

The Reflation Trade: Fund Flows & Fundamentals

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ScotiaMcLeod

January 2011

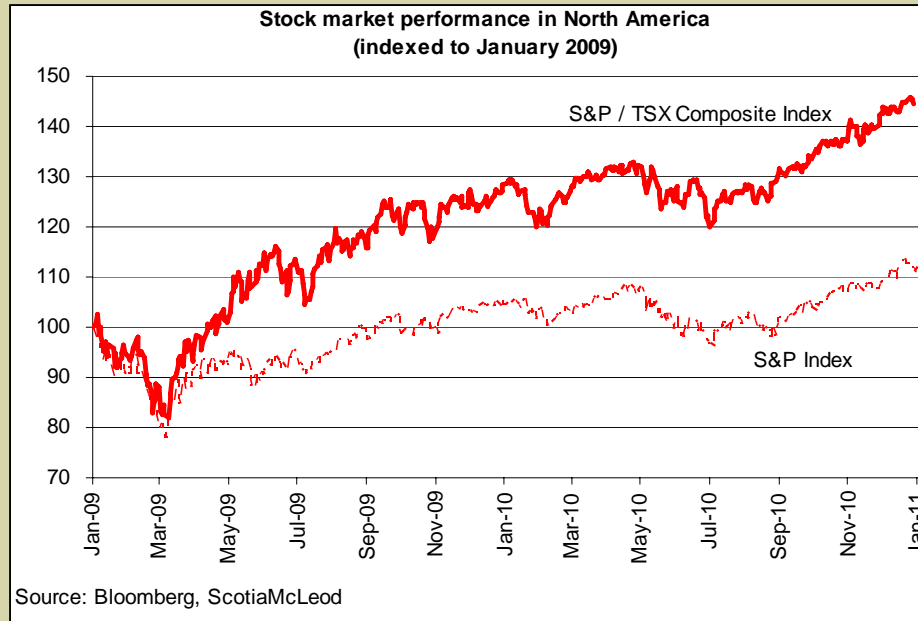


Review of 2010

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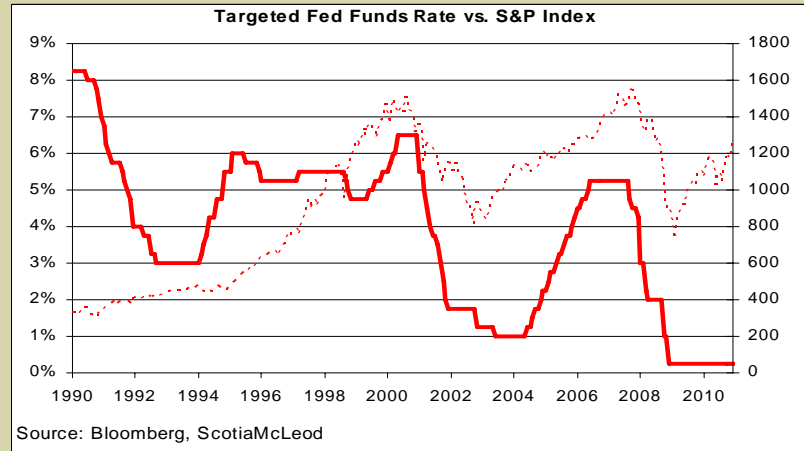
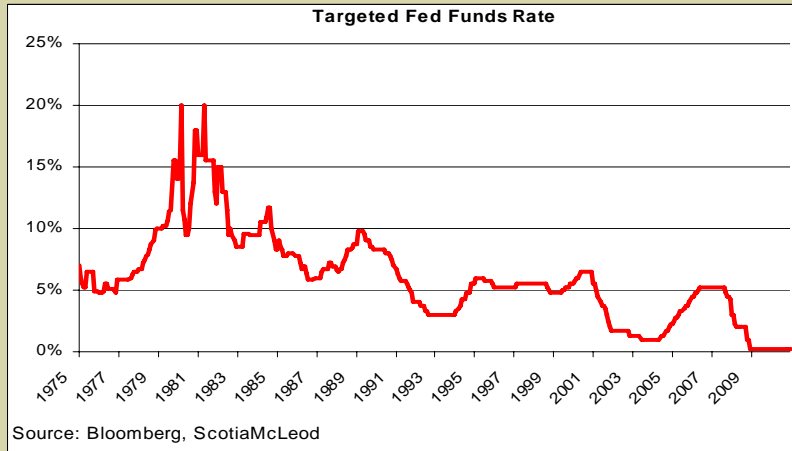


