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## AROUND THE WORLD

# The world has changed!

Though the U.S. economy has decelerated sharply over the last six months, the global economy has continued to expand quite robustly. This is due especially to strong growth in rapidly emerging economies such as those of the BRIC countries (Brazil, Russia, India, and China). Russia and Brazil are riding the run-up of commodity prices; China and India are riding the migration of labour-intensive production to low-wage parts of the world. The net result is that standards of living have been rising sharply in countries with a combined population of 2.8 billion – 40% of the world's people. The BRIC economies account for only 21% of global GDP, but in 2007 they contributed 42% of global growth. This state of affairs had the bullish camp proclaiming early this year that these countries were sustainably decoupled from the U.S. economy and relatively immune

to a U.S. recession.

We have our doubts. The long-term trend of the BRIC and other rapidly emerging economies is unquestionably upward, but the degree of integration of the global economy, coupled with signs of serious slowdown in the euro zone, suggests that while these countries will continue to grow very fast by the standards of the advanced economies, their exports are likely to slow sharply. We consequently think global economic growth is likely to cool in 2008 to a rate closer to the long-term average of about 3.5%. That prospect suggests a considerable softening of resource prices. We see retreats on the order of 25% to 40% in the price of commodities such as oil, copper and cereals, especially since regulators are thinking of tightening margin rules on the commodity exchange to rein in speculative activity and financial demand.

## UNITED STATES

# A recession, yes, but no apocalypse in view

Deteriorating economic indicators during the first quarter have prompted most experts to declare the U.S. already in recession, or at least on the verge. Household finances have worsened sharply as gasoline prices surge and property values slump. As regular readers of *Investment Strategy* know, over the past year we have repeatedly expressed apprehension about what a collapse of the U.S. housing bubble would do to the economy. So it will come as no surprise that our base case scenario is one of a U.S. contraction in the first half of this year and a rise of the unemployment rate to the neighbourhood of 6% from the current 4.8%. To put things in perspective, a recession (as opposed to a depression) is a normal cyclical phenomenon that helps purge excesses or imbalances that arise during an expansion. There have been seven of them in the U.S. over the last 50 years.

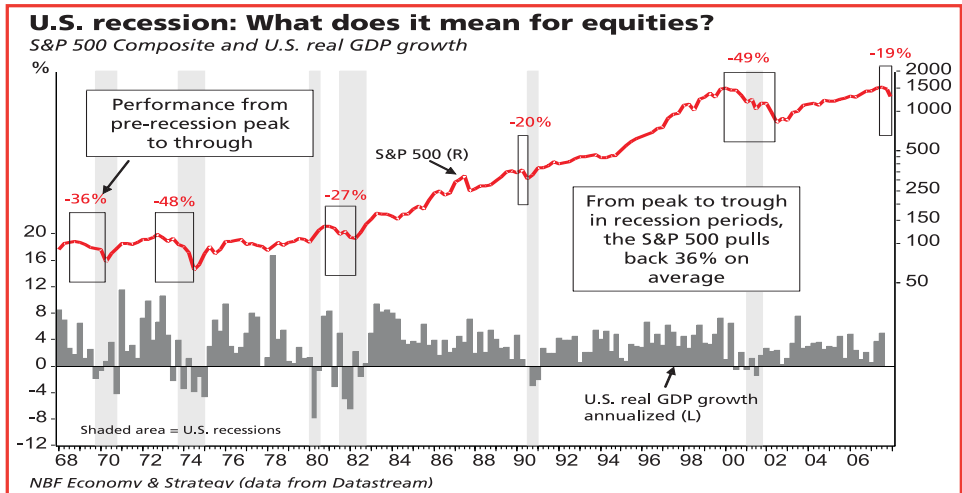
In our view, the incipient recession south of the border will be relatively moderate and – thanks to the unprecedented scope of government and central bank countermeasures – is highly unlikely to degenerate into depression. In addition to fiscal stimulus of more than \$150 billion (about 1.5% of GDP) enacted by the administration and Congress, the Federal Reserve has cut its policy rate 3% since late August and recently announced initiatives to narrow the exceptionally high risk premiums currently demanded on credit market instruments. Since one major aspect of the liquidity crisis is "reintermediation" (banks and other first-line lenders keeping their loans on their own books instead of selling them to others), we think these unconventional tools will have much greater effect than a simple recourse to cuts in the policy rate.

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# Volatility and downside potential, two different things

Financial markets have been much more volatile since the beginning of the U.S. subprime mortgage crisis. Both the New York and Toronto stock exchanges (as measured by the S&P 500 and S&P/TSX indexes) have declined almost 20%. Apart from the almost \$200 billion in asset writedowns that commercial and investment banks have been forced to announce, cyclical stocks have been brought low by growing investor conviction that the U.S. economy is definitely in a recession. As the chart shows, the U.S. stock market tends to fall at least 20% in a recession. Of the 43 corrections exceeding 10% since the Second World War, only 11 turned into a bear market (decline of 20% or more). But because of the effect of recession on profits, every one of the seven U.S. recessions of the last 50 years has been accompanied by a correction of more than 20%. The current market retreat is hardly surprising in this light.

