



MACDOUGALL, MACDOUGALL & MACTIER INC.

Service to investors since 1849

MONTHLY MARKET COMMENTARY

INVESTMENT RESEARCH

SEPTEMBER 2011

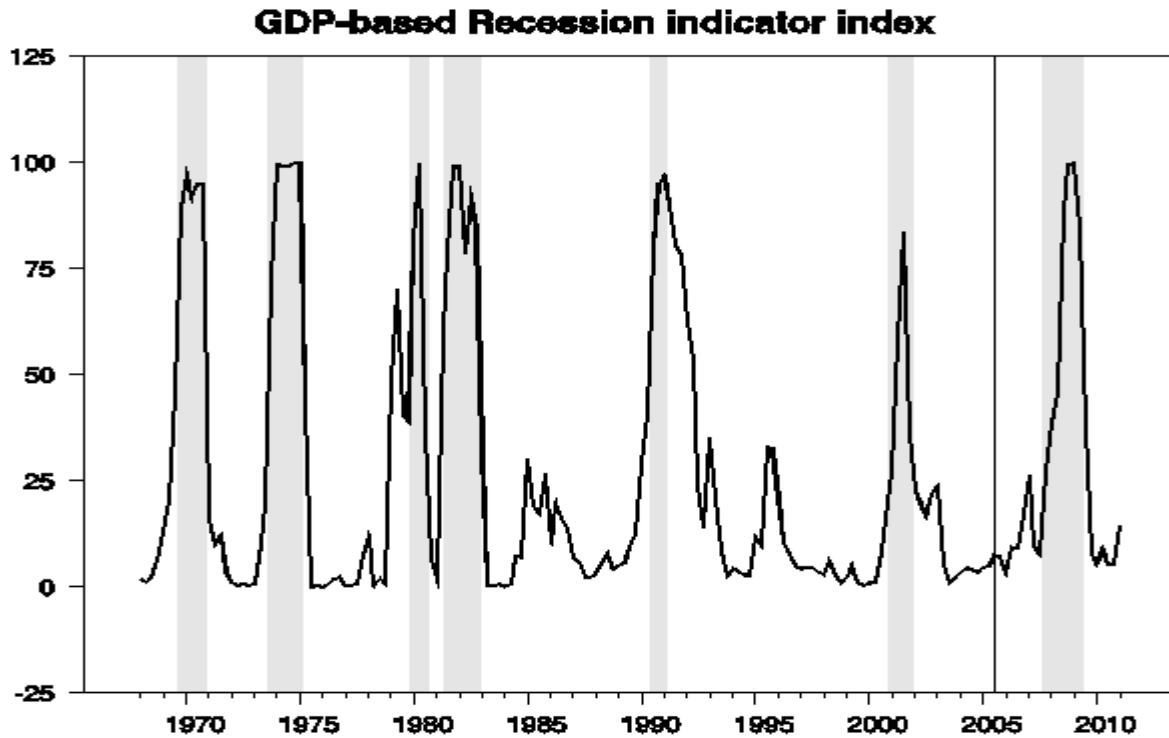
August 2011 Review

	August 31, 2011	December 31, 2010	% Change
TSX	12,768.7	13,443.2	(5.0)%
S&P 500	1,218.9	1,257.6	(3.1)%
DJII	11,613.5	11,577.5	0.3%
NASDAQ	2,579.5	2,652.9	(2.8)%
10 Yr. Cda Bonds	2.49%	3.12%	(63) bp
10 Yr. US Bonds	2.22%	3.29%	(107) bp
90 Day Cda T-Bills	0.86%	0.98%	(12) bp
90 Day US T-Bills	0.01%	0.12%	(11) bp
US\$ vs. Can\$	\$1.014	\$1.002	1.2%

Life in the Slow Lane

August was a poor month for equity investors. For the month the TSX was down 1.4%, but fared much better than their U.S. counter-parts. All three major U.S. indices were down for the month. The biggest drop came from NASDAQ (down 7.0%), followed by the S&P 500 (down 5.7%) and the Dow Jones Index (down 4.4%). Government bond prices rose (interest rates fell) as investors sought safe haven securities. For the month of August, U.S. Ten-Year Treasury yields fell from 2.8% to 2.2% and Canadian Ten-Year Government bond rates fell from 2.8% to 2.5%. The cause of the decline in stock indices is due to concerns over the state of the U.S. and global economy. Most of the economic data continues to be poor and economists have clearly underestimated the level of weakness, but the data appears to be consistent with an economy still growing but at a very slow pace as opposed to pointing to a renewed recession (the so called double-dip recession).

