Monthly investment commentary

January 2010

2009 HIGHLIGHTS – BY THE NUMBERS*

55.2% - the rise in the S&P/TSX since the March 9, 2009 low (the S&P500 rose almost 65%).

1979 - the last time the S&P/TSX had a yearly gain greater than 30.7% (the 1979 return was 38%).

87% - the portion of S&P/TSX returns that came from the Financial, Energy and Materials sectors.

323% - the amount Canadian base metal stocks rose.

27% - the gain in the price of gold bullion (Canadian gold stocks only rose 5.7%).

-17.4% - the currency effect on the S&P500 for Canadian investors. The Canadian dollar rose 15.9% to end the year at $0.95(U.S.).

83% - the portion of the Canadian bond market return that came from corporate bonds (they rose by 16.3%).

-0.2% - the Government of Canada bond index return.

0.18% - the average annual yield on a 3-month T-bill at December 31, 2009.

$1.4 trillion (U.S.) – the size of the U.S. Federal deficit in 2009. It was $459 billion in 2008.

7.2 million – the number of jobs lost in the U.S. since the end of 2007 (versus only 158,000 in Canada over the same time period).

13 million – the number of vehicles bought in China in 2009, making the Chinese the largest purchasers of cars in the world (vs. approximately 10 million in the U.S.).

*Source: Andersen Economics, Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

CAN YOU BELIEVE IT!

A mere twelve months ago investor sentiment was something akin to 'going to hell in a handbasket'; corporate America shelved its five-year strategic plans for five-week survival plans; and it seemed nothing short of Pollyannaish to be thinking about equity markets ending the year flat in 2009, let alone hope for 20-30% annual equity gains.

Sure - we are still a far way from recouping 2008 losses. Yes - the weakening U.S. dollar has created a significant drag on foreign investments. And no - we haven't solved all the world's economic woes. But one year later, investors can look back with satisfaction at a pleasantly surprising year of strong world markets!

Table 1– Summary of major market developments

Market returns*	Q4 2009	YTD
S&P/TSX Composite	3.1%	30.7%
S&P500	5.5%	23.5%
- in C$	*3.2%*	*6.1%*
MSCI EAFE	2.9%	20.9%
- in C$	*0.3%*	*10.1%*
MSCI Emerging Markets	6.9%	58.7%
DEX Bond Universe**	-0.2%	5.4%
BBB Corporate Index**	1.1%	18.9%

*local currency (unless specified); price only
**total return, Canadian bonds
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

NUMBERS DON'T LIE, BUT…

All major world markets rebounded in 2009 (see Table 1) as improving economic data began rolling in around March. The more notables include the MSCI Emerging Markets index which ricocheted to end the year up 58.7% (of note, it was down 47.3% in 2008), followed by the Canadian S&P/TSX whose non-stop rally since early March took it up 31%, its best one-year gain since growing by more than 38% in 1979.

Numbers don't lie. In the investment business we live and die by numbers. Quite frankly, we tend to love numbers more than most (see 2009 Highlights)! But we know that numbers don't always tell the whole story. Take the numbers in Table 1 for example, nowhere does it even hint that 2009 started with investors fearing the global financial system was on the verge of collapse. It was only after the capital markets hit their trough in March that the price of global equities, corporate and government bonds, and commodities all marched steadily higher. Nor does Table 1 give any real sign of the 'low quality' rally that saw 2009's rising tide lifting some ships higher than others. The more sold-off an asset had been (i.e. for companies that tended to mean the closer they were to collapsing), the higher it rose as investors (almost indiscriminately) added risk back into their portfolios. Nor does our summary of results in Table 1 highlight that so many retail investors, still shaken by the recency of severe stock market volatility, poured money into bond funds, foregoing longer-term growth prospects in spite of the rapidly improving outlook for equities.

RATE AND SEE

Thankfully, the Canadian bond market also had a relatively strong year. The increased investor demand for corporate bonds and the dramatic narrowing of spreads from historically high levels (virtually an exact reversal of 2008's response to credit concerns) helped spur a rally in corporate bonds. In fact, though corporate bonds only represent a little over a quarter of the Canadian bond market (27.5% of the DEX Bond Universe), corporate bonds represented 83% of the index's 5.4% return in 2009. Had you held only Government of Canada bonds in 2009 (the so called 'risk-free' bet), you would have actually lost money.

Bond investors may be interested in knowing that despite near-zero central bank rates, bank lending conditions are still tight. Don't get us wrong, they are a whole lot better than last year, but still nowhere near what we might call 'normal'. Simply put, it's just not as easy at it used to be to borrow money. And while the Canadian yield curve steepened in 2009, it is more a reflection of central banks continuing to keep short-term rates anchored at low levels, rather than any inflationary concern being priced into longer term bonds. So while 2010 may still see corporate bond spreads narrow a bit further (creating some capital appreciation opportunities for corporate bonds), the overall low yield environment will remain a headwind for fixed-income investment returns in 2010.

