Review

Change is the law of life. Those who look only to the past or present are sure to miss the future. - J.F. Kennedy

Global equity markets staged a dramatic recovery in 2009, significantly outperforming even the most optimistic forecasts and resulting in one of strongest rallies in recent memory. Because of 2008's financial crisis, the year started out very badly with stock markets in a free fall for several weeks, but ultimately they staged an historic 60% rebound from the March lows. Credit must be given to governments and central banks world-wide who helped restore investor confidence through their coordinated efforts and who successfully averted economic disaster. Canada's equity market benefited from an especially strong rebound in commodity and financial stocks, climbing over 35% - its best year since 1983. Remarkably, the best-performing asset class was Emerging markets, which surged ahead by over 50%.

Even though 2009 was an exceptionally strong year, that fact doesn't tell the whole story. During the last four months of 2008, global markets fell over 30% and they continued to drop a further 20% through early March 2009. The subsequent impressive rally still leaves many major equity indices standing roughly 25% below their cyclical highs. This is clear evidence of how devastating 2008's market rout really was.

Longer-term equity returns were also disappointing because two of the worst bear markets in history have occurred in the last 10 years.

Emerging markets were one bright spot in the decade, and even Canada fared relatively well. Overall however, these two asset classes represent less than 15% of the total capitalization of world equity markets. The lion's share is in U.S. and International markets, which suffered negative annualized returns over the decade. This has been unprecedented, even during the 1930s!

At this juncture, we are wise to remember that markets move in cycles. Although Canada has out-performed the U.S. by roughly 10% per year this past decade, the reverse was true in the 1990s. We should also note that in *local currency* terms, U.S. equity returns were *up* 5.5% per year over the past seven years, including the 37% drop in 2008. For Canadian investors, it is the 30% rise in the loonie over the greenback that hampered U.S. returns, negatively impacting them by over 3% per year for the decade.

Fixed income markets fared well last year as the economy stabilized, with the short term bond index rising 4.5%. Over three years, bonds also significantly outperformed stocks, but not so in 2009 when bond returns were well below stocks. This is typical behaviour during an economic recovery, as investors' focus shifts toward concern about rising interest rates and inflation. Real return bonds, which provide a hedge against inflation, had a very strong year, rising almost 15%.

Following are the returns for the major indices for the period ended December 31, 2009:

	4th quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (DEX 30-Day T Bill)	0.1	0.4	2.4	2.7	3.1
Canadian Bonds (DEX Short Term Bond)	0.4	4.5	5.7	4.7	5.7
Canadian Stocks (S&P/TSX Comp.)	3.9	35.1	-0.2	7.7	5.6
U.S. Stocks (S&P500)	3.5	8.1	-9.0	-2.4	-4.1
Non-North American Dev. Stocks (EAFE)	-0.3	12.6	-9.4	0.7	-2.0
Emerging Markets Stocks (MSCI Emerging)	6.0	52.6	1.4	12.3	6.6

All returns in Canadian dollars. Source: SS&C Technologies and PalTrak

Outlook

It is never safe to look into the future with eyes of fear. – E.H. Harriman, railroad magnate

As the page turns on the so-called “lost” decade for equities, long-term investors may be in a quandary about the right investment strategy going forward. On top of a justifiable frustration in not having been rewarded for ten years of risk-taking, stock investors have some concern that the current rally may not be on solid footings. The potential cracks in the foundation of economic recovery are well-publicized, such as:

- The global economy is still shaking off one of the worst recessions on record in spite of massive government spending, which itself has resulted in alarming levels of public debt worldwide. As governments attempt to withdraw fiscal and monetary stimulus, which they eventually must do, the recovery may falter.
- Consumer balance sheets are not in good shape - some have been stretched by declining assets (stocks, real estate, low returns on bonds, etc.); others have been damaged by reduced incomes and/or unemployment.
- The “cost of doing business” is going up at a time when tax increases are on the horizon. Expensive challenges lie ahead which involve providing domestic security in an “Al Qaeda” world and addressing the issues of environmental sustainability in an era of depleting resources.

After any bad experience, it is only human nature to focus on the risks of something else going wrong. But the expression, “it is always darkest before the dawn”, should also come to mind. In a way, a market always reflects the opposing viewpoints of pessimists and optimists, with the current price being the point of convergence.

To help shed some light on how financial assets may be priced in the year ahead, we’ve set out three economic scenarios below and attached a probability to each one.

