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Economic and Capital Markets Outlook

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The global economic recovery is well underway. In most of the world a new cycle of expansion has begun. The task now shifts to sizing up the next phase of the economic cycle beginning in 2011. Questions central to this discussion are whether the need to correct government deficits may upset the recovery and could a lack of confidence in government finances cause further disruption in financial markets.

In our view, the ongoing recovery is durable albeit not spectacular. Government deficits, while large, can be funded particularly given subdued borrowing by the private sector in developed economies such as the U.S. and U.K. The significant events that have occurred in Europe over the last few months are being dealt with in a logical manner and should prove manageable. The large imbalances in Greece are of particular concern and the path to stability will require very serious efforts. Governments have bought time for this to be accomplished.

Powerful economic forces in the developing world should offset the consolidation taking place in developed countries and the world economy should be expected to progress. Current slack demand in the debt markets will eventually reverse and argue for rising interest rates, particularly given a heavy calendar of government borrowing. The global upturn will be accompanied by rising corporate profits and improving stock markets. These trends should not be measured in weeks of performance but in years.

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Global Economic Recovery Gathers Pace

The U.S. economy is making good progress following the sharp slump created by the freeze in credit markets in late 2008 and early 2009. Businesses continue to gear up as evidenced by the fact that industrial production is growing and in May was 8% above the year ago level. Additionally May factory new orders were up 17%. In turn, new full-time factory jobs created during the first 6 months of 2010 total 136,000 contributing to total non-agricultural employment gains of 880,000. While this still leaves employment 0.1% below year ago levels, hours worked are 1% higher.

We are convinced that the level of economic activity calls for further gains in hours worked and employment. Nominal GDP is now 0.3% above the previous peak reached in the second quarter of 2008 while total employment remains 5.3% below its peak. Two points are worth noting from this observation. First, job growth is typically a lagging indicator and the current positive momentum is a promising sign. Second, gains in activity generally precede job creation particularly in the early stages of recovery and are the reason for notable productivity improvement.

Reviewing a broad selection of U.S. economic data on a year-over-year basis it is easy to point to improving trends. Retail sales for the most recent 3 months to May were up 8.1%. Airline traffic in May was 16.8% higher. Year to date vehicle sales were up 17%. Truckers hauled 6.2% more tonnage in the first 5 months. Intermodal rail traffic was 21% ahead in May and existing home sales rose 19%. This sampling of data illustrates that it will be easy to beat last year's credit crisis induced weakness. As the year progresses, more evidence of this will be forthcoming.

Our forecast for 2010 calls for approximately 4% real GDP growth. This will be supported by improving trends in employment, personal incomes and spending. Corporate balance sheets are strong. Profits rose 33% in the first quarter and were only 4% under the prior peak registered in the 3rd quarter of 2006. Business inventory to sales ratios in recent months have been at their lowest levels in 10 years. These factors should encourage greater investment in both equipment and inventories. Investment in structures such as commercial buildings remains weak and we would not expect much help from this type of activity until later in the cycle.

On a national income basis, government spending grew 3.3% in the first quarter versus last year. Trends between various levels of government have begun to diverge. Expenditures at the state and local level, which account for 60% of government activity, nudged up 0.9%. From California to New York, headlines have been speaking of deficits and efforts to cut spending. On a positive note, surveys of state and local Treasuries are reporting improving revenue trends. At the national level expenditures rose 7.2% during the quarter with military spending rising in line. Federal spending is forecast to grow 3.5% in the fiscal year ending September 30, 2010 and slow to 2.3% next year.

Another element in the GDP outlook is trade. In April, exports were 28% above April 2009 and imports were 29.5% higher. While the net balance adds to or subtracts from GDP growth, the level of activity that is suggested by these numbers is very strong compared to a year ago and will have spin-off effects throughout the economy.

On balance, we see little to detract from our view of steady improvement. An element that could swing the outcome for healthy growth in 2010 would be a tendency of consumers to save more or less. We are currently expecting the household saving rate to remain in the area of 4%. Should the saving rate increase incrementally to 6% by year-end, the impact would be to reduce growth in 2010 from 4% to about 3%. For the time being, we remain in the 4% growth camp.

Growth trends across the world generally point towards economic recovery. In Canada, real GDP was up 2.2% compared to a year ago, driven by gains in personal consumption and residential investment. The Canadian labour market has also rebounded with 215,000 jobs created in the first five months of the year and employment now approaches the peak level seen in 2008. Economic growth has been recovering elsewhere in the Americas. In Brazil, real GDP expanded by 8.9% in the past twelve months. During the same period, Mexico's economy grew by 4.3% while smaller countries such as Chile, Colombia and Argentina are growing at rates ranging from 1.0% to 2.5%.

