



## **The Great Recession Is Dead – Long Live The Recovery – But How Strong Will It Be And How Long Will It Last?**

As we head towards the holiday season we remain cautiously optimistic as data released through the summer continue to point towards an improving economic picture. While some credit for this stabilization must go to fiscal stimulus, perhaps more is due to the massive support provided to the financial sector since the crisis began. Banks have been recapitalized, money markets have normalized and most importantly there has been no repeat of a Lehman Brothers-like collapse. Notwithstanding government support programs, global economies are ultimately driven by consumption. To this end, ahead of the recent G20 meeting, the United States urged world leaders to launch a major rethink of the global economy. They would like to see major exporting economies such as China, Japan and Germany boost consumption while debtor nations like the U.S. boost savings. While we expect consumers to remain cautious due to still rising unemployment and lower disposable income, recently released data show that for the most part, developed economies are on the road to recovery. In the U.S. and other key economies, industrial production, fueled by the “cash for clunkers” or equivalent programs has resulted in a slight rebound of capacity utilization. The effects are being seen in the metals related goods, machinery, chemical, food and clothing sectors. Housing markets are recovering, albeit from egregiously low levels of activity, consumers are aggressively reducing their credit burden and global equity markets have rebounded, instilling a stronger sense of confidence for both investors and consumers alike.

On the back of inventory rebuilds, improving real estate markets, signs that corporations may have over-shed labor and easing bank lending conditions, GDP growth continues to be revised upwards. Corporate earnings momentum is also being revised up – *and once it turns positive it usually stays for a number of quarters* - due to extreme labor reductions and outsourcing of low margin businesses. On a short term basis - long term is a different story - inflation will remain muted. While capacity utilization may be trending upwards the tremendous amount of slack that is still around, both in the U.S. and globally, is in itself deflationary in nature. Nothing has emerged from the G20 meetings that would impede current markets – no exit strategies and no worries that rates won’t stay low. The result is a steep yield curve into the foreseeable future – the combination of low interest rates and government intervention will result in lots of liquidity and support for asset prices. Equities will receive further support from earnings as the operating leverage kicks in and productivity gains will be the feature of a “jobless recovery”. The debate on gold and what levels it will attain will continue to rage on as the yellow substance is now viewed as a safe haven investment for uncertain times, a hedge against inflation as well as an alternative to a forecasted weak U.S. dollar (*note China buying gold*). We would also guide our clients to watch for a U.S – Cdn dollar exchange rate moving towards par, possibly by early next year, driven by rising energy and commodity prices.

### **United States**

The U.S. has managed to step back from the brink and the worst has most likely been seen. The stabilization in the housing market, the declining rate of job losses, the success of the “cash for clunkers” program and strong rebound in profits at major banks are indications that a recovery is clearly beginning to build. With government stimulus ( 25% of the program has been spent so far ) beginning to pick up momentum at the same time that manufacturers rev up production to rebuild inventories, the strength of the third quarter GDP numbers may catch experts off guard. It may look like a “V” shaped rebound at first, but if the fragility of the U.S. housing sector and a still strained financial sector keep demand on a lackluster track, we may actually experience a “U” with a longer wait for sustained stronger growth. While the news is more positive on the consumer spending front, households are not returning to their spend-all days choosing rather to increase savings. It will take a rebound in both personal wealth and real incomes along with falling unemployment to get the American consumer back to a point where they hit the stores with a devil-may-care attitude. It may be a while before we have a clear picture of the strength and durability of this recovery. Meanwhile, President Obama’s healthcare program will be an additional burden on the budget, putting further pressure on public debt which is forecasted to reach 48.0% of GDP this year. On the positive side, the U.S. president’s nomination of Ben Bernanke to a second term as chairman of the Federal Reserve has removed some niggling doubt from investors’ minds.



