

## QUARTERLY COMMENT

First Quarter 2009

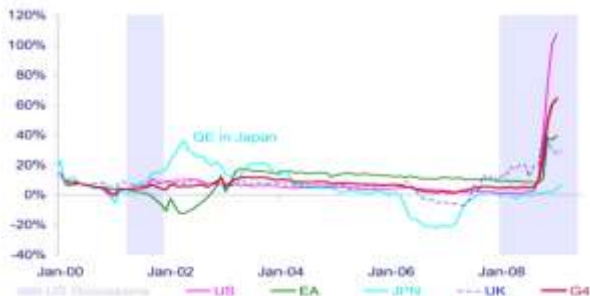
### ECONOMIC ENVIRONMENT

Amid signs of improvement in both credit markets and the real economy, global equity indices rallied sharply in March. Despite this powerful move, more than 20% in some instances, most developed markets registered declines over the quarter. The U.S. equity market declined for the 6<sup>th</sup> consecutive quarter, the longest stretch since 1970 and had its worst first quarter decline since 1939.

The optimism evident at quarter end was due, in part, to the view that the coordinated efforts of world monetary and fiscal authorities would positively impact economic growth.

As the following chart shows, monetary policy has been especially aggressive.

### MONETARY BASE year-over-year % change



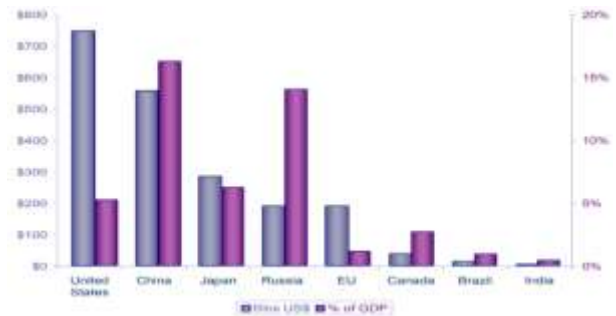
SOURCE: Haver Analytics, Morgan Stanley

Monetary aggregates have expanded rapidly in a very short time period. The U.S. and the U.K. have effectively moved to a zero interest rate policy. These efforts are designed to thaw credit markets frozen since the Lehman bankruptcy, move investors away from the ultra-safe U.S. Treasury market and increase the amount of bank lending.

Following the lead of the new U.S. Administration, massive fiscal incentives have also been announced in

the developed and developing economies. The size of the announced stimulus in terms of absolute dollars and as a percentage of GDP is particularly large in the U.S., China, Japan and Russia. Better growth in these countries would meaningfully impact world growth.

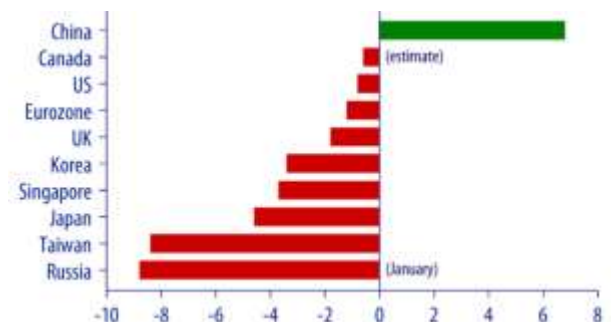
### FISCAL STIMULUS



SOURCE: BMO Capital Markets, Haver Analytics

The impetus for these actions is the state of global economic growth. Leading economic indicators suggest that this global slowdown will most closely resemble the synchronized decline of 1973-1974. Certainly, real GDP has fallen across the board with the notable exception of China. While still positive, the pace of Chinese growth has fallen by more than half. Data released during the first quarter show a continuation of this negative trend.

### REAL GDP Q4 - year-year % change



SOURCE: BMO ECONOMICS

While there are many causes for the current economic climate, the bubble in the U.S. housing market is viewed as one of the major contributors. As the air has come out of this bubble the values of derivatives based on residential real estate have declined precipitously and consumer spending has retrenched in the face of unprecedented declines in personal wealth.

