

JULY 2010

MD Perspectives

Slowing economic recovery puts pressure on markets

Long-term sustainability of recovery still rests on housing, consumers, banks and credit

With governments around the world winding down stimulus measures, and in some cases announcing spending cuts to battle deficits, there are fears that the global economic recovery could be losing steam. Markets traded lower in the second quarter as investors reacted to economic data that suggested the housing, manufacturing, employment and construction sectors in the United States are faltering.

The dominant sentiment is that if the U.S. economy stumbles, the global recovery could be in jeopardy. Market watchers were particularly disappointed with a significant drop in pending home sales in May. Sales were 30% lower than in April—the biggest decline on record. This drop followed the expiration of a tax credit aimed at first-time homebuyers.

Although sliding stock markets in the second quarter were unwelcome news for investors, markets are still significantly higher than they were during the depths of the financial crisis in late 2008 and early 2009. The Standard & Poor's (S&P) 500 Index was 11.3% lower in U.S. dollar terms, and down 7.4% in Canadian dollars, in the second quarter. The S&P/TSX Index slipped 5.4% in the three months ending June 30. The MSCI World Index finished 12.5% lower in the second quarter in U.S. dollar terms, and down 8.5% in Canadian dollars.



There were, however, some glimmers of hope during the quarter. In the United States, May jobs data showed growth in private payrolls, which eased concern that the job market was trapped in a downward spiral. There was also good news from the Federal Reserve's Beige Book. This report on economic conditions is used at Federal Open Market Committee meetings, where the Federal Reserve sets interest rate policy.

In June, the Beige Book report stated that economic activity continued to improve in all 12 Federal Reserve Bank

districts. The report was noticeably more positive than April's Beige Book, with improving areas outnumbering declining areas. Consumer spending and tourism activity generally increased in June. Business spending also rose. Employment and capital spending edged upward, but inventory investment slowed. Non-financial services, manufacturing and transportation continued to gradually improve. Commercial real estate remained weak, although some districts reported an increase in leasing. Financial activity was little changed on balance, but a few districts reported a modest increase in lending. Overall, the Beige Book supports Fed Chairman Ben Bernanke's view that the recovery will continue, but at a more modest pace.

Worries over the government debt crisis in Europe drove investor sentiment lower in May and early June. A bailout for Greece and an emergency fund to re-establish financial stability in the eurozone, combined worth more than US\$1 trillion, were not enough to dispel concerns that the crisis could spread through Europe and beyond. By quarter-end, however, the situation had stabilized somewhat. Markets responded positively to a number of developments that show European policymakers are determined to get their economies back on track. In the United Kingdom, the new government

Highlights

- ▶ Markets will not deliver long-term value to investors without a strong U.S. economy.
- ▶ We are watching for a clear long-term trend toward improved liquidity.
- ▶ Work closely with your MD advisor to focus on your portfolio's long-term strategic asset mix.



unveiled a tough budget designed to curb public spending. The Greek government stood firm in the face of ongoing demonstrations against austerity measures. European Union officials are planning a series of stress tests to gauge the solvency of European banks.

Canada's economy also faced headwinds during the quarter. The government debt crisis in Europe, a potentially worse-than-expected slowdown in the United States, and possible fallout in China were the chief detractors from growth. The emerging China story is the newest wrinkle in the slowing-global-growth story. In May, the Conference Board reported that China's expansion may have peaked. This led to a sell-off in key commodities and natural resources companies. Oil fell below US\$70 per barrel before recovering to trade around US\$76 per barrel at the end of the month.

Canada's economy stalled unexpectedly in April. Growth in gross domestic product was flat, compared with 0.6% growth in March. Consensus forecasts had called for 0.2% growth in GDP for April. Statistics Canada pointed to a "large decline" in retail trade of 1.7%, after a 1.9% gain in March. Manufacturing and utilities were also weaker, but growth in mining, wholesale trade, the public sector and construction acted as a counterweight. Canada's economy remains strong, however—this was only the first time in eight months that it did

not expand. Forecasts are still pointing to strong overall growth for the year. As a result, the Bank of Canada will likely continue to raise rates to stay ahead of the curve on inflation, although it has not committed to the timing of this course of action.

The economic news from the quarter was important but, by itself, cannot tell us how sustainable the ongoing recovery is. Our analysis continues to underline the importance of sustained growth in the U.S. economy because, without it, the global economy will not remain on sound footing. For example, U.S. consumer spending accounts for about 70% of U.S. gross domestic product, and this spending in turn translates into 20% of global GDP. The global economy cannot return to health without a rebound in demand from U.S. consumers.