## Canada

The Canadian economic recovery promises to be a brisk one and will probably proceed at a more furious pace than originally anticipated by the Bank of Canada. Retail sales are expected to continue to climb and manufacturing and wholesale data will continue to be supportive of an economic recovery. As the outlook for the U.S. economy is getting better by the day, expectations of the drag from trade on this side of the border will be much less severe than the past twelve months. The domestic areas of the Canadian economy continue to receive significant boost from accommodative policy. Low rates and higher confidence levels have consumers back in the auto showrooms and scoping out bargains in the real estate markets. All of this bodes well for income, consumer spending and eventually capital spending. In spite of the surprising rate of recovery, we don't anticipate any material developments to come out of the Bank of Canada - in the near term. Foreigners are finally coming to the realization that there is more to Canada than just commodities and our superior financial underpinnings. The changing face of Canada's equity market is putting more of the country's top stocks on global radar screens. The average market capitalization of Canada's top 60 companies is U.S. \$15.8 billion. The 10 year compounded annual growth rate for Canadian equities was 7.8% compared to -0.7% for the MSCI World Index of stocks and -2.5% for the S & P 500. Even so, over half of the Canadian sectors are still trading at a discount to their global peers while the TSX 60, on average, remains underweighted on a global perspective.

## Far East

While more green shoots have begun to appear in the developed economies, they are nothing compared with the lush jungle sprouting in the East. In 2008, while G7 politicians were still debating the necessity of stimulus packages and the form that they should take, China had already moved decisively to implement policies aimed at confronting the global crisis. They have thrown so much fiscal and monetary stimulus into its economy that a recovery of some size was inevitable. The revival in emerging Asia's industrial production is even more impressive thanks largely to China, and is the only region in the world where output is back to pre-crisis levels. In India meanwhile, the scenario remains quite robust ( *GDP forecasted to grow at 8.0%* ) and is focused on domestic demand. The weak monsoon season has improved of late and may only impact GDP by 1 – 1.5%, perhaps less by the time it is over. There are some difficulties on the ground for some farming communities, but there are some economic amelioration programs in place. Japan's economy also seems to be recovering powered by the expansion in China, a major domestic stimulus package and progress in inventory adjustments. The election results should be a watershed for change in Japan. The Democratic Party of Japan will focus on cementing stronger ties with Asian countries, especially China. Meanwhile, August numbers for Singapore, Thailand and Korea showed sharp improvements in exports.

## EuroZone/United Kingdom

Signs of life are beginning to show in Europe as recent economic indicators have surprised on the upside. The euro area's two largest economies, Germany and France, surprised everyone by returning to growth in the second quarter. Together they account for half of the region's economic output. The expansion is reflecting strong government spending, strengthening household spending and rising exports. The big test now will be for the ECB to hold the course and resist any shift in monetary policy until a recovery is clearly established. There are no inflationary worries so erring on the side of caution should not prove too much of a challenge. It should be noted that these are early signs and there are still huge pockets of weakness through Europe especially in Italy, Spain, Ireland, the U.K. and Eastern Europe. The Bank of England continues to increase quantitative easing as the U.K. is still in a recession and struggling to return to positive growth. While there is some upbeat news on the property market, conditions in the U.K. labor market continue to worsen. We can expect the number of people out of work to rise before unemployment peaks.

## Commodities

The fact that commodities bottomed at their highest cyclical troughs ever, in the face of the most severe global recession in 70 years, tells us where the new floor with regards to pricing stands. More specifically, it highlights concerns over future supplies. Today, executives of the major global resource companies are business people, not geologists, and as such have been much more disciplined from a production and spending standpoint. The main drivers behind the recovery in commodity prices have been the massive global stimulus plans centered on infrastructure spending, with China at the head of the class. Targeted projects infer that massive amounts of copper, concrete and steel will be required. While some kind of pullback would not be a surprise, those metals with perceived threats of supply disruptions will remain strong. Investors need to be aware of the impact of



strikes at major mines around the world which can deplete inventories very quickly. In a year where actual consumption decreased, the oil industry was only able to replace 88.0% of production – *in spite of increasing spending by 23.0%*. When global economic activity recovers, oil markets will not only see higher prices, but supply issues and talk of shortages will once again dominate. North American natural gas markets are currently well supplied with reservoirs bulging at the seams. However, falling prices, lack of drilling activity and depleting production will ultimately result in a price recovery. Demand for agricultural commodities has strengthened despite the economic downturn. The long term dynamics of rising disposable income and higher caloric intake, forecasted from the populations of emerging markets, bode well for this industry.

