

**Milos:** Hello and thanks to all of our listeners who have tuned in. My name is Milos Kostich and as Vice president sales Strategic Alliances, it is my pleasure today to have with me Andrew Simurda, Vice President and portfolio manager of the Canada Life Canadian Equity Value Fund. Welcome Andrew.

**Andrew:** Hello

**Milos:** Andrew you have been optimistic and quite bullish as you analyzed markets in our discussions during the fall of last year. You cited several market factors supporting your positive views on the market and I would ask you how your view of equity markets stands currently and whether there have been any changes in the fundamental arguments supporting your positive stance regarding the equity markets today.

**Andrew:** Milos, there are six factors one must monitor when analyzing the market from a top-down perspective. These factors are economic, monetary/fiscal, valuation, sentiment, supply/demand and technical.

At a bear market bottom and the beginning of a new bull market the following factors should be present.

**Economic Factors:** Forecasts for a recession become a consensus and in some downturns predictions of depression. Hard asset prices fall, unemployment surges and retailers inventories are full.

**Monetary/Fiscal Factors:** Central banks pump liquidity into the system by cutting rates. Government spending initiatives are announced. The yield curve steepen's.

**Valuation Factors:** By most metrics the market becomes grossly undervalued. Deep value investors become buyers of the market. Analysts lower their earnings estimates fast and repeatedly.

**Sentiment Factors:** Investors become excessively pessimistic. Purveyors of doom and gloom are many and capture the media attention. Sentiment measures show extreme pessimism. Investors panic.

**Supply/Demand Factors:** Cash on the sidelines is huge. Savings rates climb. New-issue markets dry up but insider buying spikes.

**Internal/Technical Factors:** As major stock markets post new lows and selling pressures become extreme but internal breadth measures are improving with less and less stocks making new lows.

Now remember, the stock markets are a discounting mechanism. So when all these factors are present, there is a high probability that the markets have already priced in the downturn. Therefore, the risk/reward of investing money in the equity markets at this juncture is very promising.

Late last year to earlier this year, I argued that all the above factors were in place for the start of a new up market.

Fast forward to today, one has to look at each of these factors once again to assess what the markets are discounting and to assess the risk/reward of being invested in equities.

On the economic factor, I would argue that markets today are pricing in a consensus view of modest economic recovery which is sub-par versus historical recoveries. However, since many question the longevity of the recovery and many still predict a double dip recession, a sustainable recovery is not fully priced into the markets today.

On the monetary/fiscal factor, central banks around the world remain committed to a period of lower interest rates, expanding money supply and further government spending initiatives. The yield curve remains historically steep. As a result, government policies should not hinder the markets ability to move higher in the short to medium term.

On the valuation factor, markets are no longer cheap. However, they are also not expensive. I would argue that on many metrics the markets are fairly valued today. With better earnings anticipated, a low interest rate environment envisioned, market multiples should not be an impediment at this time to markets moving higher.

Sentiment is no longer pessimistic. It would also be hard to argue that sentiment readings are neutral. Today, I believe that sentiment towards equities is moderately bullish. However, there remain many skeptics which keeps sentiment overall in check.

Supply/Demand factors remain bullish for equity markets. Pension funds, balance funds, cash within equity mutual funds and cash in retail money markets and retail bond funds remain near historic levels. Retail and institutional investors remain underweight equities.

Lastly, while market technicals are short term overbought, the internal market breath continues to improve and numerous other indicators are pointing to higher stock market levels over the immediate term.

As a result of the above Milos, I remain positive on the equity markets going forward. The economic data continues to improve which will lead to expanding earnings, valuations remain fair, government policies and the yield curve remain positive for stocks, equities remain underweighted with a huge amount of cash on the sidelines, sentiment is not excessive and the market technicals remain favorable...excluding the possibility of a healthy short term correction.

**Milos:** We have all heard the various opinions about the role that the BRIC countries will play in the future global economic turnaround,, Do you believe that the overall global recovery is more dependant on the Western world's return to more robust 2008 consumption/consumer spending levels or should we be looking at other factors entirely?

**Andrew:** Milos, today Russia, Brazil, India and China represent roughly 15% of world GDP combined. The US represents roughly 40% of the global economy. As a result, these countries remain too small to be the saviour of global growth on a stand-alone basis if the US economy were to continue to contract. However, if the US and Europe are able to achieve sub-optimal growth going forward of roughly 2% and the BRIC countries were successful in driving internal consumption which leads to growth of 6% plus then global growth can approach trend growth of roughly 3.5%.

