

ECONOMIC AND MARKET COMMENTARY JUNE 30, 2010

THE CURRENT PICTURE

The second quarter of 2010 was not kind to equity investors across the globe, as evidenced in the table below. Equity market indices fell into negative territory after hitting highs for the year in April resulting in year-to-date returns also falling into negative territory. The Canadian market was down 5.5% for the quarter and down

2.5% for six months. The U.S. market as represented by the S&P500 declined 7.5% for the quarter and was down 5.4% for the six months ended June 30, 2010. The greatest decline was in international markets (MSCI EAFE) which were down 8.6% in the quarter and down 8.3% for the six months.

Returns for Major Indices to June 30, 2010						
	Qtr	YTD	1 Yr.	3 Yrs.	5 Yrs.	10 Yrs.
S&P/TSX Composite	-5.5	-2.5	11.9	-3.9	5.5	3.3
S&P/TSX 60	-5.7	-3.3	7.9	-3.5	6.1	2.8
S&P 500 \$CAD	-7.5	-5.4	4.4	-9.9	-3.6	-4.8
MSCI EAFE \$CAD	-9.9	-11.8	-2.9	-13.0	-1.5	-2.7
MSCI World \$CAD	-8.6	-8.3	1.1	-11.0	-2.3	-3.8
DEX Universe	2.9	4.2	6.9	6.9	4.9	6.6
DEX Short-term Bond	1.7	2.2	4.3	6.3	4.5	5.6
DEX 91 day T-Bill	0.1	0.2	0.3	2.1	2.8	3.0

This pullback, in many respects, was to be expected as the equity markets had advanced from the March 9, 2009 lows without any appreciable declines. As a result, the one year returns to the end of June for Canada and the U.S. are still positive (+11.9% and +4.4% respectively) with the exception being international markets (outside North America) which were still down 2.9% for the twelve months to June 30, 2010. From the market bottom (March 2009) until the end of June 2010, the TSX has advanced 56%. While this

increase is noteworthy, in point of fact the S&P/TSX has yet to regain its high of approximately 15,000 which it achieved in June 2008. With the index closing June 30, 2010 at 11,294, the market is still 25% off its June 2008 high.

Bond markets, on the other hand, presented investors with positive returns in the second quarter with federal government bonds outperforming corporate bonds and long dated bonds outperforming short-dated bonds. Interestingly, while the general expectation had been for interest rate increases across the yield curve, the curve essentially flattened with short rates rising but long rates declining causing an increase in the prices of long bonds. This flattening explains the outperformance of the broad DEX Universe index over the DEX Short-term index.

THE SHORT TERM

With the decline in equity markets in the second quarter, the question on many investors' minds is whether this correction signals the beginning of a new bear market and/or a "double dip" recession. We don't believe that this is the case. The economic backdrop is still sufficiently positive to support an advancing market, albeit one that is expected to advance in fits and starts.

Why this cautious optimism? For a number of reasons, including:

- Corporations are holding excess cash on their balance sheets which will either be used for making capital investments, for dividend increases or for share buy-backs, all of which are supportive of equity prices;
- Interest rates continue to be low (and expected to remain low at least in North America for the foreseeable future) which in the short-run is positive for equities;
- Valuations are at reasonable and attractive levels (the price/book value of the S&P 500 is at the lowest it has been in the last twenty years save for the 2008/09 bear market);
- Corporate profits are rising; and
- Real personal incomes are also rising.

We haven't failed to notice that:

- Employment in the U.S., while growing, continues to be weak;
- The housing market in the U.S. continues to struggle;
- Consumer spending is muted albeit increasing; and
- The prospect of new fiscal austerity programs in the G8 countries is becoming a cause for concern.

