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MONTHLY MARKET COMMENTARY

INVESTMENT RESEARCH

MARCH 2010

February 2010 Review

	February 28, 2010	December 31, 2009	% Change
TSX	11,632.0	11,746.1	(1.0)%
S&P 500	1,104.5	1,115.1	(1.0)%
DJII	10,325.3	10,428.0	(1.0)%
NASDAQ	2,238.3	2,269.1	(1.4)%
10 Yr. Cda Bonds	3.39%	3.61%	(22) bp
10 Yr. US Bonds	3.61%	3.84%	(23) bp
90 Day Cda T-Bills	0.17%	0.24%	(7) bp
90 Day US T-Bills	0.12%	0.05%	7bp
US\$ vs. Can\$	\$0.9502	\$0.9515	(0.1)%

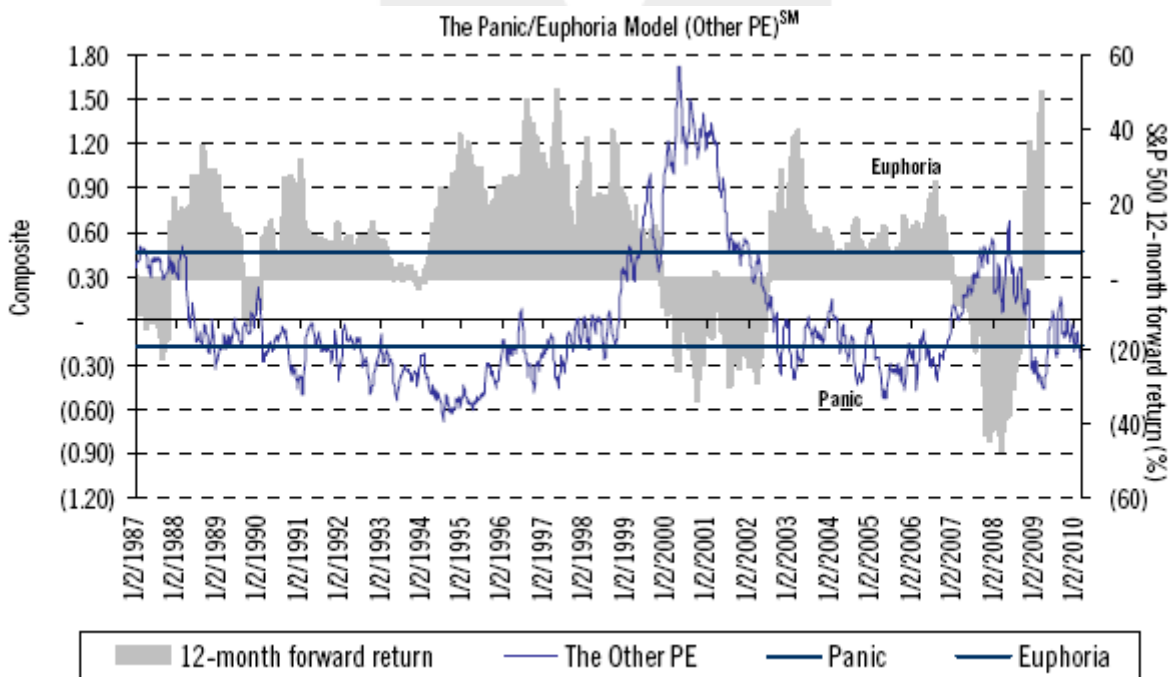
February Blahs:

We find writing the February monthly comment the most difficult of the twelve months. February has the least amount of days in the month so we scurry to meet our self enforced deadline of writing this comment within days of month-end. More importantly, we find February's cold winter weather tends to weigh on our attitude and emotions. Currently, we find February's winter "blahs" has also infected investors' attitudes towards the stock market. It strikes me that many investors have turned a "cold" shoulder towards the stock market as many of the perennial "bears" towards the economy and stock market have caught the attention of the public. This prevailing attitude shows up in investors surveys, which have shown a great deal of skepticism towards the gains (will these gains hold) global stock markets have enjoyed during the past year. There is general disbelief that markets can further rise after gains of over 30% in a year and very few believe stock market valuations are inexpensive. Nevertheless, we do feel gains, particularly in the TSX (sound banking system in Canada plus commodity exposure) are very likely in the months ahead and markets are inexpensive.

We note as proof of our optimism is trend in earnings (profits). Earnings based on the 500 companies listed on the S&P Index, for example, have been revised upward again by most strategists, as the recently released fourth quarter 2009 earnings have come in stronger than expected. The prime reason for the stronger than expected earnings is due to better sales (revenue). Last year, most companies reported higher than expected earnings due to rapid cost reductions. At that time, many skeptics/bears towards the stock market pointed to the lack of revenue growth concluding the stock market gains were short lived, as cost reduction programs implemented were coming to an end. Based on the recent increased earnings, it is revenue growth that is stronger than expected. Combining revenue growth, with a still very lean corporate cost culture, one gets very strong earnings. We expect this revenue growth and cost consciousness to continue for the next several quarters, if not years.

Commenting on the most recent earnings release, U.S. bank *Citigroup* states, "The aggregate "beat" in 4Q 2009 was about 9%. However, if not for \$14.4 billion in TARP repayment (one time item) related charges in the financial sector the beat would have been a record +19.5%."

As we mentioned above, there is no lack of skeptics towards the stock market. We illustrate one model that captures investors' attitudes below.



