

Towers Perrin Market Review – January 1, 2009 to March 31, 2009

The deep and synchronized recession that is battering the global economy has led governments to take unprecedented action. The United States continues to be among the worst affected countries, with GDP contracting by 6.3% on an annualized basis during Q4 2008, but much of Europe and Japan is also reporting significant declines in GDP. Canada reported a 3.4% annualized decline in GDP during Q4 and even the optimistic Governor of the Bank of Canada is now expecting worsening economic news. Job losses continue to mount globally (as companies slow production in response to falling sales), driving unemployment rates sharply upward. The consumer in many countries has dramatically slowed spending (e.g., retail sales in the U.S. and Canada are down 10% and 5% respectively during the early part of 2009), with the auto sector being among the worst hit.

At the G20 meeting in London, global leaders pledged to work in concert to ensure that national policies do not take precedence over global needs, including a commitment not to restrict international trade and to continue to finance developing countries. Central banks in the developed countries are emptying their monetary policy toolboxes. They have lowered the rate at which they lend to banks to their lowest level in history, with rates in both the U.S. and Canada now at 0.25%, the U.K. at 1%, the EMU at 2% and Japan at 0.1%. Many central banks are now employing techniques referred to collectively as “quantitative easing” (such as purchasing their sovereign bonds) to attempt to lower interest rates at the long end of the yield curve and improve debt financing for companies. Governments in many countries (particularly the U.S. and U.K.) are implementing massive spending programs that are likely to have countries running deficit budgets for a number of years. Canada is likely in better fiscal shape than most countries, as we began the period with a history of significant surpluses and low levels of debt relative to GDP and our fiscal spending program is relatively modest. Governments have also introduced a wide variety of programs to permit banks to repair their balance sheets and to encourage them to lend money to creditworthy customers. While these monetary and fiscal policies may ultimately prove to be inflationary, current concerns are more about the possibility of deflation.

Bond markets continue to show signs of marked dislocation, as liquidity issues continue to dominate market behaviour. Government yield curves are very steep, with short term rates being driven to near zero by central bank policy. 30-Year government bond yields in the U.S. and Canada are hovering around 3.5% at March 31 (for the U.S., this is up sharply from the December 31 rate of 2.7%). In Canada, provincial bond yield spreads continue to be high due primarily to the flight to Canada bonds. In many parts of the world, investment managers have limited ability to trade corporate names (particularly those lower in the credit spectrum). Corporate spreads (the difference between the yield on a corporate bond and a comparable term sovereign government bond) remain extremely wide; for example, in the U.S., spreads are at levels not seen since the Great Depression and show few signs of narrowing significantly. This is making it very difficult for companies (even those with solid credit ratings) to obtain debt financing to help them weather the economic storm. The Canadian bond market was one of the best performing bond markets in the world, as the yield on long-term government bonds remained relatively stable and corporate spreads actually narrowed significantly; this is at least partially due to the favourable press being accorded Canadian banks (as Financials comprise over 60% of the corporate portion of the Canadian bond index). Yield spreads on U.S. financials remain extremely wide. It may require evidence of significant improvement in the strength of global economies before credit spreads outside Canada narrow significantly.

Equity markets continued to fall sharply through January/February, but have staged a rally since early March. At this stage, the global rally seems to be primarily in lower quality highly leveraged companies and only time will tell whether we have seen an actual market bottom. As the market becomes convinced that the end of the recession is approaching, one should expect that higher quality companies will take on the market leadership role. While day-to-day volatility

has calmed somewhat from the October/November roller coaster, it is still far higher than would be expected in normal market conditions. No developed markets were able to produce positive returns during the first quarter, as Financial stocks continued to drag markets downward. The Canadian market fared better than many markets (down 2%) largely due to the relatively strong performance of Canadian banks and insurance companies (particularly during March) and the strong performance of Research in Motion and Potash. In the global markets, the Financial, Utilities and Industrial sectors led markets downward over the quarter, with returns of -20%, -15% and -15% respectively and Information Technology was the only sector to post a positive return (+2.4%). The U.S. market was down 11% over the quarter and major European markets were down between 10% (UK, Switzerland) and 17% (Italy). Asia posted better results, with Japan being the worst market at -9%. The emerging markets were the one global bright spot, with a return of +3%, although this was perhaps more related to a rebound from the horrendous beating they took in Q4 2008.