

2Q09 Update

Will Unemployment Trample Green Shoots?

After a brutal first quarter that saw world markets briefly breach the ugly lows of November 2008 and then snap back, the second quarter of 2009 saw markets continue their strong rally off their first-quarter bottoms. We finally saw some welcome positive returns over the second quarter: the TSX was up 20%, S&P 500 up 6.3%, Europe-Australasia Far East up 16.1%, and the World Index was up 11.7% (all figures in Canadian dollar terms).

With business activity picking up and credit markets thawing, leaders have claimed that the “green shoots” of recovery are sprouting and that the worst over. We have definitely seen signs of increased appetite for risk in the marketplace. However, companies continue to cut costs by laying off workers, driving unemployment up to multi-year highs. In this Update, we examine the evidence presented to us on the economic and technical (market data) fronts.

First, a look at one of our favourite charts: that of the top 100 companies in the world. In our last Update (written in early April), we wrote “We are encouraged that at the bottom right-hand corner of this chart, you can see that some support is being built with a tentative new uptrend being formed”.

2-Year Chart of the Global Top 100 Companies



Source: www.globeinvestor.com

We are happy to see that the uptrend is no longer “tentative”, as a new uptrend is solidly in place with a recent new high poking above the prior peak set in early June. This index is now up by over 50% from its low.

Returns to the end of the last quarter for the broad-based indexes were as follows:

| Term/Index | TSX Comp. | S&P 500 | Russell 2000 | NASDAQ | DEX Univ. Bond |
|------------|-----------|---------|--------------|--------|----------------|
| 3 months | 20.0% | 15.2% | 20.2% | 20.0% | -1.9% |
| 6 months | 15.4% | 1.8% | 1.8% | 16.4% | -0.9% |
| 1 year | -28.3% | -28.2% | -26.3% | -20.0% | 7.4% |
| 3 years* | -3.7% | -10.2% | -11.2% | -5.5% | 6.6% |
| 5 years* | 4.1% | -4.1% | -2.9% | -1.9% | 5.9% |

* annualized

Below we look at the economy and various market indicators that we regularly follow.

