

- **Bad news:** For some reasons (see notes below) both media and investors cling to the idea that little has changed economically speaking, and that capital markets remain very vulnerable and risky. Yet we are in the last act of this economic cycle --- precisely the time when: companies file for bankruptcy protection; ponzi schemes and other frauds are revealed; job losses mount; and, the savings rate goes up. So, for those who want to find it and focus on it, there is an abundance of economic misery, but it's all lagging the market --- it's telling you what has been and not what's coming. Here's a reality check courtesy of the **Economic and Strategy Group** with **National Bank Financial (NBF)**.

- **Part 1: the economy** – it's on the mend in the U.S. and Europe and elsewhere, says **NBF**, thanks to the massive injection of government cash. The signals are too numerous to ignore. Central banks are even expected to take their foot off the monetary pedal soon. The U.S. economy is turning following 17 months of recession. For example: unemployment growth is slowing; corporate earnings are predicted to rise rather than fall; productivity has surged; housing is very affordable. Canada, in spite of a 5.4% Q1 decline in GDP, is better off. In particular, Canadian household finances, house prices, government indebtedness and the banking system are considered to be more stable. On the other hand, regional economic disruptions (especially in **Ontario**) are significant and will not be easily reversed. Nevertheless, the Canadian economy is ready to be lifted by the rising tide of global economic activity, however modest. **NBF** does note that the run-up in energy prices is quite speculative as demand fundamentals are not there. Given current global economic output, WTI oil should be in a US\$60-\$70 range.

- **Part 2: fixed income** – credit conditions are returning to normal levels of risk as signalled by the narrowing spreads on overnight lending between banks. According to **NBF** an initial **Fed** rate hike is anticipated by the end of Q4 2009, with a Canadian increase to follow in mid-Q1 2010, in an attempt by central banks to return to a more neutral policy stance. This will push the yield curve up affecting the price of bonds (especially short term instruments). In this context, both Provincial debt and corporate bonds, where spreads have opened up as their financial conditions have deteriorated, are a necessary offset to the interest rate risk of Canada bonds.

- **Part 3: equities** – the **NBF's** analysis concludes that 4 key conditions have been met for a growing equity market. The key criteria are: oil prices below the 2008 average; a more stable housing market; earnings expectations in line with economic realities; and, stable financial markets. Based on historical valuations, the **S&P 500** is expected to rise to 1,120 over the next year, or up 25%. The **S&P TSX** is expected to rise 17% from current levels to 11,600. **NBF** recommends investors favour financials, IT and consumer discretionary stocks and shun cash.

- **Comment: NBF's** findings are broadly in line with the advice and analysis offered by **TD Newcrest**. As we relayed in our previous newsletter, **John Aitkens** published a report last week proclaiming the end of the U.S. recession. The conclusion offered is not surprising given the analysis and reasoning provided by both parties over the past 9 months but probably comes as a surprise to investors too absorbed with day to day economic results and market volatility. Both forecasts are actually quite moderate: both the **S&P 500** and the **S&P TSX** are predicted to be at values below index levels set 10 years ago!

- **Comment:** To June 30<sup>th</sup>, 2009 the **S&P TSX** is up **15.43%** on the back of commodities and financials plus RIM. **S&P 500** is up **1.78%**, held back by ongoing concerns about consumer weakness.

- **Why are investors so fearful? Asymmetric loss aversion:** time and time again (in 1987, 1990, 1998, 2002 and 2008) investors have embraced the *apocalypse du jour* and dumped stocks. Fear overwhelms reason. Why? It is fundamental to human nature that we fear loss much more than we hope for gain. "Losing money feels twice as bad as making money feels good", says Richard Thaler of the University of Chicago, and as a result, investors react disproportionately. Asymmetric loss aversion is why we tend to require insurance that is out of proportion with risk.

- **Why are investors so fearful? Volatility, loss and risk:** what keeps investors fearful is a failure to distinguish between **volatility** (when markets go up and down in *significant* daily increments) and **loss**. Clearly one does not equal the other unless you sell. In the aftermath of a correction, it would be disturbing if markets were not volatile. But investors will react to the daily shifts in valuations if they have not defined a realistic **investment horizon and objective**. Many investors also mistakenly see investing as something that is a daily exercise involving short term gains, rather than a 2-3 year undertaking involving long term gains and a stream of income. The absolute increase in volatility in the past 10 years has contributed to that perception (resulting in the day trading phenomenon). Investors also have little appreciation of what **risk** is, or how it is measured and controlled. In bear markets investors magnify risks and equate it with **uncertainty** (a situation where risk is unknown) and as a result panic. And lastly, humans as investors behave like **herd animals**. They sell on masse and sometimes even buy on masse. Even for professional investors, it is extremely hard to resist such a market.

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