MFC Global Investment Management®

WEEK IN PERSPECTIVE

FEBRUARY 12, 2010

Is the Consumer Ahead of the Curve?

The sovereign debt issues of Greece continued to be a focus of attention during the week. Despite the unresolved issues of how the EU will deal with Greece, markets managed to move forward, albeit modestly.

There was little in the way of economic news that carried a significant impact on the markets. US Retail sales were up in January by 0.5%; excluding auto sales, retail sales were up by 0.6%. The results were above expectations and more importantly, core retail sales - sales excluding motor vehicle dealers, building material suppliers, and gasoline station expenditures - rose 0.8% in January after declining 0.3% in December. Consumers were likely spending away their blues in January as overall consumer sentiment weakened (measured by the University of Michigan Consumer Sentiment Index). The index fell to 73.7 from 74.4; consensus expectations were for a gain to 75.0.

While more and more attention is focused on government debt, which has ballooned around the world in the aftermath of the "great recession" and record fiscal stimulus, it appears that the US consumer is finally getting their debt under control. In 2009 US consumer debt fell by 4% from US$2.56 trillion to US$2.46 trillion, only the second time since 1945 that total debt has fallen in a calendar year. Credit card debt fell by 9.5%, the first such decline since 1969. The de-leveraging by the consumer has become reality. The near-term impact is weaker consumption growth in the US which will likely keep economic growth below trend once the fiscal and monetary stimulus comes out of the system. The long-term benefit is much healthier household balance sheets.

Corporate earnings continue to be quite positive in Canada and in the United States. Of the 379 S&P 500 companies that have reported, 74% have beaten expectations, 9% have met expectations and 17% have missed. The results are a little more balanced in Canada as 58 companies have reported with 32% having beaten expectations, 34% met and 34% missed. Expectations were high going in to the earnings season and much of the good news had already been priced in. As such, it is not a surprise that the positive results haven't had more of a positive impact on equity markets.

The recent correction took the S&P 500 back 8.1% from its high on January 19 through to the low on February 8. In Canada, the S&P/TSX fell 7.2% since its high on January 8. During this period Canadian Small Cap companies marginally outperformed, which is consistent with the view that small cap companies are in a position to continue to outperform large in 2010. The BMO Small Cap Index's peak coincided with the peak in the S&P 500 Index on January 19. The index fell 7.0% through February 4 when it reached its low, marginally outperforming the large cap index. More impressively, year to date small cap companies have returned a gain of 1.5%, outperforming the S&P/TSX Composite Index which has fallen by 2.4% over the same period.

Ted Whitehead, Vice President and Senior Portfolio Manager for the Manulife Growth Opportunities Fund comments, "We continue to believe that small cap companies will outperform in 2010. Historically small cap companies have been more sensitive to an economic recovery, and while the recovery may not be as strong as prior experiences, growth is still positive. Additionally, last year Canadian small cap companies raised approximately $63 billion through equity issues, with much of that cash still sitting on their balance sheets. We are already starting to see merger and acquisition activity pick up with the large cap companies. We believe m & a activity will pick up within the small cap space. Lastly, from a valuation perspective small cap companies are trading at a 20% discount to large caps when measured on a price to book value multiple and are 14% cheaper than their historical P/B multiple. Our contention remains that in this environment small caps have the potential to deliver better results on the upside with similar results on the downside."

MFC Global Investment Management®