

Insanity: doing the same thing over and over again and expecting different results.

-Albert Einstein

<p>Canada</p> <ul style="list-style-type: none"> • Stronger Q2 & Q3 GDP growth than in the U.S. • BOC will tighten before the Fed. July? • Leading indicators index up 8 consecutive mos. • Corporate profits rebounding sharply • Residential building permits back to peak levels • 3 consecutive mo. gains in commercial permits • Consumer confidence rebounding in Ontario • Core CPI up to a 2.1% yr/yr increase in Feb. • 5 monthly employment gains in past 7 months • Bond market confidence in budget outlook • Total govt. debt/GDP ratio less than half US, UK • U.S. shale gas to displace Alta gas in Ontario? <p>United States</p> <ul style="list-style-type: none"> • Fed not yet ready to tighten • Low interest rates for an “extended period” • Bank lending is still declining • Smaller banks under severe capital constraints • 40% of unemployed out of work at least 6 mos. • New home sales back down to a record low 	<p>Rising inflation and stronger than expected economic growth is putting pressure on the Bank of Canada to raise interest rates in advance of the Fed. A number of recent economic indicators – real GDP, retail sales, wholesale sales and manufacturers’ shipments and new orders – have all been stronger than expected. Exports now show five consecutive monthly increases. Canada’s core CPI inflation rate unexpectedly accelerated in February to a yr/yr increase of 2.1%. Core inflation was not expected to reach 2.0% until the 3rd Quarter of next year. The next Bank of Canada interest rate announcement dates are April 20th, June 1st and July 20th. Many are now expecting a July rate increase. The foreign exchange market expects rate differentials to widen with the U.S. after mid-year and the CAD has increased sharply relative to the USD. Net job creation over the seven months ending in February amounts to 158,500. This restores approximately one-third of the jobs lost since the recession began. The latest monthly gains were mostly in full-time positions but they were concentrated in the public sector. Hiring plans remain positive, especially for jobs in education and mining. The employment gain of 20,900 in February was a positive surprise and the unemployment rate is now down to a 10-month low of 8.2%.</p> <p>STIMULUS WITHDRAWAL</p> <p>Stronger than expected growth performance has heightened the pressure on governments and central banks to implement stimulus withdrawal plans. The risk is that the withdrawal could be premature. A fine balance of short-term stimulus and longer-run restraint is needed. Political tolerance for elevated budget deficits is very limited in both Canada and the United States. The U.S. is in far worse fiscal shape though. Their 2010 federal budget deficit will be 10.6% of GDP. The debt to GDP ratio will reach 60% this year - the highest since the 1940’s. In addition, Alan Greenspan is being harshly criticized for keeping interest rates far too low for far too long. The Fed is determined not to repeat this mistake. Interest rates are likely to move a lot higher within the next 18 to 24 months. We all want to be convinced that economic growth is sustainable but the downside is how central banks will react. Demographic pressures from Medicare costs will add to worries about long-term U.S. fiscal over-stretch. Longer-term the U.S. budget outlook is bleak. Budget deficits between now and 2020 are projected to amount to over \$10 trillion. It could be possible to cut the deficit/GDP</p>
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<ul style="list-style-type: none"> • Federal fiscal stimulus set to fade in 2nd Half • Inventory boost will be gone by mid-year • 2.5% annualized growth rate in Q1/2010 • Manufacturing is leading the recovery • Equipment spending rising at a 5% real rate • Upward trend in exports • Employment increases expected this spring • Another fiscal stimulus package needed • Federal debt/GDP highest since just after WW2 <p>Global</p> <ul style="list-style-type: none"> • No quick fix for debt crisis in Greece • Sovereign debt crisis could spread globally • Could prompt premature fiscal tightening • Trade-weighted USD highest since last June • Global economic rebound will be slow • China continues to tighten • Europe's recovery grinds to a halt in 4th Quarter 	<p>ratio in half but this would only take it to around 5.0%. Funding needs point to much higher U.S. rates. The American economy is in the precarious position of becoming too heavily indebted, and in the unfamiliar position of having their biggest lenders (such as China) unloading their holdings of US treasuries. The Federal Reserve's quantitative easing program, which essentially monetized debt, is being phased out. Final estimates stand at over \$1.4 trillion worth of mortgage purchases and approximately \$300 billion worth of US treasury securities purchases. The obvious concern is inflation, which will further destabilize a smooth recovery of the labor markets. The bottom line is that the growth recovery cycle will collide with the longer-term problems of unsustainable government debt and sharply higher interest rates before mid-decade. The U.S. is not alone. Japan, Germany, France and Britain all face sharply higher levels of public debt. We can expect synchronized global spending cuts and tax increases. This has never happened before. The end result could be a shorter growth cycle than what we have become accustomed to. Earlier in the post-WW2 period business cycle expansions were shorter, lasting around three years. For example, the 1970 to 1973 recovery cycle lasted only 36 months (from November 1970 to November 1973). Before 1960 we had seen four consecutive recovery cycles that lasted on average only 36 months. We expect growth to continue for the next three years but we should be prepared for another recession before 2015.</p> <p>First Quarter, 2010:</p> <p>There is a low probability that today's corporate earnings (and thus the stock markets) are anywhere near their peak for this economic cycle. Consumer sentiment, as measured by the Conference Board of America, is still near its cyclical low, meaning that gloom and doom still prevail, and therefore consumer and capital spending is below trend.</p> <p>We feel that consumer confidence will slowly rebound beginning in 2010 as unemployment begins to fall and housing prices flatten out. So far this is playing out as we exit the first quarter of 2010 ending March 31. Initial unemployment claims and the overall unemployment levels in the US are slowly improving and consumer confidence, while still at low levels, is holding steady. There is still a great deal of labour and manufacturing slack in the system, meaning that there is little pressure on interest rates, which will remain at low levels for an extended length of time. The best returns in this environment are likely to be found in the least-loved asset classes with improving fundamentals which continue to be global stocks and US housing.</p>
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Economic Outlook 2010:

