

AS AT JUNE 30, 2010

How can public debts be reduced without stifling the economy?

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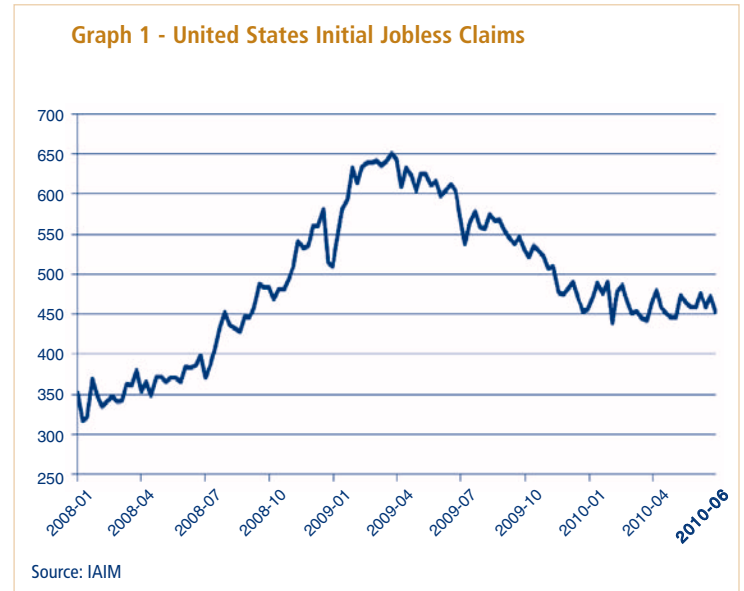
The 2010 harvest could be difficult for many farmers in the Prairies, especially in Saskatchewan. The humid conditions—whether incessant rain or saturated fields—have caused significant planting delays in most of the province. Let us wish them more clement weather for the remainder of the season.

On the world economic front, the climate has not been too pleasant either. While several green shoots had sprouted since last year, they no longer appear very sturdy. In contrast to the humid weather of the prairies, the economic seedlings seem to have dried up and do not appear to be growing any higher.

The latest economic data have been disappointing. New claims for unemployment benefits in the U.S. rose in the last few weeks of June, suggesting that the number of layoffs is up and that jobs are scarce at the moment. As illustrated in graph 1, these new claims are at high levels and have not showed any signs of improvement since the start of the year. In addition, home sales in the U.S. have declined, and investor and consumer confidence remains extremely fragile.

In Canada, after two quarters of impressive growth, the second quarter of 2010 has gotten off to a weak start. The GDP remained more or less unchanged in April, after having recorded seven consecutive monthly increases (see graph 2). Among other things, a significant drop in activity was seen among auto sector retailers.

One of the biggest risks for the economic recovery is the exit strategy for the various monetary and fiscal policies. On the monetary front, central banks are well aware of the negative economic impact that could result from tightening their monetary policies too hastily. Such that the U.S. Federal Reserve may stay put until the summer of 2011, given that inflationary pressures are weak. In fact, in the short term, the risk of deflation is probably higher than the risk of inflation. In Canada, it is expected that the key rate will be raised very gradually.

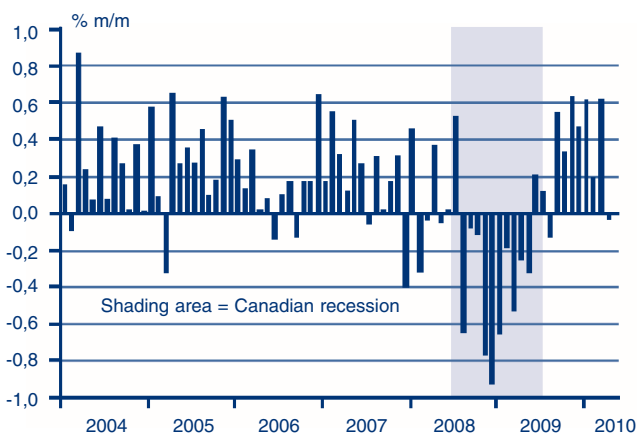


rible experience of the Great Depression. Nonetheless, at the Toronto summit, the G20 countries agreed to tighten their belts to halve their deficits by 2013 and to reduce the weight of their debts in relation to their gross domestic products by 2016. It will be up to each country to figure out how to do this without compromising the economic recovery. In light of the lessons of history, the question that arises is, why are most political decision-makers clamping down?