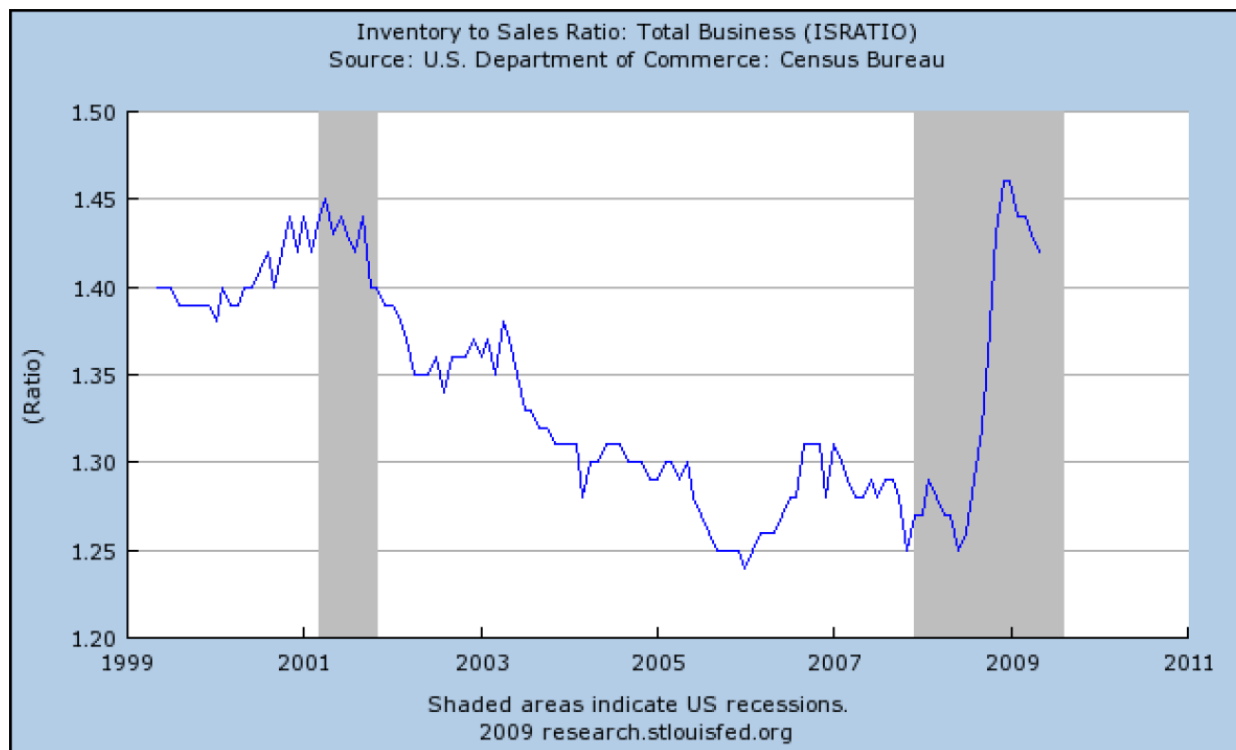
The Economy

For the most part, we believe the worst of the global recession is behind us. Many leading indicators have improved significantly:

- Credit spreads (the additional amount that businesses have to pay to borrow money compared to governments) have contracted significantly.
- Global new order indexes have turned up from historic lows. Typically, a turnaround signals future economic improvement.
- OECD leading indicators inflected up in April. Since World War II, these indicators have turned up on average 5 months before the end of recessions, and tend to be the most reliable of global leading indicators.
- Pending home sales have risen for the fifth consecutive month in the U.S., the Case-Shiller home price index has risen for the first time since July 2006, housing starts are at their highest level since November 2008 (up 22% from their low) and building permits bottomed in April (up 14.5% from their low). The housing inventory situation is also improving, with the number of vacant housing units for sale dropping for the second consecutive quarter (at their lowest level since the second quarter of 2006).

Let's look at some of our favourite economic indicators to see how they're doing:

Below is a graph of U.S. inventory to sales (the ratio of the value of goods in inventory compared to current sales). We are still at an eight-year high for this value, but at least we are beginning to see it decline.



As mentioned earlier, credit spreads have contracted dramatically. Below is a graph of the “TED spread”, a measure of what the private sector has to pay above what governments pay in interest on loans. As you can see, it spiked up very high near the end of last year (at the height of the credit crunch), then pulled back and appeared to climb again in late March, but has since dropped to a very low level. This indicates that there is a lot less fear of lending to businesses, since the premium required for taking such an investment risk has plummeted.

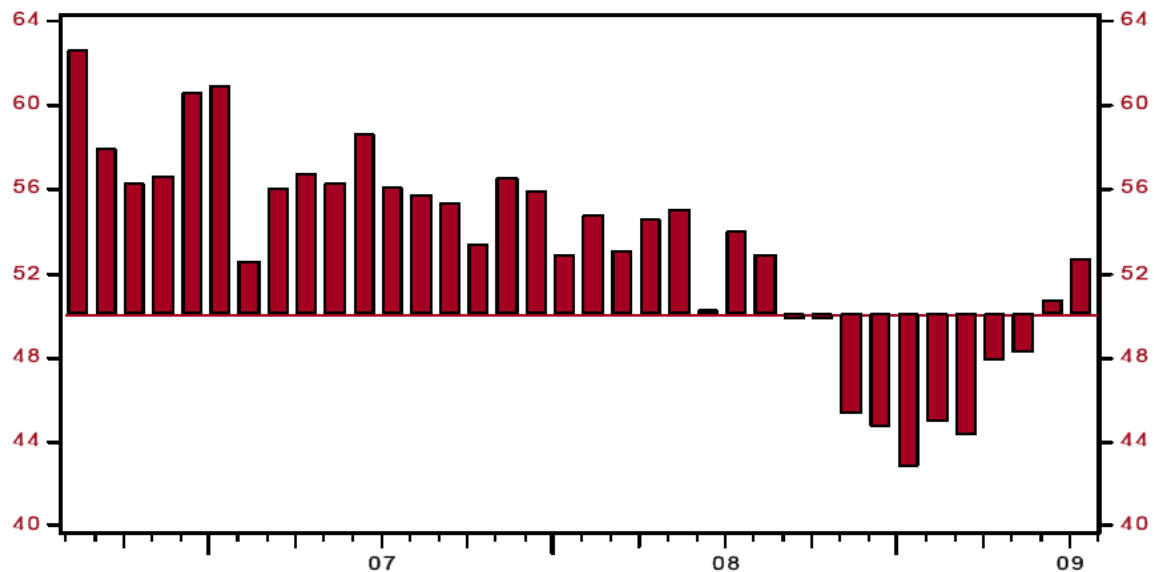


Concurrent with the reduced interest rate premium for lending to businesses, demand for credit has picked up:

