

AS AT DECEMBER 31, 2009

The global recession has ended. Now what?

By Eric Vachon, MBA, CFA

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Having emerged from the deepest recession in over 60 years, the world economy is back on track to expand in 2010, after a retraction in 2009. Central banks and governments implemented economic recovery plans that enabled several countries to begin showing positive growth in the third quarter of 2009. However, as the private sector is still moving slowly in resuming its contribution to economic activity, government participation in countries' gross domestic products (GDP) should remain significant in 2010—but for how much longer?

The world economy is expected to grow close to 3.1% according to the IMF (International Monetary Fund) but it is unmistakably the emerging countries—particularly those in the Asian region, and especially China—that are now leading the way. The strength of this recovery is due both to their limited exposure to the problems of the finan-

cial crisis and to the vigorous stimulus plans these countries were able to put in place. The OECD leading indicator (30 member countries) points unequivocally to an economic recovery for the coming months. But it is countries that are not members, in particular the BRIC (Brazil, Russia, India

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and China) that are showing the strongest growth, bolstering the likelihood of synchronized world economic growth.

The economic recovery expected in 2010 hinges on the continuity of measures taken by the central banks and government assistance. However, these measures cannot be permanent, and will have to be one day withdrawn, because the level of public debt is starting to become a major concern. For example, in Greece, the economic and financial crisis was amplified by major economic imbalances, both internally and externally. A budgetary deficit, a high level of public debt and a considerable current

account deficit have caused its credit rating to be downgraded, while its national debt (debt held by the public) to GDP ratio is nearly 110%. This downgrade increased the cost of Greece's loans. In order to restore market confidence, Greece will have to make substantial efforts to improve its budgetary position. Should this prove impossible, Greece would not be the first to default on its obligations. Mexico, Russia and Argentina have all done so in the past.

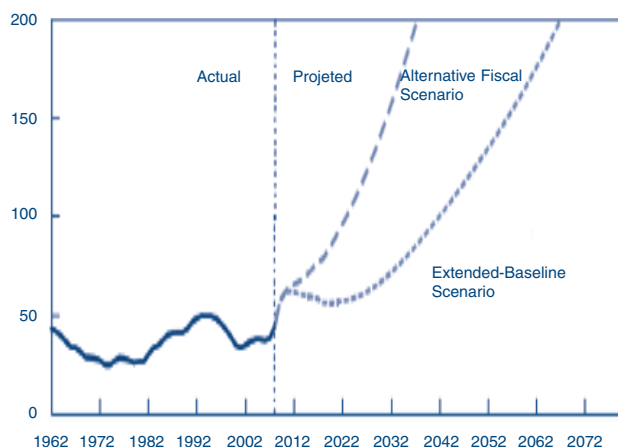
This is just one example, for the financial situations of several countries have deteriorated since 2009. Developed countries such as the United States are on the same track, but to a lesser extent, as their federal debt (debt held by the public) to GDP ratio continues to grow. In the U.S., it reached 53% in the third quarter of 2009, compared to 50.8% the previous quarter. This trend is destined to continue in the years to come, as the deficit is expected to remain high in 2010 and to be reduced only gradually in the years following. The Congressional Budget Office is predicting a public debt to GDP ratio of 61.4% at the end of 2010 and more than 65% starting in 2011.

Graph 1 - Gross Domestic Product (forecast) for 2010

GDP Growth	
United States	1.5%
Canada	2.1%
Europe	0.5%
Japan	1.7%
China	9.0%
India	6.4%
Brazil	3.5%
Russia	1.5%
World	3.1%

Source: International Monetary Fund

Graph 2 - Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios



Source: Congressional Budget Office

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Eventually, governments will have to begin slowly eliminating the stimulus measures put in place. This is unlikely to happen in 2010, since the G20 countries have agreed to maintain these measures this year. But one day they will have to plan on reducing their budgetary deficits and their growing public debts. They will do so when private sector activity becomes more vigorous. Meanwhile, we can already deduce that governments will reduce their spending while increasing taxes, which will mean tighter fiscal policies. But this will have to be done gradually, because the central banks will also have to raise their interest rates. This double action could be difficult for economies to support. The objective of re-establishing a balanced budget will be the next challenge for countries that used public debt to save their economy.

