

## U.S. Equity

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### Buy U.S. Stocks in September

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With the S&P 500 Index up 50% from its “panic-induced” low in March, the consensus view is the U.S. equity market is in a short-term overbought position and headed for a pullback. We don’t disagree. Scotia Capital’s Portfolio Strategist, Vincent Delisle’s proprietary tactical indicator (U.S. Panic-Euphoria Model) suggests the equity market may have moved too far ahead of fundamentals. Credit Suisse notes their tactical indicators are sending a mildly cautious signal.

However, any pullback in the U.S. market is likely to be short lived and shallow (less than 10%). Persistent wholesale selling of U.S. equities is unlikely as the market is flooded with improving economic data and reports which show an ongoing rebound in corporate profitability.

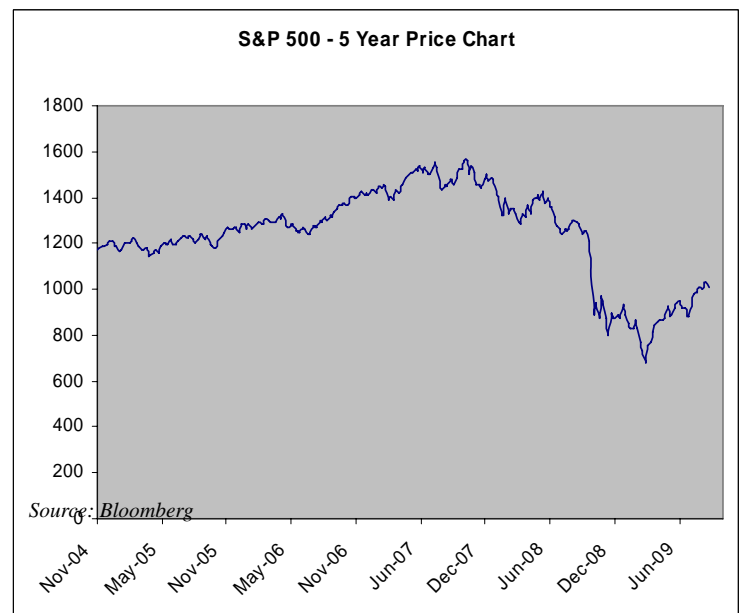
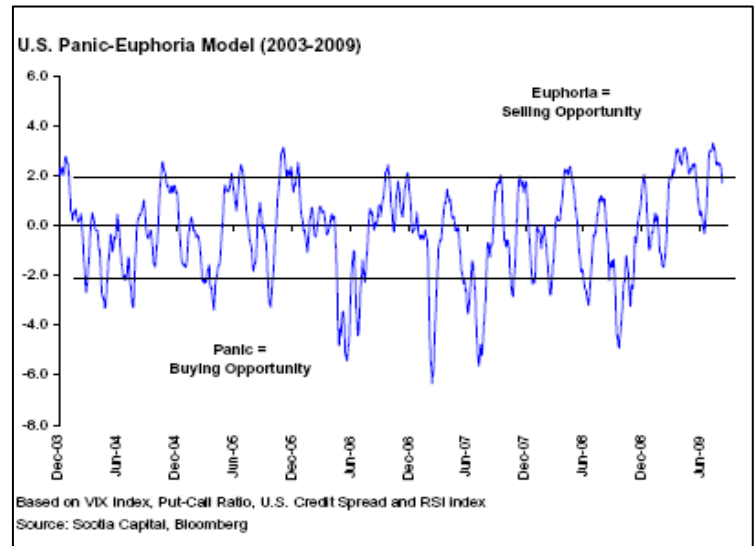
It is very possible U.S. economic activity could slump again later in 2010. Signs of a rapid recovery in Q3 and Q4 of this year could force central bankers to remove economic stimulus and raise interest rates prematurely. A low interest rate environment remains a key element supporting sustained economic growth. There is little doubt the highly leveraged consumer balance sheet has little tolerance for higher rates. However, central bankers appear to be in no rush to remove economic stimulus creating a “sweet spot” for the economy and financial markets.

U.S. equities are generally under-owned and some of the proverbial “mountain of cash” sitting in money market funds could find its way back into equities providing further support for stock prices. An over abundance of liquidity, low interest rates, and an improving economy are a formula for higher stock prices.

