

4Q08 Update

"It was the best of times, it was the worst of times..." – Opening line from "A Tale of Two Cities"

Well, no one will shed a tear to see 2008 gone. With record-setting market declines amidst massive changes on Wall Street and in the world markets, and a world-wide credit crunch sparked by the deterioration of U.S. sub-prime mortgages, we believe 2009 can only get better.

We are encouraged that so far, markets have not retested the bottoms they set last quarter. Much negativity appears to be priced in, and dividend yields on many stocks and most indexes are at record highs, levels usually associated with buying signals. We await confirmation of a bottom by the formation of new uptrend lines.

As it applies to 2008, the "worst of times" part of our quote above needs no explanation. As for "the best of times," we fall back on the old investing refrain that it is best to buy when no one else wants to (the point of maximum pessimism, when the headlines contain nothing but doom and gloom as was the case back in November). While we don't have high hopes for a strong rally this year, we remain confident that over the next few years current prices will be looked back upon as buying opportunities.

The Markets

No developed-nation market recorded a positive gain in 2008. Selected declines were as follows:

Index	Return
TSX	-35%
S&P 500	-38%
Euro Area	-43%
Nikkei (Japan)	-42%
World Index	-44%

The chart of the top 100 companies in the world neatly summarizes the market action over the past year:



Source: www.globeinvestor.com

In the bottom right-hand corner of this chart, you can see that some tentative support is being built, and that world markets have so far bounced off the lows we saw last quarter.

Markets tend to look forward and price in future events, so based on this price action we are tentatively optimistic that the worst is behind us. In other words, stock markets are leading indicators, and begin their advance before the economy turns around.

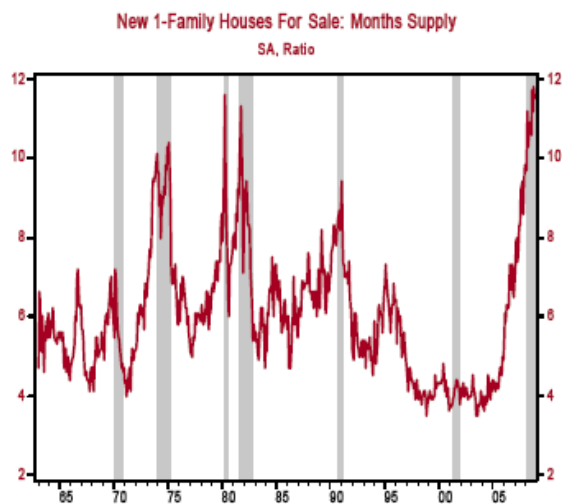
The Economy

Here we briefly summarize a number of concerning negative trends:

- Job losses have been increasing, and unemployment rates around the world are rising.
- Home sales continue falling and inventories are at all-time highs.
- Commercial rents have begun to decline along with occupancy rates, while commercial real estate debt defaults have risen.
- Retail sales are also declining.
- Auto sales are down 36% from a year ago, and are at 26-year lows (not to mention the Big Three car companies are teetering on the verge of bankruptcy; GM is still worth less than Mattel, a toy car manufacturer). For the first time in history, sales are below replacement demand, meaning that the number of cars on the road in the U.S. is actually declining.
- U.S. bankruptcies are up 32% over a one-year period.
- Manufacturers are dealing with a major inventory overhang: the inventory to sales ratio has hit a high of 1.75 times, a level not seen since 1993.

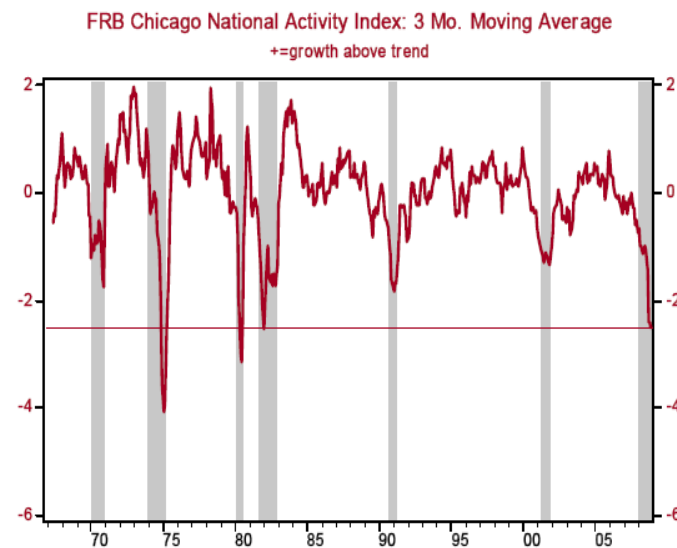
We have included some charts that summarize the deterioration in the U.S. economy (all grey bars refer to prior recessionary periods). The chart on the left shows how high home inventories have risen, in terms of months of supply. The chart on the right is a leading index that takes into account 85 variables on economic activity, and is at a multi-decade low.