Credit demand rising

Combined Mfr and Service Sectors CMI: New Credit Applications

SA, 50+=Growth



Source: Haver Analytics, Banc of America Securities-Merrill Lynch

On the housing front, we have seen inventories of new homes dropping from their peak set late last year:

Inventory situation improving

New 1-Family Houses For Sale: Months Supply

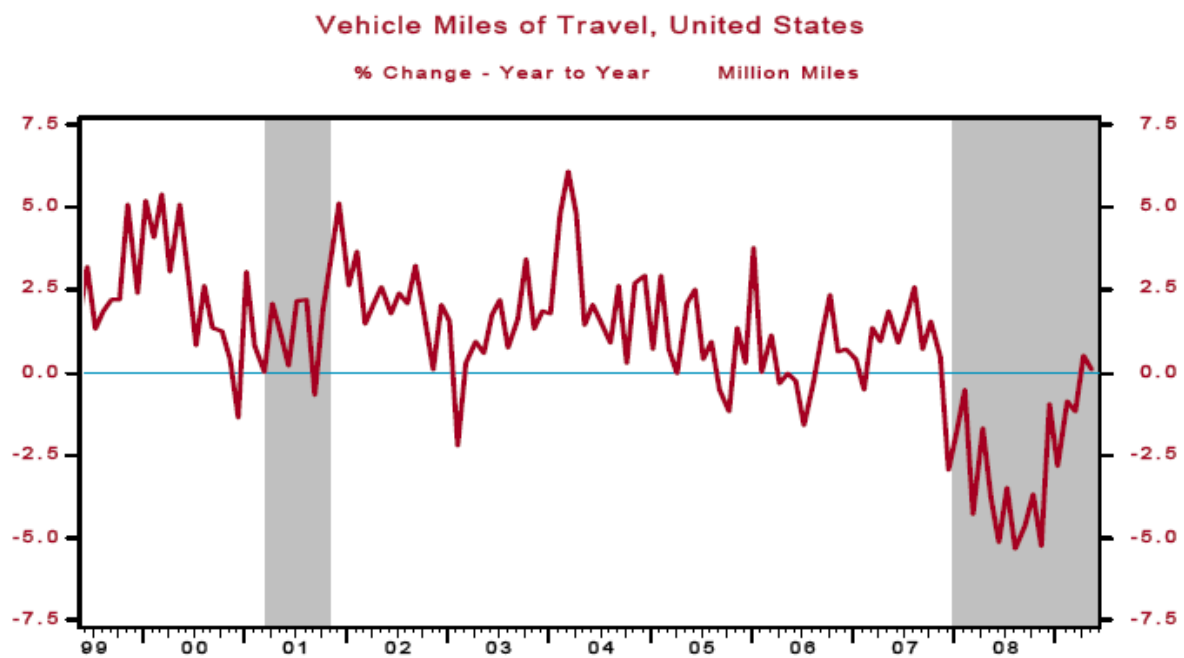
SA, Ratio



Source: Census Bureau, Haver Analytics

And finally, on an anecdotal basis we are seeing drivers getting back into their cars again:

Miles driven up two months in a row



Source: Banc of America Securities-Merrill Lynch Research, Haver Analytics

However, while the economic indicators imply the worst is over, the big question here brings us back to the title of this quarter's Update: will rising unemployment nip this nascent recovery in the bud?

