FOCUS

Desjardins Securities

VOLUME XXII, NO. 6, JUNE 2011

EDITORIAL

ED SOLLBACH, CFA
PORTFOLIO STRATEGY AND
QUANTITATIVE RESEARCH ANALYST

RETAIL STRATEGY

"We believe it makes sense to build a core portfolio around high-yielding stocks that can deliver 3–6% returns just from dividends."

In this edition of the *Focus*, we examine recent market-related developments as we enter the traditionally weak summer season, and how the bond and stock markets will be affected as the US Federal Reserve ends its massive quantitative easing program at the end of June. We re-emphasize the need for stocks that offer attractive yields vs bonds and cash as core holdings in a diversified equity portfolio.

MARKET UPDATE

The S&P 500 corrected 6.5% between mid-February and mid-March on concerns about US$110 oil, war in the Middle East, and the earthquake and potential nuclear meltdown in Japan. The commodity-heavy TSX, however, suffered its major correction later—in April and early May—losing 6% as frothy commodities like oil and silver corrected following an abrupt strengthening of the US dollar on renewed concerns about a sovereign debt default in Greece.

The large divergence in recent performance between the TSX and S&P 500 has prompted investor concern north of the border. We would point out that over the medium term, the S&P 500 generally leads and the TSX follows, not the other way around. Thus, the oil and commodity-induced negative divergence for the TSX is usually resolved positively for the TSX.

OIL PRICES

We had been worried that rising oil prices would hurt US consumers and the fragile US economic recovery, so we welcomed the fall in oil prices despite the collateral damage suffered by the TSX because of its 26% energy weight. Except for 2008 when plunging US housing prices threatened the entire financial system, falling oil prices have been positive for stocks and the economy. As a case in point, oil prices plunged 25% in the month after the start of bombing in Iraq I and II, while stocks gained 25% over the following three months. We believe oil prices could fall further once the conflict in Libya is resolved, as fighting around the oilfields has halted exports from Libya for now.

Despite high oil prices, US consumer spending has been remarkably strong and the US economy has generated enough private sector jobs over the last three months to bring down the unemployment rate slightly.

BOND YIELDS AND STOCKS RISE AND FALL TOGETHER

Worries about the economic recovery have resulted in a drop in bond yields of approximately 60 basic points (bps), and bonds have become more expensive while stocks have become cheaper. We believe the economy will benefit from both lower oil prices and lower lending rates—in turn stimulating the US housing sector, which continues to struggle. Stronger economic reports should then result in more risk being taken on, as bond yields and stocks rise together for a short-lived summer rally.

Another catalyst for higher bond yields is the ending of the US Federal Reserve's US$600b bond purchase program at the end of June. The Fed's bond purchases have amounted to about US$110b per month, monetizing all of the (unsustainable) US$1.5 trillion deficit. Yields will have to rise to entice private buyers to step up and buy these bonds. Fed studies, as well as our analysis, suggest US bond yields may rise by 50–75 bps before finding equilibrium.

The Fed instituted quantitative easing last summer as inflation was too low, but rising oil and commodity prices since then have resulted in worries about inflation, especially in emerging markets, where rising food prices are the main worry for consumers. Both inflation and deflation would be bad for stocks: deflation could result in another financial crisis while excessive inflation would erode the value of financial assets like stocks and bonds. This illustrates the

CONTINUED ON PAGE 2

difficulty for investors—central bankers and policymakers must tread an extremely fine line and, even if they manage to successfully walk this tightrope, the considerable risk of policy errors suggests that higher multiples on earnings are not justified at this point. Nevertheless, earnings growth should continue to drive stocks higher—we expect S&P 500 earnings growth of about 15% in 2011 to all-time record earnings of US$96. As the recovery ages, earnings growth will continue to slow and we expect at best high single-digit growth in the longer term.

INVESTMENT STRATEGY

We maintain our positive stance on equities, though we believe investors should continue to be selective in their investment approach, especially when markets become more volatile. Hence, we advise that investors take advantage of corrections to buy companies with growing profits (ie rising return on equity (ROE)) or high ROEs. Moreover, given our view that stock market gains will diminish as the bull market ages and as the US Federal Reserve tightens monetary policy, we continue to recommend high-yielding stocks that offer attractive yields vs bonds and cash as core holdings.