For Japan, a strong recovery in the rest of Asia is having a significant positive influence on exports. In April, total Japanese exports rose 40% while trade with the rest of Asia expanded by 45% compared to the previous year. This, coupled with modest rises in personal consumption and government spending, enabled real GDP to grow 4.2% in the past 12 months. Elsewhere in Asia, economic growth has also been brisk. Chinese real GDP was up 11.9% in the first quarter, while India grew 8.6%. Malaysia, South Korea, Taiwan, Hong Kong, Indonesia experienced real GDP growth rates in the range of 7% to 13%.

The economic recovery in Europe has been under the spotlight and attention has been directed towards so-called vulnerabilities in the Eurozone and various issues plaguing the sovereign debt markets. However, economic activity in this region also continued to expand, albeit more slowly, as countries of the European Union saw aggregate real GDP increase for the third straight quarter. First quarter real GDP was 0.5% ahead of last year. In the same period private consumption did slip 0.2% while investment dropped 5.5%. However government spending rose 1.8% and net exports also contributed to growth. By country, real GDP was up by 1.3% in France, 1.5% in Germany and 0.3% in Italy, while down 0.2% in the U.K. and 1.2% in Spain. The region's growth forecast for 2010 is 0.8% to 1.3% according to the European Central Bank, while the IMF forecasts 1.0%.

Greek Debt

Given that Greece's debt crisis and Europe's financial market and currency volatility were headline news over a period of several weeks, it is not surprising that many questions have been raised concerning this region's longer-term outlook. We will attempt to sort through the noise by first reviewing the key events and then attempt to shed light on three important questions: Is the European banking sector vulnerable to a funding crisis that would then create a credit crunch in Continental Europe? Is the Eurozone debt situation sustainable? Do currently proposed fiscal austerity measures significantly alter the medium term forecast for the region?

The turmoil in Europe began following reports in February that Greek national statistics underreported the extent of the country's fiscal imbalances for several years. Then on April 27th, a ratings agency announced a major downgrade of Greek government debt to less than investment grade or more familiarly known as "junk" citing among other factors the combination of a very high 2009 deficit of 13.6% of GDP, an expected high deficit of more than 8% for 2010 along with large outstanding government debt of 115% of GDP.

As many institutional investors are restricted from owning bonds of this rating, selling pressure mounted quickly and prices fell approximately 25%. Yields on 2 year and 10 year issues rose to as high as 18% and 12% respectively. Given that foreign investors held about 80% of the country's government debt, it became clear that Greece would not be able to roll over its upcoming maturities nor finance its budget shortfall. Complicating matters, concerns spread about the fiscal position of other European countries including Italy, Spain, Portugal, Ireland and even the U.K. It also raised questions about the currency union itself.

Authorities in Europe and Greece responded quickly and we believe thoughtfully with a major loan facility tied to domestic reforms in public spending and taxation. The loan facility included €80 billion from the EU and a further €30 billion from the IMF. This will enable Greece to cover its financing needs for the next three years. The terms of this agreement are clearly tough particularly for a country such as Greece where it is estimated that between 20 - 30% of economic activity is unreported and not taxed. The Greek government has instituted a combination of spending cuts including reducing civil servant wages and pensions as well as other expenditures. It has imposed tax increases including higher levels of VAT for various types of goods. Efforts to deal with non-compliance are being strengthened. In addition, it is increasing the general retirement age to 65 in keeping with moves by other countries including France and Germany.

While some have naturally expressed scepticism as to the success of the austerity plan, it is very important that it succeed in all aspects. Greeks will not accept that the cost of these reforms fall on one group alone. This would mean social strife and political instability. The government will therefore need to follow through on its efforts to broaden the tax base. These measures already appear to have borne fruit as Greece's fiscal deficit has fallen 38% in the first 5 months of this year. The target is to bring the deficit down from 13.6% of GDP in 2009 to 3% by 2014.

In our opinion, the efforts to deal with this crisis are very credible although difficult. However by 2013 - 2014, debt to GDP is likely to be above 140% while interest payments may consume one third of government revenues or about 5 times that of Germany. Therefore, we cannot rule out an adverse credit event for holders of Greek debt. However, the credit facility extended by the EU and IMF should assure debt refinancing over the next 3 years. Fortunately the national government was elected in 2009 and thus has a mandate of sufficient duration to give it the time required to enact fiscal reform. It should also be said that IMF intervention has generally worked in other similar instances. It is worth noting that a slightly higher medium-term growth rate than that forecast by the EU and IMF would materially improve the debt position of Greece. In addition, the sale of interests in various state-owned businesses could also reduce the country's obligations.

Other European Challenges

Given investors' concerns for other countries including Italy, Spain, Portugal and Ireland, the EU and IMF have proactively created a joint funding pool worth a cumulative €750 billion. This is meant to help finance European countries that may face difficulties raising capital in the bond market. One part, worth €60 billion, will be an emergency fund with capital provided by the European Commission. The second and third parts, funded by all countries of the Eurozone and the IMF respectively, are worth €440 billion and €250 billion and resemble the loan facility provided to Greece.