Supply overhang persists



Source: Haver Analytics, Merrill Lynch

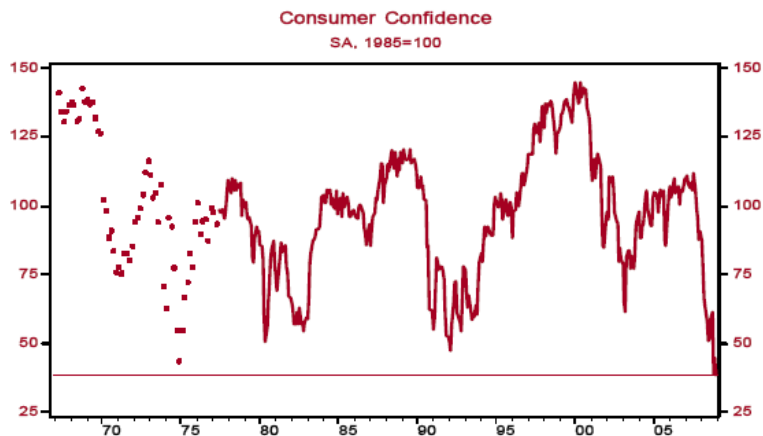
On pace for the worst recession in post-WWII era



Source: Haver Analytics, Merrill Lynch

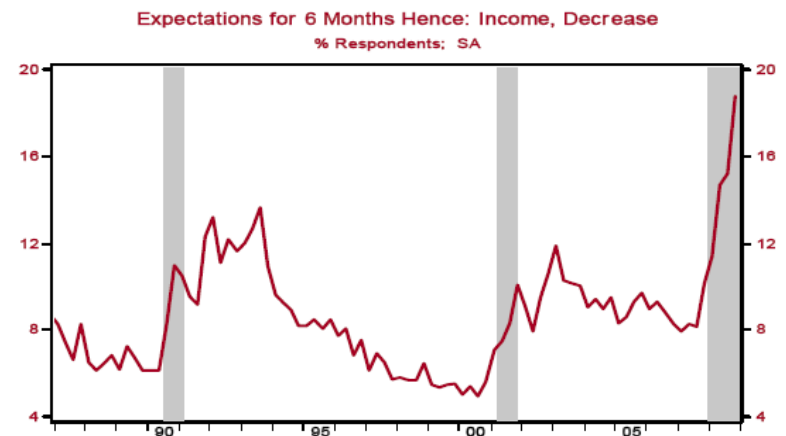
Turning to the consumer (which represents 70% of economic activity in the U.S.) we can see from the chart on the left below that confidence is at a record low. On the right-hand chart, we can see that household expectations for decreased income six months hence is at a record high.