As for the U.S. Federal Reserve, following its last meeting in December, it stated that it will continue to keep interest rates low for an extended period given the low capacity utilization rate and the high unemployment rate. As well, credit access is still limited in the U.S., whether for mortgages, consumer loans or commercial

loans. Finally, inflation should remain subdued in 2010. It is the same story for the Bank of Canada: it will not raise its key rate until at least mid-year, or even later if the vitality of the Canadian dollar continues to affect the manufacturing and export sectors.

Changes in the financial markets

After a difficult start in 2009, the stock markets won back some of the losses incurred in 2008. The S&P/TSX index ended the year up 35.1%, its best performance since 1983. One of the sectors that earned the most points in 2009 was information technology, a sector largely dominated by Research in Motion, creator of the BlackBerry. The financial, energy and materials sectors also posted solid performances. The extraordinary performance of diversified metals and mining also stood out. This sub-sector, which makes up about 4% of the index, grew more than 320% in 2009, contributing the most to the S&P/TSX's excellent performance.

Meanwhile, the U.S. and international markets had an excellent year. The U.S. market, represented by the S&P 500 index, grew 26.5%, while the international market of developed countries, represented by the MSCI EAFE index, increased 31.8% in local currency. However, once again, we must underline the negative impact of the strong Canadian dollar on these returns for Canadian investors. Once con-

Chart 1 - Market Returns as at December 31, 2009

Index	Returns (%)	
	3 months	YTD
DEX 91 day Tbill Index	0.1	0.6
DEX Universe Bond Index	(0.2)	5.4
S&P/TSX Composite Index	3.9	35.1
S&P 500 (Can. \$)	3.5	8.1
MSCI - EAFE (Can. \$)	(0.3)	12.6
MSCI - World (Can. \$)	1.6	11.1
Exchange Rate (Can. \$ / US \$)	(2.4)	(14.5)

verted into Canadian dollars, these returns are only 8.1% for the S&P 500 and 12.6% for the MSCI EAFE.

With respect to the Canadian bond market, the bond market index, represented by the DEX Universe, posted a return of 5.4% for 2009. However, there were major differences in terms of issuers. The corporate bonds sector had the strongest performance, bringing in nearly 16.3% for the year. Canadian real-return bonds, represented by the DEX RRB index, were up 14.5% in 2009. Finally, while federal bonds produced the best performance in 2008, they came in last in 2009, with a negative return of -0.2%.

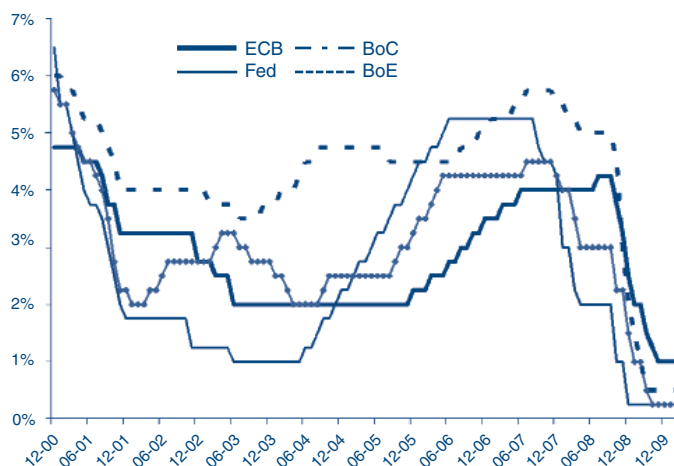
In terms of the different parts of the interest rate term structure, medium-term bonds were up the most, to 7.54%, while long-term bonds delivered a return of 5.49% and short-term bonds, 4.54%.

Outlook

The various rescue plans put forward by governments have started to take effect, and should lead to some growth in the Canadian economy. For the next twelve months, we are forecasting roughly 2.5% growth in Canadian GDP. Similarly, our forecast for the unemployment rate for 2010 is around 8.5%. We expect inflation to remain low, around 1.7% for the next twelve months.