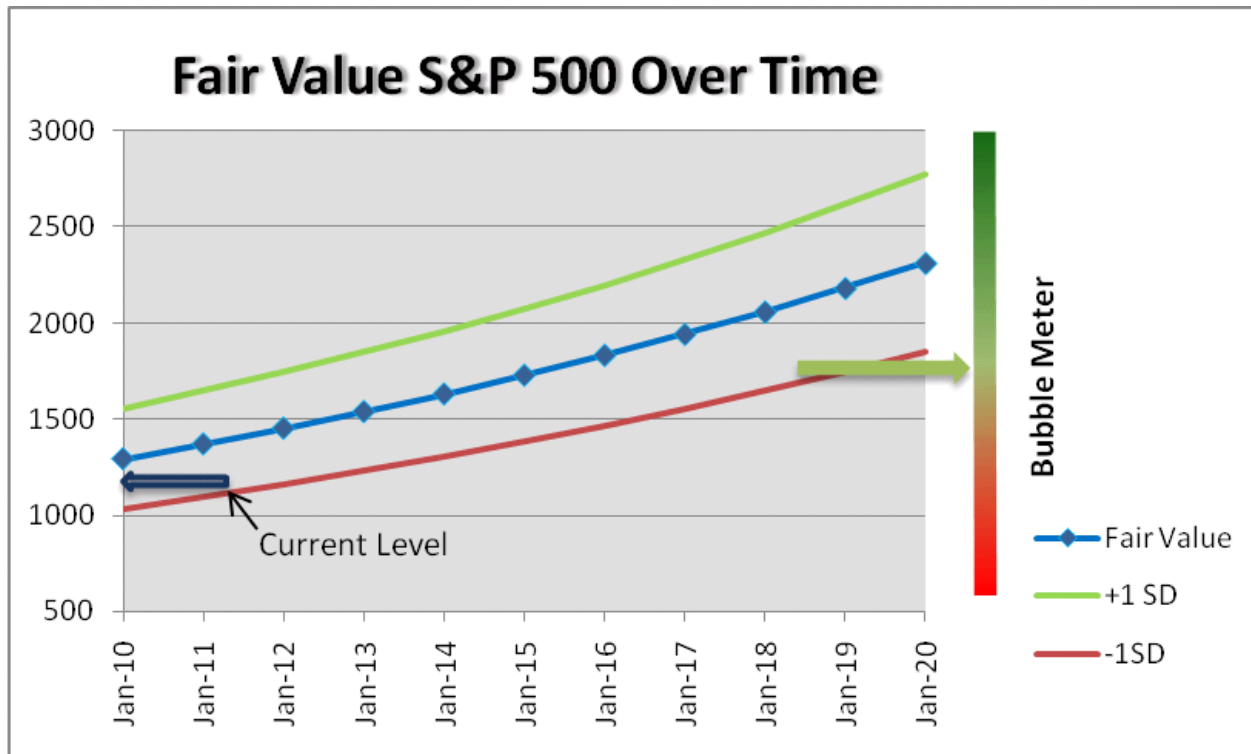
The Year of the Main Street Our leading economic indicators continue to point toward a respectable economic recovery in 2010 and 2011. While 2009 saw an improvement in the pricing of stocks and commodities, and an easing in the credit crunch, there was not a great deal of improvement in things that matter to most of the population – jobs and wage gains. This is already beginning to change in 2010. Unemployment is beginning to inch down as corporations realize their existing workforce is stretched to the limits, while inventories of goods need to be rebuilt from today's low levels. The March job report showed a 0.1% drop in average hourly earnings and a drop in the year on year wage growth rate to 2.1%, compared to 2.5% 3 months ago and 3.5% a year ago. Consumer savings rates will remain at high levels, but an easing of unemployment will nonetheless encourage modest increases in consumer spending in 2010 and 2011. As the US economy continues to mend, ***short-term and long-term interest rates are likely to gradually rise across the globe.*** Expect the US 10-year government bond yields to rise to about 4.5% from today's 3.8% and that short-term interest rates to rise by about one-half of one percent (50bps) by year end.

