

Portfolio Strategy

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Cheering The Steep Yield Curve

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Event

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- Release of our weekly strategy comment.

Implications

- Long-term bond yields have been the biggest casualty of this rejuvenating spring optimism. Since last November's abysmal 2.04% level, U.S. 10-Yr government yields are north of 181 bp to 3.85%.
- Near 0% benchmark rates and spiking long-term yields have translated into massive yield curve steepening since Q4/08. Slopes (10-year/two-year) are now hovering close to 260 bp.

Recommendation

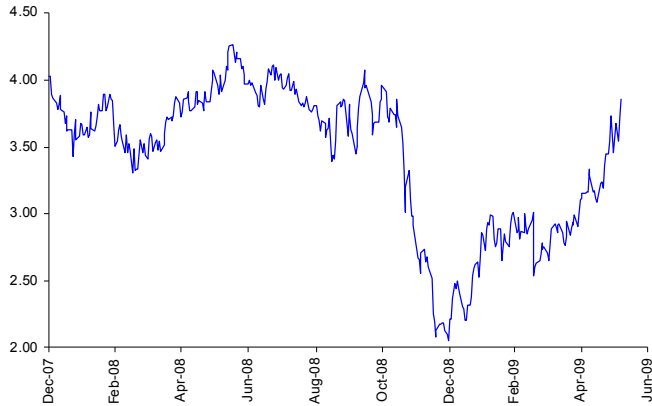
- Steep curves are positive for equities, and early cyclicals (Financials, Discretionary) tend to outperform throughout the steepening phase (now). Mid- late-cycle sectors (Industrials, Technology, Commodities) continue to perform well in the early stages of flattening. Defensives (Staples, Utilities, Health Care, Golds) outperform when the curve is flat and inverted.
- Reiterating 2009 strategic stance: Overweight Equities and corporate bonds; overweight cyclicals-underweight defensives.

Cheering The Steep Yield Curve

LT Yields Moving Up

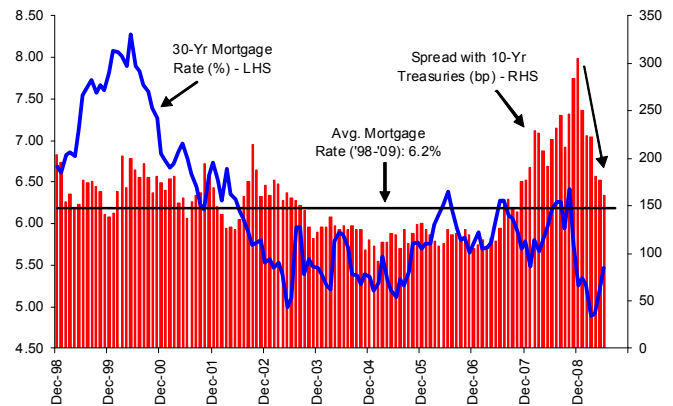
- **Long-term government bond yields have been the biggest casualty of this rejuvenating spring optimism.** With markets now busy pricing out the "depression discount", risk premiums have been normalizing and U.S. 10-Yr yields have jumped 119 bp so far in Q2. Last Friday's release of better-than-expected May U.S. payrolls data (-345k versus expectations of -520k) gave further pain to Treasuries. As highlighted by weekly claims figures, the velocity of job losses has considerably slowed down in Q2, a very healthy sign for the economy and equities. Moreover, continuous claims reverted lower last week, marking the first improvement since January.
- In Canada, 10-Yr government yields have increased 69 bp to 3.47% during the same period. YTD, the TLT index (iShares Lehman 20+ Year Treasury Bond) is down 25% and the XGB (iShares Canadian DEX All Government Bond Index) is off 2.5%.
- **Since last November's abysmal 2.04% level, U.S. 10-Yr government yields are north of 181 bp (Exhibit 1).** The jump in bond rates should be viewed as a desirable normalization after last autumn's panic. The drop in the USD also fits that pattern. Inflation expectations, as measured by the spread between government bond yields (3.85%) and yields on inflation protected bonds (1.85%), have also moved up, a sign that deflation fears have been washed away from investors' psyche.
- **Narrowing credit spreads have mitigated the overall damage to the mortgage market so far.** Credit spreads have tightened more than 190 bp YTD and BAA's are now yielding 7.77%. U.S. mortgage rates are up 60 bp to 5.45% since late April, but remain 75 bp below the 10-year average of 6.2% (Exhibit 2).