So what should investors do? Is the worst



behind us? First, it is important to keep in mind that volatility and downside potential are two different things. In our view, a lack of transparency concerning the precise risk exposure of financial actors such as banks, brokers, mortgage insurers and hedge funds will keep the market highly volatile in the months ahead as investors wonder which shoes will be the

next to drop. That said, the amount the market has fallen to date and the vigorous, large-scale interventions of central banks, government and regulators leave us thinking the correction could be mostly done with. Deep rate cuts and the massive credit facilities extended by central banks to commercial and investment banks add a great deal of liquidity to the financial system and, in conjunction with recently enacted fiscal stimulus, are likely to keep the recession moderate and short. Moreover, it should be kept in mind that the stock market has always bottomed out before the economy has (an average three months before).

We think it is too late to panic or do a mid-stream U-turn to a defensive investment strategy (an approach that the author of these lines recommended repeatedly before the present crisis broke out in August 2007). At this point we recommend that our clients be patient a little while longer, and prepare themselves mentally to capitalize on buying opportunities in equity markets as they appear – while of course remaining well-diversified among the main asset classes. Remember that the Rockefellers and Rothschilds of this world made their fortunes by having the courage to invest in large companies just at a time when other investors were panicking or forced to sell at fire-sale prices in order to meet margin calls. Whatever the valuation yardstick, most

## CANADA

### No recession in prospect but wide regional divergences

As U.S. households wrestle with a sharp deterioration of their purchasing power and the worst home equity deflation in 30 years, Canadians find themselves in a quite different position. First, since banking practices here are more conservative (little high-risk lending), the housing market has continued to thrive and home prices have continued to rise at a moderate pace. Second, the striking turnaround of public finances in recent years has given many governments room to cut taxes, adding fiscal stimulus to the economy. Third, although the price of oil is likely to fall in 2008, it will stay high enough to keep investment booming in the Western provinces. On the other hand, the manufacturing-heavy and hydrocarbon-poor economies of Ontario and Quebec can be expected to grow very anaemically, less than 1%. In sum, although exports to the U.S. account for almost 30% of our GDP, we

are confident that the strength of Canadian domestic demand makes a recession here unlikely (odds of 30%, versus 80% in the U.S.). However the uneven distribution of resources across the country will make for wide disparities among regions and economic sectors.

As for monetary policy, although the Canadian economy is by all appearances likely to do better than its neighbour, further easing by the Bank of Canada is made probable by an absence of inflationary pressure and the persistent credit crisis hovering over the North American banking system. Our target for the policy rate is 2.75%. The Canadian dollar, meanwhile, is likely to retreat in step with the anticipated correction of commodity prices. We expect it to trade in a range of 92 to 97 cents U.S. over the coming quarters and to return to parity in 2009-10.

# Approaching an Inflection Point?

As we predicted as far back as a year ago, market volatility has returned with a vengeance. Mixed in with the overall stock market declines, we have witnessed several single-day gains on the order of 4% in just the last several days. Over the last three months, the U.S. Federal Reserve has cut its key overnight lending rate 3 times for a cumulative reduction of 2%. The current 2.25% federal funds rate is now a full 3% lower than when interest rate cuts started being made back in September. Here in Canada, our overnight rate is down to 3.5%, a reduction of 1% since our central bank began cutting rates last December.

Given all of the recent stock market uncertainty, we are pleased to have recommended reducing equity weightings in two of our four quarterly comments last year. These reductions in our stock allocation mean that our cash holdings are now well above neutral levels, giving us ammunition to use for any market opportunities

that could arise going forward.

Although the stock market corrections have pushed equity prices lower across the board, it is always somewhat risky to attempt to catch a falling knife. With talk of a U.S. recession and possible global slowdown continuing, we prefer to wait a little longer before drawing down our overweight cash position and committing this money to the stock market. However, even though we are not yet making such changes to our model portfolios, we feel the inflection point at which they will become appropriate is no longer very far away.

On the fixed-income side, we have decided to reduce the recommended duration of our portfolios by 0.5 years down to 5.5 years. As short-term rates fell as a result of the cuts in the central bank's overnight rates, short and mid-term bond rates have followed. With 5-year Government of Canada yields below 3%, and 10-year yields at 3.5%, fixed income

remains relatively unattractive. We continue to recommend a neutral weighting in this asset class more because of its role as a safe harbour in these turbulent times than anything else. We also reiterate our comments made last quarter that high quality 5-year corporate bonds (banks for example) are becoming more attractive as credit spreads continue to widen.