Historically, a pullback in September has been an excellent opportunity to buy stocks. We don’t believe this year will be an exception. The Portfolio Advisory Group recommends buying on weakness.

#### Why are we Positive?

The trend in the S&P 500 remains up. It is difficult for us to envision persistent wholesale selling of U.S. equities as the market is flooded with improving economic data and reports which show an ongoing rebound in corporate profitability. U.S. equities are under-owned at both the institutional and retail level. Pension funds and other institutional money managers will find that defensive posturing will be challenged and difficult to defend in an environment where economic conditions are improving and corporate profits are rising. Investors are being paid very little to



hold cash, and U.S. Treasury securities offer little appeal outside their defensiveness. Low interest rates drive investors back into risky assets and declining credit spreads reduce the cost of capital (cost of equity) supporting higher share prices.

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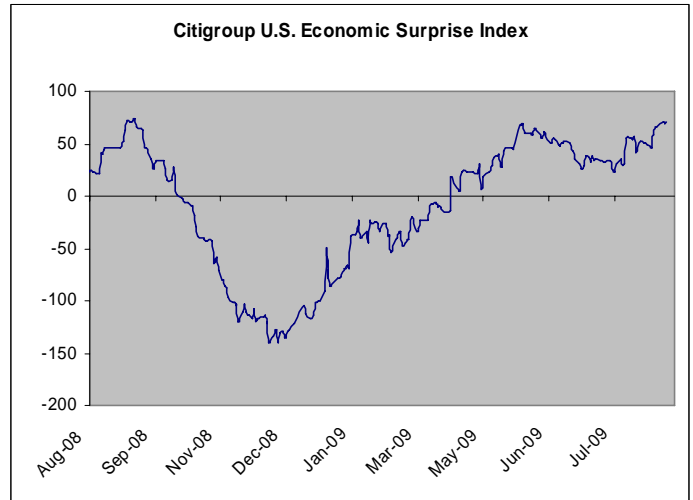
### Economic Growth Likely to Surprise

In 2008 we witnessed a synchronized global economic contraction, the worst downturn since the Great Depression. It now appears as if we are in the midst of a synchronized global economic recovery led by China, reinforced by highly stimulative monetary and fiscal policies, and improvements in financial markets. Industrial production collapsed in many countries last year, but has begun to rebound sharply. World trade volume is expanding again. Japan, Germany, France and many emerging market economies all grew in the second quarter. Others, including the U.S. and the U.K., will grow in the third quarter. Credit Suisse is forecasting global GDP to contract 0.9% in 2009 and rebound 3.9% in 2010.

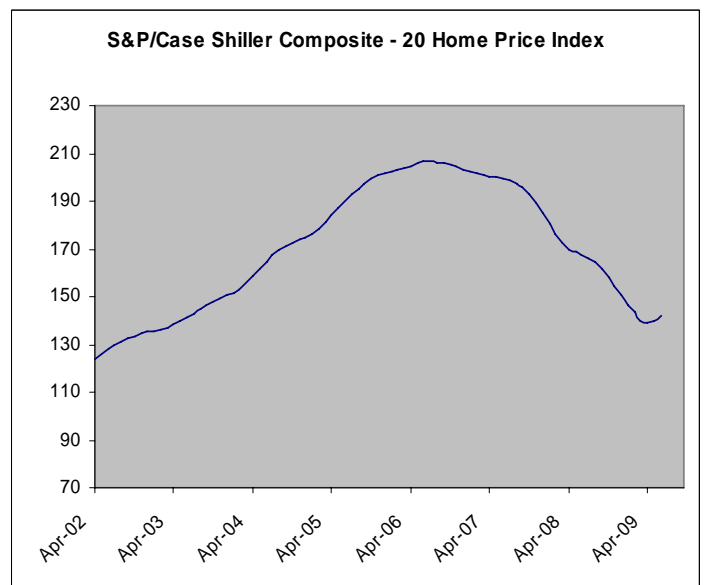
Credit Suisse's economics team believes the recession in the U.S. ended in Q2 and they are optimistic about the prospects for the economy in the second half of the year. They forecast growth in Q3 real GDP of 3.2% and 3.5% in 2010. Scotia Economics is predicting growth of 3.0% in 2010. Forward looking gauges of economic activity including the Index of Leading Indicators and the ISM New Orders Index have accelerated in recent months and point to continued upward momentum in the near term. Job cuts have gone beyond what is warranted by the decline in output and sales, suggesting labour market adjustments were front-end loaded. The decline in continuing claims, fewer temp layoffs, and a rise in the average workweek suggest the labour market is in the process of bottoming. Furthermore, recent housing data including the S&P/Case Shiller Home Price Index suggests the housing market may be bottoming after a three-year long collapse in pricing. As a caveat, home foreclosure remain at record levels and a back up in mortgage rates could derail the nascent recovery in housing.