We cannot, of course, predict the future direction of the U.S. economy, but we can be sure that markets will not deliver long-term value to investors without a strong economy supporting them. To determine where sustained economic growth will come from, we continue to focus on four key areas: U.S. consumers, the U.S. housing market, the U.S. banking system and global credit markets.

U.S. consumers

U.S. consumers remain the world's most important economic engine. The more confidence consumers show in the

economy, the more likely they are to spend. U.S. consumer confidence rose in June—hitting its highest level since January 2008. This suggests that declining stock prices are not dampening sentiment.

The Thomson Reuters/University of Michigan final Index of Consumer Sentiment increased to 76, from 73.6 in May. Although that's still lower than the average of 84.5 over the past decade, any reading above 50 indicates a positive level of consumer confidence. But as recently as November 2006, the index was at 97, so today's level shows that consumer confidence still has room to improve.

Employment worries and household debt remain the biggest challenges for consumer confidence and spending. Jobs data show little cause for optimism, although the more dire forecasts have not been borne out so far. The unemployment rate fell to 9.5% in May, which is still unacceptably high.

U.S. consumers still hold about US\$13 trillion in debt, which is an unsustainable level. The challenge will be for consumers to pay down debts but still spend enough to drive the global economy. U.S. Treasury Secretary Tim Geithner is exhorting his global counterparts, especially in Europe, to encourage consumer spending in their domestic economies in an effort to share the burden of stoking global demand with consumer spending.



On balance, our analysis suggests a downward bias toward consumer confidence. But, longer term, consumer confidence is showing the potential to improve slowly.

The U.S. housing market


U.S. housing holds the key to any emerging economic recovery, because homes remain the most important asset for the vast majority of U.S. consumers. Until housing prices recover, consumers will be wary about spending. Currently, about one in four homeowners owes more on their home than it is worth—a situation known as negative equity. However, there are some signs that the rate of negative equity could be declining slightly.

Another important gauge of the health of the U.S. housing market is the S&P/Case-Shiller home price indices. The adjusted reading for its composite 20 index of major metro areas showed a 0.3% gain in April. Government programs to encourage homebuying and help for people to refinance their homes have provided a significant boost in housing demand. But, after the stimulus runs out, house prices could slide. This analysis is borne out by the steep drop in pending home sales in May.

Our analysis suggests that employment rates will likely hold the key to a sustained recovery in the housing market. When prices begin to appreciate in a sustainable way, homeowners should start to feel more confident about spending, which will help to drive the economy. For now it is too early to point to a clear, sustained trend in the housing market.

The U.S. banking system

Good news emerged from the U.S. banking sector during the quarter. The stability of the U.S. banking system is on an upward trend, according to the KBW large bank index. We are also seeing improving, and in some cases record, profits and relative stability in the top 19 U.S. banks. Together, these banks account for about two-thirds of all U.S. banking assets. But smaller regional banks, which play a central



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role in local economies by lending to small and mid-sized businesses, are still struggling, according to the KBW regional bank index. The overall volume of bank lending—a key measure of a bank's health—also remains depressed, as bankers are loathe to extend credit in uncertain economic times.

Global credit markets

Liquid global credit markets are central to any sustained economic recovery. Businesses cannot expand and drive economic growth without predictable and affordable access to credit.

Global credit markets tightened in response to the turmoil in Greece and fears of contagion to other heavily indebted countries, like Spain and Italy. But the market response was nowhere nearly as severe as what was seen in the wake of the global credit crisis when lending dried up.

During the second quarter, the difference (spread) between essentially risk-free debt instruments like U.S. Treasury bonds and the three-month London interbank offered rate (LIBOR)—a key measure of risk in the credit markets—jumped from normal levels of about 10 basis points to 30 basis points as Greece threatened to default. (A basis point is 1/100 of a percentage point.) The lower the spread, the lower the risk perception associated with extending credit. Spreads are showing signs of declining, along with lessening fears of European

debt defaults. It's also important to note that, at the height of the global credit crisis, spreads soared to more than 360 basis points.