Countries needing to borrow from these entities will be required to undergo significant fiscal rebalancing to access the monies. These facilities will be outstanding for three years and are conditional on countries respecting certain fiscal parameters. These contingent plans are important given the fact that Europe's financial system is highly integrated and that cross border financing in relation to GDP has doubled over the last decade to 80% of European GDP.

A more immediate concern for the ECB has been the reluctance of European banks to lend to one another. In the wake of the Greek crisis, concerns for contagion spreading to other weak debtor nations and more recently the results of a stress test for European banks to be published in July have precipitated this freeze. As a result, the ECB has been actively intermediating funds among Europe's banks.

The lending provided by the ECB is secured by a wide array of collateral that banks can post such as government bonds, corporate bonds and mortgages. According to our understanding, the ECB is permitted to continue this at will or until funding markets stabilize. That the ECB can act as a conduit of fund flows in the inter-bank lending market is very helpful and should prevent forced asset sales from banks which may temporarily be facing liquidity issues. Consequently, our current understanding of the European bank funding issues is that although there are problems, programs and mechanisms are in place or could be added that should accommodate participating institutions and prevent unnecessary tightening.

		Greece	Portugal	Ireland	Spain	Italy	Germany	France
2009 GDP	Billion €	€239	€164	€164	€1,051	€1,521	€2,407	€1,922
2009 Deficit	% of GDP	-13.6%	-9.4%	-14.3%	-11.2%	-5.3%	-3.3%	-7.5%
2009 Gross Debt	% of GDP	115.1%	76.8%	64.0%	53.2%	115.8%	73.2%	77.6%
2010 Deficit	% of GDP	-9.3%	-8.5%	-11.7%	-9.3%	-5.3%	-5.0%	-8.0%
2010 GDP	% nominal growth	-0.2%	1.6%	-2.6%	0.1%	1.5%	2.0%	2.0%
2010 Gross Debt	% of GDP	124.9%	85.8%	77.3%	64.9%	118.2%	78.8%	83.6%

Countries often perceived to be of higher risk and cited as possibly contributing to contagion include Italy, Portugal, Spain and Ireland. However each has its own particular circumstances which differ materially from that of Greece and none have suffered the same debt downgrade to "junk" status nor do we believe this to be justified. The table above sets out some of the parameters most frequently assessed by markets.

It is our view that Eurozone members face a situation that is manageable. Current fiscal deficits in Spain, Portugal, Italy, Ireland and Germany are being addressed through a package of announced austerity measures. Additionally, when we look at Eurozone members in aggregate, the deficit to GDP ratio is expected to peak this year at 6.7% of GDP and the debt to GDP ratio should be around 87% in 2013. From that point onwards, further discipline will be required to reduce aggregate debt to more stable levels of 60% - 70% of GDP.

The events of recent months should not be interpreted as a failure of the European Union nor a failure of the Euro. Rather we see these difficulties as normal challenges in the process of nation building. The reality is that the new Europe is a great success. The elimination of many historic barriers has aided enormously in the movement of people, goods and services. The single currency is central to these advances and it would be mistaken to assume that recent problems would encourage abandoning the huge investment made by Europeans to arrive at where they are today.

Austerity, What Damage?

Finally, we evaluate what impact austerity measures might have on medium term prospects in the developed countries of Europe, the U.S. and Japan. Similar to most other developed countries, countries that are part of the Eurozone have experienced a recession-induced contraction in tax revenues while their expenses have increased. Consequently, deficits to GDP have risen to an aggregate level of roughly 6.3% in 2009 and an expected 6.7% in 2010. Debt levels, measured as a percent of GDP, also jumped as GDP shrank in many countries while deficits grew. For Europe in aggregate, debt increased from 66% of GDP in 2007 to 84% in 2010.

After reviewing budgets and various austerity measures announced to date across Europe, it appears that beyond 2010, nominal government spending will grow modestly by perhaps 1% - 1.5% for several years. In 2009, total government spending accounted for 51% of GDP in the Eurozone, compared with 35% in the U.S. and approximately 40% in Canada. Half of the spending is for compensation of employees and transfer payments while the other half is government consumption of goods and services. Given announced cutbacks in current and future budgets, growth in government spending will remain subdued.

Furthermore, consumer spending in Europe will continue to be under pressure as state employees experience cutbacks in salaries and benefits while wage inflation is unlikely to accelerate given high unemployment rates in many countries. Fortunately the aggregate household saving rate has risen by about 1.5% over the last 2 years and is quite high at an aggregate rate of 9.6%. In France it is 16% and in Germany it is 12%. From these levels the saving rate has room to fall and thus lend support to spending. In addition, demographics will start to have a restraining effect as the labour force is expected to stay roughly flat over the next decade, barring a significant change in migration policies.