Improvement in the residential real estate market is a crucial component of the recovery process and there are early indications of recovery.

### HOUSING AFFORDABILITY AND SALES



SOURCE: National Bureau of Economic Research

While residential real estate prices continue to decline and more than 10% of households are in default or arrears, there has been some stabilization in residential sales. More importantly, as long-term mortgage rates approach record lows, the affordability index has reached an all-time high. These factors, coupled with programs to reduce the number of foreclosures and changes in the reporting requirements of derivatives exposure for financial institutions should serve to markedly improve sentiment.

Fiscal and monetary policies operate with a distinct lag. In fact, these lagged effects can be as long as eighteen months and account for some of the challenges of policy making. The recent announcements and actions are unlikely to have had a meaningful impact on first quarter economic results and may only marginally affect the second quarter results. However, the combined effects of global coordination will likely be apparent by the second half of 2009.

Canadian economic activity has declined in tandem with the slowdown in the U.S. and the collapse of commodity prices. The impacts are evident in the performance of our exports.

### COMMODITY PRICES AND EXPORTS



SOURCE: BMO Capital Markets

Our export volumes are also vulnerable to the state of the U.S. auto market.

### AUTO EXPORTS [% of total]



SOURCE: BMO Capital Markets

Although the importance of the auto industry to the economy has declined substantially in the past few years, it still does account for 10% of exports.

The Canadian economy cannot escape world trends. However, our vulnerability is lessened by several factors. Our fiscal position is among the strongest in G-20, our banking industry has largely avoided the derivatives debacle and our housing market did not see the excesses present in other markets. Nonetheless, positive growth cannot be anticipated until there is a recovery in commodity markets and improvement in the U.S. economy and financial system.

## INVESTMENT ENVIRONMENT

Capital markets faced an array of new policy tools in the first quarter. The U.S. Federal Reserve not only moved to lower its benchmark rate to zero but also increased the number of acceptable kinds of collateral, purchased mortgage-backed securities and longer-dated Treasuries. For its part, the U.S. Treasury increased stakes in AIG and CitiGroup, expanded the TALF [term asset-backed loan facility] program and detailed plans to involve the private sector in the removal of toxic assets from financial balance sheets.

The actions were designed to improve the clogged credit markets. To date the success of these actions has been mixed.

## FINANCIAL STRESS INDICATORS



SOURCE: Haver Analytics, BMO Capital Markets

The TED spread, a traditional measure of fear in the credit markets, has improved dramatically. The spread on high yield corporate bonds, on the other hand, remains well above historic norms and indicates continued concern.

Equity markets have also had a mixed response to the government initiatives. The rally at quarter end, while impressive, still left the S&P 500 down 49% from the high reached in October 2007. The Volatility Index [VIX], a measure of market risk, approached 40 at quarter end after exceeding 80 at the start of the year. However, this level is double the long-term average of 20.

Examination of the current market in a longer-term context provides a more positive view. The following

chart shows the P/E ratio of the S&P 500 using 10 year average earnings and an inflation-adjusted index level.

## S&P 500 P/E RATIO

[inflation adjusted with 10 year average earnings]

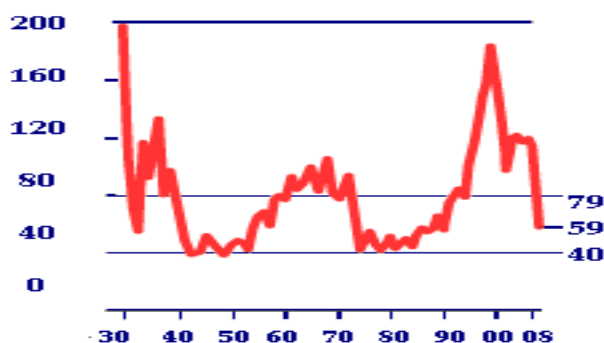


SOURCE: Morgan Stanley

The average P/E ratio, measured back to the 1890's, is 16.4x compared to the 12.0x reached at the low in March. While that level is above the 1982 low, it is important to remember that inflation and interest rates were at post war highs in the early 1980's.