Exhibit 1 - LT Bond Yields Were Pricing Depression in Q4-08



Source: Scotia Capital, Bloomberg.

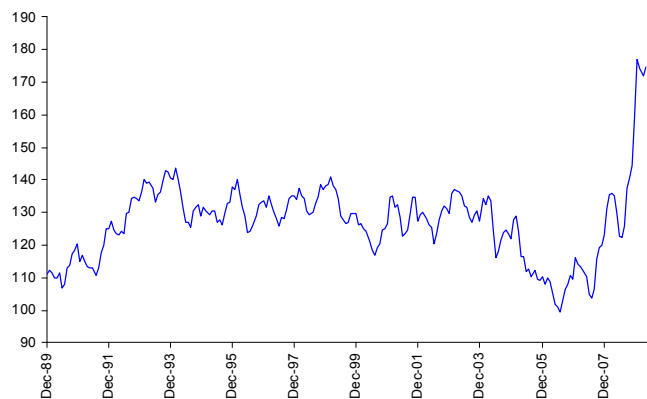
Exhibit 2 - Tightening Credit Spreads Mitigating Impact on Mortgage Rates



Source: Scotia Capital, Bloomberg.

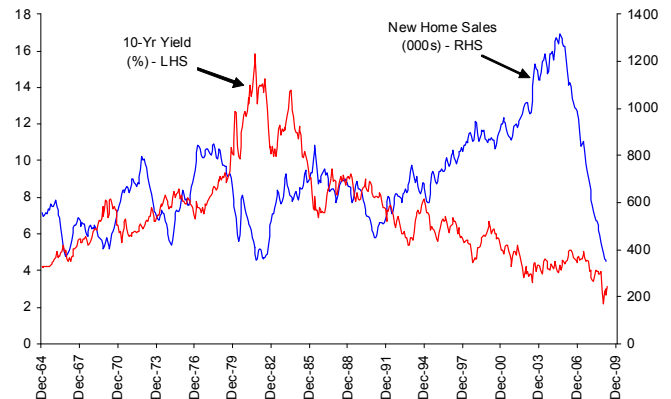
- The realization that rates are now heading higher may entice prospective buyers to purchase or refinance homes, which is precisely why monetary authorities wanted inflation priced back into markets. Last month's 6.7% increase in pending home sales (the biggest increase in seven years) may be a sign of better times for housing. Affordability remains high (see Exhibit 3) and previous improvements in U.S. home sales have also occurred alongside rising mortgage rates (Exhibit 4).

Exhibit 3 - Home Buyer Affordability Still Supportive



Source: NAR.

