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Economic and Capital Markets Outlook

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Just as the collapse in economic activity in 2008-09 led many to consider that a Great Depression was unfolding, many investors have now extrapolated recent soft U.S. economic data as early warning signs of a "double-dip" recession. On balance, we see little to detract from our view that the recovery is sustainable as progress continues to be made on many fronts. Our medium term economic forecast remains unchanged for 2011 and beyond. Headwinds from fiscal retrenchment will lead to a period of subpar growth in developed economies although this will be partly counterbalanced by robust expansion in the emerging world.

Our investment decisions have not been predicated on a return to strong growth in the U.S. and other developed economies. We continue to find company valuations to be attractive and the quality and potential of equity ideas to be high. We expect returns from equities over the next 5 years to range from 6%-14% under a reasonable set of assumptions on profitability, dividends and earnings multiples. In contrast, expected returns on bonds are very low in the 2%-3% range and our portfolios remain underweight this asset class.

PERSONAL AND CONFIDENTIAL
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Revisiting our U.S. Growth Forecasts

During the second quarter, U.S. real GDP grew by 3.0% compared with last year, while on a nominal basis the U.S. economy is now 3.9% above last year's level and 0.6% higher than the peak reached in 2008. Economic growth is occurring along the lines we expected; corporate investment in machinery and equipment is up strongly, inventories are being replenished while consumer spending remains subdued. All industrial indicators continue to point to continued progress. As of August, industrial production and durable goods orders are up 6.2% and 11.6% respectively over last year's level. In addition, rail car loading and diesel consumption are up by 5.7% and 7.9% over the same time frame.

Job creation has been rather slow but steady since the beginning of the year. From January to August, the U.S. private sector created 763,000 jobs, an average of 95,000 per month. If this pace is maintained, private sector employment in 2010 will grow by 1.1% which will not be sufficient to significantly reduce the unemployment rate, currently at 9.6%. However, this rate of job creation together with average wage increases of around 2% is consistent with a rise in total employee compensation of roughly 3%.

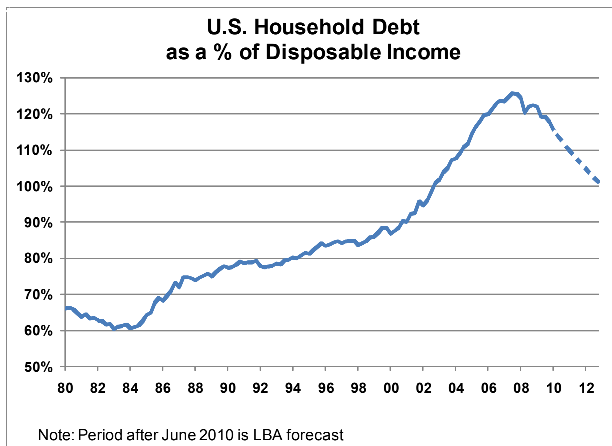
While job growth has been sluggish, private sector hours worked are on track to rise by 2.4% in 2010. It is fairly usual, when an economy comes out of a recession, to see hours worked expand more quickly than employment. If jobs begin to pick up in line with the pace of hours worked, we will see a respectable level of compensation growth in the 4% range and a steady decline in the unemployment rate. Our expectation is that the final outcome will likely lie somewhere between the two.

As outlined in prior letters, our growth scenario for the U.S. called for a healthy rebound in 2010 followed by a longer period of subpar economic growth as the impact of fiscal retrenchment and a higher saving rate kick in. Thus far it appears that real GDP is likely to expand by 3.0% in 2010, at the bottom end of our initial growth forecast for this year. A slower than anticipated rebound in the labour market, a higher saving rate – the latter data revised upwards by government statisticians during the summer months – and a faster pace of growth in imports relative to exports are the main reasons for moderating our growth expectations for this year.

We are convinced that there is very little likelihood that the U.S. economy will tip back into recession. As noted above, trends in current economic data continue to point to an expansion in activity. In addition, there are three fundamental reasons why we believe growth is sustainable.