New all-time low for consumer confidence



Source: Haver Analytics, Merrill Lynch

Household income expectations the weakest ever



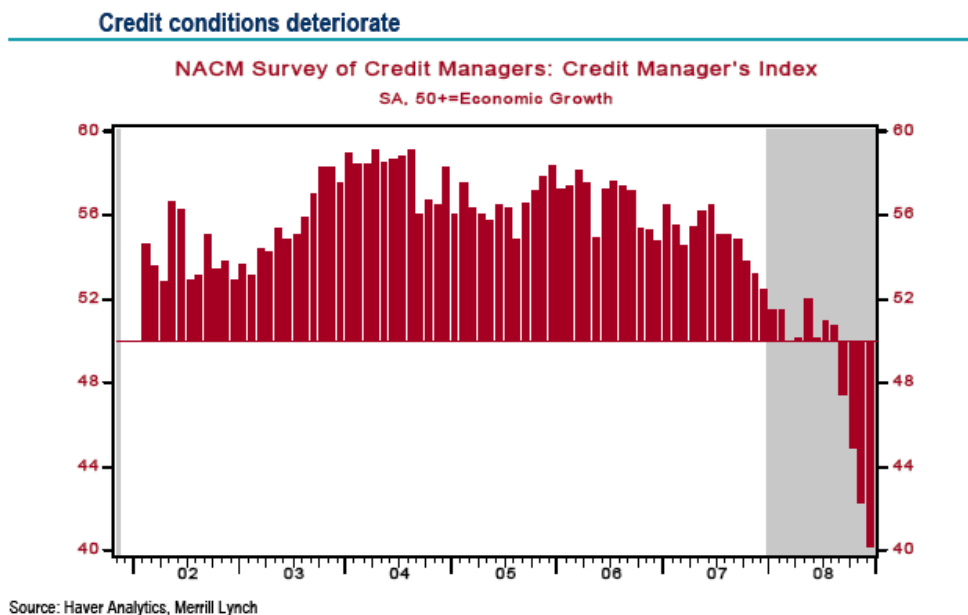
Source: Haver Analytics, Merrill Lynch

Our rationale for showing you these charts is not to scare you, but to reinforce one point: while the economic situation has deteriorated greatly compared to a year ago, these various economic indicators are at extreme levels from which historically, the stock market and the economy have recovered (in that order). Another way of putting it is that we believe the risk of the economy markedly deteriorating from this point is much lower than it was a year ago.

On a positive note, governments around the world are pulling out all the stops to stimulate the economy and prevent "Great Depression II". In the U.S., president-elect Obama's stimulus plan calls for nearly \$1 trillion in various forms of economic activity, including much-needed infrastructure spending. As our chief strategist Jeff Saut has often said, government stimulus programs have a history of working, and we don't expect this time to be any different.

The Credit Crunch

In the Fed's latest survey, 95% of banks have tightened credit availability for larger companies and 90% for smaller companies. The chart below illustrates an index of credit availability, which is at an all-time low.



A similar chart that tracks *demand* for credit looks the same, as it measures new credit applications. In other words, many companies are averse to adding leverage to their balance sheets at this time. We remain attuned to a turnaround in the above chart, which could portend a return to a stronger economy.

Fixed Income (Bonds)

We continue to expect the Fed to leave rates on hold (that is, at record lows) throughout 2009. Due to concerns over the creditworthiness of corporate borrowers, corporate bond yields are at record highs:

Corporate bond yields at 17-year high

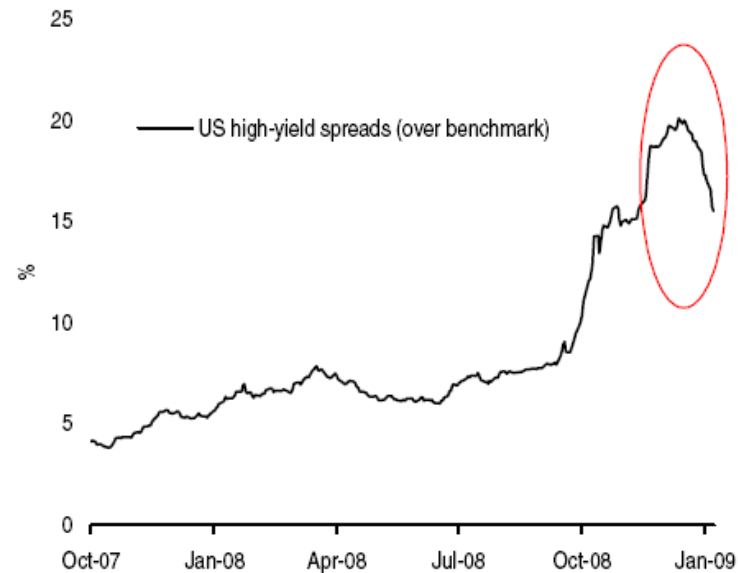


Conversely, the flight to safety has driven yields on government securities to all-time lows, in some cases negative. In other words, some investors are willing to *pay* the government in order to keep their money, just for the privilege of being assured that they will get it back.