We therefore believe that the Eurozone should continue to experience real GDP growth, but given the government spending drag this growth will be modest, likely in the range of 1% to 2%. This is in line with our forecast of October 2009 in which we had already factored weakness in government spending.

Our medium-term U.S. forecast also remains unchanged for 2011 and beyond. The two main sectors that will be challenged to grow are consumer spending and government consumption. Consumer spending faces three main headwinds. First, demographic growth will be slower over the next five years; we expect an average of 0.6% labour force growth. Second, the consumer saving rate is still rather low at 4% and we assume it will move toward 5% or more in the next two years. Third, consumers are very likely to face higher taxes as government deals with deficits.

Government spending is expected to stay flat in nominal terms starting in 2011 if the U.S. is serious about reducing its deficit to 3% of GDP by the middle of the decade. Investment activity should improve going forward as this is at depressed levels in all categories. As we sum these inputs, our expectation is for real GDP to grow from 1% - 2%. Should households maintain a saving rate at about 4%, a real growth rate of 2% - 3% is possible.

We expect global real GDP to advance by 1% - 2% in developed economies given the many challenges discussed above. Conversely, fast growing labour forces, low levels of leverage both at the state and household level and competitive cost structures continue to argue for better growth in the developing world. Given the weights of these respective regions we believe world real GDP can advance by 2.5% - 3.0% over the next few years.

Investment Strategy: Mediocre Bonds vs. Great Equity Ideas

Our strategy with regards to bonds has not changed. Interest rates are at historically low levels across the developed world. Notwithstanding record demand for funds from governments, recently private sector borrowings have been negative. As a result the overall demand for funds in the U.S. expressed as a percent of GDP is 0% compared to 27% in the quarters preceding the collapse in 2008. As economic activity grows these demands will grow and we would expect rates to rise from today's exceptional low levels.

Here in Canada the central bank began to raise rates in June. Three month T-bill rates are now 0.5% compared to 0.17% earlier this year. The Fed has not shown any inclination to increase interest rates and similar bills in the U.S. are at 0.16%. Ten year government bond yields have dropped in recent months from 3.6% to 3%. Going forward, our interest rate forecasts assume a normalization of the yield curve (the spread between the short end and long end which is now 2.77% drops towards 1.7%) and rates moving slightly higher. Given this view, our return expectations for this asset class are low. Consequently, we remain underweight bonds and are keeping duration short relative to the benchmark.

Turning to the stock market, we are struck by the strong recovery in corporate profits and the reasonableness of market valuations. Corporate profits in the U.S. were up 33% in the first quarter and are just 4% shy of record levels prior to the recent slump. We have assumed for some time that S&P 500 profits per share would recover over the next 5 years to between $110 and $130. This compares to the previous peak of $90 in 2007 and subsequent collapse to just above $60 in 2008. It should also be noted that balance sheets are quite strong today with record cash balances. The S&P 500 dividend yield is around 2.5% and slow growth prospects in mature markets suggest that managements may be more inclined towards increasing dividends. From a broad macro perspective this suggests equity returns over the next 5 years of between 7% - 14% including dividends and based on terminal P/E multiples of between 12 - 16X.

We believe both the quality of investment opportunity and potential today is exceptionally high and well illustrated by one of our holdings, Vodafone Group Plc. Vodafone is the largest global cellular carrier by revenues and second to China Mobile in numbers of subscribers. The company's networks span the globe and include mature markets in developed countries as well as emerging markets such as India.

In the U.S. the company owns 45% of Verizon Wireless, perhaps the most respected carrier as measured by Consumer Reports magazine. Verizon Wireless is a very profitable entity and is expected to be debt free in 2011 at which time we believe it will begin to distribute cash back to its two parents, Verizon Communications Inc. and Vodafone.

It is our view that Verizon Communications has a strong requirement for such distributions in order to pay its own dividend. We estimate that net disbursements to Vodafone could equal £3 billion representing 75% of the generous payout that Vodafone makes to its own shareholders. It has no need for these funds as current cash flows meet all its requirements. These monies could therefore be paid directly to its shareholders as dividends. Vodafone's current dividend yield is 6% and the company has already committed to increases of 7% per year over the next 3 years. The shares currently trade at 8X 2010 forecasted profits and 5X EBITDA.

We also believe that there remains ample opportunity for growth in the telecommunications industry, particularly in the area of mobile data. The proliferation of smartphones and communications hardware for smaller computers that are being offered at prices in the range of $300 assure continued growth in activity for many years.

Vodafone is simply one example of why we believe the quality and potential of equity ideas is excellent today and should clearly trump bonds over the next several years.

All dollar references in the text are U.S. dollar unless otherwise indicated.