The reasons vary from country to country. Greece no longer has a choice. It needs money and the markets will no longer lend it any at a reasonable rate if it does not implement austerity measures. Several other countries also fear the financial markets will turn their backs on them if they do not reduce their deficits soon. Both Spain and Great Britain fall into this category.

Then there are countries that still have the ability to borrow to boost economic growth, such as the U.S., Germany and China; these also happen to be three of the world's largest economies. Yet they are all less inclined to do so at this stage.

Graph 2 - Canadian economy takes a break in April
Real GDP (chained dollars)



Source: NBF Economy and Strategy (Data via Global Insight)

On the fiscal front, the worldwide crisis in public finances, especially in the euro zone, is quite troubling because reducing government spending before the recovery has firmly taken hold poses an obvious risk. Governments do not want to repeat the ter-

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China is concerned about its real estate sector overheating as well as inflationary pressures, which is why it has imposed limits on bank credit. Germany has chosen the path of austerity, setting itself a strict plan to tackle its deficit. Germany has long been wary of fiscal stimuli, given the role of inflation in the political rise of the Nazis. In response to the recent financial crisis, Europe, led by Germany, was much more timid about fiscal spending than the U.S., which is why the European economy is in a weaker position today.

In the U.S., with employment data having reached a ceiling, it would be difficult to drop the various stimuli put in place during the financial crisis, because they have been instrumental in boosting the economy. For example, in May, sales of new single-family homes in the U.S. fell to their lowest level since 1963 when the tax credit granted to homebuyers expired. That is why authorities must be very vigilant when withdrawing their various fiscal programs.

The government is nonetheless becoming more selective in the fiscal measures it adopts. Until now the senate has refused to approve any bill

that would extend unemployment insurance or that would help nations in poor health. Unlike other heavily indebted countries, the U.S. still has no difficulty obtaining financing at competitive rates. The goal is to find a new equilibrium, where the recovery and employment, on the one hand, and the cleaning up of public finances, on the other, reinforce each other.

Where do we stand in all this? Canada is in an enviable position both fiscally and economically. It is the only G7 member to have had a cumulative increase in employment since March 2009. In addition, its budget deficit forecast for 2011 as a ratio of its GDP will be, without a doubt, the lowest of all other G7 countries and of most euro zone countries (see graph 3). Canada has emerged from the latest crisis with its public finances having suffered much less than a good number of developed countries.

The debate is therefore over what type of economic recovery is in store. Economists are increasingly talking about a double dip scenario (i.e. a plunge back into recession or a "W" recovery). However, there are no signs pointing to such a scenario at the moment. As is often the case following a financial crisis, the economic recovery has been jerky, moving in fits and starts. It is not at all surprising to see episodes where the economic data seem to stagnate during phases of an economic pickup. It

Chart 1 - Market Returns as at June 30, 2010

Index	Returns (%)	
	3 months	YTD
DEX 91 day Tbill Index	0.1	0.2
DEX Universe Bond Index	2.9	4.2
S&P/TSX Composite Index	(5.5)	(2.5)
S&P 500 (Can. \$)	(7.5)	(5.4)
MSCI - EAFE (Can. \$)	(10.2)	(12.1)
MSCI - World (Can. \$)	(8.8)	(8.6)
Exchange Rate (Can. \$ / US \$)	4.4	1.3

should be known that the initial phases of this recovery were much better than what most financial analysts had expected. Now, to a certain degree, we are paying the price of this quicker-than-expected upturn. Moreover, too much money and effort have been devoted to date to allow a premature exit and compromise the recovery. The most probable economic scenario, therefore, is that of slow but positive growth, albeit a bit chaotic, in the second half of 2010.