However, we are seeing some signs of a thaw in the credit markets: the cost of protection against debt defaults has dropped to its lowest level in eight weeks. The improved sentiment means that corporate issuers have an opportunity to borrow more easily than just a few months ago.

We are also encouraged by the declining spread on high-yield investments, which has begun to pull back as illustrated on the next page.

High-yield spreads have finally started to narrow



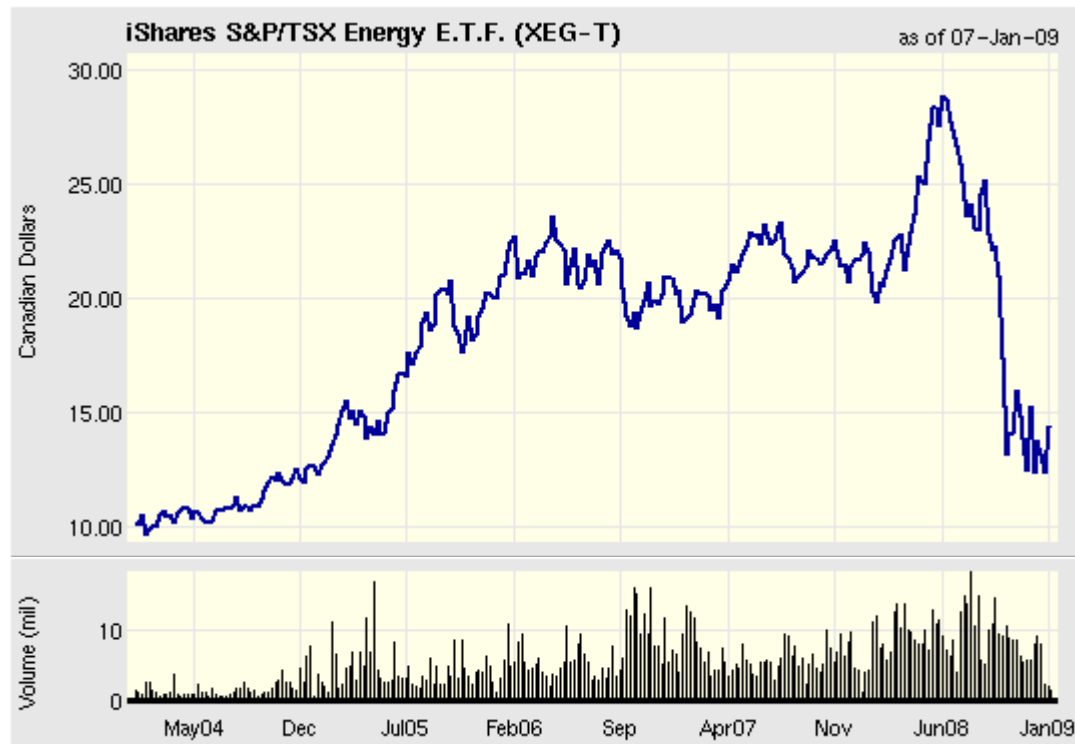
Source: © Datastream International Limited

The “spread” means the difference between the (higher) rate that riskier corporate issuers must pay to borrow and the (lower) rate that high-quality, established companies pay. The lower this difference, or “spread”, the less worried investors are about the corporate issuers’ ability to pay. And the less worried investors are, the greater chance of a rally in the stock markets.

For fixed-income investors seeking a reasonable level of yield, corporate bonds are their only option. As our clients know, we specialize in convertible debentures, a type of corporate debt security that also has the potential upside of equity. Convertible debenture yields to maturity are at record highs at the moment, with Cineplex Galaxy, Keyera Facilities, Progress Energy and Trinidad Drilling being some of the convertible issuers that we find attractive. All have double-digit yields to maturity and healthy interest coverage on their debt.

Energy

Oil reached a high of US\$147/barrel last May on supply concerns, and now has dropped to just over US\$40/barrel on demand concerns. Natural gas has also dropped to a 15-month low. At this point, we believe the downside risk to oil and gas prices is very low, and recommend accumulating energy-related shares.



