



PERSPECTIVES

Highlights

- ▲ While we are pleased the recession is behind us, we will continue to temper expectations until more concrete signs of a sustainable economic recovery emerge.
- ▲ Rising capacity utilization will be a strong signal that business and consumers are moving from paying down debt to producing and consuming assets. Our analysis suggests that only then will the global economy be on a sustainable growth path.
- ▲ We encourage investors not to wait on the sidelines, but to work with their MD advisor to refocus on portfolio purpose and rebalance according to purpose.

Year finishes on a high note, but sustained market rally depends on stronger economic growth

Housing, consumers, banks and credit remain key to unfolding recovery

Investor emotions ran high in 2009. Markets staged a dramatic comeback from the worst financial crisis in generations, delivering substantial gains starting at the end of the first quarter.

In early March, U.S. stocks were still down by half from their 2007 peak, and investors around the world were left wondering if sliding equities would ever hit bottom. By year-end, however, most major markets finished up 20% or better. After shaking off talk of a second Great Depression, equity markets soared as it became apparent that a recession, not a depression, was unfolding and this recession was also unlikely to last as long as initially feared.

We saw the Standard & Poor's/Toronto Stock Exchange (S&P/TSX) Index gain 35% over the course of 2009. The Morgan Stanley Capital International (MSCI) World Index finished 12% higher. Emerging markets were particularly strong, with the MSCI Emerging Markets Index posting a 53% gain.*

The impressive nine-month rally in 2009 left investors looking forward to 2010. And, as the year drew to a close, there were signs that equities might continue to draw strength from a global economy that appeared to be getting healthier.



We saw Canada's economic growth rate return to positive status in the third quarter. Real gross domestic product—the output of goods and services produced by labour and property located in the country—grew 0.2% in October, a second consecutive monthly advance. Production increased in most major sectors, as was the case in September. In the United States, real gross domestic product increased at an annual rate of 2.2% in the third quarter of 2009.

Oil prices spent most of 2009 moving higher, as demand for energy increased along with an improving global

* MSCI World, 11.78% in Canadian dollars; MSCI Emerging Markets, 53.0% in Canadian dollars (source: MSCI Barra website); TSX Composite, 35.05% in Canadian dollars (source: DEX).

economy. At year-end, oil was trading around US\$80 per barrel. Higher oil prices helped push Canada's resource-heavy stock market higher.

Record-low interest rates also supported markets. The Bank of Canada maintained its benchmark interest rate at 0.25%, a historical low, and reaffirmed its conditional commitment to keep rates on hold until the end of June 2010. The U.S. Federal Reserve maintained its key interest rate at between 0% and 0.25%. A recent Fed statement said rates were likely to remain low for an "extended period".

The United States lost 85,000 jobs in December after a November gain of 4,000, but the jobless rate held steady at 10%. Bullish analysts argued that, if the United States is turning the corner on job creation, it will spur consumer

spending and ultimately help exporters in Canada and around the world.

But with U.S. unemployment running at 10%—and as high as 17%, according to more comprehensive measures that include people who have given up looking for work—our analysis suggests there is no clear trend pointing toward a robust or swift economic recovery. On balance, we believe in the potential for improved global economic growth over the next few years, but the path this growth may take is uncertain.

What we can be certain of is that the current bull market in stocks will not continue without a strong economy to underpin it. To discern where the path to sustained economic growth lies, we continue to focus on four key areas: the U.S. housing market, U.S. consumers, the U.S. banking system and global credit markets.

The U.S. housing market

It is fitting that U.S. housing holds the key to any emerging economic recovery. The U.S. mortgage crisis was at the heart of the financial meltdown, and homes remain the most significant asset for the vast majority of U.S. consumers. Until housing prices recover, consumers will be wary about spending.

About one in four U.S. homeowners still have negative equity in their homes, which means their mortgages are higher than the market value of their homes. A full economic recovery will not happen until we see a significant reversal in this level of negative equity.

