

BF&M Investment Matters



GLOBAL OUTLOOK

DEVELOPED EQUITY MARKETS COULD CORRECT

Markets have risen strongly and could decline if economic fundamentals deteriorate

BUY EQUITIES ON MARKET CORRECTIONS

Stocks look good in the near-term given the lack of alternative return potential in other asset classes

EMERGING MARKET S TO OUTPERFORM

Emerging markets should remain stable while developed markets may stutter.

PREPARE FOR NEW NORMAL

GDP growth of 2 to 3% in the future is more likely, as opposed to historic rate of 4 to 5%.

PROTECTIONISM MAY HAMPER GLOBAL GROWTH

In response to the credit crisis, stronger regulations and stringent lending practices may hamper global access to capital and thus global growth.

DIVERSIFICATION BENEFITS TO RE-EMERGE

When investors risk tolerance returns, they may seek global opportunities along with other asset classes that were abandoned last year.

Financial Market Review - June 30th, 2009 to September 30th, 2009 Is this Stock Rally Sustainable?

A year on from the demise of Lehman Brothers and a global financial crisis, it seems the market has found a sweet spot. The stock market often does not move in a logical way. Trying to predict the mass action of thousands of investors, most of whom are investing on a rational basis, will not necessarily lead you to the market response.

Even within worsening, or poor, economic conditions markets can still post very meaningful rallies. Japan has been an excellent example of this having sustained seven rallies of more than 35% in the last 20 years despite a long term downward trend (Chart 1).

At times like these, a rally sweeps our spirits up with it, but investors need to evaluate their emotions and consider whether their beliefs and actions are justified. The market's latest hot streak makes the future feel predictable, but it isn't.

This rebound is a dilemma. On the one hand it reflects that panic has subsided and has confidence returned. It also aids in the strengthening of the battered balance sheets of individuals and businesses which is required for a sustained recovery. However, it may be wiser to focus on real production and data to determine if the economy has embarked on recovery.

If previous rule of thumb valuations are considered, markets may be becoming over-valued. The S&P 500 has already risen to 18 times 10-year average earnings -- above the long-term average. The task for market participants now is to assess whether there is value in equities and corporate bonds after recent advances.

Financial markets have stabilized and investors' appetite for risk is returning. The worst appears to have passed for the

global economy given recent data and corporate earnings are improving. In the past quarter, the Conference Board, the International Monetary Fund and even U.S. Federal Reserve chairman Ben Bernake have suggested the recession is waning. The U.S. economy isn't contracting as fast as it was six months ago and there are modest signs of growth. In both Europe and the US companies are making less use of the emergency facilities put in place by central bankers.

The main reason to think the rally could continue is due to supportive monetary and fiscal policy. With yields on fixed income so low and deposit yields at almost zero, stocks look attractive. Given the amount of cash on the sidelines waiting to be invested this could propel markets even higher (Chart 2).

However, risks remain for a continued advance of the markets. The economic recovery could lose steam in a few quarters as government stimulus wanes. A sustained global recovery depends on renewed growth in consumer spending and capital investment. The coming expansion could be restrained by cautious consumers in the U.S. and Europe, who are either dealing with job losses or who are saving to replace depleted assets and reduce debt burdens.

The second-quarter earnings season has seen positive surprises but recent growth has been propelled by inventory reductions and short-term stimulus packages such as the cash-for-clunkers deal with autos. Sustained domestic demand is needed for solid support for the economy. Continued sales growth at companies is essential for earnings to be a solid basis for further stock gains.

There is a rising possibility of a double-dip recession based on the timing

of exit strategies from the massive government supports. If governments take large fiscal deficits seriously, they will raise taxes, cut spending and mop up excess liquidity. If too soon, they will undermine the recovery and tip the economy back into recession. But if they maintain large budget deficits from the fiscal stimulus for too long, then inflationary expectations will increase. Long-term government bond yields would rise and borrowing rates will go up sharply, leading to slowing economy with rising inflation.

Outlook

At this juncture, it is unclear whether this is a sustained recovery, or a period of short term relief before a decline in equities. Instinctively, a recovery feels like a real possibility. But equally, the black days of late 2008 and early 2009 are too recent to be consigned to history by individual investors.

Going forward, it will be an economics-driven financial environment. Monitoring data releases will be essential to assessing the health of the recovery. Some improvement is being seen; in housing, consumer confidence and global trade. Large fiscal deficits are not favorable for government bonds or the U.S. Dollar. Cash with no yield is a poor investment. So where will the money flow? Stocks are the only asset class that can offer the potential for positive returns over the short term horizon.

All these factors imply that any setback is unlikely to test the March lows. Beyond some healthy sell off in the short term, global equities are likely to climb the wall of worry over the long run. The pace and magnitude of the recovery will surely wane over the coming quarters. Any corrections should be viewed as an opportunity to add to stock allocations.

Chart 1

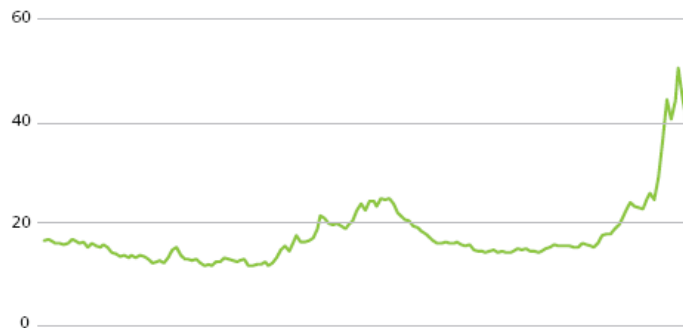
Chart 15: Japan has seen seven rallies of more than 35% in the last 20 years
Performance of Japan Nikkei index



Source: Credit Suisse

Chart 2

Chart 17: Cash piles remain very high
US money market funds relative to US market capitalisation (%)



INDEX / CURRENCY	VALUE	U.S. DOLLAR 2009 YTD
S&P 500	1030.95	17.03%
Dow Jones Industrial Average	9,695.42	10.66%
Nasdaq	2,027.08	34.58%
Toronto Stock Exchange	10,760.73	44.48%
Brazil Bovespa	61,545.50	114.59%
S&P Europe 350	1,000.19	30.54%
UK FTSE 100	5,104.50	26.80%
Japan Nikkei 225	9,802.95	15.57%
Hong Kong Hang Seng	21,620.19	45.65%
Australia S&P/ASX 200	4540.40	60.10%
Euro	1.464	4.79%
Pound	1.598	9.51%
Yen	89.70	1.05%
CRB Commodity Index	259.39	13.00%

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Past performance is no guarantee of future returns
Sources: Wall Street Journal, Bloomberg LLP, Morningstar, FT, Marc Faber, Gloom Boom and Doom.