Lending is still not happening, however, at the rate it needs to for the global economy to produce sustained growth. The broader market still needs better access to credit if the economy is to return to a sustainable growth path. Our analysis still shows the need for more liquidity and easier access to credit to deliver a sustained economic recovery. We are watching for a clear long-term trend toward improved liquidity to emerge in the broader monetary system.

Uncertainty likely to define markets in 2010

We are maintaining our defensive stance as markets continue to fluctuate. But our prudence is not a synonym for complacency. We continue to encourage you to work closely with your MD advisor to focus on your portfolio's purpose, and rebalance it so that your current mix of investments matches your long-term strategic asset mix.

Now is an ideal time to revisit your long-term financial plan and ensure that you are up to date with the appropriate strategic asset mix. To make sure you are in the best position to keep your financial future on track in the face of economic uncertainties, talk with your MD advisor, or call MD at 1 800 267-2332 to be put in touch with an MD advisor near you. ■

How leading economic indicators provide clues to economic activity

As we continue to monitor the global economic recovery, it's helpful to understand what economists—and the experts at MD—look for in trying to understand where the economy is going. Short of a crystal ball, the best source for determining the direction of the economy is by following certain economic indicators.

Essentially, there are three types of general indicators:

- ▶ **Leading indicators:** These indicators usually change before an economy as a whole does, so they are useful short-term predictors (e.g., stock prices or retail sales).
- ▶ **Lagging indicators:** These indicators usually change after the economy does; typically, the lag is a few quarters behind (e.g., unemployment rates).
- ▶ **Coincident indicators:** These indicators change at approximately the same time as the economy, and provide information about the current state of the economy (e.g., gross domestic product (GDP) or industrial production).

Because leading economic indicators can often signal changes in trends in the overall economy, they are the most useful and widely used indicators. One popular rule of thumb for interpreting leading indicators is that three successive periods of decline signal the beginning of a recession, while three successive periods of increase signal the beginning of a recovery. At MD, we use leading economic indicators to help shape our economic outlook and guide our decisions about how to manage our clients' portfolios.

Leading economic indicators in Canada and the United States

In Canada, leading economic indicators are represented by the Composite Index—a monthly compilation of leading indicators compiled by Statistics Canada and designed to forecast developments in the Canadian economy. Growth in the index indicates a healthy and expanding economy.

In the United States, the Leading Economic Indicators Index is published monthly by the Conference Board—a private research group that provides global research in areas including the economy and markets. The index is made up of 10 economic components, in which changes can signal what may happen in the overall economy.

At MD, we primarily focus on the U.S. index of leading economic indicators (LEI) as a measure to help determine the general state of the economic recovery and, specifically, the potential for a rebound in U.S. consumer activity (one of the four factors MD follows in the U.S. economy, described in more detail in this issue's cover article).

Most recently, the LEI in the United States rose 0.4% in May, as indicated in the chart below. With the exception of April 2010, when the index did not

A closer look

Here's a closer look at two of the best recognized leading economic indicators and how they're used to make financial predictions and forecasts.

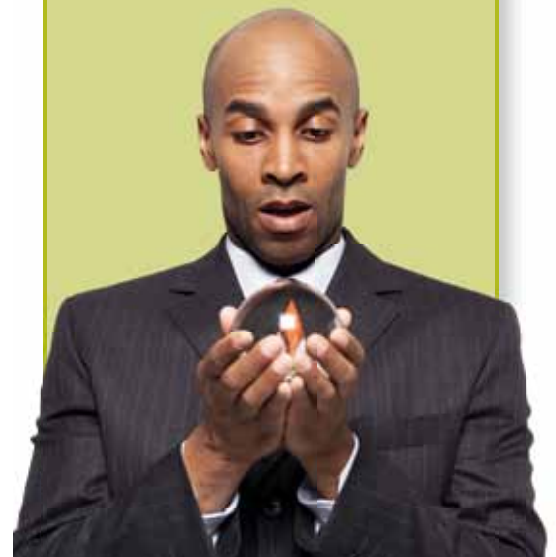
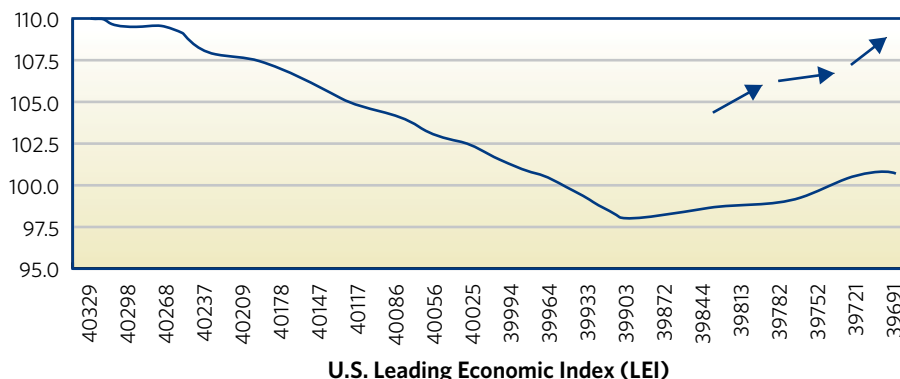
Consumer expectations