Source: www.globeinvestor.com

Above is a chart of the TSX Energy Index, which is at a three-year low. It holds all the major oil and gas companies in Canada, such as EnCana, Canadian Oil Sands Trust, Canadian Natural Resources, Petro-Canada and Suncor, among many others. This index mitigates the company-specific risk of buying individual energy companies (which tend to be volatile), while paying an attractive dividend of almost 6% at the moment. We believe the fundamental case for investing in oil and gas remains solid (supply declines by 5-7% a year, and must be replaced by more exploration and drilling). We are seeing oil and gas companies trade at historically low valuations, based on price to

cash flow or price per producing barrel of oil equivalent per day. A tongue-in-cheek saying in the energy business is, “the best cure for low oil prices is low oil prices”, meaning that when oil prices drop to a certain level (usually below the marginal cost of production at around US\$40/barrel), many barely economical projects stop and supply is reduced, which helps to support prices again. When energy demand strengthens, we expect to see the stock prices of these oil and gas companies recover strongly. As with many other stocks, we are seeing the beginnings of support forming in the bottom right-hand corner of the chart.

Energy services companies such as Trinidad Drilling are also trading at very cheap multiples; for example, Trinidad trades at a record high dividend yield of over 13% (with a payout ratio below 30%) and at half of its replacement value.

Infrastructure

Infrastructure is a theme that we have followed for a while, and the underlying story continues to improve. Many of the infrastructure companies that we follow, such as Finning International, Genivar Income Fund, and Lockerbie & Hole have record backlogs and low payout ratios on their dividends (which also have been growing each year). Infrastructure stocks should also be beneficiaries of various government stimulus programs.

On the next page is a chart of Claymore’s new Infrastructure Index fund.



Source: www.globeinvestor.com

In anticipation of government stimulus spending on infrastructure, this index has bounced off its low by over 25%. We continue to monitor this sector for attractive buying opportunities.

Canadian REITs

Canadian real estate investment trusts (REITs) now have historically low debt levels, growing and stable cash flows, and are trading at record high discounts to net asset value. Despite the economic downturn, occupancy rates are still quite high (most are over 95% occupied), and exposure to maturing leases is low. In addition, many REITs are still benefiting from rental lifts on the leases that are expiring. The simplest way to gain exposure to this sector is through the TSX REIT Index ETF, which is trading at record lows with an

annual cash yield exceeding 10%. Payout ratios are below their peaks but are still high (ranging from 80-120%), so we could see some distribution cuts by the REITs. Having said that, we believe many distribution cuts have already been priced into the market.

Technology

Technology stock prices have begun to recover along with the rest of the market. The charts of all the major technology sub-sectors (semiconductors, hardware, software, internet architecture and internet infrastructure) all look similar to the first chart at the beginning of this commentary. Technology spending by businesses will resume once more confidence returns to the economy, and when that happens, we believe this sector will rally strongly from its depressed levels.

One technology bellwether that we follow is Intel Corporation. Intel, a world leader in microprocessor production, has recently bounced off a 12-year low and is trading at a record high dividend yield of nearly 4% (with a 42% payout ratio and a 5-year annualized growth rate of 41%). It has \$12 billion in cash and \$2 billion in debt on its balance sheet. More and more applications (not just computers) require chips each year, and the barriers to entry in this business are quite high. Intel also has a growth opportunity in the new solid-state flash memory drives (these devices have no moving parts) that are beginning to replace computer hard drives (which are 1980s technology with moving parts and are prone to failure).

What we find particularly interesting is that the company just announced lowered sales guidance for 2009, yet the stock did not decline appreciably. This tells us that much negativity has already been priced into Intel, so the stock may have bottomed. Investors could reap a nice profit once the economy rebounds, and get paid an attractive dividend while they wait. As one commentator recently wrote to readers who had doubts about investing in Intel, "if you can do 10 million calculations per second with an abacus, go right ahead."