Review of 2010



- Equity markets worldwide have rebounded nicely off the lows of March 2009
 - S&P /TSX Composite Index rose 14.4% in 2010 while the S&P 500 Index advanced 12.8%
 - Outperformance by S&P/TSX due to the commodity-centric nature of the TSX
- Catalysts behind the sharp rally include low interest rates and opportunistic restocking by emerging nations
- The Fed is aiming to offset the deflationary pressures of falling home prices and soft labor markets with low interest rates (which theoretically increases borrowing) and a weaker currency (which supports export activity)

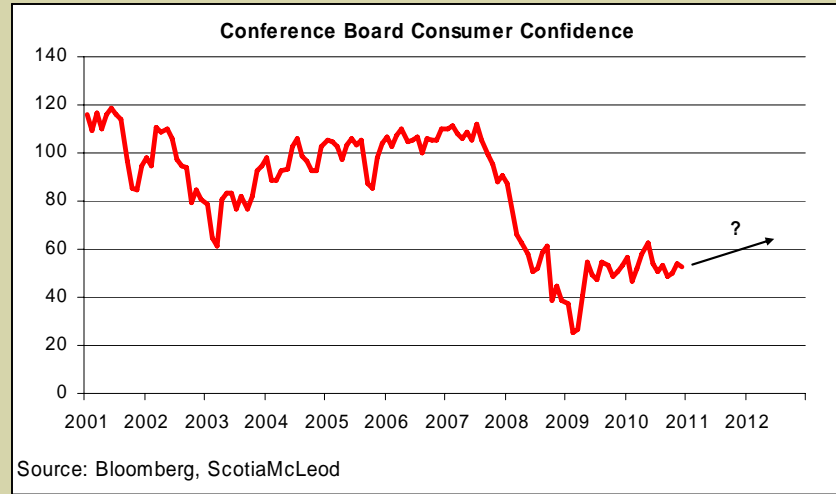
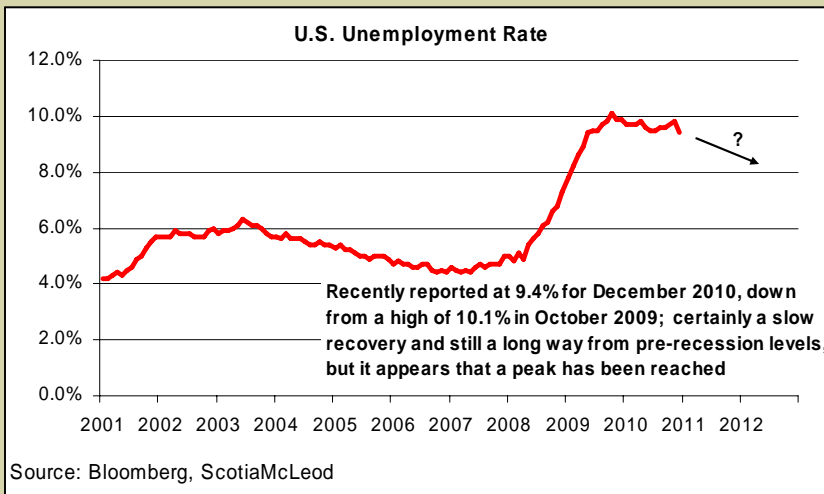
Review of 2010



- Extended period of exceptionally low interest rates has served as a key catalyst for stock markets
 - The U.S. government is attempting to reflate asset prices via monetary stimulus or quantitative easing as well as an unprecedented amount of fiscal stimulus
 - The recent “QE2”, a \$600 billion bond buying program by the Fed, has sparked a return in risk appetite
 - Such measures to keep interest rates low help to drive the reflation trade:
 - Increase borrowing, which in theory will eventually result in higher consumer consumption
 - Make equity returns more attractive than many other asset classes given higher yields
 - Allows companies to refinance at fairly attractive rates; this helps to strengthen balance sheets, which further helps to drive share buybacks as well as M&A activity
- Rising stock prices and gradually ascending asset price via reflation policies ultimately creates a “wealth effect”

