

Towers Perrin Market Review - April 1 to June 30, 2009

The dominant economic theme during the second quarter of 2009 was the perception that “green shoots of recovery” were beginning to emerge in the global economy. This was not to suggest that the recession was over, as many economies continue to show contraction in Gross Domestic Product and report continued job losses. Rather, it was based on the fact that the rate at which things were getting worse had slowed substantially. Industrial capacity utilization is running at extremely low levels further suggesting that a robust recovery is still some distance away. In the United States, the Purchasing Managers Index, a gauge of economic momentum, rose for the second straight month (in April) although it is still below the boom/bust line (indicating continued contraction). The U.S. Consumer Confidence Index has risen significantly from its February low, but is still showing negative sentiment around both economic expectations and the labour market. Canadian consumer confidence data continues to be much more positive than that in the U.S. In the United Kingdom, things look less positive, as the government is piling up a massive debt load and Standard & Poor’s recently announced that they have put the U.K.’s sovereign debt rating on negative outlook. In Canada, inflation (as measured by CPI) turned negative in June falling 0.3% from June 2008 levels; this represents the first twelve month decline since 1994 and is primarily due to two factors: the 25% decrease in energy prices over the period and the decrease in both housing prices and mortgage costs (due to decreasing interest rates).

The various government programs to support the banking system and provide liquidity to lending markets appear to be working. Several banks, including Goldman Sachs and JP Morgan, has repaid the money that was provided to them under the U.S. Troubled Asset Relief Program (TARP) and are posting better than expected financial results. The Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program (PPIP) have removed some of the toxic assets from bank balance sheets in the U.S. and have helped to bring liquidity to the asset-backed securities markets and the high yield debt markets. The U.K. government’s massive support for the banking system has maintained the viability of several major U.K. banking institutions and their quantitative easing (debt buy-back) program has provided needed support for the bond market. Central banks in the developed countries continue to use all the available monetary policy tools, maintaining the rate at which they lend to banks at the lowest levels in history (most G7 countries have rates at or below 1%). This is not to suggest that the banking crisis is over, as the recent solvency problems of CIT, a key U.S. commercial lender, illustrate.

Bond markets are beginning to return to more normal conditions. Government yield curves have risen rapidly, as investors have stopped their panicked “flight to quality”. In the United States, the yield on 10-year Treasury bonds has increased from 2.46% at December 31 to 3.55% at June 30th, while comparable Canadian rates have increased from 2.69% to 3.45% over the same period. At the same time, corporate bond yields have begun to decrease, as investors recognize that corporate bond yields were adequately compensating them for the risk of default and as the various market programs injected liquidity back into the corporate bond market. In the United States, corporate spreads (the difference between the yield on a corporate bond and a comparable term Treasury) have narrowed to “normal” recession levels. In Canada, the combination of a 1.3% drop in corporate bond yields (DEX Corporate Bond Index) and the rise in government bond yields has resulted in much better returns for corporate bonds than government bonds; the DEX Universe Bond Index posted a return of 1.3% over the quarter. In the U.K. market, this difference was at an extreme, as the corporate bond index outperformed government bonds by 7.7% over the second quarter.

Equity markets have continued to stage a remarkable recovery (began in early March) over the second quarter. There continues to be tremendous volatility from day-to-day and the market continues to over-react to news (both positive and negative). The first part of the market rally (up to early June) is now being recognized as a “junk” rally, with companies that were hurt most during the downturn (often for valid reasons) producing the strongest rebound. In the U.S. market, for example, companies whose credit rating was B or lower (i.e., close to bankruptcy) produced stock returns that were more than 3 times those of highly rated companies. Over the quarter, equity markets around the world produced double digit returns. The Canadian market surged 20% over the quarter. The MSCI World Index posted a return of 16.7%, although this was reduced by 5.0% (to 11.7%) for the unhedged Canadian investor primarily due to strengthening of the Canadian dollar relative to the U.S. dollar and the yen. As further evidence of the equity investor’s renewed appetite for risk, the emerging markets and small cap indices posted the best

performance for the quarter. For the Canadian market, the strong performance came primarily from the Financial Services sector, the Energy sector (aiding by rising oil prices) and Research in Motion. In the rest of the World, performance was much more broad-based for the quarter, with most sectors (except Health Care and Telecoms) posting double digit returns, although Financial Services stocks again led returns (at 32%). Global performance was driven by the Asian markets, as Japan posted a 20.2% return. In contrast, the major European market (U.K., France and Germany) posted returns between 10% and 17%.