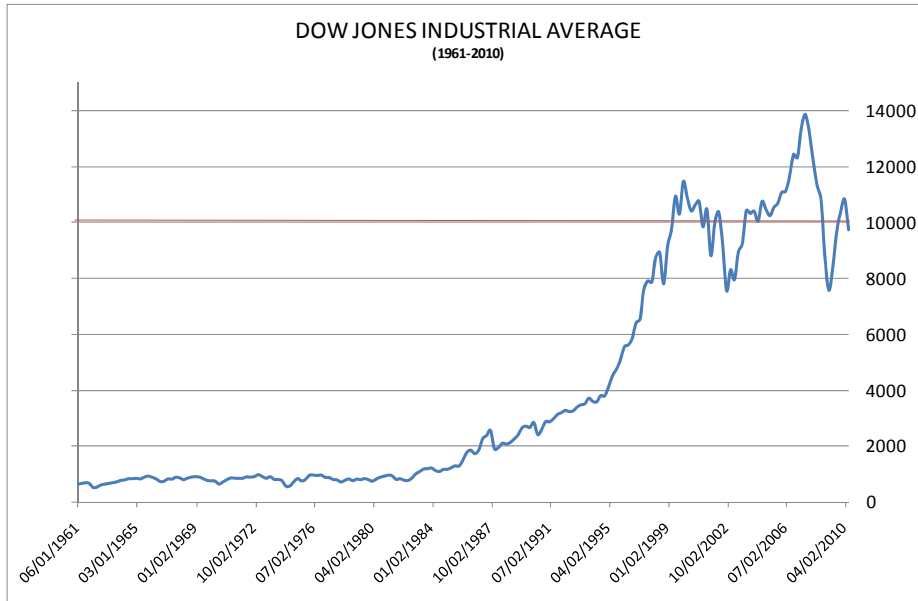
On balance, however, our expectation is that markets will continue to advance through year-end as will the economy (although more slowly) but it is not expected to be a linear climb. Key risks include the fiscal austerity measures (noted above) that are being embraced by certain G8 governments, notably Great Britain, and exchange rate decreases in the Euro, both of which could increase the risk of deflation and recession in North America. Another imponderable is the impact that U.S. mid-year elections may have on the markets.

THE LONG TERM

An issue that is gaining increasing prominence is whether we are in the midst of a secular bull market, or a cyclical bull market in a secular bear market.

We are of the view that we are experiencing a cyclical bull market in a secular bear market; the long-term trend is flat to potentially downward moving. BCA Research, a leading independent economic research firm, points out that secular bull markets require pronounced economic themes like disinflation in the 1980's and 1990's. In between those secular bull markets are extended periods of inflation (1970's) and deflation (1930's) where markets trend for a number of years. Currently there is no pronounced economic theme that would lead us to conclude that we're in a secular bull market. In fact, many have argued that the bull market from 2002 to 2007 was the result of easy money and masked a secular bear market.

The chart below confirms that it has been a challenge over the past ten years for the Dow to break decisively above 10,000. Closer to home as noted earlier, not only has the S&P/TSX yet to regain its high but for the past several months it has been a challenge for it to sustain a level above 12,000.



The bottom line? We could be in for a prolonged period of trending or range-bound markets. Specifically, we believe that equity markets will tend to trade within a relatively flat range for the foreseeable future with much volatility during that time.

WHAT THIS MEANS FOR YOU

What does this mean for your investment portfolio? Simply that achieving long term historical rates of return over the next few years will be difficult for the uninformed. We do believe, however, that there are opportunities to keep ahead of the markets.

The opportunities lie in diversifying away from traditional long only portfolios – both equity and fixed income. Alternative investment strategies that aren't strongly correlated with traditional public markets offer the opportunity to step away from range-bound markets and add value over the long term.

Audrey Robinson,
V.P., Chief Investment Officer
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Did You Know...

A secular market trend is a long-term trend that lasts 5 to 25 years and consists of a series of sequential primary trends. A **secular bull market** is a sequence of larger bull markets and smaller bear markets. A **secular bear market** is a sequence of larger bear markets and smaller bull markets. In a secular bull market the prevailing trend is "bullish" or upward moving. In a secular bear market, the prevailing trend is "bearish" or downward moving.

Did You Know...

"Alternative investment strategies" are defined to include investments in private equity, real estate, and strategies offered by money managers that have a different set of tools in their tool box. These money managers do things differently and therefore their performance is less correlated to the public markets than traditional long-only equity managers.

CONTACT US

We are in the process of introducing to our clients several new alternative money managers that we believe have the ability to outperform their respective benchmarks over appropriate time horizons. We would be pleased to discuss with you how we expect to add value by architecting portfolios differently.

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