In this context, the Bank of Canada could decide to leave its key rate at the current level for

Graph 3 - Evolution of central banks rates



Source: IAIM

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a few more months, but it may consider a rate hike in the second half of 2010, if it sees that the Canadian economy is well on the mend.

As for the bond market, we predict a return of about 3% for bonds. The equity market may continue its upward momentum, but to a lesser extent than in 2009. We are forecasting a performance of about 10% for the S&P/TSX. With respect to asset allocation, some modifications were made in the last quarter of 2010, but we are optimistic about potential returns for equities. Thus, in the last quarter, we reduced the weighting of Canadian equities by 1%, and increased the weighting of foreign equities on the basis that the U.S. economy is starting to regain shape and in order to secure gains in Canadian equities. We remain attentive to changes in the market so as to take advantage of any investment opportunities that arise.

Chart 2 - Economic and financial indicators - Canada

	2004	2005	2006	2007	2008	The most recent data	Trend	Forecast December 2010	
Real gross domestic product (%)	2.6	3.3	2.7	2.4	0.3	-3.2 ¹	↗	2.0 to 2.75	*
Inflation rate (%)	2.1	2.2	2.0	2.5	2.4	1.0 ²	↗	1.0 to 1.75	*
Unemployment rate (%)	7.1	6.5	6.3	5.9	6.5	8.5 ³	↗	8.25 to 8.75	**
DEX 91 day Tbill Index (%)	2.44	3.39	4.01	3.90	0.87	0.21 ³	↗	0.75 to 1.25	**
3-year mortgages (%)	5.60	6.00	6.20	7.55	6.25	4.25 ³	↗	4.5 to 5.5	**
10-year bonds (%)	4.31	3.98	4.4	4.0	2.68	3.61 ³	↗	4.0 to 4.5	**

¹ As at October 31, 2009 ² As at November 30, 2009 ³ As at December 31, 2009
 * Annual average ** End of period

Chart 3 - Estimated gross returns for the next twelve months starting December 31, 2009

Market indicators	Interest or dividend	+	capital gains	=	Total estimated gross return
DEX 91 day Tbill Index	0.60%	+	0.00%	=	0.60%
DEX Universe Bond Index	4.40%	-	(1.10%)	=	3.30%
Canadian stocks (S&P/TSX Composite Index)	2.40%	+	8.55%	=	10.95%

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Risk makes a comeback

By Selena Bentkowski, B.B.A.
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2009 was nothing but uneventful. The financial crisis reached its peak at the start of the year. Consumer and investor confidence plummeted while the unemployment rate soared. However, there was also a spectacular rebound on the stock markets. The bond market thawed, credit became accessible once again, and the worst recession seen in the United States since the 1930s came (technically speaking) to an end.

Nonetheless, we should not expect growth over the course of the next few months to be very strong. It will no doubt be weaker than what we have experienced in the last decade; knowing this, however, investors should be able to act accordingly.

Government stimulus programs are still in place, which should encourage economic growth in the short term. Short-term interest rates remain low, and the U.S. government has not given any indication that it plans to raise them anytime soon. Some analysts are even predicting the status quo until early 2011. This leaves the economy with plenty of time to begin functioning more autonomously. In Canada, rates should remain at their current level of 0.25% until mid-year, after which a steady and sys-

tematic increase is conceivable. Several elements could affect interest-rate decisions. On the one hand, the Bank of Canada is starting to voice its concern regarding the high level of debt held by Canadians, and this could put upward pressure on rates. On the other, the loonie continues to make gains against the U.S. dollar. An increase in rates would likely drive the loonie up even further, which would be damaging to Canadian companies exporting to other countries.

The credit market is moving again. At the end of 2008, the bond market had pretty much come to a standstill. There was a period of great uncertainty when the U.S. government made the decision not to bail out a major financial player, Lehman Brothers. This marked a major turning point in the credit crisis. Confidence among capital market stakeholders was so low that even the biggest banks were hesitant to lend each other money. The TED spread—the difference between interest rates on U.S. treasury bonds and interbank loans, an indicator of the level of risk aversion in the market—was at its widest ever. Credit was simply not available!

