

Market review

- Equity markets continued to rally through the fourth quarter, although to a lesser degree than during the previous two quarters. The S&P/TSX Composite Index achieved a total return of +3.9% for the period.
- Utilities (+13.3%) was the best-performing sector, followed by Industrials (+8.7%) and Consumer Staples (+8.2%).
- Health Care (-2.4%) and Financials (-0.7%) were the only sectors with negative returns. Information Technology (+0.8%) also underperformed.
- The bond market in 2009 was all about the quarters – one's impression of the market depended very much upon which quarter one was looking at.
- In contrast to the rest of the year, the fourth quarter was not all that rewarding. There was some profit taking in the corporate and provincial markets and some genuine concern by investors over the prospects for inflation and real yields. For perspective, the 2009 DEX Universe Index returns by quarter were: 1.52%, 1.25%, 2.71% and -0.16% respectively.
- Ten-year government yields rose globally, with the U.S. leading the charge (53 basis points), followed by the U.K. (42 basis points) and Canada (30 basis points). Noticeably, Japanese yields did not rise.
- At the shorter end of the yield curve, stability is still the name of the game, with the exception in the developed world of the commodity plays – Australia, Norway and to a lesser extent Canada.
- We have only seen two central banks raise rates: Australia (in October and November) as well as Norway (in October and December). Although there was considerable speculation in the fourth quarter that the Bank of Canada (BoC) would at least adopt a more aggressive bias, which remains to be seen, for now, the official holding pattern of the BoC remains in place.
- Perhaps, most dramatic was the quarterly dispersion of corporate bond returns. For 2009, by quarter, corporate bonds delivered the following returns: 3.48%, 6.49%, 4.47% and 0.99% respectively. (Q2 & Q3 presented huge returns by any historical standard.)
- For those who developed a sudden interest in corporate bonds, the fourth quarter proved to be a bit of a disappointment. To put things in perspective, corporate yield spreads narrowed by 215 basis points (according to the DEX Corporate Bond Index) from January to September and then only marginally by 14 basis points from October to December.
- Despite the reduced enthusiasm for corporate bonds in the fourth quarter, there was still significant appetite. Globally, new corporate issuance was substantial – U.S., Canadian and European markets saw 265, 16 and 423 \$USD billion of new issuance respectively.
- In addition, the corporate bond market has undoubtedly seen some credit deterioration. Downgrades to upgrades have been running at 4.7X in the U.S. and 2.7X in Canada. However, this ratio has greatly improved from this time last year.
- The provincial bond market generated some interest of its own, as yield spreads widened earlier in the year, to levels last seen during the Referendum years. For the year, the provincial sector returned a handsome 4.72%, albeit somewhat reduced by the negative 0.89% return in the fourth quarter.
- 2009 taught us two things: 1. the value of a well diversified bond portfolio and 2. don't get too caught up in the here and now, as fundamentals ultimately prevail over time.
- We are constantly reminded that fundamentals play out over time and that investors tend to underestimate the time it takes for them to unfold fully.
- Over the last year, investors have been preoccupied with the following:
 - Deteriorating government finances. (this too will likely take time.)
 - A virtuous economic recovery. (this will take more time.)
 - Higher rates of inflation. (this will take even more time.)
- However, in our view, none of the above has materialized in a substantial way.
- We believe the economy has yet to prove itself – government intervention is too entwined, and there is this nagging feeling of the economy still being on life support.
- We concede that in the most recent quarter we have seen improvement in business and consumer confidence surveys. However, there has not been convincing improvement in housing and employment.
- Consumer finances have improved marginally in the U.S., largely due to market appreciation. In Canada however, consumer balance sheets have deteriorated as mortgagors have responded to low rates by taking on more credit.
- We see government finances as the economy's and the bond market's "Achilles Heel". We are not yet at a point of no return, or in market terms, significantly rising real yields, but we may very well get there in the next year. U.S. debt to

GDP has risen from 37% two years ago to 54% today and is projected to be 61% for this year, according to most recent Congressional Budget Office figures. The Canadian situation is clearly not as bad.

- We remain unconvinced for the prospects of higher inflation. Yes, M1 (money market) is at record levels in the U.S. (45.6% year-over-year), but bank reserves have absorbed most of the excess liquidity. Lending to the consumer has improved, but only sparingly and lending to small business is a non-event.

Portfolio review

Performance contributors

Asset Mix

- A modest overweight in U.S. equities added marginally to performance.

Security Selection

- Strong stock selection in the U.S. and International equity components added to performance.

Performance detractors

Asset Mix

- A slight overweight to international equities detracted slightly from performance.

Security Selection

- Stock specific issues within the Canadian equity portion detracted about 51 basis points from performance.

