MACDOUGALL, MACDOUGALL & MACTIER INC.

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# MONTHLY MARKET COMMENTARY

INVESTMENT RESEARCH JUNE 2010

## May 2010 Review

| | May 31, 2010 | December 31, 2009 | % Change |
|---|---|---|---|
| TSX | 11,762.99 | 11,746.1 | 0.1% |
| S&P 500 | 1,089.4 | 1,115.1 | -2.3% |
| DJII | 10,136.6 | 10,428.0 | -2.8% |
| NASDAQ | 2,257.0 | 2,269.1 | -0.5% |
| 10 Yr. Cda Bonds | 3.35% | 3.61% | -26bp |
| 10 Yr. US Bonds | 3.29% | 3.84% | -55bp |
| 90 Day Cda T-Bills | 0.54% | 0.24% | 30bp |
| 90 Day US T-Bills | 0.16% | 0.05% | 9bp |
| US$ vs. Can$ | $0.9582 | $0.9515 | 0.7% |

### The “Flash Crash” and “Fat Finger Trade”

Despite strong economic data and reassuring market signals (more later) of a continuation of economic growth, investors are clearly nervous. This nervousness was particularly acute on May 6, when the widely followed Dow Jones Index (DJIA) intraday fell by close to 1,000 points (dubbed the “Flash Crash”), only to rebound within minutes. Initial reports pointed to a “Fat Finger Trade”, an inadvertent large sell order. The cause of the drop remains unknown (most trades during that brief moment have been cancelled) and an investigation is underway, but this event certainly added to an already nervous market.

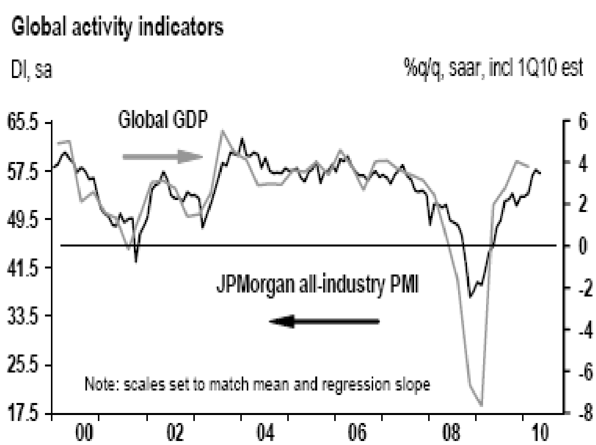
The economic fear/nervousness in the market concerns Greece, a heavily indebted nation. Although a beautiful country, it is relatively small economically and estimates are it contributes approximately 2% to the European Union’s Gross Domestic Product (the value of goods/services produced annually). The European Union contributes approximately 20% to the world’s Gross Domestic Product so Greece’s contribution to world output is less than 1%. Therefore, the economic impact on global growth will be minimal but to the financial market it became a much larger issue. Investors jumped to the conclusion that Greece’s problem would morph into another “subprime” problem, whereby a small country would have a similar effect on the global economy/financial markets as the relatively small financial company, *Lehman Brothers*, did in 2008 when they filed for bankruptcy protection in September 2008 causing a panic in the financial markets. Although one can never rule out an event of that magnitude happening again, we do not feel it will. The subprime market damage to financial institutions was over $1 trillion, while for the heavily indebted European countries (Greece, Italy, Ireland, Portugal and Spain) the Montreal based economics firm *Bank Credit Analyst* estimates the damage would be less than one-half this amount (no doubt still a large amount). More importantly, as we will discuss below, the economic background is better able to absorb another shock than in 2008. In the fall of 2008 economic growth was already slowing, interest rates were considerably higher, house prices were falling and the price of oil was over $100. Today, economic growth is rising, interest rates are at or near historic lows, house prices have stabilized and oil prices are at $70.

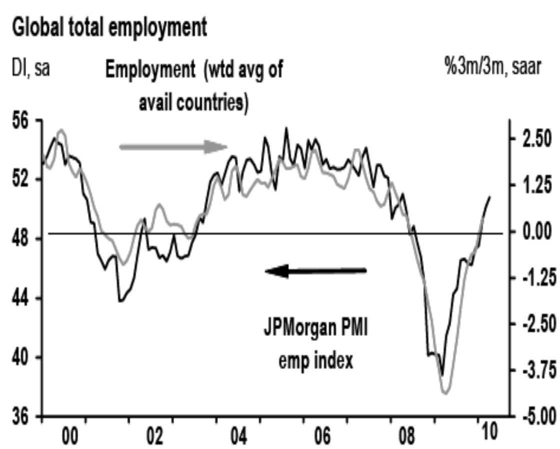
The risk of repeating another *Lehman Brothers* resides with policy errors by governments and/or central banks. The credit crisis of 2008 has taught valuable lessons to central banks and government officials. The necessary ingredients to avoid a repeat of this are readily apparent; act quickly and forcefully, back stop the banking system and provide ample liquidity to the financial markets. We do not feel a repeat of 2008 will happen, as the economic situation today is very different than in 2008. Below we explain our reasoning.