Since the start of the year, this spread has returned to a level that is a bit more in keeping with what we saw before the crisis took hold, which shows that investors' appetite for risk is back. In fact, in the last quarter of 2009, sever-

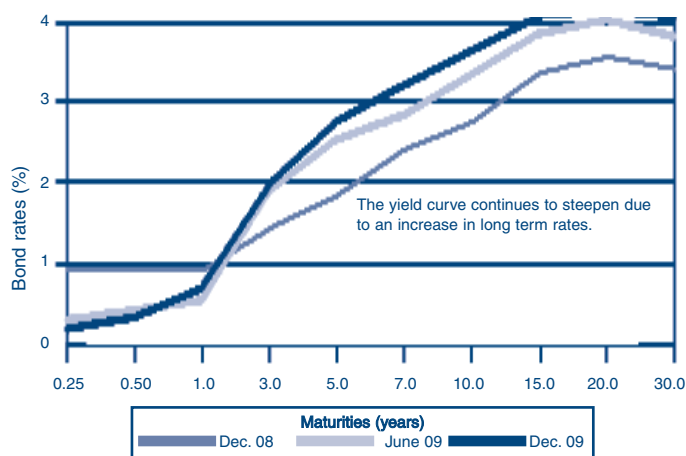
al companies turned to the markets to seek financing. Just 12 months earlier, it was virtually impossible to trade even very high-quality securities on the bond market. According to BMO Capital Markets, last November, companies issued securities totalling nearly \$11 billion, the largest amount issued in over two years, and they all found takers.

The 2009 bond market can therefore be described by a return of risk. The year began with a risk aversion level that was the highest seen in a very, very long time. Then, after the stock markets hit bottom on March 9, a number of more risky assets, which had been given the cold shoulder since the start of the crisis, began a stunning rebound.

This return of risk is playing out on two fronts:

Return of risk 1: investors are now once again looking for risk in order to obtain a certain amount of return—something higher than the 0.6% which is the approximate return currently being earned on 3-month U.S. treasury bills or on cash. During the extended period of uncertainty just experi-

Graph 1 - Evolution of the yield curve



Source: IAIM

Chart 1 - Returns of the Canadian Bond Market as at December 31, 2009

Index	Returns (%)	
	3 months	YTD
DEX Universe Bond Index	(0.2)	5.4
DEX Short Term Bond Index	0.4	4.5
DEX Mid Term Bond Index	(0.3)	7.5
DEX Long Term Bond Index	(1.4)	5.5
DEX Canada	(0.5)	(0.2)
DEX Provincial	(0.9)	4.7
DEX Municipal	(0.3)	6.2
DEX Corporate	1.0	16.3

Source: Scotia Capital Debt Market Indices

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enced, a large majority of investors took refuge in these safe havens, either putting their money in U.S. treasury bills or simply leaving it in their bank accounts.

Return of risk 2, or rather, the return on risk. We can clearly see that the most notable performances of 2009 came from investment vehicles with the highest levels of risk: the stock markets, emerging markets and small-cap stocks—in short, all the investments that had lost the most in the collapse. But bonds also managed to participate in this recovery. Corporate bonds and high-yield bonds posted quite impressive returns in 2009, outperforming the other sectors of this market. The bond market as a whole, represented by the DEX Universe Bond Market Index, delivered a return of 5.4% for 2009 (-1.4% in the last quarter of 2009), but the sector that had the strongest performance was that of corporate bonds, which brought in nearly 16.3% for the year (1.0% in the last quarter). This sector, which accounts for 27.5% of the total index, contributed 4.5% of the Universe's 5.4% return.