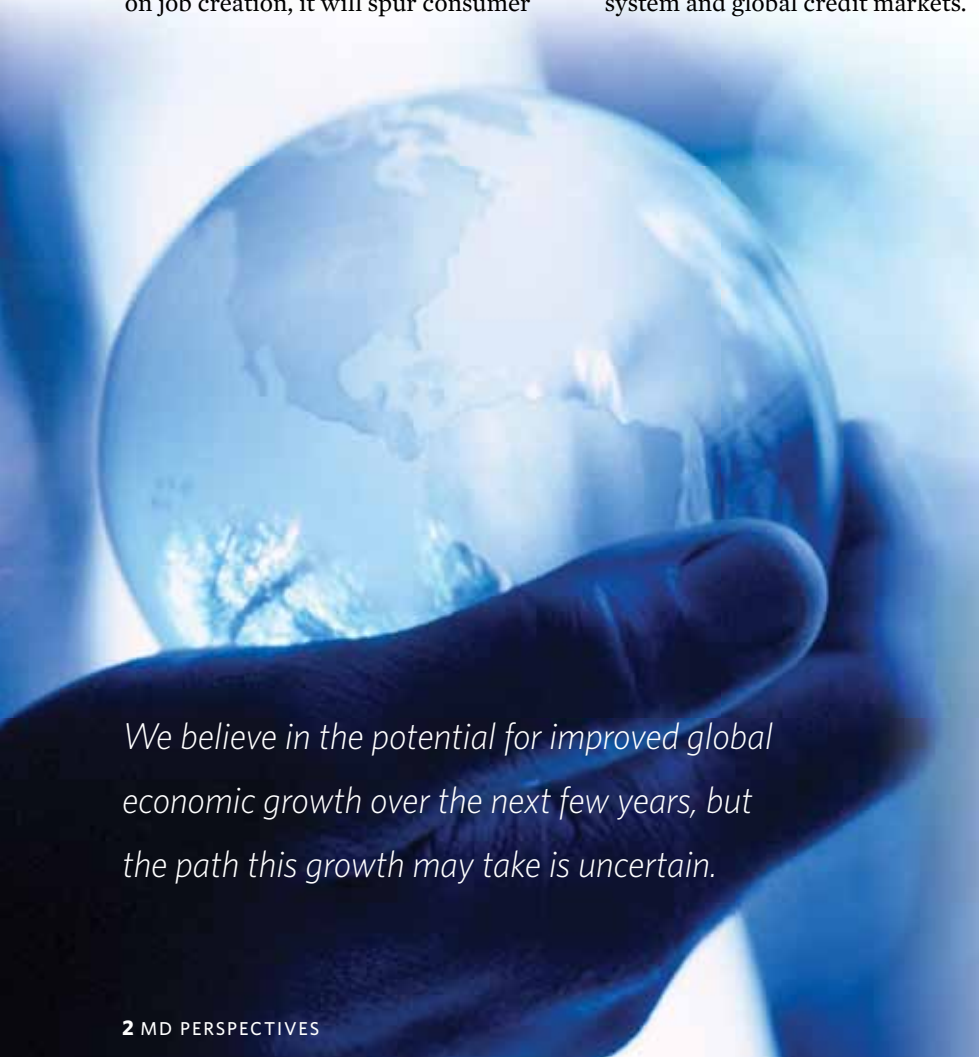
Another important gauge of the health of the U.S. housing market is the S&P/Case-Shiller Home Price Indices. In December, the annual rate of decline of the 10-city and 20-city indices slowed from November's reading. This marked roughly nine months of improved readings in these statistics; though still dropping, home prices have declined at continuously lower rates. In September 2009, the annual rate of decline in home prices was 8.5% for the 10-city index; in January 2009, the annual rate of decline was 19.4%.

Part of the drag on home prices is coming from the overhang of unsold homes on the market. The threat of another wave of foreclosures also exists; however, as foreclosed homes work their way through the market, prices will eventually begin to firm up.

Once prices appreciate, homeowners will start to feel more confident about spending and will do their part to boost the wider economy. But, for now, we see no clear, sustained growth trend in the housing market.

U.S. consumers

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In late December, the U.S. Commerce Department said spending climbed 0.5% in November after increasing 0.6% in October. Also encouragingly, household net worth in the United States—the difference between a household’s assets and liabilities—rose for the second quarter in a row, growing 5% to an estimated \$53.4 trillion in the third quarter, according to the U.S. Federal Reserve. This equalled a US\$2.7 trillion rebound in net worth.

This increase in net worth, though, was largely attributed to rising stock prices boosting the value of Americans’ investment portfolios. Many Americans will not have participated in this wealth creation, as household debt remains a major concern. And, when adjusted for inflation, the net worth of American households actually declined over the past decade. This compares unfavourably with the sharp gains seen in every previous decade since data were initially collected in the 1950s.

The Reuters/University of Michigan Consumer Sentiment Index climbed to just over 72 in December. Any reading above 50 indicates a positive level of consumer confidence. But as recently as January 2006, the index was at 90, so today’s level shows that consumer confidence still has room to improve.