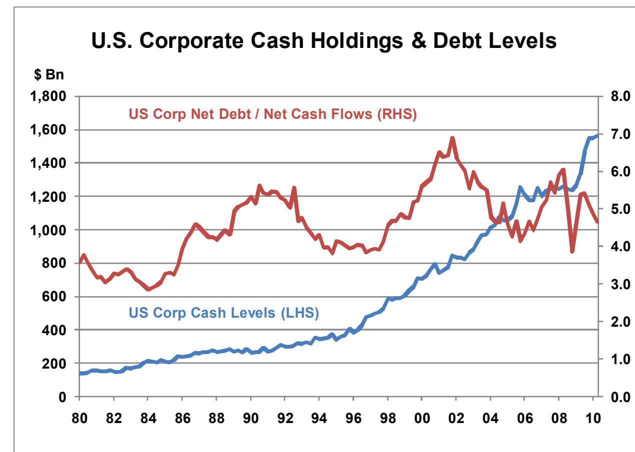
First, household spending can expand even in the face of consumer deleveraging. Household debt reached a peak level of $13,410 billion in Q3 2008, representing 120% of disposable income. In Q2 2010 household debt totalled $12,905 billion, a drop of $507 billion and accounted for 114% of disposable income. During this period, households saved $1,118 billion and the saving rate rose from 4.5% to 6%. Using a conservative assumption that the entire decline in debt was funded by household savings (although a part of the decline likely reflected write-offs) consumers used 45% of their savings to pay down debt. Despite raising their saving rate and deleveraging, households still managed to increase their spending by $83 billion between Q3 2008 and Q2 2010.

Looking ahead, using a base case assumption of 2.5%-3.5% disposable income growth and a saving rate that remains steady around 6.0%, U.S. households will be able to save $700 billion annually. Assuming a third of these savings are dedicated to debt repayments, household leverage will be reduced by $230 billion annually. Under this scenario, the ratio of household debt to disposable income will fall to 100% by the end of 2012, back to the level prevailing in 2003. Household spending would also grow in line with disposable income growth, in a range of 2.5%-3.5% per annum in nominal terms or $250 billion to $350 billion per year.



Second, the precautionary hoarding of cash balances among U.S. non-financial corporations is unappealing given near-zero returns on such investments. Corporate holdings of cash and cash like instruments increased from $1,185 billion in Q4 2007 to $1,510 billion in Q2 2010. The corporate sector in the U.S. is not highly levered, with net debt to cash flow at 4.5x and cash flow coverage of net interest costs at 4.8x. We are of the view that U.S. non-financial firms will begin to put this money to work. From an economic standpoint, the greatest impact would be felt if corporations decide to increase their level of capital investment.

Alternative uses of the cash stockpile are an increase in distributions to shareholders, either through an increase in dividends or stock buybacks, or a pick up in M&A activity. The latter two uses of funds would be most beneficial to stock market investors. Corporations are likely to follow a combination of all three strategies in deploying their high levels of cash to more productive uses.



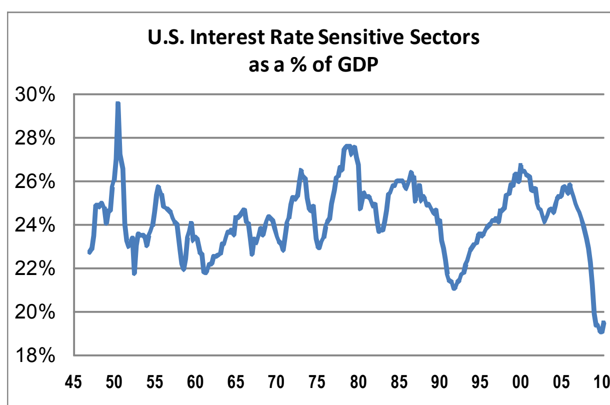
Finally, given that the main interest-rate sensitive sectors of the U.S. economy are already at a historically depressed ratio to GDP, it is difficult to foresee further significant declines from current levels. The four sectors which are most affected by interest rates and consumer and corporate confidence are durable consumer goods, residential real estate, commercial real estate and investment in equipment and machinery. While all sectors have yet to rebound meaningfully and are still operating well below longer-term averages, equipment investment has begun to turn around.

Durable goods spending consist mainly of expenditures on cars and parts, which account for 62% of this category. Car sales are running at an annual rate of 11.3 million units since the beginning of the year, compared to a level of 10.4 million in 2009.

Yet cars sales are still 31% lower than the average level prevailing from 1998 to 2008 and also well below the 15 million unit mark, the level we estimate is required to stabilize the car fleet. A factor that played a critical role in the contraction seen in 2009 was credit availability as car companies and their financing arms were in severe financial distress. This situation has now largely been resolved. In the short-to-medium term we do not see a meaningful change in either city development models or a significant improvement in public transport infrastructure. This together with a continuing rise in the car-driving population suggests that the current level of auto sales is already well below trend and is unlikely to move substantially lower.

