EQUITY RESEARCH

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INVESTMENT STRATEGY

Outlook & Portfolio Strategy – Update

Market momentum may enable strong finish to 2009, but 2010 will be challenging

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Index Levels

TSX	10878.35
TSX Venture	1289.62
DJIA	9789.44
S&P 500	1042.88
Nasdaq Composite	2049.20
MSCI World Index	283.15
Risk Metrics	
VIX	29.78
TED Spread	0.23%
FAIL®	6.81

Prices and levels as at close on November 2, 2009

Interest Rates & Commodity Prices

Canada T-Bill (90 days)	0.16%
US T-Bill (90 days)	0.04%
Canada 10-year Govt.	3.43%
US 10-year Treasury	3.42%
Canada 30-year Govt.	3.94%
US 30-year Treasury	4.26%
CRB Index	273.50
Spot Gold	US$1059.50
Crude Oil (Dec.)	US$78.13
Canadian Dollar	92.87 US cents
USD/Euro	1.4797
USD/JPY	90.46

Source: Bloomberg

Summary

- While financial markets are factoring in a robust rebound for the global economy in 2010, the actual recovery is likely to fall short of expectations, in our opinion.
- As a result, we believe next year is likely to be a challenging one for financial markets as economic reality tempers rampant bullishness.
- Our top three reasons for advocating caution –
  1. Valuations are no bargain despite optimistic earnings projections.
  2. Risk appetite is rising to levels that suggest complacency.
  3. Can old leaders lead new bull markets?
- In our opinion, strong market momentum is likely to overcome the nervousness that has manifested itself in recent weeks, leading to positive performance by equities as we head towards year-end.
- As a result, we are revising our end-2009 index targets to 11,500 (from 11,000 previously) for the TSX Composite and to 1,100 (from 1,000 previously) for the S&P 500.
- We believe that the risk-reward payoff is presently tilted in favour of stocks over bonds. Our recommended asset allocation is therefore – Stocks 55%, Bonds 25%, Cash 20%.

Table 1: Major equity indexes – Q3 and YTD* change

Country	Index	Change in Q3 '09	Change in YTD*
Canada	TSX	9.8%	21.0%
Canada	TSX-V	16.9%	61.8%
US	DJIA	15.0%	11.5%
US	S&P 500	15.0%	15.5%
US	Nasdaq	15.7%	30.0%
Mexico	Bolsa	20.0%	28.0%
Brazil	Bovespa	19.5%	63.9%
UK	FTSE 100	20.8%	15.1%
Germany	DAX	18.0%	12.9%
France	CAC 40	20.9%	13.1%
Russia	RTS	27.1%	113.5%
Japan	Nikkei	1.8%	10.7%
Australia	ASX 200	19.9%	22.0%
India	Sensex	18.2%	64.8%
China	CSI 300	-5.1%	86.7%

*as of Nov.2, 2009
Source: Bloomberg, Global Securities Research

MARKET REVIEW

Optimistic expectations fuel stellar market gains

Thanks to the shot-in-the-arm provided by stimulus efforts around the world, the global economy seems to have recovered faster than one would have thought possible a scant six months ago. That's the good news. The bad news is that market reaction to this unexpectedly rapid recovery (we hesitate to call it "V-shaped") has been disproportionately optimistic, even euphoric at times. As a result, valuations have expanded and risk metrics have contracted at an exceedingly sharp pace, in some cases reverting back to levels last seen in 2007 (more on this subject later), the year global equity markets reached a record high.

Investors globally had little cause for complaint in the third quarter, with solid double-digit gains being the norm for most major equity markets (Table 1), notable exceptions being China and Japan. The S&P 500's 15% gain in Q3 enabled it to post its best two-quarter advance since 1975. Year-to-date, the resource-heavy TSX-Venture index and the BRIC giants (Brazil, Russia, India and China) have led the upward charge. But we believe the substantial outperformance of commodities and emerging markets is a cautionary signal, as discussed later in this report.

OUTLOOK

While financial markets are factoring in a robust rebound for the global economy in 2010, the actual recovery is likely to fall short of expectations, in our opinion. The global rally in equities, commodities and other assets over the past eight months has front-loaded gains in asset prices arising from renewed economic growth. As a result, we believe next year is likely to be a challenging one for financial markets as economic reality tempers rampant bullishness.

We discuss below our top three reasons for suggesting that caution may be warranted in these markets.

1. **Valuations are no bargain despite optimistic earnings projections.**

Since our previous strategy update in July, earnings estimates have been lowered for the companies that constitute the TSX Composite, and are relatively unchanged for the S&P 500. Index earnings for the TSX – based on "bottom-up" analysts' earnings estimates – are now estimated at $623 in 2009, compared with an estimated $645 in July. While we continue to hold the view that TSX index earnings this year may exceed the $623 estimate, our estimate of $637 is now only 2% above consensus. We have pared our earlier expectations as the rebound in commodity prices has been offset to a significant extent by the Canadian dollar's surge in recent months.

TSX index earnings are forecast to increase 28% to $796 in 2010, based on bottom-up earnings estimates. In our opinion, that earnings growth rate may prove to be too optimistic. Our current forecast for TSX index earnings for 2010 is at $760, or 4.5% below the consensus number. Table 2 provides a summary of YTD sector performance and our forecast earnings change for TSX sectors for 2009 and 2010.