One of the economists we read and respect is Professor James Hamilton at the University of California, San Diego. He regularly writes a blog called Econbrowser (<http://www.econbrowser.com/>). He comments on various economic releases and uses the data to forecast the probability of a U.S. recession. His record has been excellent, calling a recession well before the National Bureau of Economic Research (the official body that declares if the U.S. is in recession). His probability of being in a recession is quite low versus consensus (around 35%). Based on the economic data at the end of July he places a probability of a recession that started in the first quarter of 2011 at only 14.4% (see below).

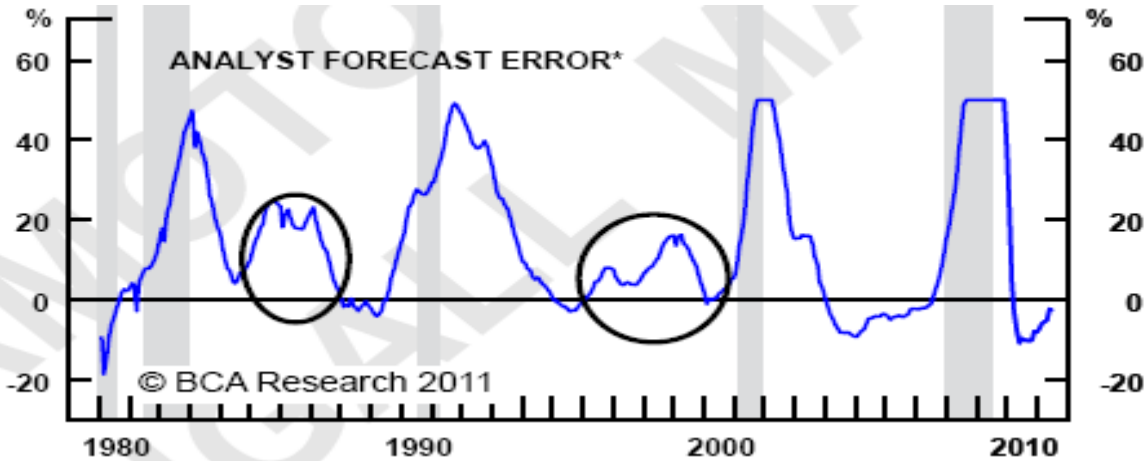


He has not updated his probability given the various poor economic statistics released in August, but on his blog (September 2) he writes the following:

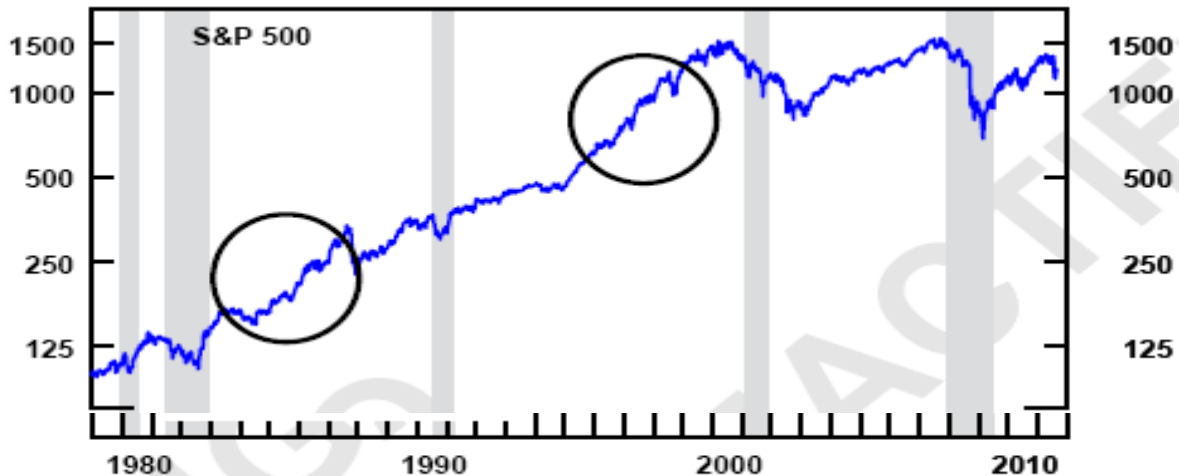
“None of this is intended to deny the basic reality of all these indicators—we’ve been making painfully little progress in recovering from a very depressed situation, But, so far at least, the trend remains one of disappointingly slow improvement rather than indications of another turn down. And my prediction for the second half remains where it has been—another 6 months of disappointing slow growth.”

