BUY stocks in a balanced portfolio.

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- Why invest in stocks now? Many investors continue to shun stocks. Some of them justify their aversion by buying into the fear that the gains to date are ephemeral and that the economic recovery will reverse itself. Good investment practice and stock market history doesn't support such an approach.

- In a **balanced portfolio**, the allocation to stocks is always 50% or more. An investor who doesn't own stocks or has a minimal allocation to them is essentially shorting the stock market. With cash returns at zero such an approach significantly diminishes the ability of a portfolio to recover from the earlier decline in valuation.

- On a **P/E basis**, stock valuations in **Canada** at the beginning of September were up to around 14.5 times 12-month forward earnings versus 10.2 in March. In the **U.S.** the **S&P 500** was trading at 10.7 times 12-month forward earnings in March and 14.4 in early September. Such increases in valuation are *normal* following a recession. As the analysts at the **National Bank** point out: "By the time the last 14 U.S. recessions bottomed, the forward P/E of the S&P 500 had climbed on average to 13.4 from 11.2 at the market trough. A year later, the multiple was 16. In the last five recessions, the Canadian ratio of price to reported earnings, after declining from an average 12.9 at onset of recession to 10.5 at market trough, climbed back to 12.7 at recession end and to 15.1 a year later."

- Q2 earnings were characterized by widespread positive earnings surprises. The degree of these earnings revisions demonstrates that companies are now more productive and profitable and the extent to which the 'street' is being cautious about the recovery and future earnings.

- In U.S.$, on a year to date basis, **Canada's** stock market is up around 50%, up there with **China** and **Spain,** while the **S&P 500** is up only 22%. In nominal terms the **TSX Composite** is up approximately 26% versus 18% for the **S&P 500.** Canada's stock market however has a much greater degree of single stock and sector risk than the **S&P 500.** Gains in the exchange rate magnify the differences between Canada and the U.S. and temper the desire to diversify beyond Canadian stocks. Without greater diversity, a Canada-only stock portfolio is more volatile.

- the **VIX** or the **Chicago Board Options Exchange Volatility Index** is down at near normal levels and hitting 52 week lows. Credit markets are operating normally. Spreads between corporate bonds and 10 year government bonds for example have narrowed significantly.

- The current yield on 3 year government bonds is approximately 1.40% in the **U.S.** and 1.90% in **Canada**. The current yield on **the S&P 500** ETF is 2.24% while the **TSX Composite** ETF generates just over 3.0%.

- Market watchers, analysts, gurus, experts etc. have been predicting *ad nauseam* that the economic recovery is weak and that earnings and stock prices are fragile. Remember **Warren Buffet's** maxim: "When investors are fearful, get greedy. When investors are greedy, get fearful." Even Mr. Buffett seems to have misplaced his own advice.

-On September 19th, **James Grant**, a respected analyst and a long time bear announced in the **Wall Street Journal** his conversion to a bull --- "I am about to propose that the recovery will be a bit of a barn burner", he says. His analysis makes for interesting reading and is posted in its entirety on our web site. Two points salient to our discussion jump out:

- "Americans are blessedly out of practice at bearing up under economic adversity … it has been a generation since a business cycle downturn exacted the collective pain that this one has done. Knocked for a loop, we forget a truism. With regard to the recession that precedes the recovery, worse is subsequently better. The deeper the slump, the zippier the recovery. To quote a dissenter from the forecasting consensus, **Michael T. Darda**, chief economist of **MKM Partners**: "[T]he most important determinant of the strength of an economy recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period."
- "To the English economist **Arthur C. Pigou** is credited a *bon mot* that exactly frames the issue. "The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant." So it is today. **Paul A. Volcker, Warren Buffett, Ben S. Bernanke** and economist too numerous to mention are on record talking down the recovery before it fairly gets started…. Among economists polled by **Bloomberg News,** the median 2010 GDP forecast is for 2.4% growth. It would be an unusually flat rebound from a full-bodied downturn. Our recession … bear[s] comparison with the slump of 1981-82. In the worst quarter of that contraction, the first three months of 1982, real GDP shrank at an annual rate of 6.4%, matching the steepest drop of the current recession … the **Reagan** recovery, starting in the first quarter of 1983, rushed along at quarterly growth rates over the next six quarters of 5.1%, 9.3%, 8.1%, 8.5%, 8.0% and 7.1%. Not until the third quarter of 1984 did real quarterly GDP growth drop below 5%."

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