Review of 2010

- Notionally, the wealth effect driven by fund flows and unprecedented stimulus packages will create a virtuous circle that involves:
 - Improving the affordability of big ticket items and housing
 - Stabilizing labor markets and correspondingly, bolstering consumer confidence
 - Enhance business confidence and inspire capital spending
- Recent economic data, which have mostly surprised to the upside, appears to support this theory



Review of 2010

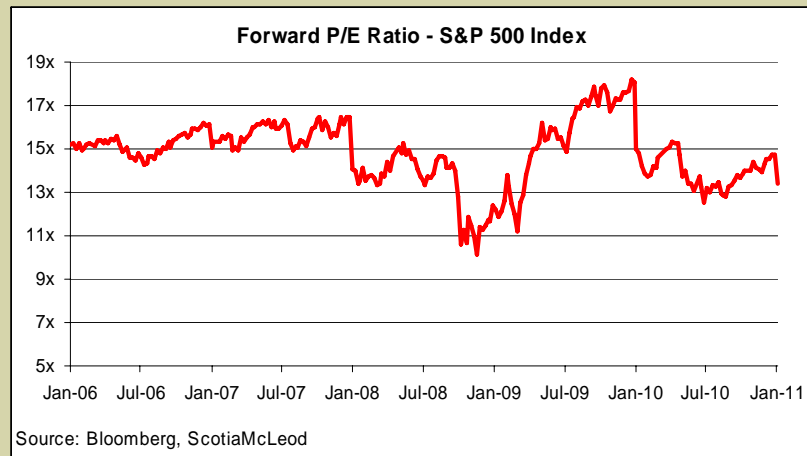
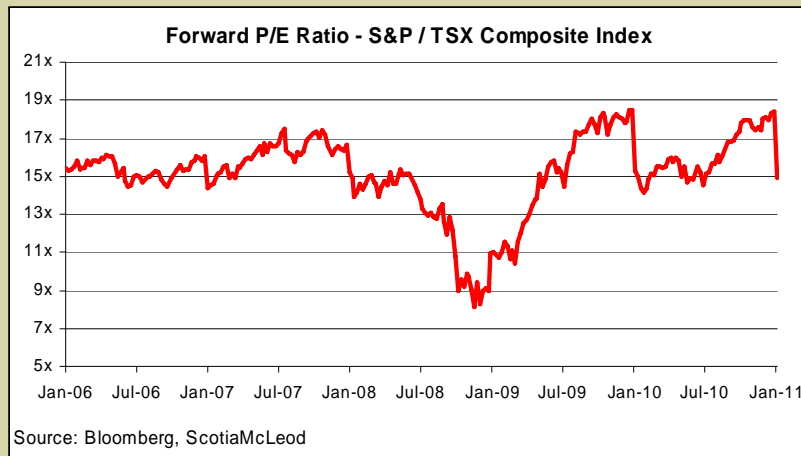
- With the reflation trade driving funds to equities and also helping to stabilize the economy, the S&P/TSX Composite rallied 14.4% in 2010
- The S&P/TSX Composite Index tends to be rather commodity-centric with over 50% of the index coming from the energy, materials and industrial sectors
 - Many of the stocks in these sectors stand to benefit from a pickup in economic activity as well as the continued weakening of the U.S. dollar
 - Accordingly, the Materials sector was one of the strongest performers in 2010 as gold and copper prices surged to new highs
 - Weighting of the Materials Index on the overall exchange has increased from 19% to 24% last year

	% Weight in the Index		Sector Performance
	<u>2009</u>	<u>2010</u>	<u>in 2010</u>
S&P/TSX Financials Index	30.5	27.9	6.3%
S&P/TSX Energy Index	27.6	26.6	10.0%
S&P/TSX Materials Index	19.4	24.1	35.8%
S&P/TSX Industrials Index	5.6	5.5	14.4%
S&P/TSX Consumer Discretionary	4.3	4.5	21.8%
S&P/TSX Telecom Index	4.3	4.0	16.3%
S&P/TSX Info Tech Index	3.5	2.4	-11.6%
S&P/TSX Consumer Staples Index	2.8	2.5	8.3%
S&P/TSX Utilities Index	1.7	1.7	12.6%
S&P/TSX Health Care Index	0.5	0.8	50.3%
S&P/TSX Composite Index	100.0	100.0	14.5%