Source: Citigroup February 26, 2010

The chart is called the "Other P/E" with P standing for Panic and E for Euphoria. The dark line in the graph is the reading (left scale) of this index, while the light shaded area is the twelve month forward stock market return (right scale) based on the Other P/E readings. This sentiment indicator is composed using the NYSE short interest ratio, margin debt, The American Association of Individual Investors bullishness/bearishness data and some other publically available information. The two dark lines represent one standard deviation meaning 65% of all observations lie between these lines. Below/above these dark lines represent periods when investors are in a state of Panic/Euphoria. The most recent reading shows sentiment is breaking the one standard deviation reading meaning investors attitude towards the market is near panic. In recent years when this sentiment reading was at or below these levels, the one-year returns were excellent. Examples of this include the years 2004 to 2007 and early 2009. Despite poor sentiment towards the stock market at the time of the reading, one-year returns proved to be excellent.

Budget deficits and inflation. Do deficits lead to inflation?

One of the lingering effects of the past recession is large government budget deficits (spending exceeding revenue collection) that have been created. Investors are concerned that budget deficits ultimately lead to higher inflation, as governments may resort to “printing” more money to pay for these deficits. We have reviewed the economic literature and the answer appears to lie with the independence or lack of independence between a country’s central bank and its elected government. In the developed world with independent central banks (U.S., Canada) there is little evidence that budget deficits lead to higher inflation, but in some developing countries with less independent central banks running persistent deficits do appear to lead to higher inflation.

Running a government’s financial affairs is similar to running a household. As in any household, it must pay for its bills. Households have three ways to pay for their spending. They can work to earn income, live off the income generated from their assets (interest/dividends or rental income) or they can sell some of their assets. Should household spending exceed their earnings they will need to borrow the difference, likely from a financial institution. Governments have this same option of borrowing when spending exceeds revenue (tax collection or asset sales) by issuing bonds. Bonds are nothing more than a promise to pay in the future the borrowed money. In general, governments issue bonds to the public. Financing budget deficits, in this manner as is currently being done by Canada and the U.S., is not inflationary as the money the government has to spend by issuing bonds to the public is money the bond purchasers (the public via mutual funds and/or pension funds) no longer have to spend, so this financing of the deficit merely shifts spending from the private sector to the public sector. There has been no “new money” that has been created.

Governments around the world have issued record amounts of bonds to finance their deficits and have not experienced any difficulties in raising the money, as global investors (public) appear hungry to buy government debt. Another way of looking at this is investors (the public) have decided to save (by buying debt) rather than spend the money available to them. To-date we see little if any effect of these large deficits causing inflation to rise. For example, the largest deficit is in the U.S. but their latest Consumer Price Index reading of inflation is at 2.6% year-over-year with the increase due entirely to the rise in energy prices (unrelated to the borrowing by governments). The core inflation rate (excluding the most volatile elements of the index being food and energy prices) is much less at 1.6%.

Unlike households, governments have another option to finance the deficit. The government can create money and use it to pay for the goods and services it buys. It is the extent to which monetary policy (normally for setting interest rates and issuing bank notes) is used to help balance the government’s budget that will determine the effect of budget deficits on inflation. Monetary policy is typically left to the central bank of a country, which in developed economies, acts independently of government fiscal policy (spending and taxation). In Canada it is the Bank of Canada that sets monetary policy, in the U.S., the Federal Reserve Board. The independent nature of the central bank is taken very seriously by investors. If investors felt this independence was being comprised, investors would sell that country’s currency. In Canada, the Governor and Senior Deputy Governor of the Bank of Canada are appointed by the Bank of Canada’s Board of Directors, not by the Federal Government. The Federal Government is represented by the Deputy Minister of Finance of Canada which sits on the Board of Directors but has no voting power. Central bank employees are regulated by the Bank of Canada, not by federal public service agencies. Similar safeguards in the U.S. exist to protect the independence of the bank.

The independence of central banks is of paramount importance as they have the authority to create and issue money. If government bodies (say Department of Finance) were allowed to force central banks (say Bank of Canada) to buy bonds directly from them this would certainly be inflationary. This is the classic case of what is called the “printing of money”. In this case, governments have new money to spend that was not given up by the private sector. The public still has the money they had before governments issued bonds to the central bank, but the government “created” new money, so the spending power of the public and private sector in this

instance has expanded by this printing of money . Currently in the U.S., and to my knowledge in Canada, this is against the law to force central banks to directly buy newly issued bonds.

For those investors unconvinced of deficits not being a cause of inflation, one should watch for regulatory changes, where central bank independence is being comprised. This would be viewed poorly by investors.

Ian Nakamoto
Director of Research

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<u>Company</u>	<u>Ticker</u>	<u>Disclosures</u>
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Glossary of Terms:

EPS	Earnings per Share
P/E	Price to Earnings Ratio
EBITDA	Earnings before Interest, Taxes, Depreciation and Amortization
Market Cap	Total Shares Outstanding multiplied by Shares Price
Enterprise Value	Fully Diluted Shares Outstanding
PEG	P/E Multiple Divided by Growth Rate
ADR	American Depository Receipt
WACC	Weighted Average Cost of Capital
Risk Free Rate	10 Year Treasury bond
Yield	Dividend divided by Share Price
ASP	Average Price
DSOs	Days Sales Outstanding
Capex	Capital Expenditures
CPU	Cost per Unit
EVA	Economic value Added
EV / EBITDA	Enterprise Value / Earnings before Interest, Taxes, Depreciation and Amortization
DCF	Discounted Cash Flow
Holts DCF	Holts Discounted Cash Flow
DYT	Dividend Yield Target
Yield	Yield
BSOPM	Black Scholes Options Pricing Model
BETA	Quantitative measure of the volatility of a stock, mutual fund, or portfolio, relative to the overall market
MF	Mutual Fund

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