Ongoing employment worries and household debt are perhaps the biggest impediments to consumer confidence and spending. Until consumers feel confident about their job prospects and their ability to manage debts, it’s unlikely that they’ll



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start to spend freely enough to propel the economy. On balance, our analysis points to continued downward pressure on consumer confidence.

The U.S. banking system

The initial wave of high-profile failures of financial institutions like

Lehman Brothers in September 2008 has subsided. We are also seeing relative stability in the top 19 U.S. banks, which account for roughly 65% of all U.S. banking assets. But there were still more than 100 U.S. bank failures in 2009. The average amount of assets at stake in each of these failures was around US\$1.6 billion. This is lower than the almost US\$3 billion average seen in 2008, but it is still of concern.

Positive results from stress tests conducted by U.S. banking regulators on 19 of the country’s largest banks in the second quarter of 2009 were borne out during the second half of the year. The tests showed that the banks have enough capital reserves to enable them to withstand losses and continue lending. Interestingly, stress tests were conducted using a projected unemployment rate of 10%, a level since reached in the United States. We will continue to watch banking stability closely as a marker of how the economy is likely to perform.

Global credit markets

Global credit markets will play a central role in any sustained economic recovery. Credit is the lubricant that keeps the global economic engine running smoothly. Without consistent and affordable access to credit, business cannot expand and drive economic growth.

Fortunately, global credit markets continue to normalize after seizing up in the wake of the financial crisis. At year-end, a key measure of risk in the credit markets—the difference (spread) between overnight indexed swaps (OIS) and the three-month London interbank offered rate (LIBOR)—was at 0.08%. OIS is based on the rates set by central banks and LIBOR is the rate that the biggest banks charge each other for credit. The lower the spread, the lower the risk perception associated with

extending credit. The current spread is now close to its historical norms. This stands in stark contrast to October 2008, when the spread was 3.6%—indicating that credit was frozen and banks were not inclined to lend, even to each other.

Despite the encouraging news regarding LIBOR spreads, however, the broader market still needs better access to credit if the economy is to return to a sustainable growth path. We are watching M3**, an important measure of the money supply, very closely. M3 is a broad measure of money supply that provides insight to how monetary assets are cascaded through the financial system. This measure is not growing strongly, which means significant amounts of money are sitting on the sidelines, in short-term monetary assets, and not working through to the wider economy.

Overall, our analysis is still calling for more liquidity and easier access to

credit as essential contributors toward driving a sustained economic recovery. We are waiting for a clear long-term trend to emerge, pointing toward improved liquidity in the broader monetary system.

Optimism on the rise, but no clear trend for 2010: volatility likely

We welcomed the impressive rally in 2009, but our analysis demands we resist the urge to chase returns as 2010 opens. Still, it is important to highlight that our prudence is not a prescription for complacency.

At the individual level, we continue to encourage investors to not wait on the sidelines. Instead, you should work with your MD advisor to refocus on your portfolio's purpose and to rebalance your portfolio, to ensure that your current mix of investments matches the strategic mix you have defined with your MD advisor. At the investment manager level, we continue to subject our investment managers to rigorous due diligence to

ensure that their interests and yours remain in synch.

We are pleased that the recession is behind us, but we will continue to temper our expectations until more concrete signs of a sustainable economic recovery emerge. Until then, we expect to experience more market volatility in 2010 as the global economy slowly grows stronger.

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 Financial at 1 800 267-2332 to be put in touch with an MD advisor near you. ▲

** The Federal Reserve Board has discontinued reporting on M3, but we source data providers who aggregate an M3 equivalent measure.



How this recession was different and what it means for the recovery

There is no denying the consensus view that we have emerged from recession. But this good news is tempered with a desire to forecast when the economy will return to a path of sustained economic growth. Or, to put it more bluntly: When will things return to normal?

To get a better sense of what to expect from the slowly unfolding recovery, we first need to understand the nature of the last recession and how it differed from previous recessions. There are four basic types of recessions: business cycle, single sector, exogenous and balance sheet. The most recent recession can be classified as a balance sheet recession.

Business cycle recessions

Business cycle recessions are the most common. They typically have what economists call an “income shock” at their root. Generally, rising inflation leads to higher interest rates as central bankers try to cool growth. If rates overshoot and dampen inflation and growth, the result is an economic slowdown. Businesses and consumers find the cost of borrowing too high in a high-rate environment and they are forced to cut back. This leads to layoffs, which, in turn, reduce consumer spending and confidence. A negative cycle of growth sets in, and a recession takes hold.