Source: Bloomberg, ScotiaMcLeod

Review of 2010

- Despite the strong rally since March 2009, valuations remain reasonable and are not excessive
 - S&P/TSX Composite currently trading at 14.9x earnings versus the long term average of 15.1x
 - S&P 500 Index is valued at 13.3x versus the long term average of 14.7x
- Dividend yields still quite attractive, particularly in relation to other investment alternatives in what is still considered to be a low interest rate environment
- Concerns of a credit crisis in North America has faded as most companies have strengthened their balance sheets
- Interest rates are at all time lows and will remain there for an extended period; recent talk of rate upticks are more related to a normalization process as opposed to a process aimed at decelerating growth
 - Over the near to medium term, in our opinion, central banks will continue to prioritize economic growth over containing inflationary pressures



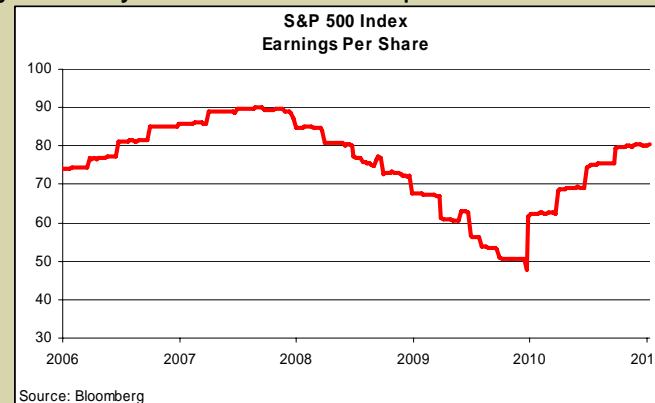
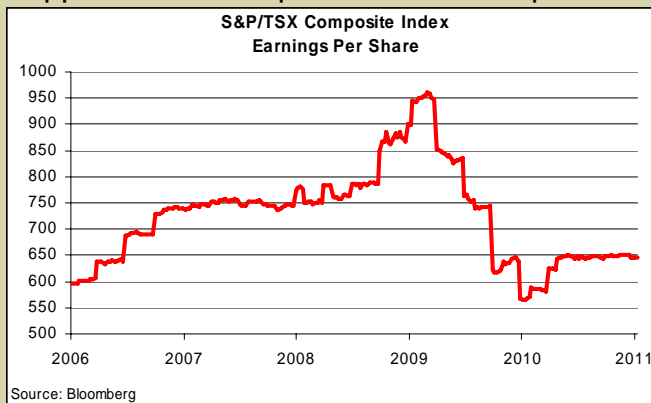
Outlook for 2011

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Catalysts

- Corporate earnings and economic data appears to have troughed over the past twelve months, and in some circumstances, have started to show some modest improvements and upward momentum
 - S&P 500 earnings reached a trough of ~US\$48 in 2009 and has since bounced back to the US\$80 level
 - Consensus is now expecting earnings of US\$107 in 2011 and US\$117.50 in 2012; implying annual EPS growth of ~10%
- Against the backdrop of low interest rates and signs of economic stabilization, investor risk appetite is gradually returning to more normalized levels
 - Tangible gains in U.S. jobs should reinforce positive sentiment shift toward equities
- Some funds, corporations, and retail investors are still overweight cash or money-market funds and have not participated in this recent rally; they will very likely be looking to buy the dips in this reasonably valued market
- Strong balance sheets mean that companies will actively seek opportunities to deploy capital; this translates to the possibility of increasing business investment, M&A activity, and aggressive share buybacks
- The US dollar faces numerous headwinds given their fiscal position; however, its is worth noting that a weak US dollar supports domestic production and export activity of many multi-national companies