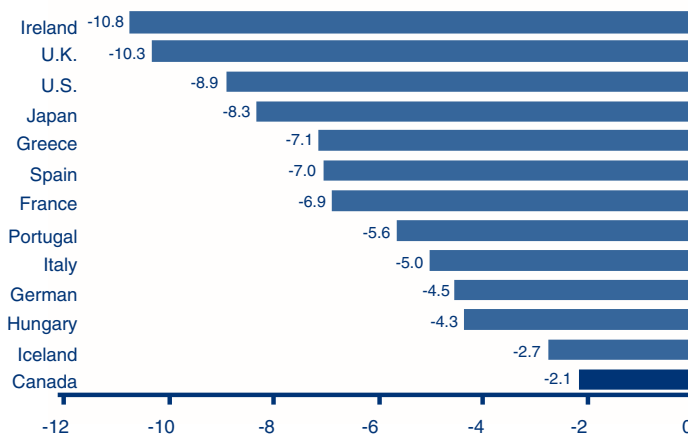
Changes in the financial markets

The first half of the year has ended and questions as to what the second half of 2010 will bring have only just started. While it may seem premature to talk of the economy slipping back into a recession (the "double dip" scenario), a slowing in growth can be seen in the economic data. There has certainly been a loss of momentum, which the stock markets seem to confirm.

Not yet having recovered from the poor returns of 2008, investors suffered the full brunt of market players' risk aversion in the second quarter. After four consecutive quarters of gains for the major North American stock market indexes, a first drop was recorded in the months of April, May and June.

The U.S. and international markets, represented by the S&P 500 and MSCI EAFE, lost more than 11% in local currency in the second quarter. The Canadian stock market and emerging markets fared better, a reflection of the relative

Graph 3 - Canadian public finances: An enviable position (2011 fiscal deficit as a % of GDP)



Source: NBF Economy and Strategy (Data via l'OECD by Datastream)

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good standing of their economies. These two markets, represented by the S&P/TSX and the MSCI Emerging Markets respectively, fell close to 6% in local currency in the second quarter.

The debt problems in Europe, the slowing of economic growth in China and the general state of the economic situation in the U.S. have been the main themes in the last few weeks.

As for the first six months of 2010, the significant drop in the indexes in the second quarter erased the gains made by North American markets in the first quarter. The major North American indexes ended the month of June at lower levels than at the start of the year.

Three winners to highlight so far in 2010: gold (and gold stocks), the U.S. dollar and the bond market. The price of gold has climbed nearly 14% since the start of the year (after having climbed more than 25% in 2009). The greenback has risen close to 15% against the euro since the start of the year. It has also risen more than 1% against the loonie.

In the Canadian bond market, yields on Canadian government bonds fell considerably amid the broad flight to "safety in quality": the rate on 10-year Canadian government bonds went from 3.6% to 3.1% in the second quarter (the more rates drop the more bond values rise on the secondary market). Under these circumstances, the DEX Universe Bond Index, representing the Canadian bond

On the economic front, there are no signs pointing to a double dip scenario (i.e. a return into recession).

Chart 2 - Economic and financial indicators - Canada

	2005	2006	2007	2008	2009	The most recent data	Trend	Forecast June 2011	
Real gross domestic product (%)	3.3	2.7	2.4	0.3	-2.6	3.3 ¹	➔	2.9 to 3.2	*
Inflation rate (%)	2.2	2.0	2.5	2.4	1.3	1.4 ²	➔	1.5 to 2.0	*
Unemployment rate (%)	6.5	6.3	5.9	6.5	8.5	8.1 ²	➔	7.75 to 8.0	**
DEX 91 day Tbill Index (%)	3.39	4.01	3.9	0.87	0.21	0.52 ³	➔	1.0 to 1.5	**
3-year mortgages (%)	6.0	6.2	7.55	6.25	4.25	4.50 ³	➔	5.0 to 5.75	**
10-year bonds (%)	3.98	4.4	4.0	2.68	3.61	3.08 ³	➔	3.75 to 4.2	**

¹ As at April 30, 2010
* Annual average

² As at May 31, 2010-
** End of period

³ As at June 30, 2010

market as a whole, posted an attractive return in the second quarter, at close to 3%.