Outlook and strategy

- We remain bullish on equity markets for the simple fact that monetary policy remains stimulative. With core inflation at 1.5% (1.7% in the U.S.) and the unemployment rate at 8.5% (10% in the U.S.), we expect the Bank of Canada and the Fed to remain on hold for at least another three to four quarters. Of course, there will be significant debate around the timing of when and how the central banks will begin to remove stimulus and raise rates, fearing loose monetary policy will overstay its welcome and sow the seeds of the next bubble. Furthermore, with governments spending their way out of this recession, budget deficits are ballooning and concern lies in how they will ultimately pay for this spending binge. These are topics of future strategy pieces. The point is that we are still in the early stages of a recovery from an extraordinary recession, and that the structural issues that caused the crisis (overleveraged consumer; global trade imbalances) will take years to correct. In our opinion, it is the cyclical opportunities over the structural issues that will dominate markets for at least the first half of 2010.
- With the S&P/TSX Composite Index trading at a 2010 price/earnings ratio of 15 there appears to be limited value in the market, especially from a multiple expansion perspective. However, with 25% earnings per share growth currently priced in the market after a dramatic 37% drop in trailing operating earnings, growth expectations are relatively reasonable considering the starting point and

are below historic recovery levels recorded following previous recessions. From a sector perspective, we retain a positive bias toward materials favoring copper and coal due to robust emerging market demand and supply constraints on the copper side. Our favored play to gain exposure to both of these commodities is **Teck Resources Ltd.** We are also constructive on the Industrials. Increased government infrastructure spending is finally coming to fruition and commodity producers are investing in projects that were contemplated prior to the economic crisis. **SNC-Lavalin Group Inc.** provides exposure to both of these opportunities. Lastly, we've recently become more cautious on the banks both due to the proposed capital rules released by the Basel Committee, which in its current proposed form appear to be restrictive, and to backlash in sentiment toward the banks that has been building in Washington. Canadian banks are on solid footing but from a tactical portfolio orientation, it'll be difficult for our banks to gain significant ground against the wall of worry that's building in the U.S. and European jurisdictions.

- Forecasting is always easy in hindsight, nevertheless, one can always learn from one's past errors and try not to repeat them. We were clearly heard saying:
- *"We continue to be more bearish than most, and are doubtful that any significant rebound in the economy and the stock market will occur in 2009."*
- While we continue to be more bearish than most (you might ask what exactly we've learned), we have a better appreciation that our bearishness will likely take more time to play out, and that our bearishness is relative. We expect a protracted recovery. However, we have learned not to underestimate the resolution, or short term impact of governments.
- With respect to government, we don't expect their intervention to disappear soon and that should continue to benefit equities and corporate bonds as yield spreads become stable and narrower.
- Government bonds may be another story – particularly in the U.S. If government balance sheets continue to deteriorate, we expect real yields to respond at some point by moving higher. However, we tend to lean toward that playing out much later in the year, albeit with some shorter term volatility. Canadian government bonds should outperform in this scenario.
- Any rise in yields will likely be capped by the negative impact that higher rates will have on the economy.
- The Canadian economy appears more resilient than that of its southerly neighbour, although that may be a bit misleading. Growth to the north has been better, but most of that has been on the back of a more indebted consumer responding to lower interest rates. We expect this behaviour is likely to wane as the year progresses.
- In regions where there is substantial excess capacity in plant, equipment and most importantly labour, we don't expect to see a rise in inflation. Effectively, this includes most developed and developing countries. The implication is that bond yields will not rise over the medium term due to rising inflation expectations.

- Aggregating our outlook for real bond yields and inflation expectations, leads us to expect coupon- like returns for government bonds in 2010. Investors have been anticipating the worst from government bond markets for several years; we expect this year to again surprise them with positive returns of 2% to 3%.
- The Bank of Canada and the Fed will both remain on hold throughout most of the year, although we expect investor sentiment to shift around on this topic.
- The bias for the yield curve is for flattening in Canada. The curve is already steep and any rise in short rates will likely imply flattening.
- The corporate bond market was quite a performer during 2010, generating returns of 10.97%, 21.30% and 25.87% in Canada in short, mid and long ranges respectively. We don't expect 2010 to repeat those kinds of returns, but there will be the opportunity for coupon plus some capital gains. There is currently an imbalance between the demand for income securities and the available supply – we expect this situation to persist. Expect corporate returns to be volatile, but with a positive bias in the range of 4-5%.
- We are selectively looking for tactical opportunities. In the shorter term, we feel there will be opportunities to capitalize on the steepness of the credit curve. We continue to have a conservative bias and feel the risk-reward trade-off in the long end is most compelling in defensive sectors, whereas in the shorter end we continue to favour subordinated issues of high quality names.

Any amount that is allocated to a segregated fund is invested at the risk of the contract holder and may increase or decrease in value.

This report is published to provide additional information on economic conditions and investment performance. It was prepared by Laketon Investment Management.