

“Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years.”

Warren Buffett



WATSON DI PRIMIO STEEL

Investment Management

Knowledge Discipline Integrity

Volume 5, No. 1

June 2009

Investment Perspectives

Over the Horizon – Recovery?

In our last *Perspectives* we spoke of the upcoming year as a period of uncertainty and then opportunity as the fundamental global economic picture eventually improves. As of this writing, we have now witnessed global markets rally on average 30% from the severe market bottoms created this past March. It appears that the all-pervasive fear has evolved toward a view of scepticism and may now be approaching a mild optimism. In our view, due to the concerted efforts of both global monetary and fiscal stimulus, world markets have priced in a dodging of a protracted economic downturn or depression. There are legitimate reasons for this rebound: the downside risks to the world economy have eased and investor confidence has improved.

Although global markets have rebounded considerably over the past three months, on reduced risk and signs of improvement in the economic trends, expanded stock market valuations based on current

earnings could be argued to be reasonably valued in the current low interest rate environment. In light of this, we now enter an important period where the corporate earnings outlook over the next year should begin to improve. This phase will be necessary in order for equity markets to advance further and is capable of occurring despite worsening U.S. and Canadian unemployment statistics which are traditionally lagging indicators to future economic growth. In fact, the Canadian and U.S. unemployment rates have now reached 8.6% and 9.5% respectively. Many economic commentators expect the U.S. rate to breach 10 to 11% within the next 12 months. The upcoming period exemplifies the old Wall Street adage of the market “climbing a wall of worry”.

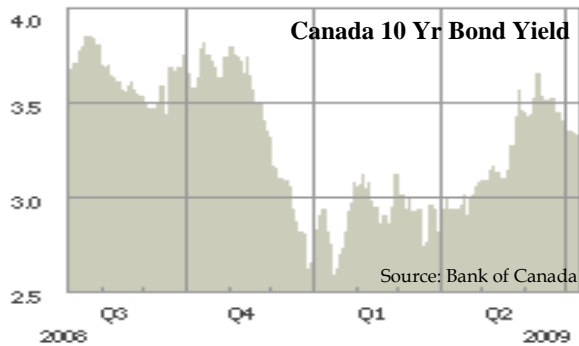
As always, we thank you for your continued confidence and support.

Equities:

The charts to the left display the 12-month price performance of the S&P/TSX Composite (TSX), the S&P 500 and EAFE indices. For the first six months of this year, the TSX provided a return of 17.6% on a total return basis. In U.S. dollar terms, the S&P 500 returned 3.2% year-to-date and the EAFE returned 5.6%. Once again the strength of the Canadian dollar has substantially reduced the U.S. dollar returns to -2.2% and 0.2% respectively.

In Canada the strong performance of the TSX was led primarily by the energy and financial sectors. Both areas maintain a heavy weighting in the index. The onset of the credit crisis battered each of these sectors

hard and now their outperformance from very depressed levels suggest a much improved market sentiment towards an economic recovery. The U.S. market, although led by gains in the technology sector, continues to lag in various other areas and also against both the Canadian and world markets. This may be indicative of the continued economic issues that the United States confronts as a nation. In international markets, equities of many of the developing countries, specifically China, are outperforming once again as they were prior to the onset of the global recession.



Fixed Income and Interest Rates:

Since the end of last year, the Canadian overnight target rate has fallen from 1.50% to a low of 0.25%. Meanwhile, the U.S. Fed funds rate has remained in the range of zero to 0.25% over the same time period. In the continuing efforts to ensure that financial markets stay flush with liquidity, both the Canadian and U.S. central bank policy rates remain at historic lows. Conversely, the yield on the 10-year Canada bond, as illustrated in the chart to the left, has risen from 2.69% to 3.36%. Similarly in the United States, the yield on the 10-year U.S. Treasury has

moved up even sharper from 2.25% to 3.52%. The upward sloping yield curves are a healthy sign that financial market participants may be pricing in future growth and inflation expectations. A vastly different perspective from the year end when both yield curves were flashing strong warning signs of deflation risks to our economies. Even so, some market participants view the steep rise in U.S. treasury yields as a worrisome sign of lower demand for their debt due to the downward pressures on the U.S. dollar and their ballooning U.S. budget deficits.

Currencies:

After experiencing a steep drop during the final quarter last year, the Canadian dollar has once again gained strength against the U.S. dollar and, as a consequence, has held back returns from international markets. Our dollar has risen from \$0.82 at the beginning of the year to just over \$0.86 at the end of June, representing an increase of approximately 4.5%. As sentiment improves towards a recovery in the global

economy, the Canadian dollar continues to move in positive correlation with strengthening commodity prices and in particular world oil prices. Likewise, as we witnessed prior to the financial crisis, the U.S. dollar has yet again displayed weakness against other major world currencies (Euro, Pound, Yen) while the inflows/flight into the dollar reverse.

\$CDW (Canadian Dollar Index) INDX
30-Jun-2009 Open 86.82 High 86.87 Low 85.94 Close 86.01 Chg -0.41 (-0.47%)



\$WTIC (Oil - Light Crude - Continuous Contract (EOD)) INDX
30-Jun-2009 Open 71.60 High 73.38 Low 68.90 Close 69.89 Chg -1.60 (-2.24%)



\$GOLD (Gold - Continuous Contract (EOD)) INDX
30-Jun-2009 Open 937.90 High 945.10 Low 923.50 Close 926.60 Chg -11.20 (-1.19%)



Commodities:

Subsequent to a period where the markets were pricing in a severe global recession, most commodity prices have begun to recover from their steep declines over the past year. Of particular note, the price of crude oil, gasoline and copper have experienced sharp rebounds from their recent bottoms. From the beginning of the year, the price of oil has climbed 56% from US\$45 per barrel to almost US\$70. Meanwhile, again in U.S. dollars, gasoline prices have risen 79% and copper prices have rebounded 70%. Generally, all three of these commodities are good early indicators

of a future pickup in worldwide industrial demand activity. Moreover, despite the deep global recession, Chinese demand for industrial commodities has been particularly strong. With China leading the global recovery, the Chinese have already begun to restock their inventories. Also noteworthy, has been the relatively weak performance of gold prices. Although very volatile, the price of gold has risen a modest 5% from US\$884 at year end to \$927 by the end of June. This may be indicative of stronger recent outflows as the flight to gold as a safe haven abates.

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