Bond portfolio managers who favoured longer terms to maturity will have done better than those who bet on shorter terms in this quarter, as the best performance in the bond market came from long-term bonds, up 5.1%, as compared to 3.3% for medium-term bonds and 1.7% for short-term bonds.

Outlook

Despite the latest disappointing data on economic growth in Canada, we are forecasting GDP growth of about 3% for the next twelve months. During that same period, inflation should not be a major issue; its level is expected to hover near the Bank of Canada's target level of 2%. We are predicting some raises in the central bank's key rate, which should bring the key rate from its current 0.5% at the end of

June 2010 to 1.0% at the end of June 2011.

Despite the stock market correction of the second quarter, stock markets should offer attractive returns in the next twelve months (see chart 2), although they will be less spectacular than what we saw in 2009 (see chart 3). Meanwhile, the bond market is expected to deliver weak returns, given the current level of rates and the risk that interest rates will rise over the next twelve months.

The loonie, which recently lost ground to the U.S. dollar, is expected to climb somewhat over the next twelve months to reach near parity, the sturdiness of the Canadian economy and demand for raw materials being the main sources of this movement to parity.

Aside from the regular rebalancing of portfolios to stay aligned with our strategic vision, our tactical asset allocation has not undergone any changes since the start of the year. We continue to underweight bonds in favour of equities. Given that inflation is not a source of real concern, it should not have a negative impact on the stock markets. Improvement of employment data in the U.S. is a key element in this recovery. While we maintain some reservations as to the real value of the stock markets, we believe there will be some upward movement. We remain poised to modify our asset allocation at the first signs of more changes in fundamentals.

Chart 3 - Estimated gross returns for the next twelve months starting June 30, 2010

Market indicators	Interest or dividend	+	capital gains	=	Total estimated gross return
DEX 91 day Tbill Index	0.75%	+	0.00%	=	0.75%
DEX Universe Bond Index	4.25%	-	(3.70%)	=	0.55%
Canadian stocks (S&P/TSX Composite Index)	2.90%	+	14.45%	=	17.35%

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How should sovereign debt be restructured?

By **Éric Vachon, M.B.A., CFA**
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Investment Management Inc.

Now that the G-20 summit is over, market and governments' concerns about the ability of some sovereign states to honour their debts have returned to the financial news pages. It was not so long ago that the state of U.S. public finances was at the forefront of investor preoccupations, when its budget and trade deficits seemed disproportionately large. Now, all eyes are on Europe.

When an indebted country holds its own currency, investors can, through the depreciation of this country's currency, show their disappointment with the country's financial management. This problem of poor management can continue as long as the country's GDP is high enough in relation to the size of its debt and the country is able to raise taxes. This is the case of the United States.

In Europe, the creation of a single currency in 1999 has created a different dynamic. To enter the economic and monetary union (EMU), countries must fulfil the Maastricht economic criteria set out in 1992. These can be summed up as follows: no annual deficit greater than 3% of GDP and no public debt greater than 60% of GDP.

The concept of a single currency and of the creation of a European Central Bank (ECB)

has many benefits for Europe. First, a single currency is less subject to purely speculative fluctuations. Second, a single currency simplifies trade and fosters healthy competition, benefiting consumers. Finally, to join the EMU, the financial state of the country must be sound.

However, the concept of a single currency and a European Central Bank also has its disadvantages. The fact that member countries cannot set their own interest rates had become the most recurring criticism. Regardless of a member country's economic situation, the ECB's key rate applies. Another weakness of the ECB is its lack of a punitive system for delinquent countries that no longer meet the Maastricht economic criteria, such as Greece.