Risks

- Many countries and regions are not entirely out of the woods; issues with sovereign debt could potentially stall the recovery process
 - Government bond yields in Europe remain elevated despite the €750 billion 'safety net' announced by the European Union and the International Monetary Fund last year
 - Yields on the ten-year bonds of Greece and Ireland currently stands at 11.0% and 8.0%, respectively
 - In our opinion, the financial strains confronting some debt-burdened European nations could temporarily unnerve the market but the odds of a 'double dip' recession are still fairly remote
- Risk of deceleration in emerging economies as risks of inflation begin to rise
- Bringing outsized fiscal deficits under control is a difficult and lengthy process; withdrawing unprecedented fiscal and monetary stimulus plus the restructuring of the global financial system will impede growth prospects in many countries through mid-decade
 - The government's gradual withdrawal of stimulus programs could be a net drag in 2011, though private sector activity will likely offset it
- The free spending U.S. consumer has had a major influence on economic growth over the past cycle but tightening credit markets and soft labor markets will likely force a change in spending habits
 - Some of this will be offset by a shift of power in the global economy: PricewaterhouseCoopers forecasts that China will overtake the U.S. as the world's largest economy also in 2032. "This renewed dominance of China and India, with their much larger populations, is a return to the historical norm prior to the Industrial Revolution of the late 18th and 19th Centuries. That caused a shift in global economic power to Western Europe and the U.S. -- this temporary shift in power is now going into reverse."

Economic Forecast

	Real GDP			
	2000-2009	2010E	2011E	2012E
World	3.6%	4.4%	4.2%	4.4%
Americas				
Canada	2.1%	2.9%	2.4%	2.7%
U.S.	1.8%	2.8%	2.7%	2.9%
Mexico	1.9%	5.1%	3.5%	4.0%
Brazil	2.9%	7.5%	5.5%	5.0%
Europe				
U.K.	2.7%	1.8%	1.6%	1.7%
Euro-zone	1.2%	1.9%	1.4%	1.6%
Germany	0.7%	3.5%	2.3%	2.4%
France	1.8%	1.8%	1.3%	1.5%
Asia				
Japan	0.7%	3.4%	1.6%	2.7%
China	10.2%	10.0%	9.5%	9.7%
India	7.2%	8.3%	8.5%	8.8%

Source: Scotia Economics

- Scotia Economics recently raised U.S. GDP growth forecast for 2011 by 0.2 percentage points to 2.7%, reflecting the stronger momentum in retail and manufacturing activity
 - Growth forecast for 2012 is unchanged at 2.9% and incorporates a gradual decelerating trend amid increased fiscal restraint and rising interest rates
- The slightly better trend in U.S. domestic demand will spill over to Canada, with GDP growth this year now pegged at 2.4%, up from 2.2% previously; 2012 forecast is unchanged at 2.7%
 - The modest U.S. outperformance in 2011-12 reflects a more competitive U.S. dollar and later-in-coming fiscal belt-tightening

Market Forecast

- 2011 will be transition year for policy and inflation as Scotia Capital's Strategist sees higher bond yields
- Valuations favor equities over bonds in the next 12-18 months
- 10-20% EPS growth in 2011 plus modest P/E expansion should help to lift equities
- While a balanced portfolio is always a priority, the strategist recommends overweighting Energy, Technology, Industrials, Financials; Underweight gold and defensives

Forecasts	2009	2010	2011 E	2012 E
Equity				
S&P/TSX	11,746	13,443	14,000	
EPS	600	700	860	925
S&P 500	1,115	1,258	1,325	
EPS	57.03	83.00	90.00	95.00
Mexico Bolsa	32,120 (A)	38,550	41,000	
EPS	1770.24	2,100	2,400	2,600
Interest Rates				
BoC	0.25%	1.00%	1.50%	2.25%
CA 10-Yr	3.61%	3.12%	3.50%	4.00%
Fed Funds	0.25%	0.25%	0.25%	2.00%
US 10-Yr	3.84%	3.29%	3.75%	4.25%
Currencies & Commodities (Yearly Average)				
CAD (USD/CAD)	1.14	1.00	0.96	0.94
EUR-USD	1.39	1.34	1.37	1.45
USD-YEN	94	81	84	90
USD-MXN	13.5	12.3	12.8	13.2
Brazilian Real	1.74	1.66	1.65	1.70
WTI	61.92	79.00	93.00	98.00
Natural Gas	4.17	4.40	4.40	4.75
Copper	2.32	3.40	3.85	3.70
Gold	973	1,225	1,400	1,550

Source: Scotia Capital estimates; Scotia Economics.

