REVIEW & COMMENTARY
4TH QUARTER 2009

Last year, we titled our year end review ***Brave New World*** which after the past year seems more prophetic than we had anticipated. Our scorecard was mixed but overall we got more things right than we did wrong.

“Brave” was more than an appropriate description of what was required in the past twelve months. While bravery is sometimes confused with ignorance, the appropriate term is often decided after time; if time proved one right then those who survived are considered brave. When time proved one wrong, then ignorance is more often used. For 2009, those who stood fast will be considered brave – markets roared back from the precipice of a financial armaggedon and whether it was financial intervention or some other force, markets and economies around the globe continue to heal. The time to full recovery will vary but unless there is a systemic shock to the markets (i.e. geo-political conflict, US congressional intervention, etc), world economies are on the road to recovery.

Last year’s predictions were:

Credit markets will continue to improve and the stock market will respond positively in 2009. Well certainly both predictions came true. It is troublesome that US banks lending activity remains well below expectation, while this could mean that borrowers are required to meet higher standards, it is probably a combination of this and the fact that with short term interest rates so low, the banks can easily invest money in short term risk free assets and make a decent spread. It may not be until shorter term rates start to increase that banks will be forced to pursue a more normal course of business and return lending activities to higher levels.

Certainly the stock market responded beyond our expectations but remember at the time of writing last year we hadn’t hit the lows of the markets either. But by most counts equities provided some decent returns- up over 30% in Canada as measured by the TSX/S&P index, the S&P 500 (in US dollars) gained over 23% and the Nasdaq Composite (in US dollars) gained over 40%. Certainly that was a positive response. From the lows in March, the returns were considerably higher.

Most commodity prices will rally in 2009. This appears to be an accurate prediction, however, we will admit that the word “most” suggests some inaccuracy on our part. Many commodities have been stronger than anticipated given the stage of recovery in the world economy and while they may be anticipating greater growth than can be presently justified, the markets are forward looking. It has been suggested that many creditor nations (ie China, India, and some in the Far East) are diversifying their substantial currency reserves by buying commodities as a hedge against the weakening US dollar. Certainly this would explain some of the strength. We don’t anticipate a significant sell off (yet) of the US dollar, in fact next year it should stabilize. However, we do not see it returning to its former glory either any time soon.

Volatility will remain high but the lows for the equity market were reached last quarter. We seemed to miss the mark here. Equity lows were achieved in March of 2009 and made the last quarter 2008 lows look mild in comparison given the volatility. The ascent from the March lows weren’t exactly in a straight line despite being more than welcome, however, it was typical of a rebound from a significant sell off. Volatility, measured by the VIX index, started the year close to 40 (down from a high of close to 100 in the latter part of 2008) and almost halved by year end. This could not be construed as remaining high. Thus, this prediction fell well short.

…/2

Predictions for 2010…

North American equity markets will provide positive returns again this year. US and Canadian corporate balance sheets are in remarkably good shape and earnings are expected to improve nicely in 2010. While the equity markets are reflecting this to some degree, low interest rates will continue to drive investors to equities (see our last quarterly titled ***Zero Tolerance***). As debt financing becomes easier for companies, this may lead to further consolidation in several areas such as Gold, Energy and Materials- a particular benefit to Canadian markets. We anticipate returns more modest than 2009 and dividends will be a more influential part of investors' total return. Many Canadian stalwarts such as BCE, Enbridge, and Emera have already increased their dividends and we expect several other companies, particularly some of the Canadian Financials, to follow in 2010.

Many Global and Emerging economies will continue to rebound and drag the US economy and many of the G8 countries along with it. According to Thomson Reuters, John Lipsky, Deputy Managing Director of the International Monetary Fund estimated that recent improvements in economic data and financial markets would result in another upgrade in the IMF's World Economic Outlook which comes only months after its most recent upward revision last October when world GDP was increased to 3.1%. In the last week of December and the first few days of January 2010, economic indicators are pointing to an economic rebound. The ISM (Industrial Survey of Managers) posted its highest levels since April 2006. UI claims in the US fell to 432,000 at the end of December, the lowest level since July 2008 and measure 240,000 lower than their peak in March. And at the end of the first week of January, it is predicted that modest job growth may be evident in December 2009. The US currency will remain under pressure, possibly sending the Loonie toward parity but present relative levels are expected for the remainder of the year.

Bond prices in the mid to long term area will come under downward pressure particularly in the latter half of 2010. Assuming Chairman Bernanke is re-appointed, the Federal Reserve will keep short term interest rates low well into the second half of 2010 if not the whole year or at least until there is abundant evidence of a sustained US recovery. However, the open markets will start to reflect higher interest rates thus pushing mid to long term bond prices lower before year end. We believe that an official change in US interest rate policy will be declared well in advance, giving sufficient warning. In fact, the first increase in rates may not be met with a negative reaction in equities but once the second increase is realized, a more cautious *short term* stance in equities will be considered.

Our final line in the 2008 Review and Commentary was … **"And those who stayed the course will prosper".** It may not have been as much prosperity as we all would have liked but it was, and continues to be, the proper course of action.

Thank you for braving 2009 with us.

Stodgell Investment Management Ltd.