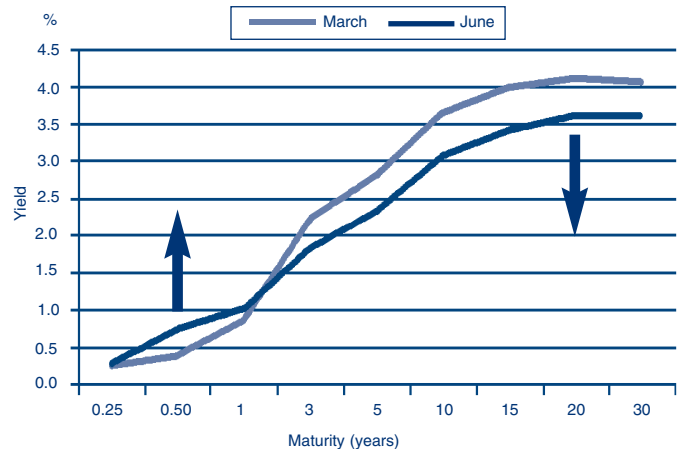
This lack of a punitive system has impacts on the value of the euro, which has fallen against other currencies. The entire euro zone suffers from the doings of its few delinquent members. After having joined the euro zone, some countries ran up high debts without seeing any impact on their currency (the euro) because of the responsible conduct of other members (e.g., Germany). This was the case of Portugal, Spain and, especially, Greece, which has received the most media attention.

The question remains: what should be done with sovereign debt? This debt is

held by several investors. For countries that possess their own currency, it is foremost a political choice. It is up to the government to decide whether it continues to levy additional taxes to finance repayment (in which case, the population assumes the burden), or whether it renegotiates repayment with its creditors (in which case, the banks and institutional investors take on the burden), with the resulting consequences on its currency. This was the case of Russia in 1998 and Argentina in 2002.

In the case of the euro zone, the situation is more complicated. If a member country were to default on repayment of its sovereign debt, the consequences would extend to the other euro zone countries. Even a partial default would force the more affluent countries (e.g., France and Germany) to bail out the creditors of this sovereign debt. This is equivalent to transferring the public debt of a delinquent country to a better-managed country. The current desire is to avoid renegotiating sovereign debt so as not to send a negative signal to the rest of the world. It is in this context that the ECB refused to buy up the sovereign debt from

Graph 1 - Canadian Yield Curve



Source: IAIM

Chart 1 - Returns of the Canadian Bond Market as at June 30, 2010

Index	Returns (%)	
	3 months	YTD
DEX Universe Bond Index	2.9	4.2
DEX Short Term Bond Index	1.7	2.2
DEX Mid Term Bond Index	3.3	5.0
DEX Long Term Bond Index	5.1	7.8
DEX Canada	3.1	3.8
DEX Provincial	3.3	4.6
DEX Municipal	3.2	4.5
DEX Corporate	2.3	4.5

Source: Scotia Capital Debt Market Indices

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European banks in the way the U.S. Federal Reserve and the Bank of England did last year. The ECB does not want to take the risk of suffering the losses that could come from entering securities of doubtful quality into its balance sheet, with the exception of Greece, which is the object of a separate €110 billion plan. On June 30, however, the ECB did lend €131.9 billion in three-month funds to European banks. The institution led by Jean-Claude Trichet explained that 171 banks had borrowed the funds at a fixed 1% rate as part of the assistance program for European banks.

These tensions are being felt on the bond market, where the yield spread between government borrowings issued by the euro zone's peripheral countries and by Germany are widening, a sign that risk aversion has increased. In the last week of June, the yield spread between Greek bonds and German bonds—the benchmark for the European bond market—grew to 770 basis points. It rose to more than 800 basis points during the Greek crisis.

Current troubles in the euro zone have highlighted the fragility of this monetary union, affecting confidence in this currency. The solidarity of member countries is being put to the test, as responsible countries such as Germany could be forced to support the weakest countries. It is clear that the euro zone will have to live with the negative impacts of the austerity plans in order to help get the finances of certain countries back onto an even keel.

Bond market performance

With respect to the U.S. market, in the second quarter, bond investors continued to seek safety in Treasury bonds. The U.S. yield curve was down for all terms to maturity.

For example, the 10-year rate fell from 3.83% to 2.95%.