With regards to our Canadian equity strategy, we also have no major changes to report. We continue to like the consumer staples sector for its defensive characteristics, a trait we also see in some of the less "discretionary" consumer discretionary stocks. Finally, we remain underweight the more cyclical components of the market like energy and materials, as we believe a U.S.-led slowdown will eventually be felt here, regardless of the strength of the decoupling effect of China and other emerging markets. The one exception remains the gold sub-sector, which like bonds, will remain a hedge until the skies become somewhat calmer and brighter.

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experts now agree that the equities are not expensive and Federal government bonds are very expensive (5-year yield currently below 3%). Paradoxically, given the specter of recession in the U.S., our comfort level is distinctly higher for the U.S. than for the

Canadian market because of the latter's high exposure to resources. We anticipate that in today's integrated global economy, the Asian economies – major consumers of raw materials – will sooner or later be slowed by the U.S. consumer recession.

(CONTINUED FROM PAGE 1 "United States")

Among the unconventional measures is the Fed's recent authorization of a \$200-billion envelope of loans to investment banks (until now available only to commercial banks) against which borrowers can put up mortgages and blue-chip securities as collateral. Another is the decision of regulators to relax the capital requirements for two federal home-financing agencies, Fannie Mae and Freddie Mac, a move that is likely to improve household access to mortgage credit and pave the way for an easing of mortgage rates. Many experts, including a former chairman of the Fed, agree that stabilization of the U.S. housing market is a prerequisite for restoration of household and investor confidence. Treasury Secretary Henry Paulson said recently that the U.S. will do "what it takes" to keep Wall Street's problems

from knocking the country into a 1930s-style depression or an economic crisis.

Besides the credit crisis there are, as always, other factors that could delay or hasten the turnaround we anticipate in the fall of this year. Among them are oil and other commodity prices. The surge of oil and food prices since January will bite into the purchasing power of U.S. consumers and offset the efforts of government and central bank to stimulate the economy. Conversely, a steep drop in resource prices (for whatever reason) would be good news for U.S. consumers and would lower the inflation expectations of economic actors generally. Whatever the case, we are confident that, absent a return to protectionism after the presidential election, the current headwinds will lose force over the months ahead and the seeds sown since December will begin to bear fruit.

## OUR FORECAST

	2005	2006	2007	FORECAST 2008
<b>Gross Domestic Product (%)</b>				
Canada	3.1	2.8	2.7	1.4
U.S.	3.1	2.9	2.2	0.6
<b>Inflation (%)</b>				
Canada	2.2	2.0	2.1	1.2
U.S.	3.4	3.2	2.9	3.3
<b>Short-term rates (T-Bills, 91-Day) (%)</b>				
Canada		1.48		2.41
U.S.		0.58		1.92
<b>10-year bond yields (%)</b>				
Canada		3.45		3.84
U.S.		3.34		4.07
<b>30-year bond yields (%)</b>				
Canada		3.94		4.29
U.S.		4.16		4.83
Canadian dollar		U.S.\$0.98		U.S.\$1.00
<b>S&amp;P / TSX Sector Rotation</b>				
<b>Overweight</b>		<b>Underweight</b>		
Consumer Discretionary	Consumer Staples	Energy	Materials	(except Golds)

## 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%	14%	–
Fixed-income (duration: 5.5 years) <sup>1</sup>	60% to 100%	70%	70%	–
Canadian equities	0% to 30%	10%	8%	–
U.S. equities		5%	4%	–
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%	10%	–
Fixed-income (duration: 5.5 years) <sup>1</sup>	50% to 80%	60%	60%	–
Canadian equities	20% to 45%	10%	8%	–
U.S. equities		10%	9%	–
Foreign equities		10%	9%	–
Alternative investments <sup>2</sup>	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%	7%	–
Fixed-income (duration: 5.5 years) <sup>1</sup>	30% to 65%	50%	50%	–
Canadian equities	30% to 65%	15%	12%	–
U.S. equities		15%	14%	–
Foreign equities		10%	9%	–
Alternative investments <sup>2</sup>	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%	9%	–
Fixed-income (duration: 5.5 years) <sup>1</sup>	25% to 45%	35%	35%	–
Canadian equities	40% to 75%	20%	16%	–
U.S. equities		15%	14%	–
Foreign equities		15%	14%	–
Alternative investments <sup>2</sup>	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%	12%	–
Fixed-income (duration: 5.5 years) <sup>1</sup>	0% to 30%	20%	20%	–
Canadian equities	55% to 100%	20%	16%	–
U.S. equities		20%	18%	–
Foreign equities		20%	18%	–
Alternative investments <sup>2</sup>	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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