Capital Markets Outlook:

The Chart below highlights the current opportunity we see in the stock markets today. The blue "Fair Value" line assumes future nominal dividend growth of 5.5% and an equity risk premium of 4.8% above 10-year government bonds. We believe these assumptions are reasonable, if not conservative, given the outlook for global economic growth and productivity going forward. The +1 and -1 standard deviation lines represent the long-term average volatility of the S&P 500 (+/-20%) and can be considered a proxy to account for forecasting error. On the right axis we have superimposed our "Bubble Meter" readings which are used as a gauge to help determine the level of speculation in the stock market. All else being equal, low speculation means less downside risk for investors and vice versa.

The US stock market as of March 31, 2010 was approximately 7.0% shy of its short-term fair value, and close to properly discounting future growth rates and risk. However, speculation is still quite low, as are corporate margins, so annual returns for the equity markets are likely to outpace the returns of most other investments such as cash and bonds over the next decade. The secular bull market for gold is still intact. Currently, we are experiencing a period of consolidation around the \$1,100 level. As long as the U.S. deficit continues to spiral out of control and the Federal Reserve continues irresponsibly printing money, the threat of inflation and currency depreciation remain. The Bombay Bullion Association reported that in March gold imports into the country were running between 23 to 28 tons compared to 4.8 tons a year ago. Russia also added 6.2 tons in February. In addition, the World Gold Council recently signed an agreement with the Industrial and Commercial Bank of China to develop new gold investment products and programs for its clients.

S&P 500 Long-Term Fair Value



Bubble Watch:

Based on our models used to identify financial bubbles and “irrational exuberance”, there do not appear to be any areas within the capital markets that would cause systemic risk to the global economy. Despite a strong rally in global stock markets in 2009, investor sentiment remains subdued and stock ownership remains well below normal levels. There remains great skepticism and fear with respect to owning stocks, while cash and bonds remain overbought. We continue to believe there is an unsustainable mountain of cash sitting in savings and money market accounts in the US and Canada. We believe this cash hoarding will slowly dissipate and find its way back into the stock and housing markets as investor and consumer confidence improves. One area of concern is in China, where massive spending by state enterprises to create employment is likely to cause an overshoot in real estate and manufacturing capacity, and down the road, a spate of bad loans which the Chinese government will need to socialize. The Chinese stock market is also quite expensive at over 30X earnings.

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