**Economic Indicators**:

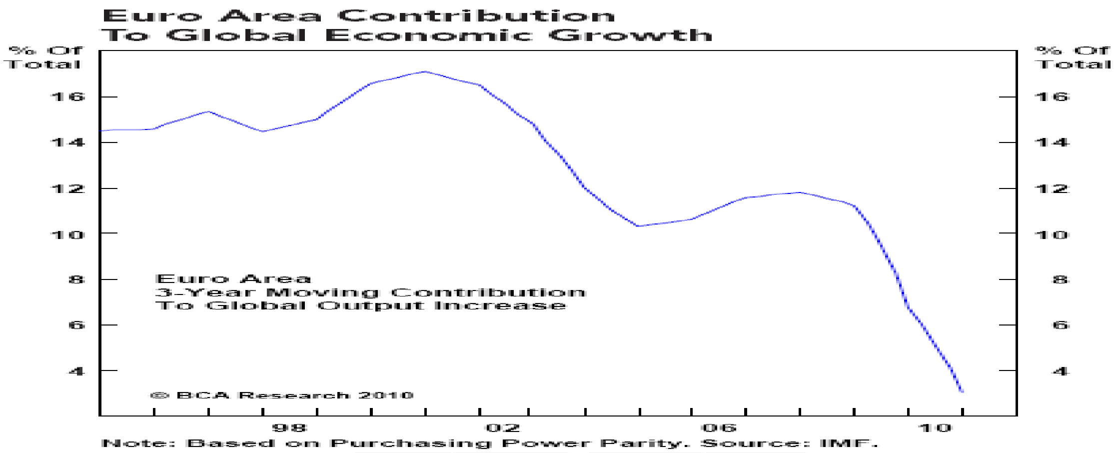
The current economic momentum is very strong, which we illustrate in the two graphs below. The graph on the left with the title Global activity indicators shows two lines; the Purchasing Manager's Index (dark line) and global GDP growth (lighter line). Both activities have rebounded sharply from the depth of early 2009. The big surge upward is likely over and we are likely transitioning to a steady sustainable growth rate, but certainly not a contraction. In 2007, both indicators had peaked and were declining before the demise of *Lehman Brothers* in September of 2008. The second graph on the right illustrates global job creation which has also been strong, although on Friday June 4th, the U.S. report showed a slowing of the rate of growth (not a contraction). We focus on job creation because when this happens this reinforces economic growth as employment growth leads to more spending by individuals causing businesses to hire more, setting up a virtuous circle. In 2007, the employment growth rate had peaked and followed several years (2004 to 2007) of strong job creation. In retrospect, businesses had likely become fat and certainly ill prepared for a recession. When the recession hit, firms needed to react quickly by reducing staff causing the reverse of the virtuous circle. Today, firms are hiring but are still operating in a lean fashion.

One should be aware that the unemployment rate may increase in the coming months as many "discouraged" workers will likely re-enter the work force. In calculating the official unemployment rate, governments count only those people actively looking for employment. Last year many individuals became so discouraged they stopped looking for employment so they were excluded from the official calculation. We believe more people are moving from the discouraged category to the actively looking category, as a sign people have greater confidence in finding full time employment.



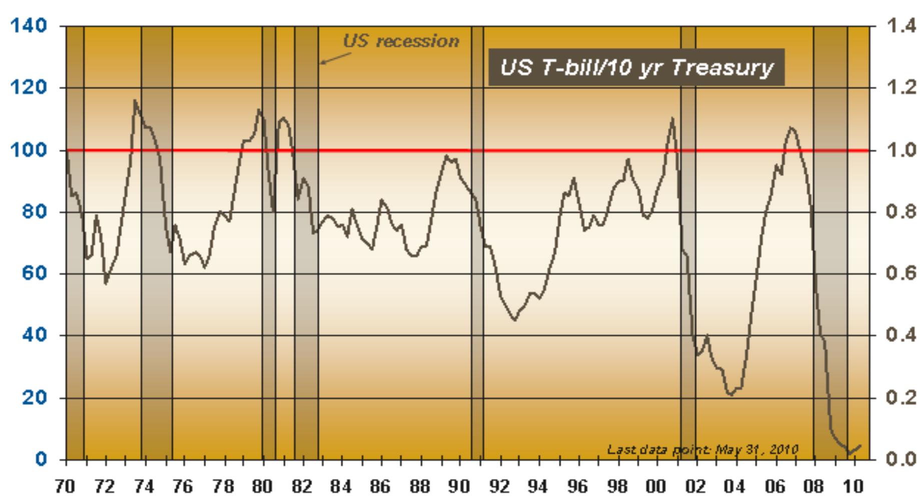
The graph below illustrates the influence the Eurozone has had on global growth. As one can see, Europe's influence on global growth has waned for several years. For example, when global growth was approximately 5% in 2000, Europe's contribution was 16% of that amount or 0.8%.