Another way to examine value in the market is to compare the total market capitalization to GDP.

## MARKET CAPITALIZATION AS A % OF GDP



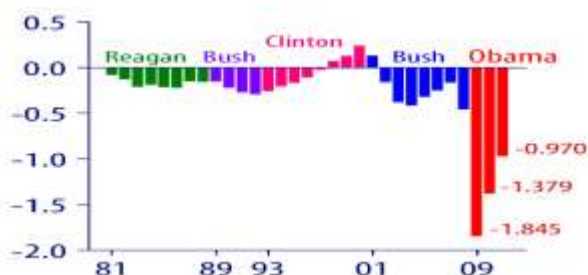
SOURCE: Calculated Risk

In the last 80 years market capitalization as a percentage of GDP has averaged 79%. The current ratio is 59%. Although above previous bear market lows this metric would suggest markets are reasonably valued.

## INVESTMENT STRATEGY

There has been much debate around the proposed and enacted measures used by the U.S. Administrations over the past year. There is no debate about the fact that U.S. deficits will increase measurably over the next several years.

### U.S. TREASURY BUDGET BALANCE [\$ Trillion]



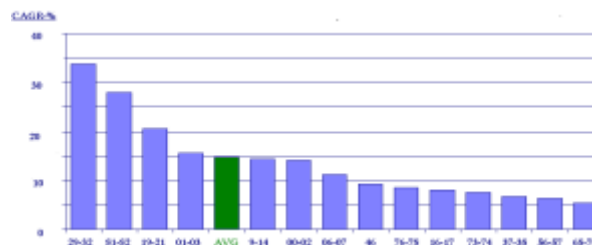
SOURCE: BMO Economics estimates

The prospective budget deficits and rapid expansion of the monetary aggregates has raised the spectre of inflation once economic growth resumes. Certainly past periods of rapid expansion of government spending accompanied by loose monetary policies have resulted in accelerating inflation.

With interest rates at decades- low levels, we think it prudent to maintain a relatively short average term in bond portfolios and to hold a position of inflation protected bonds in registered accounts. We continue to evaluate opportunities in the corporate investment grade sectors.

Equity market bottoms are only visible with hindsight. Using history as a guide, we do know that market troughs are inevitably followed by a lengthy period of positive equity results. The following chart shows that after a market trough, 5 year compound returns, before the inclusion of dividends, have not only averaged 15% but have never been below 5%.

### DJIA 5 YEAR ANNUAL COMPOUND RETURN



SOURCE: RBC Asset Management

We have selectively added to equity positions where we find high quality, superior growth prospects and attractive valuation metrics.

Teva Pharmaceuticals is an example of the opportunities we see. An Israeli based drug manufacturer, founded in 1901, Teva has grown to be the largest generic manufacturer on a global basis. In the U.S., alone, Teva holds a 24% share in generic prescriptions and a 16.7% share of total prescriptions. Since 1990, sales and earnings growth has exceeded 20% on an annual basis.

The generic market is particularly appealing because of the large volume of drugs coming off patent. Between 2008 and 2018 more than \$150 billion of drugs will lose exclusivity. Generics market will also benefit from the pressure on governments world-wide to control healthcare cost increases.

Teva trades at 14.1x 2009 estimated earnings and yields 1.2%. Return-on-equity has averaged 17.2 % and the debt/equity ratio is a low 23.9%.

Negative news on the economy and corporate earnings is likely to persist over the next few months. Capital markets will remain challenging but can be expected to present good investment opportunities for the patient long-term investor.

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