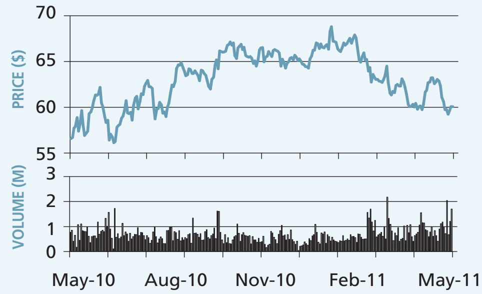
Indeed, we believe it makes sense to build a core portfolio around high-yielding stocks that can deliver 3–6% returns just from dividends and that can approach long-term market returns going forward, especially when the market stalls or corrects. Currently, the TSX has an average yield of 2.4%, while TSX banks yield about 3.6%, REITs about 5.5%, telecom about 5%, and some former energy trust companies like Crescent Point (Focus 15 list) more than 6%. Returns from dividends are an important component as we enter the seasonally weak summer period.

Stocks without dividend protection have generally been more volatile over the past year. We note that more than half of the TSX sectors have seen corrections of 10% or more over the past 10 months as this momentum-driven market is constantly rotating between sectors.

Our Focus 15 and institutional portfolios both yield more than the TSX, a deliberate "core + more" strategy—ie a "core" portfolio built around high-yielding stocks, with the "more" comprising stocks with superior profit growth.

RECOMMENDATIONS

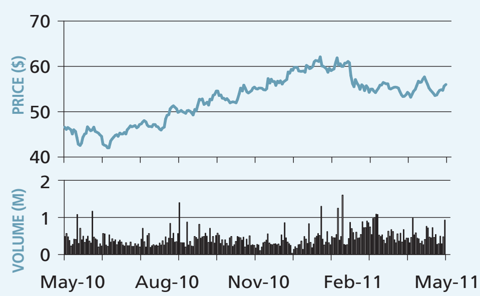
CANADIAN PACIFIC RAILWAY LIMITED (CP)



RATING	BUY–AVERAGE RISK
Target	$72.00
Symbol	CP
Exchange	TSX, NYSE
Recent price	$60.08
Total potential return	22%
52-week range	$56.11–68.82
Shares O/S	169.4m basic, 170.7m FD
Market cap	$10,178m
Year-end	Dec-31
Revenue	2011E $5,352m
	2012E $5,818m
Adjusted EPS	2011E $3.71
	2012E $5.07
Dividend yield	2.0%

Sources: Desjardins Securities, company reports, Bloomberg

SNC-LAVALIN GROUP INC.



RATING	BUY–AVERAGE RISK
Target	$64.00
Symbol	SNC
Sector	Engineering & construction
Recent price	$56.01
Total potential return	16%
52-week range	$41.59–63.23
Shares O/S	151m basic, 152.2m FD
Market cap	$8,456.2m
Year-end	Dec-31
EBITDA*	2011E $472m
	2012E $577m
EPS*	2011E $2.06
	2012E $2.50
Dividend yield	1.5%

*Excluding Infrastructure Concession Investments
Sources: Desjardins Securities, company reports, Bloomberg

- CP volumes to recover following challenging weather conditions
- Improving operating ratio should drive strong EPS growth over the medium term
- Attractive valuation provides solid risk/reward proposition

CP provides rail and intermodal freight transportation services in Canada and the US midwest and northeast, and is the second largest Canadian railroad in terms of revenue behind CN.

Freight volumes are down 4% in the year to date (vs our forecast of +1%) following very challenging weather conditions with heavier-than-usual snowfall during the winter and ensuing floods in the spring. However, CP's operations are recovering from the toughest winter in decades, and many commodity groups are expected to see an increase in volumes as fluidity returns to the network. We expect volumes to increase by 7% in 2012.

CP reiterated its intention to reach an operating ratio (operating expenses/revenues) in the "low 70s" in the next 2–4 years, despite the significant setback in the first quarter of 2011 resulting from the challenges posed by the weather and higher fuel prices. Our forecast for 2012 is 75.7%, and we continue to believe that CP is on track to meet its target. As a result of the company's leaner cost structure, we anticipate that increased volumes should have a larger impact on EPS in the coming years.