Looking at residential investment, new housing starts have averaged 575,000 per year since the beginning of 2009. According to our estimates, the U.S. needs about 1.5 million new homes per year to accommodate population growth and the replacement cycle of old homes. With an existing housing glut of roughly 2 million unsold homes, it may take a further 2-3 years for this inventory to clear given that some of these homes are not located in areas of population growth or may be unappealing to prospective buyers. However, the current rate of new builds per annum appears to be a level of construction activity that is closer to the lows and unlikely to fall dramatically further.

Since WWII, the share of these combined four sectors to GDP typically declined by 1.5%-4.0% during recessions. During the current cycle, these sectors declined by 6.1% to reach 19.0% of GDP in Q1 2010, a new post-war low. A scenario in which the U.S. economy reverts back into recession is equivalent to expecting a renewed fall in these four sectors of activity. We see little evidence to suggest that such a historical anomaly will take place.



We remain persuaded that the U.S. economy is set to enter a period of subdued growth ranging from 1.0%-2.0% due to the combined impact of fiscal tightening and a scenario in which the household saving rate stays in a range of 6%-8%. Should households opt to maintain a lower saving rate of around 4%, the impact would be to boost real GDP growth by an additional 1%, to a range of 2%-3%.

A Review of the Global Economy

In an attempt to assess the robustness of the economic recovery in the developed and developing world, we have constructed two global indicators for retail sales and industrial production. These series capture approximately 86% of global activity in these sectors (based on combined shares of worldwide GDP). According to our measures, average growth over the last three months compared to the same period last year is 7.4% for worldwide retail sales and 9.1% for worldwide industrial production. These strong numbers are largely due to the growth witnessed in Asia and Latin America. In the

last twelve months, China's real GDP is up by 10.3%, India's real GDP is up by 8.8% and other countries in Southeast Asia are expanding at rates of 6% or higher. In Latin America, Brazil is growing by 8.8% while Mexico's real GDP expanded by 7.6%.

Canada's economy has rebounded well from the recession. Over the past twelve months, real GDP increased by 3.4% while nominal GDP was up 6.7%. The labour market continues to improve as all jobs lost during the recession were added back over the past year and employment is up 2.4% above last year's level. On the fiscal front, both Ontario and British Colombia recently announced that their deficits for 2010-11 are likely to be lower than originally forecast. Canada's economy is likely to grow by 3.0% in 2010 and we expect medium term growth to average around 2%.

Economic activity in the Eurozone continues to expand, notwithstanding the significant challenges experienced by several member countries in their respective bond markets during the first half of the year. Real GDP grew 1.9% in the region over the past year and has now expanded for four consecutive quarters. Germany is the best performing country, as a weaker Euro is boosting exports and a strong fiscal position has supported government spending levels. Consequently, real GDP in Germany is up by 3.7% over the past twelve months, compared to 1.9% for France, 1.3% for Italy and -0.1% for Spain. Progress continues to be made in the U. K. as real GDP growth was 1.7% above last year's level.

Overall, current economic developments are in line with our expectations. Economies in the developed world will transition to a slower growth path in the range of 1%-2% as fiscal consolidation and, particularly for Anglo-Saxon economies, a higher saving rate and consequent subdued spending impacts growth from 2011 and beyond. Conversely, government finances are stable and household debt levels are low in the emerging world and in these regions growth prospects remain bright. We therefore believe that global real GDP growth will range from 2.5%-3.0% over the next few years.

Investment Strategy: Bonds

Interest rates have fallen quite sharply over the past quarter as uncertainty about the strength and durability of the U.S. recovery has prompted many investors to park their funds in government securities. Between April and September, yields on two-year U.S. Treasury notes fell from 1.10% to 0.40% while ten year yields dropped from 3.85% to 2.50%. In Canada, two and ten-year yields moved from 2.00% to 1.40% and 3.70% to 2.75%. Somewhat surprisingly, longer term yields fell even as the Bank of Canada increased the overnight rate from 0.25% to 1.0% in their last three consecutive meetings.

Medium and longer-term yields in the U.S. remain lower today than twelve months ago. This is partly explained by the absence of private sector borrowing. Indeed savings by corporations and households have entirely offset the enormous demand for funds by government and a large amount of these savings are being funneled into bonds. Looking at net cash flows to U.S. mutual funds between September 2008, which marks the beginning of the credit crisis and August 2010, equity funds have seen outflows totaling $167 billion while bond funds have received $500 billion. Furthermore, a look at

commercial bank balance sheets over the same period shows that they have accumulated an additional $438 billion in Treasury and agency-backed securities.