Table 2: TSX Sector Performance and Forecast EPS Change

TSX Group	YTD Change (%)	Forecast EPS change (%) 2009	2010
Financials	30.6%	0.9%	11.8%
Energy	26.0%	-55.4%	29.2%
Information Technology	24.0%	31.7%	11.1%
Health Care	23.4%	11.4%	20.0%
Materials	21.6%	-34.7%	50.0%
Industrials	9.9%	-22.6%	7.7%
Consumer Discretionary	2.3%	-19.7%	25.0%
Utilities	-0.5%	0.4%	4.5%
Consumer Staples	-2.8%	1.2%	5.0%
Telecom Services	-5.3%	6.7%	1.7%
TSX	**21.0%**	**-25.3%**	**19.3%**

Source: Global Securities Research, Bloomberg

For the S&P 500, bottom-up earnings estimates suggest index earnings may rise 13% to $55.78 this year, surging 33% to $74.33 in 2010. In our opinion, those estimates could also prove to be too buoyant.

The eight-month rally in equities has driven valuations to levels where they are no bargain. The TSX Composite currently trades at forward multiples of 17.5x 2009 forecast earnings (based on consensus estimates) and at 13.7x 2010 earnings. The S&P 500 trades at forward multiples of 18.7x 2009 earnings, and at 14.0x 2010 earnings. Those are fairly rich valuations on a historic basis.

2. Risk appetite is rising to levels that suggest complacency.

Most indicators suggest that the risk pendulum has swung from extreme aversion earlier this year to renewed enthusiasm for volatile assets. Gains by emerging market equities, junk bonds and commodities have outpaced those posted by their conservative counterparts by huge margins. With sales of the lowest quality corporate bonds soaring, junk bond yields have dropped significantly, despite abundant risk. According to Fitch Ratings, CIT Group's bankruptcy filing has pushed the US high-yield default rate for 2009 to 13.1%. The TED Spread (the difference in yields between three-month USD LIBOR and three-month US T-Bills) fell to a 5½-year low of 16 basis points in September (compared with an average 148 basis points from August 2007 to February 2009), while the LIBOR-OIS spread also fell in September to 11 basis points, the five-year average level in the period prior to August 2007.

Part of the rebound in risk metrics represents a recovery to more normal times after the panic-driven period that extended from September 15, 2008 – following the collapse of Lehman brothers – to the first week of March 2009. However, an inordinate increase in risk appetite could have the effect of fostering complacency and threatening the market recovery.

3. Can old leaders lead new bull markets?

The 2003-07 bull market was characterized by runaway gains in commodities such as crude oil (up over 200%) and copper (up over 330%). These gains were fuelled by rapid economic growth in China and the other BRIC nations, whose equity indexes also posted spectacular gains during this five-year period (Table 3 – for comparison purposes, we have also shown returns for the TSX-Venture and S&P 500).

Table 3: Total Returns from 2003 to 2007

Index	Total Return (%)	Annual Equiv.
Russia RTS (US$)	580.5%	46.7%
India SENSEX	552.8%	45.5%
Brazil BOVESPA	467.0%	41.5%
China CS! 300*	459.0%	80.5%
TSX-Venture	164.4%	21.5%
S&P 500	82.8%	12.8%

*since January 2005

Source: Bloomberg, Global Securities Research

Market history suggests that new bull markets are always accompanied by a change in leadership, with the Old Guard making way for dynamic new sectors. However, the recent market ascent has been accompanied by a renewed belief in the same drivers that fuelled much of the 2003-07 bull run – specifically, rapid economic growth in China and India, and surging commodity prices. In our opinion, these drivers are unlikely to be as influential this time as they were in the previous bull market, a factor that is especially pertinent to the resource-laden TSX Composite. While the IMF recently estimated that China and India will continue to be among the fastest-growing economies this year and next, we believe that their growth rates will be appreciably slower than those recorded earlier in this decade, given the subdued recovery expected in the rest of the world. The secular decline in the US dollar and resurgent demand in the emerging nations provide a positive outlook for commodities. However, slowing global growth and a decline in Chinese metal intensities over the long term may help restrain commodity price gains.

STRATEGY

Our view continues to be that equities have *not* embarked on a multi-year bull run. Rather, we believe there is a distinct possibility that equity markets may be range-bound for a few years, as the new mood of frugality among consumers leads to a tepid economic recovery.

In our opinion, strong market momentum is likely to overcome the nervousness that has manifested itself in recent weeks, leading to positive performance by global equities as we head towards year-end. As a result, we are revising our end-2009 index targets to 11,500 (from 11,000 previously) for the TSX Composite and to 1,100 (from 1,000 previously) for the S&P 500. At this point, we expect very modest gains for these indexes in 2010, based on our view that they are currently running well ahead of fundamentals.

We believe that the risk-reward payoff is presently tilted in favour of stocks over bonds, especially in light of the outsize gains posted by corporate bonds in recent months. As a result, we are raising the equity allocation in our recommended asset mix by five percentage points at the expense of bonds. **Our recommended asset allocation is therefore – Stocks 55% (up 5 points from 50% earlier), Bonds 25% (down 5 points from 30% earlier) and Cash 20% (unchanged)**.