Exhibit 4 - Housing Rebounds Occur Despite Rising Mortgage Rates

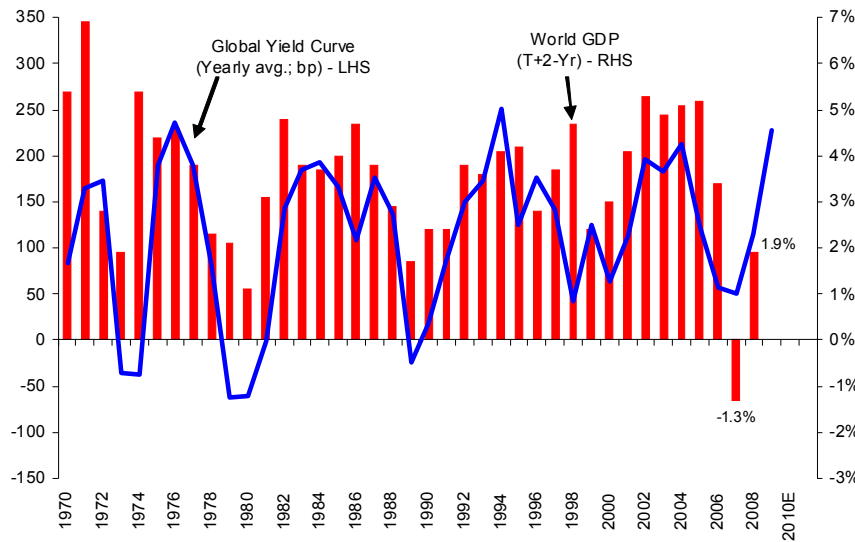


Source: Scotia Capital, Bloomberg.

Yield Curves Steepening

- Drastically stimulative monetary policy (near zero benchmark rates) and spiking long-term yields have translated into massive yield curve steepening since Q4/08, with slopes (10-year minus two-year) now hovering close to 260 bp. Steep yield curves are positive for equities and profits, but steepening curves even more so.
- **Based on our global yield curve indicator, world GDP growth should surpass 2.5% in 2010 before getting back to cruising speed of 3.5% in 2011.** Exhibit 5 looks at the relationship between our global yield curve and world GDP growth two years later. Since 1970, a global yield curve close to/or exceeding 200 bp (current one is 260 bp) has **always** translated into world GDP growth exceeding 3.5% in the following two years.

Exhibit 5 - Global Yield Curve & World GDP Growth (2-Years later)

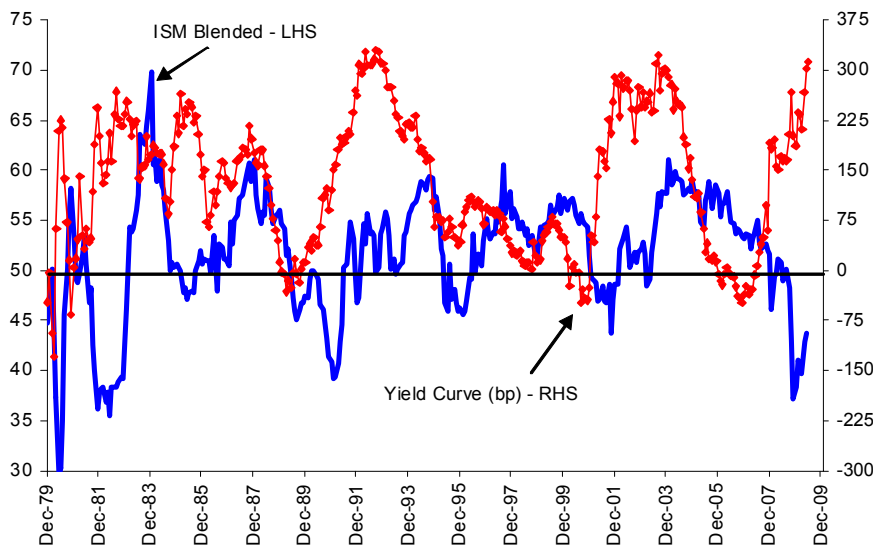


U.S. Yield Curve prior to '80, and Global YC thereafter - (Country weighted:US, CA, GE, FR, IT, UK, JN, CH, IN).

Source: Scotia Capital, IMF, Bloomberg.

- **We expect the steepening phase to extend until ISM/PMI indices settle comfortably above the 50 level (Exhibit 6).** Global yield curves have only been steepening visibly since late October 2008 (recall the Federal Reserve was the only one cutting rates from August 2007 to October 2008). When growth picks up (ISMs >50), monetary rhetoric should change and slopes should start to flatten. This will likely be a 1H/10 event.