On the Canadian front, the curve flattened over the last quarter, given that the short section of the curve is always influenced by the Bank of Canada, which raised its key rate from 0.25% to 0.50%. In the long section, rates dropped from 4.06% to 3.65% as inflation expectations dissipated in light of doubts over the world economic recovery.

In summary, we can see in chart 1 that, for the Canadian bond market, the long-term section posted a better performance than the short- and medium-term sections in the second quarter. As well, provincial bonds offered the best return during the second quarter followed by the federal bonds.

In conclusion, economic growth in 2009 and in the first months of 2010 surprised many people. However, the sovereign debt problem in Europe has put some sand in the gears, potentially calling into question the continuation of the world economic recovery.

“Sell in May and go away?” Not so sure!

By Selena Bentkowski, B.B.A.
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Given recent events, the old saying about selling stocks in May and not returning to the stock market until the fall may not be the strategy to follow—or is it? The second quarter of 2010 is now a thing at the past, and few people will miss it. While it had a promising start, the quarter turned sour in May and June, leaving world stock market participants perplexed and anxious.

Some less positive economic news from around the world put a damper on market momentum. Europe remains at the heart of current challenges, but positive economic data from the United States is stagnating, which is enough to worry stock market investors and weaken their appetite for risk once again.

Concerns over the sustainability of the economic recovery are starting to affect U.S. consumer confidence, which plummeted in June, contributing to the worst single-day stock market performance since the start of the year. On June 29, the S&P/TSX fell 3.0%. The U.S. stock market, represented by

the S&P 500, re-treated 3.0% as well, while Shanghai saw its stock market drop 4.3%.

Moreover, downward revisions of some of the data on China, on which a large part of the global economic recovery is based, were hardly greeted favourably by the markets. Measures taken by the Chinese

Banks will have to make sure they retain sufficient levels of high quality capital to absorb any such future shock themselves, without having to call on public monies.

government to curb real estate speculation coupled with lower growth expectations also had an impact on North American markets.

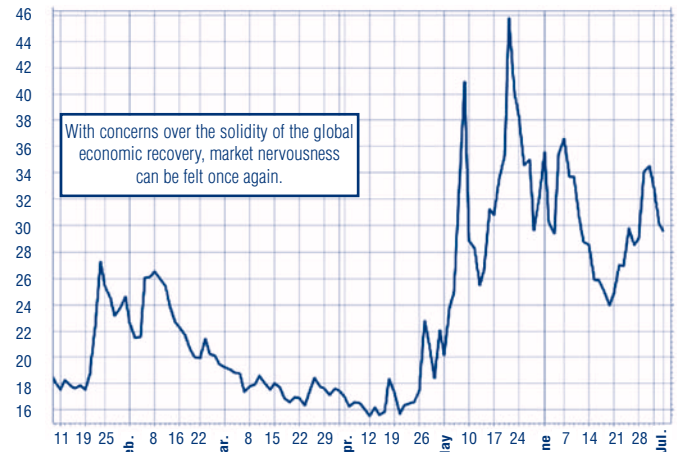
Yet there is one important new element coming from China: a flexible exchange rate for its currency. The Yuan is no longer pegged to the U.S. dollar. The U.S. has been waiting for this for a long time in order to render trade relations between the two countries more equitable. However, for this decision to have any real impact, the currency needs to be valued according to market conditions and not be subject to controlled fluctuations, as seems to be the intent of the Chinese government.

For the moment, the consensus of economic analysts seems to be that the impact

of this measure will be moderate. In the long term, however, some sectors could benefit. Raw materials are one example. The rise of the Yuan would make these materials less costly for the Chinese who need them in order to continue with infrastructure development, thereby possibly increasing demand. It should be noted, however, that such an adjustment did not occur automatically for all raw materials before the Yuan was tied to the U.S. dollar back in 2005. Some raw materials even saw their prices drop since the law of supply and demand remains specific to each market. In short, although the news was greeted positively much uncertainty remains with the respect to the central bank of China's new position on its currency.

