.	Asset Class	Minimum/Maximum	Benchmark	Recommended Weighting
	Cash equivalents	0% to 15%	5%	4%
	Fixed-income (duration: 5.8 years) ¹	50% to 80%	60%	58%
	Canadian equities	20% to 45%	20%	23%
	U.S. equities		7.5%	9%
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.	Asset Class	Minimum/Maximum	Benchmark	Recommended Weighting
	Cash equivalents	0% to 20%	5%	4%
	Fixed-income (duration: 5.8 years) ¹	30% to 65%	45%	43%
	Canadian equities	30% to 65%	25%	29%
	U.S. equities		10%	11%
	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.	Asset Class	Minimum/Maximum	Benchmark	Recommended Weighting
	Cash equivalents	0% to 25%	0%	0%
	Fixed-income (duration: 5.8 years) ¹	25% to 45%	35%	30%
	Canadian equities	40% to 75%	25%	31%
	U.S. equities		15%	17%
	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.	Asset Class	Minimum/Maximum	Benchmark	Recommended Weighting
	Cash equivalents	0% to 30%	0%	0%
	Fixed-income (duration: 5.8 years) ¹	0% to 30%	20%	15%
	Canadian equities	55% to 100%	25%	30%
	U.S. equities		20%	22%
	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