One may consider the above comment as merely an academic exercise (and depressing for those seeking jobs), but the direction of the economy directly impacts profits and is one of the key determinants influencing the stock market. As the economy continues to move forward, profits will continue to move up, albeit at a much slower rate than the past two years and the stock market should move up. The consensus earnings, according to *Thomson Reuters*, for the S&P 500 for 2011 and 2012 are \$98.70 and \$112.60, respectively. The corresponding P/Es based on the S&P 500 closing as of August 31 at 1,218.9 are 12.3X and 10.8X. These valuation numbers are historically low. We do feel the 2012 forecasted numbers are too high and analysts will need to lower them but we forecast earnings will still be above 2011 levels.

We found a study by *Bank Credit Analyst (BCA)*, a leading economics/capital markets research firm that states even if forecasted earnings for 2012 are too high (likely to be the case) it requires a “big miss” (over 40%) by analysts to cause significant damage to the stock market (refer to the graphs on the following page). According to BCA, even if profit forecasts are 20% too high it will have little influence on the stock market. It is the direction of profits that is most important.



* The analyst forecast error (above) is the difference between the forecasted 12 month profits of the S&P 500 and the actual earnings. As one can see, it takes a big miss in profits (above 40%) before markets (S&P 500) react negatively (below). Big misses (over 40%) that significantly impacted the market occurred in 2008/2009, 2000, 1990/1991 and 1982/1983. Smaller misses (20% or less) to forecasts (circles) have little impact on the stock market.



Source: Bank Credit Analyst, September, 2011

Unless we have a full blown credit crisis, likely emanating from Europe, we see the likelihood of profits dropping by an amount to significantly affect the stock market as low. Typically, profit forecast errors of 40% or more occurs when there is a shock to the economy. In 2008/2009 it was the credit crisis, in 2000 it was the technology boom/bust. We continue to believe equity markets will move up over a 12 to 18 month horizon and outperform fixed income securities (especially government bonds) as long as profit growth continues. The valuation of the stock market is not an issue as the price to earnings, price to book and dividend yield metrics support a rising stock market.

Is there a solution to slow growth?

There is a “healthy/heated” debate on how to deal (which policies) with the slow growth/lack of job creation in the U.S. All policy makers agree the robust economic growth rates, prior to the financial crisis, will not be achieved, but many argue the 1% (most recent U.S. growth rate) can be improved.

One point of view policy makers should have as their top priority is a meaningful reduction in the U.S. deficit/debt situation. This course of action has become particularly popular after the U.S. lost its AAA rating by the rating agency Standard and Poor's earlier in the month. These policy makers believe if immediate action is not taken, higher interest rates will follow (ironically the reverse has happened since the downgrading of the U.S. government credit rating) causing another recession. The focus on deficit reduction will likely mean a further combination of tax increases and cost reductions (i.e. further government lay-offs and less program spending). Critics of this argument say a cure to a weak economy is not less stimulus (higher taxes and less government spending), but more.

The other point of view is deficit/debt reduction should be a priority, but not right now. The latter argument says deficits can be reduced through greater economic activity and job creation. It was the loss of jobs and economic activity that caused the deficit. By focusing on job creation and increasing economic activity, the debt/deficit will eventually be reduced. The solution to job creation/increase economic activity is for governments to provide more stimuli to the economy (tax incentives, infrastructure spending etc.) and deficits/debt in the short-term should be increased. The leading proponents of this argument include the Nobel Prize laureate Paul Krugman (also a columnist for The New York Times), Richard Koo (an economist who has written on the Japanese "lost" decade and a former adviser to the Japanese Government), Martin Wolf (influential columnist with The Financial Times of London) and Christine Lagarde (the newly appointed Managing Director of the IMF).

We have looked at the pros/cons of both arguments and feel the second course of action is the better one. Currently, it appears governments are adopting both methods with little success. Certainly governments should not be so focused on deficit/debt reduction. As Krugman writes in The New York Times:

"Ever since the acute phase of the financial crisis ended, policy discussion in Washington has been dominated not by unemployment, but by the alleged dangers posed by budget deficits....deficit spending helps support a depressed economy are no threat at all....So short-run deficits aren't a problem; lack of demand is, and spending cuts are making things much worse." New York Times September 4, 2011.