Given its recent share price decline, CP's current valuation presents an attractive risk/reward proposition for investors. Based on consensus estimates, CP is trading at a 2012 P/E multiple of 11.9x vs 14.4x for CN—the largest spread since early 2009. In addition, CP recently increased its dividend by 11% to $1.20/share, which translates into a dividend yield of 2.0%.

Our $72 target for CP is based on the average of three valuation methods: a 15x P/E multiple on our 2012 adjusted EPS estimate, an 8.0x EV/EBITDA multiple on our 2012 EBITDA estimate, and a discounted cash flow valuation.

- Noise from geopolitical instability opens a window of opportunity for investors
- SNC should be able to compensate for the "Libya" gap with prospects in its other markets
- Improving performance from US peers should support SNC's valuation

SNC continues to show a rock-solid balance sheet, with $650m of freehold cash ready to be deployed into new acquisitions and investment opportunities to underpin long-term shareholder value. Its most recent acquisition—that of the 300-employee firm Groupe Stavibel—has effectively positioned SNC to participate in large-scale development in northern Quebec (Plan Nord), which is expected to translate into over $80b in investments over the next 25 years. A number of opportunities should also continue to arise from new P3 investments, which could boost our current valuation of $21/share for the Infrastructure Concession Investments portfolio.

Recent awards such as the long-term service contracts with Saudi Aramco and BHP Billiton are tangible examples of how SNC continues to benefit from its diversification. Likewise, a growing number of projects are being approved on the back of surging base metal prices, and the next 12–18 months look set to bring a steady flow of new opportunities for the company.

While some investors have expressed concern about the current instability in the political environment in North Africa and the Middle East, and that it could lead to greater uncertainty in SNC's earnings growth, we remain confident that the company has the depth to more than compensate for the gap created by the loss of its Libyan projects. Similar periods in the past have led to some of the best opportunities for investors to jump into the name at decent prices—given the recent weakness in the stock, investors are once again presented with such an opportunity.

We would also note that the company's increasing business prospects are reflected in the recent improvement in its backlog. Furthermore, the valuation of many of its competitors should provide support for SNC's valuation.

Our $64 target for SNC's shares is derived from a sum-of-the-parts valuation.

Sources: Desjardins Securities, company reports, Bloomberg

COMPANY	TICKER	RATING & RISK	TARGET PRICE ($)	MARKET CAP (M$)
Toronto-Dominion Bank (The)	TD	Top Pick–Average	91.00	74,427
Bank of Nova Scotia (The)	BNS	Top Pick–Average	64.00	63,104
Daylight Energy Ltd.	DAY	Top Pick–Average	13.50	2,053
Thompson Creek Metals Company Inc.	TCM	Top Pick–Average	21.00	1,735
TransForce Inc.	TFI	Top Pick–Average	20.00	1,485
Freeport-McMoRan Copper & Gold Inc.	FCX	Buy–Average	US$79.25	US$44,922
Bank of Montreal	BMO	Buy–Average	70.00	35,405
Manulife Financial Corporation	MFC	Buy–Average	21.00	31,214
BCE Inc.	BCE	Buy–Average	41.50	30,055
TransCanada Corporation	TRP	Buy–Average	45.00	29,889
Teck Resources Limited	TCK.B	Buy–Average	76.00	28,774
Brookfield Asset Management Inc.	BAM	Buy–Average	US$37.00	US$20,591
Alcoa Inc.	AA	Buy–Average	US$28.10	US$16,998
Agrium Inc.	AGU	Buy–Average	106.30	12,278
Bombardier Inc.	BBD.B	Buy–Above-Average	9.00	11,757
First Quantum Minerals Ltd.	FM	Buy–Above-Average	163.25	11,451
Cameco Corporation	CCO	Buy–Average	46.00	10,404
Canadian Pacific Railway Limited	CP	Buy–Average	72.00	10,178
Eldorado Gold Corporation	EGO	Buy–Above-Average	US$21.25	US$8,507
SNC-Lavalin Group Inc.	SNC	Buy–Average	64.00	8,456
Metro Inc.	MRU.A	Buy–Average	52.00	4,971
Finning International Inc.	FTT	Buy–Average	34.00	4,863
Industrial Alliance Insurance and Financial Services Inc.	IAG	Buy–Average	44.50	3,466
Jean Coutu Group (PJC) Inc. (The)	PJC.A	Buy–Average	11.50	2,560
Quebecor Inc.	QBR.B	Buy–Average	40.00	2,208

Source: Desjardins Securities Portfolio Advisory Group in collaboration with Research analysts.