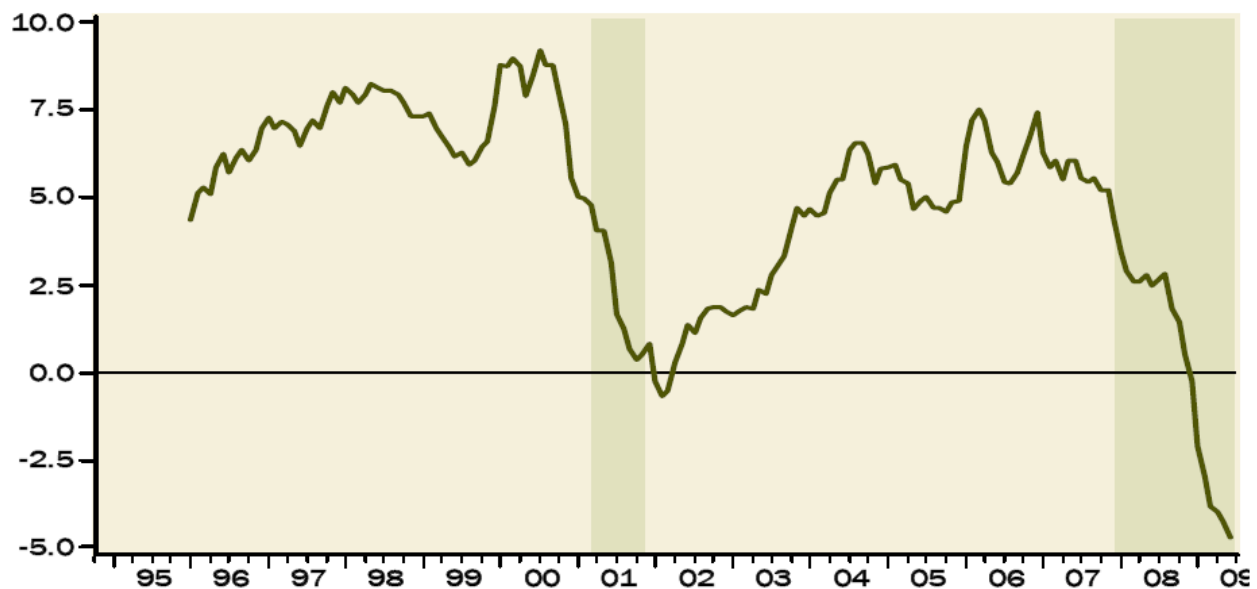
Canadian unemployment is at a seven-year high of 8.6%, and the U.S. unemployment rate is at 9.6% with a rate of over 10% expected by the end of the year. If people don't have jobs, or are worried about their jobs, they will reduce spending, and consumer spending is 70% of the economy.

And those who still have jobs are not experiencing wage growth, which doesn't bode well for increased spending on discretionary items:

NO GROWTH IN WAGE-BASED CONSUMER INCOME

United States: Wage and Salary Disbursements

(year-over-year percent change)



Shaded region represent periods of U.S. recession

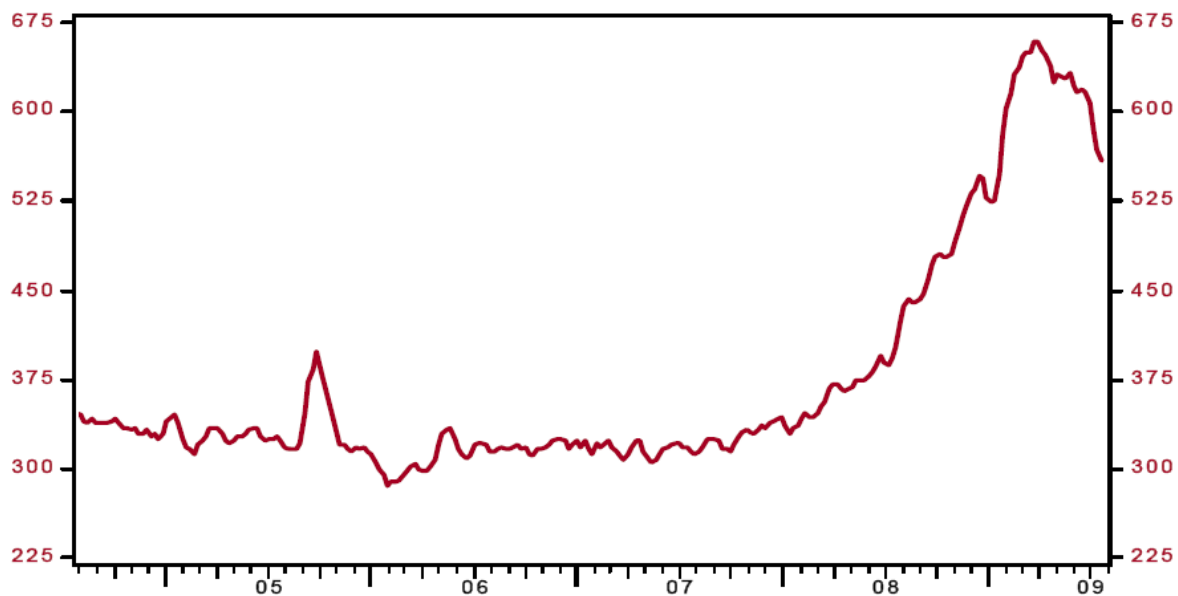
Source: Haver Analytics, Gluskin Sheff

But, to end this section on a positive note, while we remain concerned with unemployment, at least jobless claims have peaked and are dropping:

Jobless claims trending down

Unemployment Insurance: Initial Claims, 4-Week Moving Average

SA,Thous (I)



Source: Haver Analytics, Banc of America Securities-Merrill Lynch

Finally, we can take comfort that unemployment is a lagging indicator, so the worst could definitely be behind us as the markets seem to be implying. We look at various market indicators in the next section.

