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Economic and Capital Markets Outlook

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More than a year since the financial crisis precipitated a significant economic contraction, the world economy has regained its footing and steady sequential growth is occurring in many countries. Annual comparisons are set to be particularly favorable in 2010, considering the abrupt fall in economic activity that occurred in the first half of 2009.

However, one of the direct consequences of the massive intervention by government and monetary authorities across the developed world is the significant increase in deficits. Current fiscal trends are unsustainable and growth in the developed world is likely to be subpar over the medium term as governments will look to remedy these imbalances. Governments in developing economies did not intervene meaningfully during the financial crisis and in these regions growth prospects remain bright.

Growing pressure on interest rates resulting from government financing needs suggest investment opportunities in bond markets remain limited. Conversely, corporate profits should continue to see steady improvement from current levels and this should continue to provide solid returns for well chosen equity investments.

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Prospects for Global Growth in 2010

In the U.S., real GDP expanded in both the third and fourth quarter of 2009. Real GDP is now up 0.1% compared to a year ago and is 2.0% above the trough reached in mid-2009. The main drivers of this recovery are a pickup in household spending, investment in machinery and equipment and a slowdown in the rate of inventory liquidation.

As of February, retail sales were up for six straight months and increased by 3.9% compared to last year. The sequential improvement seen in consumer spending is backed by a slow but steady upturn in wages. Together with low personal tax rates and government transfers, disposable income increased by 2.1% over the last 12 months.

We continue to believe that a recovery in labour markets has begun. Real GDP has contracted by 1.7% since the end of 2007 while total employment is down by 5.9% and hours worked in the private sector are down 8.5% over the same period. This leads us to think that there is very little to no excess capacity on company payrolls. Also, many leading employment indicators are pointing toward job creation. The employment indexes of the purchasing manager surveys and the impressive growth seen in the payrolls of temporary employment services suggest U.S. job growth will resume this year. The March employment report also points in this direction as it marked the first month since May 2007 in which more than 150,000 jobs were created.

Companies are also gearing up production. Orders for durable goods are up 9.1% over the past year and gains have been registered over the past six consecutive months. Looking at the monthly inventory numbers to the end of January, inventory destocking ended in September 2009 and has stabilized since then. The inventory to sales ratio for the combined manufacturing, wholesale and retail sectors now stands at 1.25, below the peak of 1.45 reached in mid-2009 and also below the average level of 1.28 during 2004 - 2007. Therefore, any additional demand is likely to be fulfilled through new production instead of selling out of inventory. In addition, corporate profits are expanding again. Profits are up 24% since the low point reached in Q4 2008.

Our economic scenario for 2010 projects real GDP growth to approach or exceed 4.0%. We expect an increase in hours worked of 1.5% to 2.0% combined with an increase in wages of a similar amount. As tax rates will remain low and we assume no increase in the household saving rate, the rise in disposable incomes will translate directly into consumer spending. Other sectors that will contribute to economic growth are higher investment in equipment and machinery, a partial rebuild of depleted inventories and government stimulus spending. Residential investment, net exports and state and local government spending are expected to be steady this year. Private non-residential investment in structures will continue to decline given the dearth of financing available for these projects and the high vacancy rates seen in both commercial and office properties. Looking further ahead to 2011 and beyond, fiscal questions come to the forefront. A more extensive discussion of these matters will be presented in the latter half of this letter.

In Canada, economic growth has bounced back strongly over the last six months as all sectors of the domestic economy have been growing. Real GDP was up 1.4% between the fourth quarter and second quarter of 2009, although still 1.2% below the prior year's level. The fastest growing sectors were personal spending, government activity and housing. Corporate fixed investment was down slightly as were inventories and construction while capital spending on machinery and equipment increased. Trade subtracted from growth over this period as imports outpaced exports. Looking forward to the rest of 2010, our economic forecast for Canada is similar to that for the U.S., with real GDP expected to expand by 3.0% - 4.0%.

European economies are slowly coming out of the recession. German real GDP was flat sequentially in the fourth quarter and is still 2.4% lower than in the prior year. Private sector demand has not yet rebounded and all the improvement in economic output can be attributed to higher government spending and a pickup in foreign demand for German exports. France is faring somewhat better, with real GDP having expanded for the third quarter in a row. Economic growth has been generated through higher household and government spending. Sources of growth are similar in the UK where real GDP grew sequentially for the first time in seven quarters. For 2010, most economic forecasters are expecting gains of 1.0% to 2.0% for Western Europe as a whole.