DESJARDINS SECURITIES INC. LEGAL DISCLAIMERS

For company specific disclosures, analyst certification and legal disclaimer, please visit http://www.desjardins-securities.ca/Disclosures/English.aspx or send request to Desjardins Securities Inc., 1170 Peel Street, Suite 300, Montreal, Quebec H3B 0A9, Attention : Research

Dissemination of Research

Desjardins Securities makes all reasonable effort to provide research simultaneously to all eligible clients. Research is available to our institutional clients via FirstCall Research Direct, Multex and Bloomberg. In addition, sales personnel distribute research to institutional clients via email, fax and regular mail.

Analyst Certification

Each Desjardins Securities research analyst named on the front page of this research publication, or at the beginning of any subsection hereof, hereby certifies that (i) the recommendations and opinions expressed herein accurately reflect such research analyst's personal views about the company and securities that are the subject of this publication and all other companies and securities mentioned in this publication that are covered by such research analyst, and (ii) no part of the research analyst'scompensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by such research analyst in this publication.

Additional Disclosures

Desjardins Securities' equity research analysts are compensated from revenues generated by various Desjardins Securities businesses, including Desjardins Securities' Investment Banking Department. Desjardins Securities may have a long or short position or trade as principal in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should not rely solely on this publication in evaluating whether or not to buy or sell the securities of the subject company. Desjardins Securities expects to receive or will seek compensation for investment banking services within the next three months from all issuers covered by Desjardins Securities Research.

Legal Matters

This publication is issued and approved for distribution in Canada by Desjardins Securities Inc., a member of the Investment Industry Regulatory Organization of Canada (IIROC) and a member of the Canadian Investor Protection Fund (CIPF). In the US, this publication is issued via the exemptive relief described in SEC Rule 15a-6, and through reliance on Desjardins Securities International Inc., a member of FINRA and SIPC.

This publication is provided for informational purposes only, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. The securities mentioned in this publication may not be suitable for all types of investors; their prices, value and/or income they produce may fluctuate and/or be adversely affected by exchange rates. This publication does not take into account the investment objectives, financial situation or specific needs of any particular client of Desjardins Securities. Before making an investment decision on the basis of any recommendation made in this publication, the recipient should consider whether such recommendation is appropriate, given the recipient's particular investment needs, objectives and financial circumstances. Desjardins Securities suggests that, prior to acting on any of the recommendations herein, you contact one of our client advisors in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this publication to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

This publication may contain statistical data cited from third party sources believed to be reliable, but Desjardins Securities does not represent that any such third party statistical information is accurate or complete, and it should not be relied upon as such. All estimates, opinions and recommendations expressed herein constitute judgments as of the date of this publication and are subject to change without notice.

US institutional customers: Desjardins Securities International Inc. (a wholly owned subsidiary of Desjardins Securities Inc.) accepts responsibility for the contents of this report subject to the terms and limitations set out above. Institutions receiving this report should effect transactions in securities in the report through Desjardins Securities International Inc., an institutional broker/dealer registered with FINRA and the US Securities and Exchange Commission.

Although each company issuing this publication is a wholly owned subsidiary of Desjardins Group, each is solely responsible for its contractual obligations and commitments, and any securities products offered or recommended to or purchased or sold in any client accounts (i) will not be insured by the Federal Deposit Insurance Corporation ("FDIC"), the Canada Deposit Insurance Corporation or other similar deposit insurance, (ii) will not be considered a deposit or an obligation of Desjardins Group, (iii) will not be endorsed or guaranteed by Desjardins Group, and (iv) will be subject to investment risks, including possible loss of the principal invested.

The Desjardins trademark is used under licence.

NOTE: All information (including prices and returns) as at May 20, 2011

Desjardins Securities
1170 Peel Street, Suite 300, Montreal, Quebec H3B 0A9
514-987-1749 1-888-987-1749

Desjardins Securities