The Markets

Last quarter we mentioned the Volatility Index, commonly known as the “VIX” or “fear index”. This index measures the degree to which market prices fluctuate, both up and down. The higher the measure, the greater the uncertainty and fear in the marketplace. Late last year during the market turmoil, it spiked up to a record high but retreated to just below 40 when we wrote last quarter’s Update. Since that time, it has dropped even further, nearly halving in value. The downtrend from the beginning of this year is clear, which shows that fear is leaving the market but the Index has yet to reach the lows of early 2007.



Regular readers of our Updates know that we like to follow an important leading indicator that tracks the cost of shipping dry raw materials (used in all manufacturing processes) called the Baltic Dry Index. Increasing demand for raw materials indicates that manufacturers are placing orders to feed their own processes, presumably due to increased orders from their own customers.



When we wrote our last Update in April, the Baltic Dry Index had just bounced off its bottom and was showing signs of resurgence. Over the last quarter that uptrend was confirmed and now we are seeing a consolidation with some support at the 3,000 level. If this support holds and we continue to see higher highs and higher lows, then that will boost our confidence in an economic (and stock market) recovery.

One of our favourite leading indicators is the price of copper (used in nearly all manufacturing and construction processes):



Copper was already showing strong signs of a turnaround at the beginning of last quarter, when it was up by 40% off its bottom. Since then it has surged strongly upwards in a definite uptrend, up another 55%. For us, this is one of the most powerful arguments that the worst is behind us and that companies are beginning to rebuild inventories in anticipation of increased demand.

Another metal that has seen demand bounce back strongly is steel, used in large infrastructure projects and some manufacturing. After falling off a cliff in the middle of last year and bouncing along a record low until earlier this year, the steel sector has definitely turned around. We are watching this closely (for a breakout above resistance at 50) for added confirmation that demand for steel (which would point to an economy regaining its footing) is on solid ground.