Exhibit 6 - U.S. Yield Curve and ISM: Expect Steep Curve until Blended ISM Settles Above 50



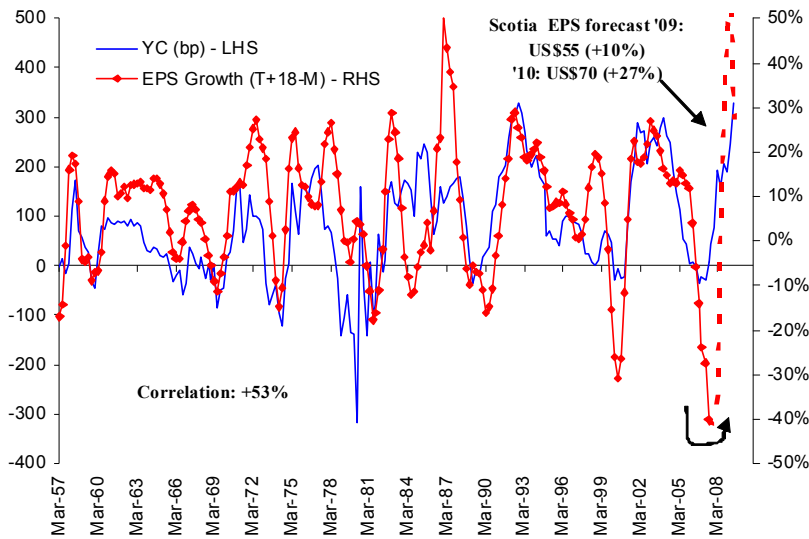
ISM manufacturing prior to Jul-97, Blended ISM (25% ISM manufacturing and 75% ISM non-manufacturing) thereafter.

Source: Scotia Capital, Bloomberg.

Yield Curves & Profits

- We use the shape of the yield curve to forecast the forward trend in S&P 500 earnings. As illustrated in Exhibit 7, there is an 18-month lag between the slope of the U.S. yield curve and the visible impact on S&P 500 profits. Based on this relationship, and a very steep U.S. yield curve of +325 bp, we expect earnings to increase 20%-25% to the US\$70 level in 2010.

Exhibit 7 - U.S. Yield Curve & Forward S&P 500 EPS Growth

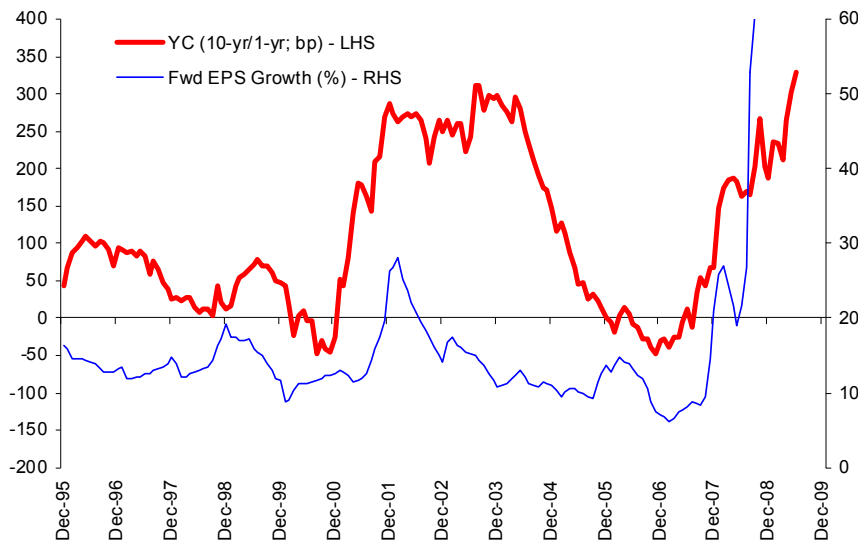


*Yield Curve based on U.S. 10-Yr Yield minus 1-Yr Yield (bp)

Source: Scotia Capital, Bloomberg.

- In addition to an improving top line next year, a weaker USD could add a dollar or two to S&P 500 earnings next year. Roughly a third of S&P 500 earnings are earned overseas and hence are negatively correlated to the DXY.
- The Financials sector is one that we believe will continue to cheer such steep curves, especially since short-term rates are slated to stay low until the first half of 2010 with the long end moving up. As depicted in Exhibit 8, S&P 500 Financials profit growth is at its best in periods of steepening curves.