Consumer expectations, using data from the University of Michigan's Survey Research Center, measure consumer sentiment—or consumers' degree of optimism regarding the state of the economy—expressed through saving and spending. Increasing consumer confidence indicates economic growth and more consumer spending and consumption. Decreasing consumer confidence indicates higher likelihood of decreased spending, leading to slowing economic growth.

Amount of manufacturers' new orders for consumer goods and materials

This is a valuable leading indicator because increases in new orders for consumer goods and materials usually mean positive changes in production. New orders contribute to a decrease in inventory, and contribute to unfilled orders, meaning future revenue.

The Conference Board U.S. Leading Economic Indices since July 2008



change, the LEI has risen in 13 out of the last 14 months. The rising index has been driven by the increasing amount of money in the economy, the rebound in manufacturing and slow improvements in the job market.

In Canada, leading indicators rose 0.9% in May—a gain that marks the 12th consecutive month of advances year over year. May's reading was equal to the 0.9% gain in April and approximately equal to the average increase over the

past 12 months. A year ago, growth in the index was led by housing and the stock market. These components have slowed in recent months, and the manufacturing sector is now driving growth, contributing to a stronger GDP.

What does this mean overall?

The LEI increase points to continued—although slower—economic growth in the United States. Although the European debt crisis continues, it has not directly hindered the U.S. economy from

advancing at this point—though economists are not ruling out a slowdown in European growth next year, which could weaken U.S. economic improvement.

We continue to advise you to remain focused on your long-term financial plan, and to work with your MD advisor to ensure that your current mix of investments matches the strategic asset allocation that's appropriate for your financial purposes. ■

Proposed Harmonized Sales Tax (HST) for mutual funds

Ontario and British Columbia have announced that they will be following the lead of Newfoundland and Labrador, Nova Scotia and New Brunswick by harmonizing their provincial sales taxes with the federal Goods and Services Tax ("GST") as of July 1, 2010, to form a single Harmonized Sales Tax ("HST").

The HST will combine a provincial sales tax component of 8% with the GST of 5% for a combined rate of 13% in Ontario, and a provincial sales tax component of 7% for a combined rate of 12% in British Columbia.

MER Components	GST @ 5%	HST blended rate @ 10.10%
Management fee	1.50%	1.50%
Administration fee	0.10%	0.10%
Taxes	0.08%	0.16%
MER	1.68%	1.76%

Beginning July 1, 2010, MD Physician Services and MD Private Trust would normally be required to collect a combined 13% HST on management fees and administration fees charged to the MD funds and, in certain cases, the MD PIM pool funds. Currently, management fees and administration fees are subject only to the 5% GST. Pursuant to information released by the Department of Finance, the fund manager is allowed to calculate a blended rate for each fund, which is the rate to be applied to management and administrative fees as of July 1, 2010. The blended rate varies for each fund, depending on the location of the investors; however, the average blended HST rate for all the funds is 10.10%. While the blended

HST rate is less than the Ontario 13% rate, as the management expense ratio (MER) of a fund includes taxes, it is expected that the HST will result in an increase in a fund's MER.

As an example of the impact a higher tax rate may have on a fund's MER, the table above shows a hypothetical fund with a current MER of 1.68%. Applying a blended HST rate of 10.10% on the management fees and administration fees, instead of the current 5% GST, would result in an MER increase of 0.08%.

This chart is presented for illustrative purposes only. At the time of writing, the federal government had not yet finalized

the rules and regulations, nor the details regarding how the HST will be administered for mutual funds.

Please visit Canada Revenue Agency's website at www.cra-arc.gc.ca/ harmonization for more details regarding self-assessment requirements.

If you have any further questions, contact your advisor, or call 1 800 267-2332. ■

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