

With recession fears in the U.S., rumours of possible downgrades of bond insurers, and return expectations dampened after the January 2008 sell-off, it is time to review the longer term perspective for equities.

Today, in both Canada and the U.S., equity risk premiums are at their highest level in the past 40 years implying that a great deal has been discounted. On a cash and earnings yield basis, equities offer excellent returns compared to T-Bills and bonds.

At the same time, global liquidity remains at an all-time high and short-term interest rates are falling (See *Figure 1*). Investors have an excellent long-term environment to invest in equities.

Instead, we find that the true risks today are found in bonds and in the desperate search for the 'risk-free' yield advantage of one to 200 bps over Libor. The result of this search has led to a near record compression in spreads and yields too small to compensate for the risk of capital loss. We believe further large losses in the high yield markets are coming as almost 48 per cent of all U.S. corporate bond issues this year were rated B- or lower and historically 50 per cent of bonds rated B- or lower default within 10 years.

In Canada, the bond story is not one of defaults,

positive earnings are now falling for the first time since mid-2002. In addition, 2007 was the fifth consecutive year of a rising multiple for Canadian equities. A further increase is unlikely.

In the U.S., quarterly index earnings have turned negative for the first time since the cycle began in 2003. With a credit crisis and weaker domestic economy, downward pressure remains on corporate earnings. Perhaps the only good news is the cheaper U.S. dollar. As a majority of firms in the S&P 500 have foreign sales that account for 30 per cent or more of total sales, it is reasonable to expect that a weak U.S. dollar will lead to significantly increased revenue for those companies. The largest beneficiaries include semi-conductor, household products, and technology industries followed closely by the automotive, food, energy, and pharmaceutical industries.

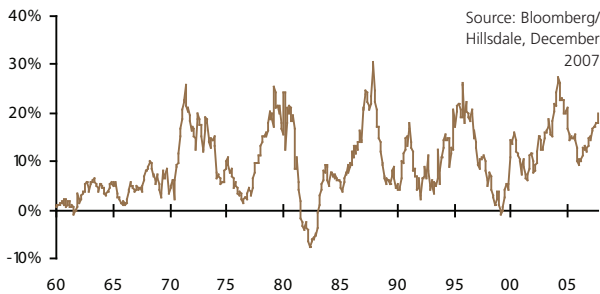
On The Value of Active Management

Because equities are undervalued, but index earnings are negative, we believe that now is an important time to employ active management and to avoid cap-weighted indices.

Significant dislocations caused by credit market stress, opportunities presented by rapidly changing curren-

Now Is Time For Active Management

Figure 1 Global Liquidity (YoY % Change)
US Monetary Base + World Foreign Exchange Reserves



but of erosion of capital due to inflation. Real returns for 10-year Government of Canada bonds are 175 bps today, near an all-time low. Most importantly, Canada's unemployment rate is now at a 30-year low pushing wage settlements into the four per cent range. The last time wage settlements were rising at this rate (1991), 10-year government bonds yielded nine per cent. Today that number is four per cent.

... But Poor Index Earnings

With excellent risk premiums supported by liquidity and falling short-term interest rates, the key to success is to find companies with earnings growth, a task requiring true skill today.

In Canada, slowing commodity prices and a higher currency have negatively affected corporate earnings. TSX Com-

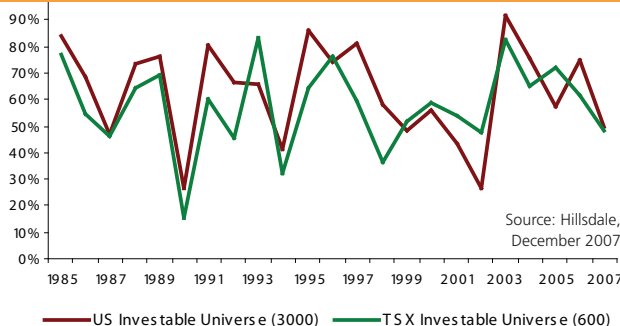
panies, and increased correlations among large cap indices all provide plentiful opportunities for exploitation by active managers today.

As evidenced by *Figure 2*, even the most difficult economic environments of the past 20 years have seen a minimum of 25 per cent of stocks rising. In Canada and the U.S. this year that would represent a minimum of 720 stocks heading up.

Based on these facts, we believe an active long-only manager (with large breadth and a healthy tracking error) searching for 50 good companies still has excellent odds of making a profit in 2008.

For investors with risk budget constraints or short-term liquidity requirements who are comfortable with alternative investments, now is the time to allocate to long/short or market neutral strategies. This is preferable by far to hiding in cash or bonds or trying to enhance returns with lower quality credits. ■

Figure 2 % of Stocks Up over 12 Months



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