Exhibit 8 - U.S. Yield Curve & Financials Expected Earnings Growth (12-M Forward)



Source: Scotia Capital, Thomson Financials.

Steep Curve Bullish For Equities and Early Cyclical

- In terms of asset mix, inverted curves are good for bonds, steep curves are more positive for equities. From an equity strategy standpoint, early cyclicals (Financials, Discretionary) tend to outperform throughout the steepening phase (now), and mid- late-cycle sectors (Industrials, Technology, Commodities) continue to perform well in the early stages of flattening. Defensives (Staples, Utilities, Health Care, Golds) outperform when the curve is flat and inverted.
- The USD strengthened last Friday following better-than-expected payrolls, which is one the few times we have seen the greenback trade up with improved U.S. fundamentals this year. If this trend continues (and it should, as the DXY is very oversold), early cyclicals should do better.
- With the U.S. savings rate now up to the 5.7% level, and job-loss fears abating, we expect decent consumer spending/inventory rebuild to stimulate GDP growth sooner rather than later. We believe Equity markets will want to go higher as investors go from pricing "depression" to pricing a recovery, and what's left of "bears" will eventually capitulate, i.e., flows will support the market.
- The strategic outlook (bullish) **must** override the tactical signals (overbought rally, euphoric state of S&P 500). We expect asset mix shifts toward equities and corporate bonds throughout the second half of the year.
- We reiterate our 2009 strategic stance: Overweight Equities and corporate bonds; overweight cyclicals-underweight defensives.

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Appendix A: Important Disclosures

Company	Ticker	Disclosures*
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* *Legend*

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We have a three-tiered rating system, with ratings of 1-Sector Outperform, 2-Sector Perform, and 3-Sector Underperform. Each analyst assigns a rating that is relative to his or her coverage universe.

Our risk ranking system provides transparency as to the underlying financial and operational risk of each stock covered. Statistical and judgmental factors considered are: historical financial results, share price volatility, liquidity of the shares, credit ratings, analyst forecasts, consistency and predictability of earnings, EPS growth, dividends, cash flow from operations, and strength of balance sheet. The Director of Research and the Supervisory Analyst jointly make the final determination of all risk rankings.

Ratings

1-Sector Outperform

The stock is expected to outperform the average total return of the analyst's coverage universe by sector over the next 12 months.

2-Sector Perform

The stock is expected to perform approximately in line with the average total return of the analyst's coverage universe by sector over the next 12 months.

3-Sector Underperform

The stock is expected to underperform the average total return of the analyst's coverage universe by sector over the next 12 months.

Other Ratings

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Under Review – The rating has been temporarily placed under review, until sufficient information has been received and assessed by the analyst.

Risk Rankings

Low

Low financial and operational risk, high predictability of financial results, low stock volatility.

Medium

Moderate financial and operational risk, moderate predictability of financial results, moderate stock volatility.

High

High financial and/or operational risk, low predictability of financial results, high stock volatility.

Caution Warranted

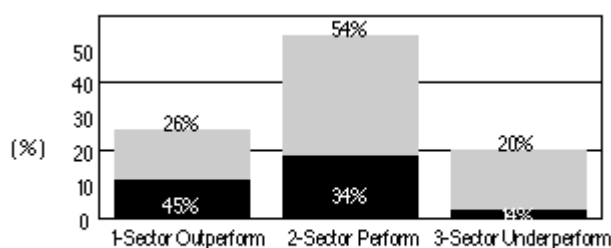
Exceptionally high financial and/or operational risk, exceptionally low predictability of financial results, exceptionally high stock volatility. For risk-tolerant investors only.

Venture

Risk and return consistent with Venture Capital. For risk-tolerant investors only.

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* As at May 31, 2009.

Source: Scotia Capital.

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