So the big question from a global growth perspective is what rate of growth the US can achieve as the economic recovery continues. The ultimate answer to this question lies in what will be the new normal savings rate of the US consumer in aggregate. The reason this is important is that US retail consumption represents just under 70% of the US economy. Over the last couple of decades, the US savings rate had fallen from over 10% to less than 1% in aggregate in 2008 and this structural change was the reason for above average global trend growth during this period of time. Since 2008, American consumers have made a radical adjustment in their spending habits which has lead to Americans now saving close to 6% in aggregate, down from a recent peak that was approaching 8%. This adjustment has had a large negative effect on global sales and trade. While some would argue that the US savings rate needs to exceed 10% to repair American household balance sheets many other economists argue for various reasons that the level is closer to 6% and therefore we have already seen the peak. I believe in the latter. If in fact we have seen the worst of the savings adjustment in the US, then there is a good likelihood that US growth going forward will be stronger then many expect and what is priced into the equity markets. I believe this will be the case and take comfort in a recent report from the Economic Cycle Research Institute. This independent and highly regarded organization leading index for the US economy is making 26-year highs and point to the strongest economic recovery since 1983. Time will tell.

**Milos:** There have been some substantial drops in the price of natural gas and needless to say some interesting movements in the price of a barrel of oil in the last year. Andrew can you give the listeners a sense for what your take is on these 2 commodities presently and how that has played out for some of the Canadian players in those 2 areas?

**Andrew:** Milos, last April when I last commented on the Canadian equity markets I addressed my outlook on the Oil market. In a nut shell, my oil call was almost bang on. I pontificated back then that for various reasons I expected that we had already seen the lows for oil this cycle of roughly \$35, that oil should trade in a range between \$40 to \$55 until the third or fourth quarter and then oil would break above \$55. I also high-lited that when generating my cash flow forecasts for oil and gas companies, I used \$55 oil for 2009 and \$70 for 2010. As this was recorded, oil is trading at \$67.00 today.

Roughly 6 months have passed since that time and I remain constructive on the outlook for oil. Given my outlook that global growth will surprise on the upside, the \$US dollar will remain weak and that global spare capacity and high inventories will be slowly eroded, the path of least resistance for oil prices is higher. As a result, I believe oil will be range bound between \$65 to \$75 for a while longer before ultimately breaking above \$75 later this year earlier next year. As a result, I have raised my oil forecast when generating cash flow estimates to \$60 in 2009 and \$75 in 2010 with a bias to increase them again.

I recently turned positive on the outlook for the Natural Gas and believe that we have recently seen the lows for this cycle just several weeks ago below \$3 US/mcf. Why the positive outlook? Firstly, I must state that the natural gas prices are driven by supply and demand within North America while oil prices are driven by global supply and demand. Gas prices last peaked in mid 2008 at close to \$14us/mcf. Since that time prices have collapsed to a recent low below \$2.50 us/mcf.

Why the collapse? Three main reasons. The most important being that US growth in the production of natural gas has surprised even the most bullish of energy forecasters. New drilling technology has lowered the price of drilling gas from unconventional resource plays known as shale gas. The US has vast reserves of shale gas that in the past was uneconomical to drill. It is estimated that \$4.50 US/mcf is needed to make drilling shale gas profitable. The second reason, growing imports of LNGs over the last two years. The third reason is the significant decline in demand from chemical, electricity and manufacturing companies due to the economic recession. These three reasons combined have lead to inventory levels of natural gas in the US which are significantly above the 5 year averages.

The best cure for low prices is low pricing as drilling has fallen substantially in Canada and the US. With natural gas prices higher in other areas of the world, LNG tankers are being redirected to these areas and with growing confidence in an economic recovery taking hold in the US, demand from industry and electricity companies should start to improve going forward. All this combined, should allow excessive inventories to be worked down, leading to higher prices going forward. For my cash flow forecasts I use \$4.50 US/mcf in 2009 and \$6.50 US/mcf in 2010.

**Milos:** Considering some of the economic discussion that we have been having today, how have you positioned the Canadian Equity Value fund to take advantage of some of these underlying fundamentals?

**Andrew:** Milos, I continue to find value within the Canadian equity markets. As a result, my cash position remains low today. Sectors I am finding the most value in are technology, energy, materials including gold, telecom services, industrials, consumer discretionary and insurance stocks. I am underweight banks, staples and utilities where valuations remained stretched versus fundamentals in my opinion.

**Milos:** Andrew, thanks as always for your comments and insight, I hope that we can have you back in the near future.

Please tune in next month for continued commentary from our portfolio managers, these audio commentaries can be found on our website at [www.laketon.com](http://www.laketon.com)