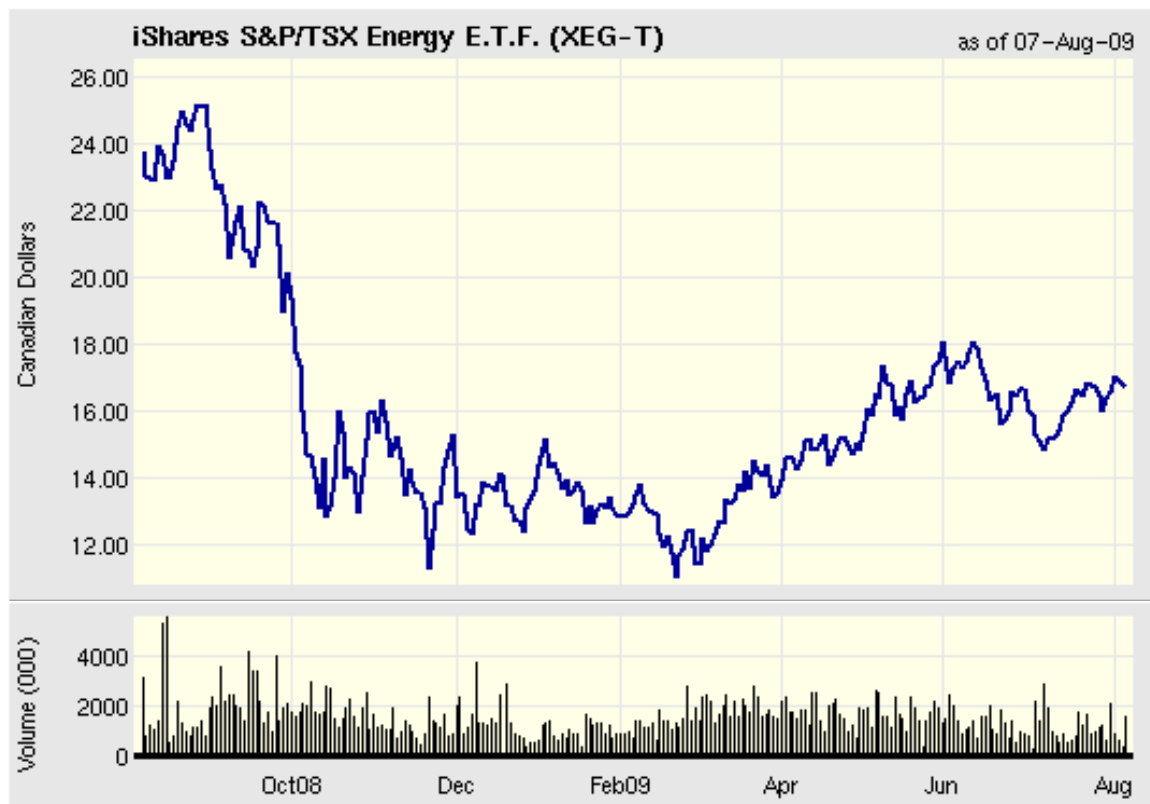


Another interesting sector is that of the home builders. We have seen a bounce off a record low with higher lows and higher highs, as well as a tentative reversal of a two-year downtrend, which are steps in the right direction.



Focus on Oil and Gas

In our last daily Market Update, we focused on the energy sector and discussed world oil demand and dwindling supply. We continue to like the oil and gas sector, and have recommended that many clients continue accumulating the TSX Energy Index, which is still yielding 3.5% even after rising from its March low. Since our last quarterly Update, this index has been choppy but appears to have formed a bottom:



Source: www.globeinvestor.com

Earlier in this Update, we discussed the "VIX", or "fear index" for the overall market. The same indicator also exists for the price of crude oil itself. Below is a chart of the Crude Oil Volatility Index, or "OVIX":



When the price of oil plunged late last year, this index rallied to the peak visible above. Now we are seeing this index bounce along the bottom, which gives us reason to believe that oil is not about to plunge again.

Balanced Portfolio

Our Balanced Portfolio was launched on January 1, 2002 and is reviewed quarterly. Our periodic rebalancing allows the portfolio to achieve maximum growth potential, while minimizing volatility.

We continue accumulating securities that pay dividends, since yields are still high and we are getting paid to wait for capital appreciation.

Balanced Portfolio as of July 1, 2009

| | | |
|--|-----|-------------|
| Equities | | 61% |
| Canadian Large-Cap | 10% | |
| U.S. Large-Cap | 5% | |
| International Large-Cap | 10% | |
| Gold | 4% | |
| Energy | 4% | |
| Materials | 4% | |
| Real Estate Investment Trusts | 9% | |
| Individual Stock Selections | 15% | |
| Fixed Income | | 18% |
| Convertible Bonds and Preferred Shares | 18% | |
| Cash | | 21% |
| Corporate Paper & GICs | 21% | |
| Total | | 100% |

Returns for the Balanced Portfolio, net of fees, are as follows (ending June 30, 2009):

| Term | Return |
|--------------|---------------|
| 3 months | 19.6% |
| 6 months | 18.6% |
| 1 year | -7.5% |
| 2 years* | -4.4% |
| 3 years* | -0.3% |
| 4 years* | 2.1% |
| 5 years* | 3.6% |
| 6 years* | 5.3% |
| 7 years* | 4.7% |
| * annualized | |

This portfolio currently has a pre-tax interest-equivalent income yield of approximately 4.4%.

Last quarter the Balanced Portfolio experienced its highest-ever quarter-over-quarter increase, at nearly 20%. Obviously this was from a very low base, since in the previous six-month period the portfolio collapsed by 23%. Standout performers last quarter (since they recovered strongly off their multi-year lows) were Trinidad Drilling and the Brookfield Properties preferred shares. We continue to see a strong rebound in many dividend-paying stocks, which despite their recent recovery still offer yields at multi-year highs. While this portfolio is still not beating the TSX 60 over the past five years (partially due to its cash and fixed-income weightings), it is closing in fast and could do so if it continues showing strength over the next few quarters.

Final Thoughts

We definitely became more aggressive last quarter, reducing the cash weighting to a three-year low of 13% and scooping up bargains given away during the panic selling. We remain on the watch for quality dividend-payers on sale and have some cash ready to deploy should more buying opportunities appear.

All the best,

Andrew Johns

Michael Assouline, CFA

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