Expectations of results from the G20 summit held in Toronto on June 26 and 27 created much volatility on the markets in the weeks prior to the meeting. The main priority of this summit was to safeguard and strengthen the economic recovery, lay the foundation for sustainable and balanced growth and strengthen the financial system in order to capably face future risks. But even with this worthy objective, investors had concerns created by a number of

Graph 1 - The S&P 500's volatility index (VIX) once again climbing higher in May and June



Source: Stockcharts.com

Chart 1 - Market Returns as at June 30, 2010

Index	Total Return	
	3 months	YTD
S&P/TSX Sector returns		
Energy	(4.9)	(6.8)
Materials	0.8	1.1
Industrials	(6.2)	(0.4)
Consumer Discretionary	1.6	7.9
Consumer Staples	(9.1)	(8.9)
Health Care	11.3	22.8
Financials	(9.8)	(2.5)
Information Technology	(25.0)	(20.5)
Telecommunication Services	3.8	9.8
Utilities	(5.3)	(2.2)
S&P/TSX Composite Index	(5.5)	(2.5)
S&P 500 (Can. \$)	(7.5)	(5.4)
MSCI - EAFE (Can. \$)	(10.2)	(12.1)
MSCI - World (Can. \$)	(8.8)	(8.6)

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uncertainties, resulting in market gyrations.

The reform of the financial sector has thrown many financial institutions off balance, banks in particular, because there are still many unknowns. However, the outcomes of the summit did allay some of these concerns. For example, the plan for a global bank tax was revised to take into account the particular situation of each country. Thus, while in some countries the tax will be implemented, in others, such as Canada, other measures will be taken to ensure that a monetary contribution is made so as to avoid having to resort to such massive government interventions as were required during the 2008 financial crisis or, more recently, the sovereign debt crisis in Europe. This news was greeted favourably by the markets, especially by the financial sector.

With this new reform, banks will have to make sure they retain sufficient levels of high quality capital to absorb any such future shock themselves, without having to call on public monies.

The general conclusion of this summit, which calmed market fears somewhat, is that the primary objectives of restoring countries' fiscal health, reforming the financial sector and applying exit strategies will be achieved, but using variable means, according to the economic conditions in each country. The danger of compromising the world economic recovery would be too high if a single and synchronized adjustment were to be applied to the budgetary and monetary policies of all countries at once.

Despite the difficulties in Europe and the weak economic data coming from the U.S. and China, there continue to be positive signs of a sustained recovery. The markets are reacting strongly to news and showing some jitters, but it is nonetheless normal to see some dips at this stage of a recovery, especially given the velocity of markets in 2009.

Markets

In Canada, the S&P/TSX Composite Index had a rough quarter (-5.5%), suffering the ups and downs caused by fears over the strength of the global recovery. The sectors that contribute the most to the index's performance, energy, materials and financial services, all had mixed results. The energy sector rebounded in June, after experiencing difficulties in April and May. Despite the surge of the greenback, this sector ended the quarter in fifth position, posting a return of -4.9%, thanks in particular to the pipelines sub-sector (-1.1%). The materials sector ended the quarter more or less back where it had started, delivering a return of 0.8%. Gold stocks, which account for close to 13% of the index, offered a very good return (21.1%) given all the uncertainty currently hanging over the markets. The sector's heavyweights performed very well: Barrick Gold (24.0%), Goldcorp (22.8%), Eldorado Gold (54.7%) and Kinross Gold (4.8%).

Financials went for a bit of a roller coaster ride. After a slow start, concerns over the sector's reform and the proposal to tax banks in order to create a reserve fund pushed this sector downward (-9.8%).

The situation was not much better for other stock exchanges. In the U.S., the S&P 500 ended the quarter down 11.4% in local currency. In Canadian-dollar terms, the rise of the greenback against the loonie led to a slight improvement of the index's performance (-7.5%).

On the global front, the MSCI - EAFE Index and the MSCI - World Index both ended the quarter down 11.2% in local currency, or -10.2% and -8.8% respectively, in Canadian-dollar terms.