Japan too is slowly recovering from recession, mostly via trade. Total exports are up 24% since the first quarter of 2009 while exports to other Asian countries are up an impressive 68% over the same period. Trade with the rest of Asia now accounts for 55% of all Japanese exports. Growth in other parts of Asia is up strongly, as can be inferred by the Japanese trade numbers. China's real GDP was up by 10.7% in the fourth quarter while the economies of India and Korea expanded by 6.0%. For 2010 as a whole, the IMF is now forecasting real GDP growth of 3.0%, with emerging countries in Asia expected to see their economies expand by an average 8.4% and contribute 23% of global growth.

Longer-term Fiscal Challenges

Over the last two years, we have seen a marked deterioration in the public finances of most of the developed world. This is in direct contrast to the early part of this decade, a period during which developed countries showed fiscal discipline. In looking at the aggregate balance sheet of the ten largest developed economies (U.S., Germany, France, U.K., Japan, Italy, Spain, Netherlands, Australia and Canada) which jointly represent 60% of the world's nominal GDP, the ratio of debt to GDP remained stable at around 50% between 2002 and 2007. During this period, Japan and the U.K. saw their government finances worsen while Spain, Australia and Canada experienced significant improvement.

Since the onset of the recession, however, all governments in the developed world acted in concert and increased government spending in an effort to replace contracting private spending. This was achieved both through special fiscal stimulus packages and so called "automatic" economic stabilizers such as unemployment insurance schemes. In addition, many governments undertook significant balance sheet expansion to restore the functioning of financial markets. This was accomplished by buying securities, extending deposit insurance schemes and offering ad hoc guarantees to financial institutions. Consequently, at the end of 2009, the aggregate ratio of debt to GDP climbed from 50% in 2007 to 66% in 2009 for the top ten developed economies and government ownership of financial assets for the same countries increased by $2.7 trillion or 7.8% of GDP.

Significant deficits are expected for fiscal years 2010-2011 as stimulus programs wind down. We are concerned with whether or not these financing requirements will place unusual stress on capital markets. What will be the impact on interest rates? How and indeed when will countries act to reduce these deficits and what will be the knock-on effects on their economies?

In 2009, in the absence of private sector borrowing, governments were able to easily finance themselves through the capital markets without exerting undue pressure on interest rates. On an aggregate basis, household savings increased by 3.0% of GDP and corporate savings increased by 3.1% of GDP from 2007 until the end of 2009 in the developed world. Furthermore, monetization of governments' debt was also needed to help balance the markets; central banks expanded their balance sheet to buy government debt or other debt securities. Most governments, most notably the U.S., have announced an end to their asset buying programs. Therefore, all new government borrowing will need to be financed by households and corporations, assuming that trade balances stay constant. Consequently, household and corporate savings will need to jointly increase by 2.3% of GDP representing additional savings of $830 billion.

This appears to be a significant challenge. The corporate saving rate is already high in most markets. The household sector's saving rate has risen in low saving countries such as the U.S., U.K. and Canada over a short period of time. Consequently, higher interest rates may be needed to induce the private sector to increase their saving rate further.

As rates move higher and financing becomes more difficult, large fiscal deficits will become more costly to finance and heavy debt burdens will be more expensive for governments to carry. We believe that governments in the developed world will need to redress their fiscal imbalances, through higher taxes and/or lower spending, or risk having the financial markets force this adjustment as was recently the case with Greece. This will adversely affect the world economy as government spending is a significant share of GDP, ranging from 20% to 25% in major developed countries. Additionally, it will be a significant political challenge. This is a key reason why we think nominal economic growth will be lower by 1% to 2% in the developed world in 2011 and beyond, in comparison to the previous economic cycle.

Investment Strategy: Bonds and Equities

Over the next one to three years, large government financing needs are likely to push interest rates higher. Longer term, our expectation for subdued nominal GDP growth in the developed world should not create an environment where interest rates are stubbornly high. In the interim, we are managing our bond portfolio cautiously, with relatively short duration and careful attention being paid to the fiscal health of the government issuers. In Canada, given the current economic performance and the persistence of close to 2% inflation, we expect the Bank of Canada to increase rates in the third quarter of 2010. How quickly and aggressively rates are raised will depend on both the actions of the U.S. Federal Reserve and the reaction of the exchange rate to a widening gap between Canadian and American short term rates.

Turning to equities, most stock markets are now trading around fair valuations. North American and Emerging markets trade closer to 16x, while stock markets in Europe are around 12x. Corporate profits are well under peak levels seen in 2007 and we expect earnings growth to return to more normal levels over the next 5 years. In addition, many companies offer healthy dividend yields that are at or above prevailing ten year government bond yields. Consequently, we continue to favor well chosen equity investments to bonds.

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