Sector Outlook

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Financials

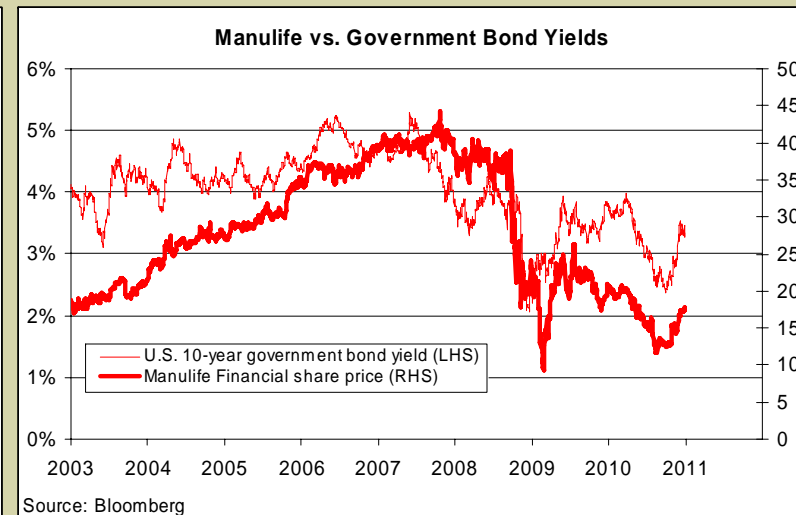
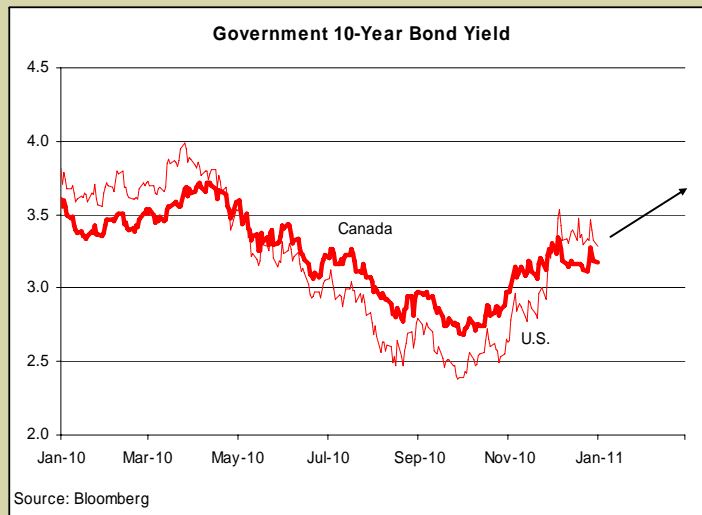
Canadian Banks:

- Banks were still very profitable during the market down turn and reported good results over the course of 2010 given fairly diversified revenue streams which limited the impact of the recession
- Sector is approaching an inflection point whereby dividend growth will resume after a two year pause
 - Cdn Western, National Bank, and Laurentian increased their dividends 18%, 6.5%, and 8% recently
- Capital positions remain strong during the quarter via internally generated capital, pushing the average Tier 1 ratio up to 13.1% from 12.8% last quarter
 - On a pro-forma basis, adjusting for Basel III changes to capital requirements, the average Tier 1 ratio is approximately 8.8%, which is well ahead of the minimum requirement of 6%
- The market down turn may prove to be a great opportunity for the banks as there are now less competitors and greater expansion opportunities
- Bank valuation remains attractive with a dividend yield of 3.8% and P/E multiples of 13.4x, 12.0x, and 10.7x trailing, 2011E, and 2012E, respectively
- Dividend growth, as well as stabilization in the economy and credit markets will be the key catalysts for further P/E expansion

Financials

Canadian Lifecos:

- Earnings over the past several quarters have been extremely noisy and in many ways, disappointing
 - Continue to take charges related to various investments (as a result of weak equity and credit markets) as well as products related to variable annuities and segregated funds
 - That said, both MFC and SLF have been trying to reduce this exposure over the past twelve months
- With improved market conditions, it would not be unreasonable to think that the worst of this 'noise' is history; however, the sector has become a 'show me' story
- Valuation is quite reasonable compared to core earnings, attractive dividend yields, strong capital ratios
- Rising bond yields will be positive for reinvestment opportunities; this, alongside firmer equity markets, could help to underpin the earnings recovery for the sector