Michael Darda, Chief Economist at MKM Partners has taken a somewhat contrarian view thinking the U.S. can have a subdued recovery in consumer spending and still post decent GDP growth in 2010. What the street and investors are overlooking is the investment side of the economy has collapsed far more than the consumer and is likely to rebound sharply. The U.S. will have an inventory and investment cycle driven by exports, business investment, and fiscal stimulus. He notes very little of the US\$787 billion in fiscal stimulus has been spent. Darda believes the U.S. could see 4% GDP growth over the next six quarters, well above Bloomberg consensus of economists' forecast of only 2.1%. Coming out of the 2001 recession which was very shallow, growth exceeded 2.1%. The U.S. economy is now working its way out of the deepest recession since the Great Depression and growth of 2.1% makes no sense to him. Looking back at 80 years of data, deep recessions have always produced steep recoveries, without exception.

Credit Suisse agrees somewhat on this last point. Recoveries following the recessions of the mid-1970s and early 1980's were extremely strong with real GDP growing 6.2% and 7.8%, respectively in the year following the recession. However, rebounds from recessions induced by financial crisis are on the tepid side, which is why they are forecasting growth of 3.5% next year. Nonetheless, still well above the consensus.



Source: Citigroup Global Markets, Bloomberg



Source: Case-Shiller, Bloomberg



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Credit Suisse puts it, “This is the **sweet spot of the financial cycle**. Large output gaps and quiescent inflation are expected to keep most central bank policy rates exceptionally low until well into next year.” In their opinion, even a modest economic recovery is supportive of financial results, and thus equity and credit markets.

### **Add Exposure to U.S. Equities on Weakness**

Credit Suisse’s yearend target for the S&P 500 is 1050, but they would not be surprised to see the index hit 1100. Goldman Sachs and JPMorgan also think 1100 is achievable. Scotia Capital estimates fair value to be closer to 1025 at yearend and 1200 by yearend 2010.

Analysis of monthly returns for the S&P 500 since 1928 indicate September is on average the worst performing month in a calendar year. With the S&P 500 up 50% from its March low, the market is due for a breather. Since 1928, the S&P 500 has on average declined 0.67% in September followed by gains in the months of October through December. Within a historical context, a pullback would only serve to enhance returns into yearend, thus creating an excellent opportunity to add U.S. equity exposure to a portfolio.

### **Cyclical Stocks Likely to Outperform**

While a correction would be an opportunity to add broad-based exposure to the market, cyclical stocks should outperform through yearend. We also favour multinationals with large and growing exposure to the emerging markets consumer and infrastructure.

The following are some of our preferred ideas:

Nike Inc. (NKE)\*

Waste Management Inc. (WM)\*

Fluor Corp. (FLR)

Apple Inc. (AAPL)

Intel Corp. (INTC)

AT&T Corp. (T)\*

Freeport McMoRan Copper & Gold Inc.(FCX)\*

Dell Inc. (DELL)

General Electric Co. (GE)

Diageo plc (DEO)

McDonald’s Corp. (MCD)\*

Oil Services HLDRs Trust (OIH)

SPDR Metals & Mining ETF (XME)

Market Vectors Steel Index Fund (SLX)

Claymore S&P/TSX Global Mining ETF (CMW-TSE)

\*currently part of the Portfolio Advisory Group’s U.S. Core Guided Portfolio

**Paul Danesi, CIM** - Director, Portfolio Advisory Group

## U.S Equity

*The author(s) of the report own(s) securities of the following companies.*

*None.*

*The supervisors of the Portfolio Advisory Group own securities of the following companies.*

*None.*

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