

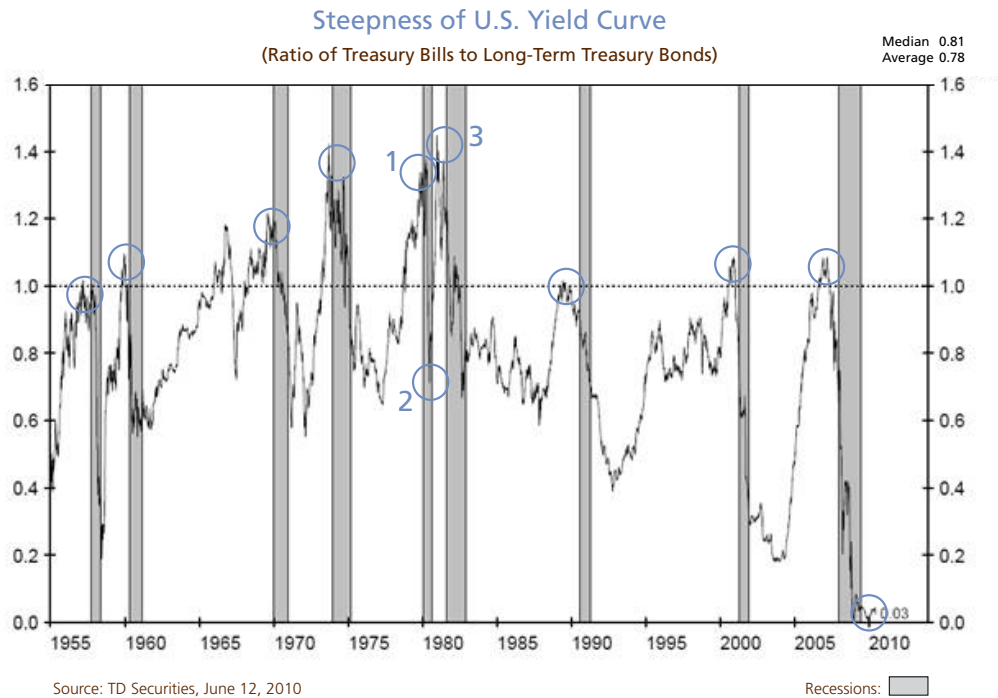
Is There a Double Dip in this Dance?

— LEE W. APPLETON, CFA, PORTFOLIO MANAGER

It's two steps forward, one step back for Canadian equity markets these days as rational and irrational sentiment vies for the heads and hearts of investors. It's a contest highly dependent on the latest economic and corporate data as well as headline news. One issue, particularly popular with the media, and overshadowing most discussions about future market performance is whether we're headed for a double-dip recession. We recognize investors' considerable worries about this matter and the significant impact of emotions on the markets.

However, based on our investment process and its inherent focus on objective market criteria, we do not believe that a double-dip recession is a likely next step, particularly in the near term. The steepness of the U.S. yield curve is a key measure in our analysis as it's a historically accurate precursor of recessions. Looking at the graph below, the yield curve has inverted (indicated by the plotted line rising above 1.0) prior to every recession (indicated by the grey bars). Looking across decades, you'll note nine inversions followed by nine recessions. More specifically, the 1980s provides a clear example of the inversion/recession relationship. We see:

1. Inversion occurs. Recession follows.
2. To help spark economic growth, the U.S. Federal Reserve Board lowers interest rates, prompting a drop in the short-end of the yield curve.
3. To combat high inflation, interest rates at the short-end of the curve rise, prompting a back-to-back inversion and a back-to-back or double-dip recession.



Today, the yield curve is as steep as it's been in 45 years with no signs of a back-to-back recession on the horizon. We recognize we're not out of the woods yet. We also know such trends take time to develop—they're not overnight events and we continue to monitor the yield curve as well as other indicators for any signs of change in direction.

For instance, looking at corporate earnings—both trailing and expected—the recovery of the S&P/TSX Composite clearly continues. For example, 2009 trailing earnings-per-share were 599. Expected earnings-per-share for 2010 stand at 728 and if realized (currently a sound likelihood) would mark a 22.0% rise year over year. Current projections put expected earnings per share at 881 in 2011, marking a considerable 21.0% increase year over year.*

As double-dip discussions prevail, our mandate is to invest in the markets today and as such our Canadian equity picks are well-suited to the tug-of-war of worries and opportunities that is underway.

*Source: S&P/TSX Composite Earnings; CPMS