With all of the stimuli being injected into the markets, the question of inflation is justified. The U.S. government has injected massive amounts of liquidity into the markets in an attempt to keep the economy afloat, and it worked. Although some of this liquidity has already been put into circulation, a large part is still to come in 2010. And even if inflationary fears are not too great at the moment, the future will eventually catch up and that is when the repercussions of these massive injections will be felt. Although in the short term, we do not need to be concerned with a return of inflation, in the longer term, the bond market seems to be indicating that it is indeed a risk. Canadian real-return bonds, represent-

ed by the DEX RRB Overall Index, were up 14.5% in 2009, and surpassed all sectors of the DEX Universe in the last quarter with a return of 4.5%.

With low rates in the short end of the yield curve, the curve remains very steep. Rates in the long end went up during the year, and this is in part responsible for eating away at the performance of federal bonds (-0.21% for the year). Generally, bonds with maturities of five years or more were up for the year. It is on such occasions that lenders fill up their coffers, by borrowing at low rates and then lending at higher ones. The one hitch is the reluctance of banks to lend money as freely as they did before the crisis. There are also borrowers, namely consumers, who are reluctant to increase their debt burden, which is already quite high.

Some investors are apprehensive that the central banks will keep their very accommodating policies in place for too long, therefore creating another situation of excess. A wide spread between the yields on 2-year and 30-year treasuries usually signals upcoming economic growth. This spread is currently at the same level as just after the 2001-2003 recession. Have we reached a plateau? Will we see a shrinking of these spreads in the coming years? Historically, we have seen these spreads reach their highest levels during recessions, to subsequently contract during the ensuing period of economic growth, which is a possible scenario this time as well.

We are still seeing a lot of money going into bonds, a sign that people are still hesitant to believe that the worst is truly behind us. However, the security of these low-risk securities is obtained at the expense of return, and this is starting to put pressure on investors to take on more risk.

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A decade in review

By **Hubert Lemire, FSA, FCIA, CFA**
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The last 10 years were marked by several haunting events: the September 11, 2001 attacks, the ensuing war against terror, and the December 26, 2004 tsunami in the Indian Ocean. A somewhat less dramatic event, or rather non-event, was the fact that no Canadian hockey team was able to win the Stanley Cup this decade. A Canadian team had managed to win the trophy in each of the previous decades, the last one being the Montreal Canadiens in 1993. The one (very) small consolation we can find is that our Canadian stock market outperformed that of Uncle Sam in this last decade—na-na na na, na-na na na, hey hey, good-bye!

On the economic and financial fronts, the 2000-2009 decade also contained its share of memorable events. We survived the Y2K bug (!) and the bursting of the tech bubble. Investors were convinced that the “new economy”—anything to do with technology, telecommunications or media—was the wave of the future. At its peak,

the former Nortel company represented more than one third of the S&P/TSX.

This decade also begat two recessions in the United States, the first from March to November 2001 and the second beginning in December 2007 and now just ended or ending. This latter was the longest recession since the Great Depression of 1929.

A major theme during this decade (and which will continue into the next) has been the dazzling progress of emerging countries such as China, India and Brazil. While the U.S. remains the planet’s driving economic force, its dominance on the world scene is slowly being diminished in favour of the emerging countries. In particular, China will soon become the second largest economic power, overtaking Japan, which has held this position since 1968.

The strong growth of emerging countries led to a heavy demand for raw materials, causing a price explosion. The CRB index, representing the prices of nearly twenty commodities listed on stock exchanges, has more than

doubled since the start of the 21st century; in particular, the prices of copper and zinc have climbed considerably. The price of oil has also skyrocketed, from \$20 at the start of the century to nearly \$150 a barrel in July 2008; it is currently at around \$80 a barrel. Gold did well this decade too, going from a low of \$260 per ounce in April 2001 to a peak of more than \$1200 an ounce at the end of November 2009.

This trend had a significant impact on stock market performances throughout the decade. Emerging market equities delivered an excellent performance for the 10-year period ending December 31, 2009 (Graph 1). The Canadian stock market, which benefited from a heavy exposure to commodities, posted a very respectable return for this period. However, this performance recently became highly volatile, with 2008 turning out to be one of the worst years on record, and then 2009, one of the best.

Although hiding your savings under a mattress would not have brought you any interest during the decade, it would still have been a better strategy than investing in U.S. or international equities: both saw their values plummet during this period.