CANADIAN MARKET HIGHLIGHTS

The broad Canadian index (see Table 2) shows all ten sectors were positive for the year, but it's interesting to note that the bulk of the returns in 2009 came from the Financials, Energy and Materials sectors – the three largest sectors in the index by weight.

- The Financials sector (particularly helped by the revival of the banks) made all of its gains in the second and third quarters of the year – a redemption after having been at the centre of the financial firestorm.
- The Energy sector was buoyed by oil prices which more than doubled in 2009 and ended the year up 102% at $79.31/barrel (West Texas, in U.S. dollars).
- A strong rebound in base metals stocks from very depressed levels helped the Materials sector rise more than 30% in 2009. Base metal stocks led the way with a huge 323% climb! Unprecedented levels of Chinese imports, new investor cash, improving economic data, and a weaker U.S. dollar combined in 2009 to significantly boost the price of commodities. The price of copper for example, more than doubled in 2009.
- Of interest, despite the rise in gold bullion prices, Canadian gold stocks rose less than 6%. The gold sub-industry group was a strong performer during the first quarter but lagged for the remainder of the year as investors saw better opportunities elsewhere.
- The Telecommunications sector was the laggard in 2009 as concerns over competitive pressures (such as the entrance of Globalive Wireless as a new player in the Canadian market) dampened investor's outlook for the sector.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	Dec.	Q4 2009	YTD
S&P/TSX	2.6%	3.1%	30.7%
Energy	4.6%	4.6%	35.0%
Materials	-3.6%	6.0%	33.4%
Industrials	6.8%	8.1%	23.7%
Consumer discretionary	5.3%	5.2%	11.1%
Consumer staples	3.1%	7.7%	6.1%
Health care	1.3%	-3.0%	28.6%
Financials	2.2%	-1.8%	38.3%
Information technology	14.8%	0.8%	44.3%
Telecom services	2.8%	6.0%	0.7%
Utilities	7.5%	11.7%	12.7%

*price only
Source: National Bank

IN 2010 THE BURDEN OF PROOF IS HIGHER

Global economic indicators are currently signaling that an economic recovery is underway. Emerging economies continue to impress with strong growth prospects, and a particularly good sign has emerged from the U.S., where finally we see some stabilization in both house prices and employment data. Canada is showing increases in economic activity as well. If expectations for fourth quarter Canadian

GDP growth hold true, this will be the first meaningful economic advance since the fourth quarter of 2007. Canada is well ahead of the U.S. in its job market recovery, and our housing market has shown remarkable resiliency.

While we expect an improving economic climate in 2010, the global recovery is still dependent on government life-support. But money cannot be created without limit and stimulus programs will eventually wind down. Many governments will confront difficult decisions about how fast to start withdrawing the huge support they provided to keep the financial system going, all the while knowing that large deficits, heavy consumer debts and stubborn unemployment remain key issues. After two years of economic drama and rollercoaster markets, one can hope for the delights of dullness, but there will no doubt be a few bumps along this road to recovery.

The past year has been first and foremost about short-term survival. In 2010 the challenge for companies will be to refocus on the longer-term – the harder part of the recovery. Better than expected earnings (reflecting aggressive cost cutting) supported the climb in stock markets from their March 2009 lows. However future earnings growth will need to come from better sales, not just cost cutting, to sustain the market's recovery. Investors are likely to be much more selective in what they buy, with a distinct bias towards high-quality stocks with solid fundamentals. In short, the burden of proof for companies is now higher.

THE CAT, THE CLIFF DIVER & THE LOTTERY WINNER

As is customary for this time of year, we take some lessons from 2009, and work towards some resolutions to make 2010 a more successful year.

1/ Plan ahead. We know this won't be the last time we see severe market volatility, so you might as well plan for it. Creating a realistic investment plan designed to help you through all market environments can do wonders by preventing you from making rash, emotional decisions at the heat of the moment. So figure out your risk tolerance, know your time horizon, and diversify your assets. And there is no time like the present for doing that. The time to purchase house insurance is before your house catches on fire – so plan ahead and start today.

2/ Stick to your guns. Especially during times of turmoil, when everything seem to be going against you, as it inevitably will from time to time, you have to stick to the underlying strategy. It's the only way to ensure you will be there for the recovery. Far too many investors missed the strong gains of 2009 because they had stepped out of the market, awaiting the all clear sign to step back in. In 2009, even after 10%, 20%, 30%+ gains, there was still no definitive 'all clear' sign. Think of Thomas Edison, the famous inventor, who once wrote, "Many of life's failures are people who did not realize how close they were to success when they gave up." It is at that very moment when things feel at their worst, that we should be most vigilant in sticking with our long-term investment plans. N.B. resolution #2 tends to be easier after you've taken care of resolution #1.

3/ Don't time the market. Since no one can accurately predict the future, the nature of market timing is an extremely risky endeavour. Ironically, it's usually done by people who are trying to avoid the risk – the risk of losing or the risk of losing out. Think about this, to have perfectly timed and reaped all the rewards of 2009 you would have had to have had the reflexes of a cat, the nerve of a cliff diver and the luck of a lottery winner. Know anyone? Me either.