



MONTHLY MARKET COMMENTARY

INVESTMENT RESEARCH

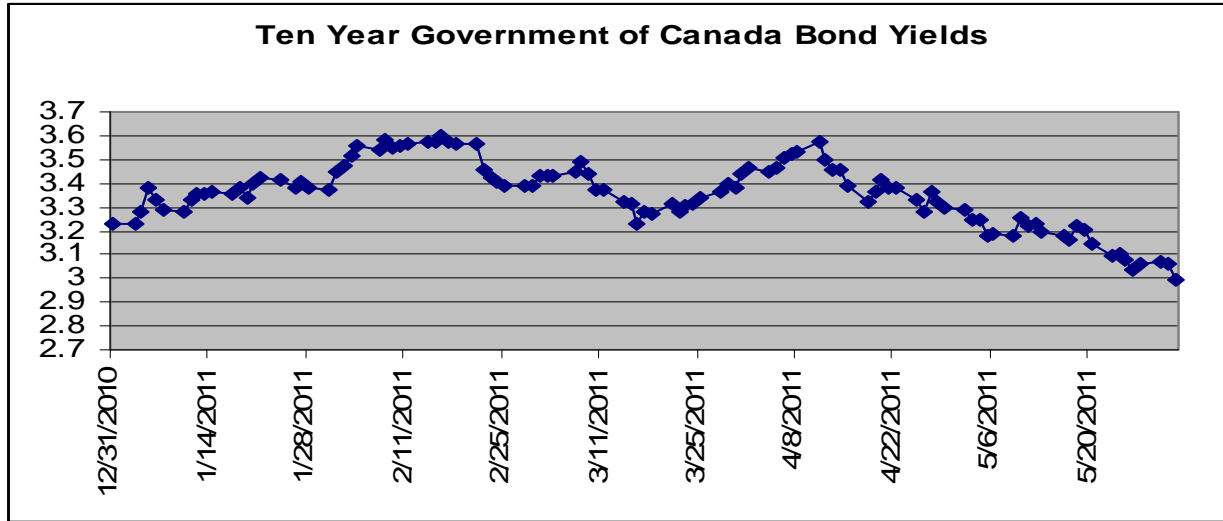
JUNE 2011

May 2011 Review

	May 31, 2011	December 31, 2010	% Change
TSX	13,802.9	13,443.2	2.7%
S&P 500	1,345.2	1,257.6	7.0%
DJII	12,569.8	11,577.5	8.6%
NASDAQ	2,835.3	2,652.9	6.9%
10 Yr. Cda Bonds	3.07%	3.12%	(5)bp
10 Yr. US Bonds	3.05%	3.29%	(24)bp
90 Day Cda T-Bills	0.98%	0.98%	0bp
90 Day US T-Bills	0.06%	0.12%	(6)bp
US\$ vs. Can\$	\$1.032	\$1.002	3.0%

Do Lower Bond Yields Lead to Lower Equity Markets?

The month of May was not a very merry one for equity investors. The stock market in Canada fell by 1.0%, while in the U.S., the S&P 500 fell by 1.3%, the Dow Jones fell by 1.9% and the NASDAQ fell by 1.3%. Bond and income seeking investors "won" the month as long-term interest rates fell pushing up bond prices and non-economically sensitive high-dividend yielding equities. Long-term interest rates (Government of Canada 10-year Bonds) in Canada fell by 13 basis points (one basis point is one hundredth of a percent), while 10-year Government Bond Rates in the U.S. fell by 23 basis points. The prime reason for the decline in interest rates is over renewed concerns about the direction of the economy and debt worries in Europe. The graph on the following page illustrates the reduction in long-term interest rates since the start of the year.



Recent economic data has been softer than most economists' expectations, indicating a general slowdown in the global economy. The news for the month has been particularly weak from the U.S. as house prices, housing starts, employment gains and industrial production was weaker than expected. We are not of the opinion that we are entering a recession (a contraction in the economy), but we are transitioning to a slower growth rate in the economy, which typically happens after an initial bounce from a recession. A mid-cycle economic slowdown is very different from an end of cycle (recession) event. The former is associated with an increase in equity markets, albeit at a slower pace than the previous two years, while the latter is associated with an equity market decline. We feel the former situation will prevail.

The biggest risk to our forecast is the price of oil. It was in mid-December of last year that oil prices rose from US\$88 a barrel to over US\$110 due to political concerns in the Middle East. Gasoline and other petroleum related products rose and consumer confidence and demand weakened. The current price of oil is US\$100. If oil prices stabilize at these levels, consumer demand/confidence should return. If oil prices spike up, a period of further economic weakness will occur. The price of oil tends to be self correcting. In periods of high/low oil prices, consumers demand less/more and oil prices tend to revert to a level consumers can afford.