Richard Koo makes an analogy to the Japanese situation of the 1990's and 2000's. In the case of Japan, the government was not only slow to react to the bursting of the real estate bubble, but took the attitude budget deficit should be addressed. At the time this made sense. Japan withdrew government stimulus much too early and chose to fight their deficit. This made the situation worse, causing a further weakening in the economy. Mr. Koo worries the deficit hawks in Washington will win the day. He argues, similar to Krugman, that not enough stimuli has been given. Both would argue monetary policy in North America has basically run its course and it is up to the Federal Government to act boldly via tax cuts and spending increases to improve economic growth and unemployment. Unfortunately, the politics of the day will make a "bazooka" approach to the economy highly unlikely.

Ian Nakamoto
Director of Research

Important Disclosures

<u>Company</u>	<u>Ticker</u>	<u>Disclosures</u>
----------------	---------------	--------------------

The research analyst (s) who authored this report certify that the views expressed therein accurately reflect their personal views and that no part of the analyst’s compensation will be related to those views.

Conflict of Interest Policy for Analysts

1. Refers to share ownership of the company in question by the Analyst. In the disclaimer section of a report, the number 1 will indicate that the analyst or a member of the analyst’s family has any position (equity, derivative or other) in the shares in question.
2. Refers to share ownership of the company in question by the Director of Research or Supervisory Analyst. In the disclaimer section of a report, the number 2 will appear if the Director of Research or Supervisory Analyst has a position (equity, derivative or other) in the shares in question.
3. Refers to any relationship the Analyst, a member of the family thereof, or firm has with the company in question. A relationship includes anything except the simple trading of stock for the company. In the disclaimer section of a report, the number 3 will appear if the analyst, a family member thereof or the firm has a relationship with the company in question.
4. Refers to whether Analysts have visited facilities and/or key operations of the company.
5. Refers to whether the company in question defrayed any of the costs of traveling to see the company in question’s facilities. In the disclaimer section of the report, the number 5 will appear if the company has paid any portion of the analyst’s travel expenses related to viewing facilities.
6. Refers to MacDougall, MacDougall & MacTier Inc. having undertaken any underwriting business from the company in question. If, in the previous 18 months, MacDougall, MacDougall & MacTier Inc. has acted as an underwriter to the company in question, it will be included in the disclaimer section of a report with footnote number 6.
7. Collective ownership by 3Macs and its affiliates of 1% or more of any class of the issuer’s equity shares for a period of 60 days preceding the issuance of the report.

Definition of Equity Research Ratings & Risk Ratings

Equity Research Ratings

The rating system for recommendations on research reports published by MacDougall, MacDougall & MacTier Inc. will be as follows:

BUY - will represent opportunities that potentially offer in excess of a 20% return on investment within a 12-18 month period.

HOLD - will represent opportunities that offer between 5% and 20% potential return on investment within a 12-18 month period.

SELL- will represent opportunities that offer less than 5% return on investment within a 12-18 month period.

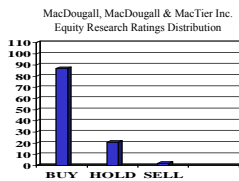
Risk Ratings

MacDougall, MacDougall & MacTier Inc. employs two risk ratings with its research reports; Above Market Risk and Market Risk.

Above Market Risk denotes a company, which operates in an inherently speculative industry, or one that is more volatile than the market as measured by its beta. Above Market Risk may also indicate weakness in the company’s balance sheet, low debt ratings, and the lack of a dividend, low liquidity or other deficiencies.

Market Risk denotes a company, which is expected to present, on average, the volatility present with the overall market, measured by its beta. Market Risk companies will generally have sound balance sheets, will be established, large cap companies in industries generally regarded as stable and for the most part will pay a dividend.

MacDougall, MacDougall & MacTier Inc. Equity Research Ratings Distribution



- Number of companies covered by MacDougall, MacDougall & MacTier Inc. Equity Research within each rating category.

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

This research report has been prepared and circulated for general information only. It does not account for the specific investment objectives and financial situation of any person receiving this report. Investors should seek professional advice regarding the appropriateness of investing in any securities discussed or recommended in this report and should recognize that statements regarding future prospects may not be realized. This report is not to be construed as an offer to sell or as a solicitation for an offer to buy any securities.

The information presented in this report has been compiled from sources believed to be reliable but no guarantee is made as to its accuracy, completeness, or correctness. All opinions and estimates contained in this report are provided in good faith and are subject to change without notice.

Montreal 514-394-3000

Quebec 418-656-1212

Toronto 416-597-7900

London 519-645-1110