Energy

- U.S. dollar weakness, economic strength in emerging markets, plus economic stabilization in North America have all contributed to upward momentum across the commodity complex
- At present, over the very short-term, we believe the price of crude oil is trading slightly above the long term average cost of production of US\$70-90 per barrel
 - Over the long term, however, with a likely recovery in demand (albeit slowly), supply constraints may eventually arise and support prices given that exploration activity in the sector has been limited over the last three years
- Natural gas is currently trading near fair value; high inventories and abundant supply are major overhangs
- For longer term oriented investors, we continue to like energy trusts; a number of trusts boasts sustainable distributions and attractive yields of approximately 7%
 - Investors are getting paid to wait while gaining some upside torque when the economy recovers
- We expect that commodity prices will remain highly volatile but there will likely be an upward bias given strong growth in China and India plus continued pressure on the U.S. dollar
- Energy sector will likely continue to show sector leadership over the foreseeable future after underperforming the broader market over the past two years

Materials

Base Metals:

- Underlying strength in the sector thus far has largely related to restocking activities and also the weakening of the U.S. dollar
- Copper in particular has reached 52-week highs while inventory levels are at fairly neutral levels
 - A number of stocks in the sector have already discounted this price trend
- Further strength in base metals will require a material and rapid rise in industrial, housing, and consumer demand
 - In our view, molybdenum and uranium has the most upside potential from current levels

Precious Metals:

- We are still positive on gold given the macro uncertainties and market volatility; while it may take some time for this assumption to materialize, we believe precious metal prices can still move higher
- Gold has effectively become a legitimate currency as investors grow weary of paper currencies
- Central banks have been keen on diversifying their assets away from the U.S. dollar and this will help to support the price of the bullion
- Scotia Capital's strategist is currently forecasting US\$1400/oz and US\$1550/oz for 2011 and 2012

Fertilizers:

- Grain and fertilizer prices have been strong lately given turbulent weather conditions around the world
- Food supply/demand fundamentals remain strong
- This sector will also benefit from a weaker U.S. dollar as well as the eventual pickup in energy use

Defensives & Technology

Consumer Staples, Utilities, Telecommunications:

- Always important to have diversified sector allocation
 - Generally, defensive sectors provide good stability in terms of capital and reliable dividend income
 - Even during an economic recovery, defensive stocks should still be part of a well diversified portfolio
- Attractive value and yield opportunities for long term investors
- Many defensive companies in Canada offer investors solid balance sheets, good management teams, earnings growth and in most cases an attractive dividend

Technology:

- South of the border, technology stocks has demonstrated strong sector leadership, outperforming the broader market over the past 12 months
- In Canada, the breadth of large-cap technology stocks is fairly limited with names such as Research in Motion and Celestica
- RIM represents 73% of the technology index in Canada and can be classified as a GARP investment – growth at a reasonable price
 - Shares trade under 10x forward EPS with earnings growth of ~10%, boasts an exceptionally strong balance sheet, and maintains an aggressive share buyback program

Summary

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Top Themes & Considerations for 2011

- The risk/reward proposition of the market skews in favor of the latter over the foreseeable future
- Market still faces some headwinds such as sovereign debt issues as well as the progressive removal of stimulus programs but nonetheless, a slow and gradual recovery appears most likely
 - Efforts to reflate asset prices, drive fund flows, and create a wealth effect appears to be showing signs of progress
 - Continued improvement in fundamentals, particularly tangible gains in U.S. jobs, should reinforce positive sentiment shift toward equities
- Rate increases and rising yields will likely become more topical as we move through the year; again, this is more of about normalizing rates as opposed to containing growth and inflation
- While a balanced portfolio is always a priority, gradually increasing cyclical exposure and adopting a “buy the dip” bias makes strategic sense
 - Markets will likely remain volatile and a focus on dividends will also help to enhance returns

Top 10 Picks for 2011

- Royal Bank (RY)
- TD Bank (TD)
- Great-West Lifeco (GWO)
- TransCanada Pipelines (TRP)
- Brookfield Properties (BPO)
- Thompson Creek Metals (TCM)
- Canadian Natural Resources (CNQ)
- Crescent Point Energy (CPG)
- Barrick Gold (ABX)
- Research In Motion (RIM)

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