1. Slow growth: The most likely scenario or consensus view is that the world will continue to claw its way out of 2009’s recession, albeit at sub-par recovery rates. The problems noted above will put a damper on the pace of recovery, but it will continue nonetheless. Businesses, spurred on by stronger consumer spending, will take over the reins of economic stimulus from governments, who must step back. As confidence builds and inventories shrink, employment eventually will start to grow again, creating the much-desired virtuous circle of even more consumer spending. Low interest rates are expected to support this economic recovery, with inflation remaining at bay.

The vast majority of economists hold this view. In 2010, they expect economic growth (GDP) for the U.S., Europe and Canada to vary between 2% and 3%, with Japan being slightly lower. Developing nations like China, India, Brazil and Chile are expected to grow much faster, with growth between 5% and 9%.

At Milestone, we also subscribe to the consensus view, which suggests to us that stocks will continue to advance, albeit at a much more subdued pace than they have since last March. Corporate profits and consumer confidence will improve, enticing investors away from bonds. Central banks will begin to reverse course, leading interest rates to rise modestly. This change in direction may provide an initial setback in stock prices, but it would be short-lived. Bond prices will start a gradual deterioration as higher interest rates emerge.

2. Double-dip recession: This scenario is much less likely, but it could materialize if businesses take longer than expected to reinvest and rehire because of weak consumer spending. In this case, governments pull the plug too soon on stimulus, thereby stopping growth in its tracks. Pent-up demand would eventually emerge and pull the economy back on track, but the delayed time frame would be another setback for stock investors.

Should a double-dip occur - which we do not expect - stock prices would fall and bond prices would rise. However, it is difficult to envision a situation where markets would retest the lows of March 2009 because of the significant progress that's been made in restoring and repairing the world's financial system.

3. Inflationary growth: At the other extreme and even less likely, is the case where consumer spending shifts into high gear, forcing businesses to restock and rehire at a rapid rate. In this scenario, demand for goods, resources and labour overheats the economy, leaving central banks behind the curve. They would respond with a series of rapid-fire interest rates increases, attempting to put a lid on inflation. Eventually this would trip the economy back into an economic slowdown or recession.

This most unlikely high-growth scenario would keep stock prices on their current upward trajectory for some time. Only after central banks "removed the punch bowl" with aggressive hikes in interest rates would they eventually falter. Bond prices, on the other hand, would suffer immediately, particularly long-term issues which are most vulnerable to inflation.

Consideration is sometimes given to a fourth case - the co-called "disaster scenario". It holds that a truly catastrophic shock to the system in the form of a severe terrorist attack or major natural disaster could severely derail the world's economic system. However, after 9/11, the tsunami and the near-meltdown of the global financial system, it is apparent that the so-called "system" may be more resilient than forecasters ever thought. In any case, this scenario cannot be planned for and we discount it for practical purposes.

Taking a longer view than 2010, we know there are other serious economic liabilities to be addressed. The problems of government debt, resource depletion and environmental destruction loom very large. Most analysts agree that the sooner they are tackled, the better off the world will be long term, but frankly, the urgency of the short-term situation is still taking precedence and has left the all else on the back-burner.

Investment Strategy

Given our view that slow growth is the most likely scenario, we intend to maintain our current flexible approach to bonds. We build a high-quality, structured ladder of maturities, optimally spread over five years. Over the past year, our fixed income investments have been primarily in GICs given their federal government backing and superior rates relative to bonds. But as the recovery takes hold and spreads tighten we will likely shift our focus back to government bonds.

Within the equity portfolio, our globally-diversified approach is optimal because we live in an uncertain world. We think the riskier asset classes, such as Small, Value and Emerging market companies, will continue outperforming during the upcoming recovery phase. That noted, the prices of Emerging market securities are already reflecting high expectations, so we will be more cautious with additional commitments.

Our final comment is to acknowledge how hard the last decade has been for investors. They have weathered an unprecedented time in stock markets that has even now only repaired two-thirds of the damage of its last storm. We believe the experience demonstrates more than ever the importance of a sustainable disciplined investment plan and think now is a good time to revisit the subject to ensure that equity weightings are in line with risk tolerance levels and investment time horizons. Looking ahead to the next decade, we observe two things: interest rates cannot go much lower which leaves bond returns low and vulnerable. Stocks, even with their inherent risks, still offer the best opportunity for investors to build their wealth and achieve their investment objectives.