Going forward, we expect interest rates to slowly climb higher as demand for funds from the private sector resumes and investors begin to progressively move away from bonds given the low returns currently available. Consequently, our expected return outlook for Canadian bonds is low and our fixed income portfolios are positioned defensively.

Investment Strategy: Equities

Stock prices were volatile over the past few months, down sharply during the spring during the turmoil in European debt markets before rebounding since mid-August. Over the past twelve months, the total return of the MSCI World Index converted to Canadian dollars is 2.5%. North American Indices have done better, as the S&P 500 is 5.8% while the TSX Composite is 11.6%.

As we look at stock valuation, most stock indices trade between 11x and 14x 2010 earnings except for Canada and Japan where the ratios approach 17x. Current average dividend yields are 2.6% in Canada, 2.0% in the U.S., 3.7% in Europe and 1.8% in Japan. These represent fair levels of valuation, particularly when compared with current bond yields. Additionally, we expect earnings to grow over the medium term.

We remain persuaded that equity markets provide significant opportunity for investments in quality corporations offering attractive return potential. The companies mentioned below are but some examples of our equity portfolio's exposures to global growth opportunities.

Carrefour is the world's second largest retailer with sales of €107 billion in over 15,500 stores spanning 34 countries. An investment in Carrefour provides exposure both to cash generating developed countries such as France and to fast growing emerging markets like China and Brazil. The company has embarked on a three year transformation program to improve efficiency and reduce its cost base by €3.1 billion and working capital by €1.4 billion. Furthermore, management is looking to refocus its product lines into fewer key categories and reinvent its hypermarkets in order to increase the appeal of its non-grocery merchandise. Carrefour is targeting annual sales and profit growth of 7% and 15% respectively over the next 5 years. If management is able to achieve these objectives, earnings per share could increase from €2.50 currently to €6 by 2015. Applying a 13x multiple would result in a share price of €80; the stock is currently trading around €40.

Wal-Mart is the world's largest retailer with sales of $405 billion. It is the undisputed leader in the U.S., pledging to provide customers good value for their money with an "Everyday Low Prices (EDLP)" policy. The retailer's international division accounts for around 27% of total sales and is growing at roughly 3 times the rate of its U.S. operations. Wal-Mart is the second largest retailer in UK, the largest in Mexico and rapidly expanding in Canada, China, Brazil as well as in other parts of Latin America. We believe that the company has a potential earnings per share growth rate of 10% per annum in the foreseeable future. It currently trades at 12x 2011 earnings with a 2.5% dividend yield.

Agrium is a major retail supplier of agricultural products and services in North and South America and a global producer and marketer of agricultural nutrients and industrial products. The company produces and markets three primary groups of nutrients: nitrogen, phosphate and potash as well as controlled-release fertilizers and micronutrients. The company generates $10 billion of annual revenues.

Although the majority of Agrium's revenues are in North America, the company is benefiting from global population growth and rising standards of living in emerging economies. Rising incomes lead to higher protein consumption which in turn requires more grain production for animal feed. Since the amount of arable land per capita is in decline, farmers across the world must find ways to increase their productivity and the use of fertilizers is part of the solution.

North American farmers are major exporters of grain and Agrium is well positioned to serve this market with the largest network of retail farm centers in North America. The company has also invested outside North America (Argentina and Egypt) to benefit from the availability of low cost natural gas which is the main input in the production of nitrogen. Agrium is currently trading at 10x 2011 earnings.

Kimberly-Clark is a global health and hygiene company focused on personal care, consumer tissue, professional and health care operations. The company has about $20 billion of annual revenues and markets household brand names including Huggies, Kleenex, Scott, Depend and WypAll.

Although the company has a strong North American base accounting for about 53% of its revenues, it has steadily increased its presence in developing economies. This region now represents close to a third of its sales and revenues and profits have grown at an annual rate of 13% and 14% respectively over the last 5 years. Kimberly-Clark is number one and number two in most of its product lines in Latin America, North and South Asia and Middle East, Eastern Europe and Africa. Usage per capita of tissue and absorbing products is much lower in these regions than in developed economies and this is expected to continue to provide a strong base for growth in the future.

In its mature markets, the company continues to expand in adjacent categories. The professional division provides hygiene and safety products (washroom and wiping products, gloves, masks and helmets) to workplaces. The health care segment provides devices (catheters, tubes, pumps) and supplies (gloves, gowns, masks and wraps) to hospitals.

Kimberly-Clark is currently trading at about 12x 2011 earnings with 4% dividend yield. Its balance sheet is solid with net debt to EBITDA of about 1.0x, and interest coverage of more than 15x.

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

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