Graph 1 - Annualized returns of various market (over a period of 10 years)

Asset Class	Index	Period ending	
		31-12-2009	31-12-1999
Canadian Equity	S&P/TSX Composite	5.6%	10.6%
U.S. Equity	S&P 500*	(0.9%)	18.2%
International Equity	MSCI - EAFE*	(1.0%)	6.5%
Emerging Markets Equity	MSCI Emerging markets*	10.2%	n/a
Canadian Fixed Income	DEX Universe	6.7%	10.1%
Money Market	DEX 91-day Tbill	3.3%	6.6%

* In local currency

Source: IAIM

The diversified metals and mining sub-sector grew more than 320% in 2009, contributing the most to the S&P/TSX's excellent performance.

Chart 1 - Market Returns as at December 31, 2009

Index	Total Return %	
	3 months	YTD
S&P/TSX Sector returns		
Energy	5.4	39.5
Materials	6.2	34.2
Industrials	8.7	27.0
Consumer Discretionary	6.0	15.1
Consumer Staples	8.2	8.1
Health Care	(2.4)	34.4
Financials	(0.7)	45.6
Information Technology	0.8	44.3
Telecommunication Services	7.5	6.6
Utilities	13.3	19.0
S&P/TSX Composite Index	3.9	35.1
S&P 500 (Can. \$)	3.5	8.1
MSCI - EAFE (Can. \$)	(0.3)	12.6
MSCI - World (Can. \$)	1.6	11.1

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In the U.S., the last ten years on the stock market are now being called the "Lost Decade." The benchmark index for U.S. fund managers, the S&P 500, was down nearly 10% for the last ten years in local currency, the first negative decade Wall Street has seen. Even after the stock market crash of 1929, the 1930s decade of the Great Depression ended with a positive return on investments.

Similarly, the international market, represented by the MSCI EAFE, also delivered a negative performance for the decade, primarily because of the Japanese economy, which had another rough decade. However, the 2000-2009 decade began at the same time as the bursting of the dot-com bubble in March 2000. This was followed by a stock market downturn, aggravated by the 2001 recession and then by the attacks of September 11, 2001.

This counter-performance of the foreign markets doesn't take into account the impact of the rise of our Canadian dollar against most other currencies during the decade, which had the effect of diminishing the returns of investments made outside the country.

Of course, stock market projections for the coming decade should not be based on what happened in the last one. The performance of U.S. equities in the previous decade is an example. As shown in the Graph 1, in 1990-1999, U.S. equities outperformed all other asset classes by far. At the moment, investors may not see any reason to invest outside of Canada, but it is always important to keep a well-diversified portfolio, not only in terms of asset classes but in terms of geographic regions as well.

We cannot conclude without a discussion of the performance of our Canadian stock market in 2009. The S&P/TSX ended the year up 35.1%, its best performance since 1983. Information technology was one of the sectors that obtained the greatest gains during the

year, a sector largely dominated by Research in Motion, creator of the BlackBerry. This sector grew by more than 44% in 2009, after having lost more than 50% in the previous year. The financial, energy and materials sectors, which together account for nearly 80% of the S&P/TSX index, also posted solid performances. There was also the extraordinary performance of diversified metals and mining. This sub-sector, which makes up nearly 4% of the index, grew more than 320% in 2009, contributing the most to the S&P/TSX's excellent performance.

With respect to sector performance, the 2009 portrait was the complete opposite of that of 2008: the sectors that had performed well in 2008 (defensive sectors) were those that did the most poorly in 2009, and vice versa. All sectors still ended the year in positive territory, unlike 2008, where they all ended in negative territory. Telecommunications, consumer staples and consumer discretionary spending obtained the lowest returns.

Finally, the Canadian dollar rose more than 17% against the U.S. dollar in 2009, recovering much of its value lost in 2008. This is one of our dollar's biggest surges against the U.S. dollar in a calendar year. Our dollar's increased strength is largely a result of the weakness of the U.S. dollar: the latter has fallen against all other major currencies, with the exception of the Japanese yen.