Copper and other base metals

All the base metals prices collapsed in the last six months, with all-important copper pulling back from a high of US\$4/pound mid-year to a low of US\$1.30/pound. As we have mentioned before, copper is one of the most important commodities to watch, since it is used in all forms of manufacturing and construction. It tends to be a good proxy for world economic activity, and we are encouraged by its recent bounce off its low to US\$1.55/pound. The cost of production for most mines around the world is around US\$1.50/pound, so at recent

levels we believe the risk of a precipitous drop from this point is low. Again, we would show you charts of various copper stocks and materials indexes, but suffice it to say they all look similar to our first chart on page 2.

Gold: Glittering in 2009?

This could be the breakout year for gold. We could see gold continue rallying from its October 2008 low due to concerns over all the U.S. dollars being printed for various bailout programs south of the border. Gold continues its uptrend from its recent low and more importantly, is attempting to break out of the downtrend that it had been trapped in since its peak in March.

New, economic gold deposits continue to get harder to find, and we expect more consolidation in the sector as larger companies take over smaller ones in order to boost their overall production. Gone are the nuggets of California or the rich seams of South Africa; most gold produced today is in chemical form that requires processing to extract. One example that illustrates this point is Newmont Mining's Batu Hijau mine in Indonesia, which can be seen from space. No visible gold is mined there, and it takes over 250 tons of rock to produce one ounce of gold (enough for about one wedding ring). Every 16 hours, Newmont's huge Caterpillar trucks (the same ones Finning supplies to the oil sands in Canada) move rock weighing more than all of the refined gold produced in human history (about 161,000 tons, enough to fill two Olympic-sized swimming pools).

Below is a chart of the TSX Global Gold Index, which contains all the major gold mining and production companies such as Barrick Gold (responsible for nearly 10% of global production), Goldcorp, Newmont Mining, Kinross Gold, Agnico-Eagle Mines, Yamana Gold, and many others.



Source: www.globeinvestor.com

Our Balanced Portfolio has a direct 4% weighting in gold stocks, with additional exposure through the Materials Index and the TSX 60 Index.

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 to favour securities that pay dividends, since their yields help to support their prices in times of turmoil, and we prefer to get paid to wait for our stocks to appreciate. Yields are at record highs at the moment, so a return to (lower) historical values would result in capital appreciation for many shares.

Other than some minor weighting changes (mainly increasing the weight of the Energy and International Indexes), there were no significant changes to this portfolio last quarter. The Balanced Portfolio's cash weighting has dropped to 22%, which still provides us with room to buy the shares or debentures of quality companies at low prices. Due to the sharp pullback in many dividend-paying stocks, the interest-equivalent yield of the portfolio is at a record high of 5.5%.

Balanced Portfolio as of January 1, 2009

Equities		55%
Canadian Large-Cap	8%	
U.S. Large-Cap	3%	
International Large-Cap	10%	
Gold	4%	
Energy	4%	
Materials	3%	
Real Estate Investment Trusts	5%	
Water	3%	
Individual Stock Selections	15%	
Fixed Income		23%
Convertible Bonds and Preferred Shares	23%	
Cash		22%
Corporate Paper & GICs	22%	
Total		100%

Returns for the Balanced Portfolio, net of fees, are as follows (ending December 31, 2008):

Term	Return
3 months	-15.3%
6 months	-22.0%
1 year	-21.4%
2 years*	-11.6%
3 years*	-4.8%
4 years*	-0.9%
5 years*	-0.9%
6 years*	2.9%
7 years*	1.6%
* annualized	

This portfolio currently has a pre-tax interest-equivalent income yield of approximately 5.5%.

Last quarter and 2008 were by far the worst periods for this portfolio since inception. Our high cash weighting helped keep this portfolio's losses to "only" 22% when the TSX was down by 35%, but we realize this is cold comfort to investors who are looking at the actual dollar value decline of their portfolios. We believe the deployment of cash at the current depressed stock price levels will help boost returns in the longer term.

Final Thoughts

Income generation and opportunistic buying are our two main objectives this quarter. One old trading saying is, "do the hard trade", meaning one should do what everyone else is not doing, and thus buy stocks when no one else wants them. Opportunities to buy quality names at multi-year lows do not come around often, so we will try to take advantage of this one. But, we will still keep a healthy cash weighting in case prices get even cheaper and to reduce portfolio volatility.

All the best,

Andrew Johns

Michael Assouline, CFA

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