## Recommendations

While it's quite likely that equity markets are currently discounting the recession's end as well as a "V" shaped recovery, we remain of the view that this cyclical bull market has further to run – but the next phase will be tougher. The current advance in equities has underlying support from improving U.S. and global economic fundamentals and upward revision in earnings. Thus far the emerging markets have been leading the recovery rebounding more rapidly, but more recently positive news flows from the developed economies has been gaining momentum. Stocks have rallied in advance of the turn in earnings, breaching important technical levels confirming that the primary longer-term trend remains upwards. This move however, has pushed valuations to levels where markets are no longer cheap and attractively priced stocks are difficult to find. Any pullback that may be incurred by markets over the next few weeks may be reflective of an overbought situation, fears of a tightening phase starting earlier than expected or unexpected growth disappointment. Within this context our weapon of choice is a benchmark weighted portfolio with a barbell strategy for equities over weighted to Canada. Cyclical leadership in energy, materials and select industrial issues on one side is offset by more conservative companies having visible earnings and the potential for dividend growth, complemented by companies that are beneficiaries of a strong loonie. Within our cautiously optimistic stance, we will continue to adhere to a strict discipline of taking money off the table as individual securities hit their target levels. On market pullbacks we will use the same disciplines to buy or add to existing holdings. The vigor of central bank response to the financial crisis makes the excess monetary creation of the 1970's look positively penurious. Despite the assurances from Chairman Bernanke, investors who look at the \$9 trillion U.S. deficit projection for the upcoming decade would be wise to hedge themselves with a hard-asset-based investment strategy. With 75 million people being added annually to the ranks of the middle class, demand for protein based foods as well as grains and soybeans will continue to swell. Energy, with a longer term emphasis on natural gas, will continue to be an integral part of our strategy. On market pullbacks, financials, select consumer and healthcare issues as well as global opportunities will be looked at. Somewhere in the next 12 months fixed income portfolios will be approaching a crossroad. With central bankers not prepared to raise rates until there is verification that the economic recovery is self sustaining, we are comfortable with our current strategy. Portfolios currently hold a combination of government bonds and both high quality corporate bonds and preferred shares. However, as the risk that rates may rise continues to mount, we will look to reduce the average term of our bond portfolios and book profits on holdings that are currently trading at premiums.

**CAPITAL MARKETS SUMMARY AS AT SEPTEMBER 30, 2009**

	<b>Economy</b>	<b>Monetary Policy</b>	<b>Currency</b>	<b>Valuation</b>	<b>Secular Trends</b>	<b>Heward Strategy</b>
Canada	=/+	=/+	=/+	=	=/+	O/W
USA	=/+	=/+	=-	=	=-	U/W
Europe	=/+	=/+	=	=	=	U/W
Japan	=	=/+	=-	=	=-	U/W
Pacific Rim	+	=/+	=/+	=	+	M/W

Legend: = neutral, + positive; - negative, O/W overweight, U/W underweight, M/W market weight, \* Under Review

**ABOUT THE FIRM**

**Headquarters:** Montréal, Québec

**Founded:** 1981

**Staff:** 21

**Portfolio Managers:** 6

**Investment Style:** Growth at a Reasonable Price (GARP) with a value bias.

**Investment Process:** Top-down / Bottom-up

**Investment Objective:** To provide long-term capital growth

**Assets Under Management:** \$800 million

**CONTACT US**

**C.F.G. HEWARD**  
INVESTMENT MANAGEMENT LTD.

2115 rue de la Montagne  
Montreal, Quebec  
H3G 1Z8

**Tel** (514) 985 5757 **Fax** (514) 985 5755

**Email** heward@heward.com

**Website** www.heward.com

**SECTOR ALLOCATION**

	<b>Target</b>
Financials	=
Telecommunications	=/+
Technology	=/+
Healthcare	=
Basic Materials/Energy	=/+
Industrial Products	=/+
Consumer Staples	=
Consumer Cyclicals	=
Utilities	=

C.F.G. Heward Investment Management Ltd.'s primary objective with this document is to provide timely information in respect of current developments in the financial marketplace and as such it may not provide sufficient detail for investors to make fully informed investment decisions. Although we endeavor to provide accurate information, there is no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. All opinions are based on our analysis and interpretation of this information and constitute our judgment as of the date hereof and are subject to change without notice. COPYRIGHT 2009 C.F.G. Heward Investment Management Ltd. No portion of this article can be reproduced in any form, in whole or in part, without the express written permission from the copyright holder.