Single sector recessions

Single sector recessions can be thought of as bubbles unto themselves. The dotcom implosion was a prime example. These kinds of recessions are usually self-contained and limited in scope. Typically, a sector (technology, for example) becomes overvalued and companies can’t sustain unrealistic growth rates. Once investors lose confidence, there is a mass movement out of the sector and it collapses.

Exogenous shock recessions

As their name suggests, exogenous shock recessions are caused by an

external event. The most dramatic example was the 1973 oil crisis. When OPEC and other oil-producing nations initiated an oil embargo, prices skyrocketed and inflation took off. The resulting recession was deep and long.

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Balance sheet recessions

A balance sheet recession best describes this most recent recession. The financial crisis put much of the banking system on the edge of—or into—insolvency. Huge numbers of businesses are saddled with so much short-term debt that it is difficult or impossible to refinance in the current market. And after years of personal saving rates near zero, American households are heavily indebted.

Recovering from this kind of recession involves businesses reducing debt on their balance sheets—something economists call “deleveraging”. Reducing debt means businesses are less likely to borrow to fund new growth until the deleveraging process is complete.

A similar challenge faces consumers. Until consumers feel more secure about their job prospects and their ability to manage their debts, they will hold off on spending. This, in turn, limits economic growth. Another key element for consumers is their level of mortgage debt. One in four U.S. homeowners owes more in mortgage debt than that home

is worth—a situation known as negative equity. Home values will need to rise and pull homeowners out of negative equity before spending growth can resume.

To overcome a balance sheet recession, central bankers try to stimulate the economy by making credit easier to obtain. Cutting interest rates is typically the first step. Today, central bankers are also engaging in other moves—you will hear them use the terms “quantitative easing” (the purchase of government bonds) and “credit easing”.

For example, the U.S. Federal Reserve’s credit easing focus is on purchasing assets that are credit-related so that they can be replaced on corporate and bank balance sheets with cash. This move is aimed at making cash available to lend to consumers, which, in turn, should give businesses more confidence to borrow while also stopping the deleveraging process.

Signs of a sustainable recovery

A very important measure to watch as the economy recovers from any recession is the capacity utilization rate. “Capacity utilization” refers to the extent to which an economy actually uses its productive capacity. It tracks what is produced (output) against the potential output that could be produced if capacity were fully used.

In November 2009, capacity utilization for all U.S. industry moved up 0.7 percentage points to 71.3%. This figure was still 9.6 percentage points below its average for the period from 1972 through 2008. Rising capacity utilization will be a strong signal that business and consumers are moving from a position of paying down debt toward producing and consuming assets. Our analysis suggests that only then will the global economy be on a sustainable growth path. ▲

Fund manager enhancements help meet our clients' needs

Recent strategic enhancements will help investors achieve their long-term investment purposes more effectively

At MD we work behind the scenes to manage the MD funds by researching, selecting, combining and monitoring some of the world's best investment managers. We follow a rigorous investment management process to help develop, and then refine, our investment solutions as our clients' needs, market conditions and investment manager characteristics evolve over time.

Following a thorough search and due diligence process, we've recently made enhancements to two of our MD funds. These changes are designed to help meet your changing and complex financial needs.

Thornburg Investment Management Inc.

Thornburg Investment Management Inc. has been selected as lead fund advisor of the MD International Growth Fund. Investors will benefit from Thornburg's disciplined investment approach and diligence in uncovering great investment opportunities. Thornburg is an employee-owned investment management company with a clear mission: to preserve and increase the real wealth of investors, after accounting for inflation, taxes and investment expenses. Thornburg accomplishes this through a range of equity strategies and by concentrating on uncovering great growth opportunities. Thornburg analyzes



promising companies with sound business fundamentals, while seeking to identify and minimize any downside risk.

Mackenzie Financial Corporation

At our direction, Howson Tattersall Investment Counsel, a co-advisor to the MD Dividend Fund, will now employ the expertise of Mackenzie Financial Corporation's Maxxum investment team to advise Howson Tattersall regarding the equity portion of the portfolio it manages. Mackenzie's Maxxum team practises a bottom-up approach, with a focus on quality

companies that exhibit attractive valuations. The team believes that future earnings and cash flow growth are the key determinants of rising stock prices and, over longer periods of time, that consistent, secular growth companies provide superior risk-adjusted results.

At MD, we're committed to helping physicians and their families realize the full benefits of careful planning, personalized advice and tailored financial solutions. To learn how our approach can benefit your portfolio, talk with an MD advisor today. ▲

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