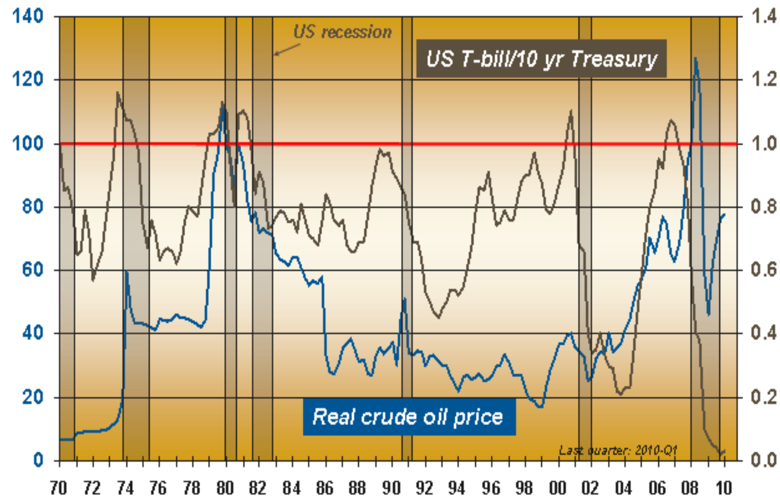

Source: Bank Credit Analyst-May, 2010

**Market Indicators:**

One measure which has proven to be very accurate predicting world economic growth/recessions has been the "shape of the U.S. yield curve". This simple ratio is calculated by taking the U.S. three month Treasury bill rate and dividing it by the U.S. Treasury ten-year bond rate. The graph below illustrates this ratio from 1970 to May 31, 2010. A ratio close to or above 1 (right scale, or 100 left scale) forecasts the U.S. / World economy is about to enter into a recession or severe slowdown. A ratio less than one forecasts economic expansion. The vertical bars in the graph indicate when the U.S. has entered into a recession and the width of the bar indicates the length of the recession. The ratio at the end of May is 0.04 indicating economic expansion. In 2007 this ratio was over one. One other variable which tends to portray an economic expansion/contraction is "real" oil prices (oil prices adjusted for inflation). When oil prices are high this acts as a tax on individuals and corporations. At the current $70 a barrel price, this is significantly less than in the last economic downturn. The second graph includes both the yield curve and real oil prices. A combination of an inverted yield curve and a sudden jump in oil prices is a sure sign of an economic contraction. Oil prices are far below 2007 and 2008 levels, but we acknowledge prices have moved up.



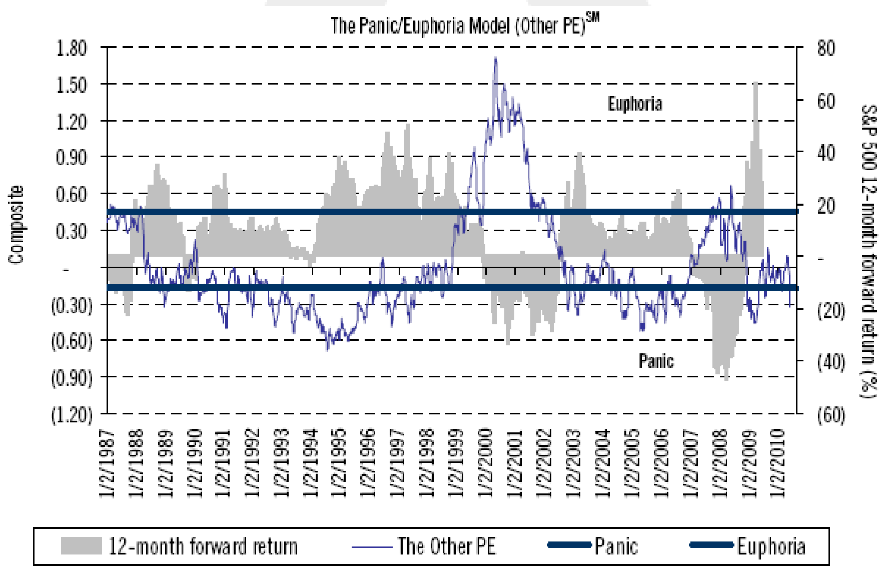

Source: DundeeWealth Economics




Source: DundeeWealth Economics.

**Sentiment Indicator:**

Sentiment towards the stock market is poor. We illustrate this below. The wavy line is what is called the "Other P/E", developed by the U.S. bank *Citigroup.* The "P" stands for Panic and the "E" for Euphoria. Readings above/below the two straight horizontal lines represents investors' attitude towards the stock market. Above/below are signs of euphoria/panic. The current reading is in the panic area.




In the past, when this reading was in the panic area, one-year returns in the stock market have been rewarding. This can be seen in the shaded area. The right scale is the one-year S&P 500 return if an individual purchased the S&P at various index readings. Although we sense the next couple of months will be volatile and the "headline" news could be bad, history has shown it has been a profitable time to invest for those with a one-year time horizon.

Last month we talked about the coming boom in mergers and acquisitions. In next month's commentary we will make concluding comments on this.

***Ian Nakamoto***
***Director of Research***

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| Company | Ticker | Disclosures |
|---|---|---|

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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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