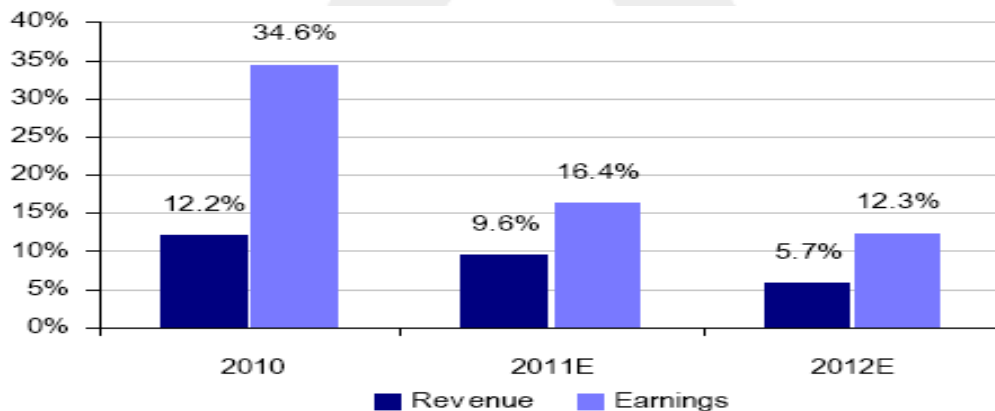
We view the current weakness in the stock market reminiscent of last year. In 2010, we had a sharp sell off in the stock market that lasted until the end of summer before markets regained traction and finished up at year-end highs. Investors worried over the debt problems in Europe. This year the same debt theme has re-emerged (and likely to do so for several more years) plus some softening economic data. Despite these worries we view equities as a good buy versus bonds. Many investors view the rally in bond prices (lower bond yields) as a precursor to poor equity returns. Last year this strategy (sell equities to buy bonds) did not work, as we illustrate on the following page. At the start of 2010, bond yields rose as did equity prices, then both fell as concerns over Europe's debt situation emerged. By mid-year, bond yields (U.S. 10-year yields) continued to decline, but equities (Morgan Stanley World Equities Index) rose. We feel this scenario is the most likely to happen this year.



Source: Citigroup Equity - June 2011

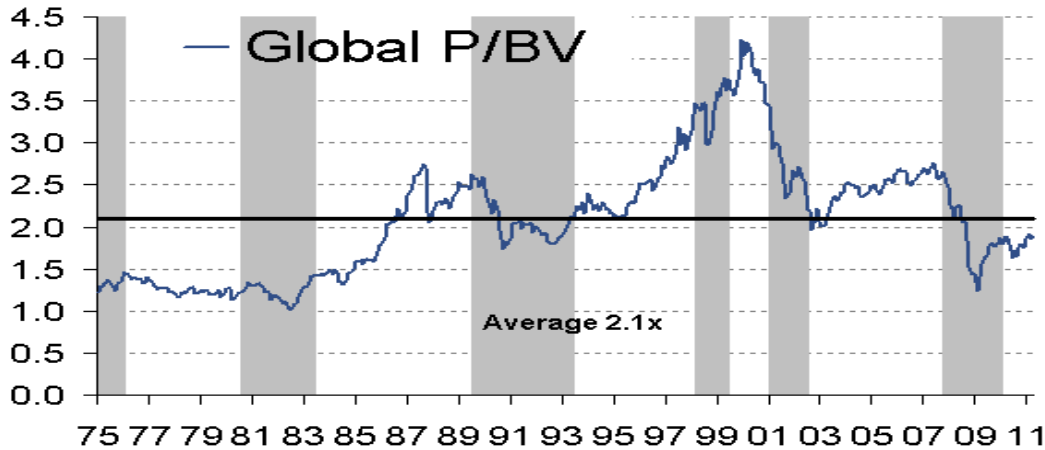
In a recent study, *Citigroup* researched how accurate bond yields have been in predicting the direction of equity markets. The study found bond yields were a poor indicator for predicting the direction of equity prices. To quote the study: “Our analysis defies the general view that the bond market is always smarter than the equity market.” On average historically, a decoupling of the two asset classes has been more likely to be resolved in favour of equities than bonds.” “Since 2001, we found ten occasions when bonds and equities decoupled. Of these ten, we found that equity markets were proven “right” six times, bonds twice and twice the conundrum were unresolved.” Citigroup expects bond prices (interest rates to rise) to decline by year-end and equity markets to increase.

Investors may be wondering, what are the “correct” variables to be watching to forecast equity returns. We feel the two most important variables are the direction of profits and equity valuation. First quarter earnings have been strong and the balance of 2011 should also be strong. Below we illustrate consensus forecast growth in revenue and profits for 2011 and 2012. As one can see, the rate of growth for revenue and earnings will slow in 2011 and 2012, but a reversal is very unlikely. We forecast the path for equity markets to follow a similar pattern. We see positive returns for equities but are unlikely to match the returns of the past two years.



Source: UBS Global Equity Strategy - June 2011

We also highlight the valuation of global equity markets. We use our long-standing, more stable valuation metric, the price to book of the global markets. As one can see, we are certainly not over-valued, but we are getting closer to fair (average) value. This indicates to us that equity returns will remain positive, but the rate of return will be less than in the previous two years when equity valuation was far below the long-term average.



Source: Citigroup. Shaded areas are U.S. recessions.

Ian Nakamoto
 Director of Research

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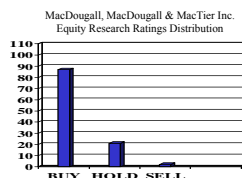
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Glossary of Terms:

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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