Market Outlook 2012 - 2013

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BMO Global Asset Management

INSIGHT SERIES

Some might argue that the past is best forgotten. But in the world of financial forecasting, the past can provide important perspective on the present and valuable insights into what lies ahead. In this year's piece, we've taken a step back to examine the journey from the prior cycle peak in 2007 through the Great Recession of 2008-2009, up to today. From that vantage point, we gain a clearer view on where we stand now and what the future may hold. And, perhaps more important, we present actionable ideas for positioning portfolios in the New Year.

Separate Accounts
Mutual Funds
Collective Investment Trusts
Pooled Funds
UCITS
Alternative Investments

Has the post-recession rebound simply paused, or are we heading for a double-dip?

What if the world's major economies show little or no growth in 2012?

Peak, Trough, Now and Next

The peak of the last economic cycle occurred in June 2007. GDP was strong in many nations of the world and interest rates were much higher than today. Consumers and businesses were spending – and banks were lending to them. As with many economic recessions through history, the decline from the top was swift and widespread, with the trough occurring near the middle of 2009. Businesses began paring down expenses, consumers pulled back spending, and banks tightened the lending reins.

The results were positive. By many measures, the U.S. economy is now at or above those prior-peak highs. However, today's economy is also facing unique challenges that appear to threaten global growth. So, what's next?

In this publication, we look at the decline from 2007 to 2009, and then the events that drove the turnaround, comparing where we stand now to where we were then. We also discuss the markets' responses to government policy shifts and see that, for the most part, they have produced encouraging results. Then, we examine the factors that appear to be causing a slowdown in growth, and review the actions taken – and still needed – to sustain the recovery. Specifically, we examine whether the economy has simply paused or is heading for a double-dip recession, as well as what it could mean if the world's major economies show little growth in 2012. Finally, we give you our thoughts on what's next for the economy and stock market, and how you might position your portfolio for the coming year.

OUTLOOK 2012

Our forecast is for slow economic growth globally, including a likely recession in Europe, modest growth in the U.S., and continued growth in emerging markets. We see upside potential in U.S. equities and income opportunities in select fixed income segments. Our key assumptions for the U.S. in 2012 include:

- Slow but steady economic growth
- Strong corporate performance, albeit a bit weaker than present
- Steady results from consumers
- Major government issues are deferred until 2013-2014
- Range-bound inflation and interest rates

For investors, success will hinge on finding the best balance of asset classes, sectors, and securities in a slow-growth environment.

THAT WAS THEN, BUT THIS IS NOW

From the peak to the trough of the recession, the major regional economies of the world contracted, in some cases quite significantly. In the case of China, growth slowed substantially, but barely dipped in local currency terms (Exhibit 1), while the European Union and United States both contracted considerably. Today, we're seeing retracement of lost ground in the United States and China, where GDP is now above the prior peak levels. The European Union has been slower to catch up, with GDP now just slightly higher than its prior peak.

Exhibit 1: Nominal GDP Trends in Local Currency

	PEAK	TROUGH	NOW
U.S. Dollars	\$14.4 tril 2Q08	\$13.9 tril 2Q09	\$15.2 tril 3Q11
EU (27) Euros	€9.2 tril 2Q08	€8.8 tril 2Q09	€9.3 tril 3Q11
China RMB	¥32.1 tril 3Q08	¥31.6 tril 2Q09	¥48.1 tril 3Q11

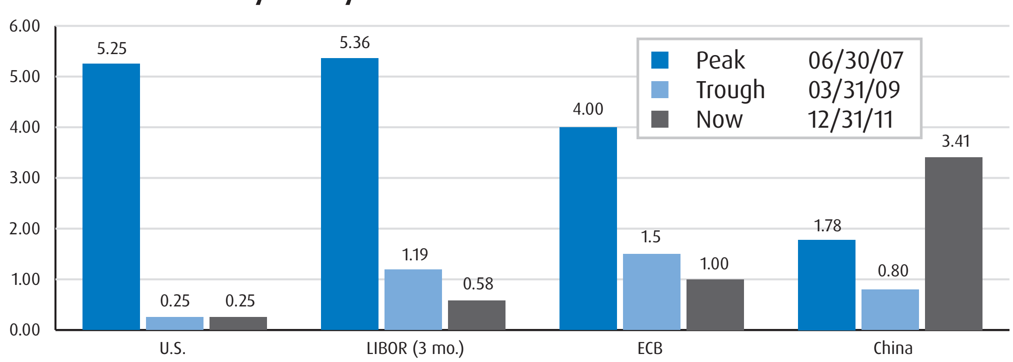
Source: Bureau of Economic Analysis, Eurostat, National Bureau of Statistics: China

What's behind the rebound? Very simply, this economic recovery has been orchestrated by two tools of government worldwide — monetary and fiscal policy.

- **Monetary policy shifts.** At the peak of the last business cycle in June 2007, interest rates in the U.S. were at 5.25%. Today, they're at 0.25%. Likewise, LIBOR (London Interbank Offered Rate) has shrunk from 5.36% to 0.58%, while the European Central Bank (ECB) has slashed its lending rate from 4% to 1% (Exhibit 2).

  A reduction in interest rates is a common way governments attempt to stem an economic decline. The goal is to make capital affordable enough to entice businesses and consumers to invest and spend. This will only happen when they are confident that capital is cheap, and will remain cheap. Major governments in the U.S., Europe, and globally have sent that message — loud and clear.

Exhibit 2: Monetary Policy Shifts Interest Rates



Source: Bloomberg

- **Fiscal policy actions.** Governments worldwide also stepped up spending to stimulate economic growth (Exhibit 3). The U.S. led the charge, committing more than $800 billion, of which $527.5 billion was spent from 2009 to 2010. That represented 3.7% of GDP.

Exhibit 3: Crisis-Related Discretionary Fiscal Stimulus Packages

Country	2009-2010 Total (% GDP)	2009-2010 Total ($ bill)
U.S.	3.7%	$527.5
China	5.8%	$284.7
Japan	5.0%	$253.4
Germany	3.6%	$120.7
Russia	7.3%	$89.7
Australia	4.6%	$45.9

Source: International Monetary Fund, Strategas Research Partners

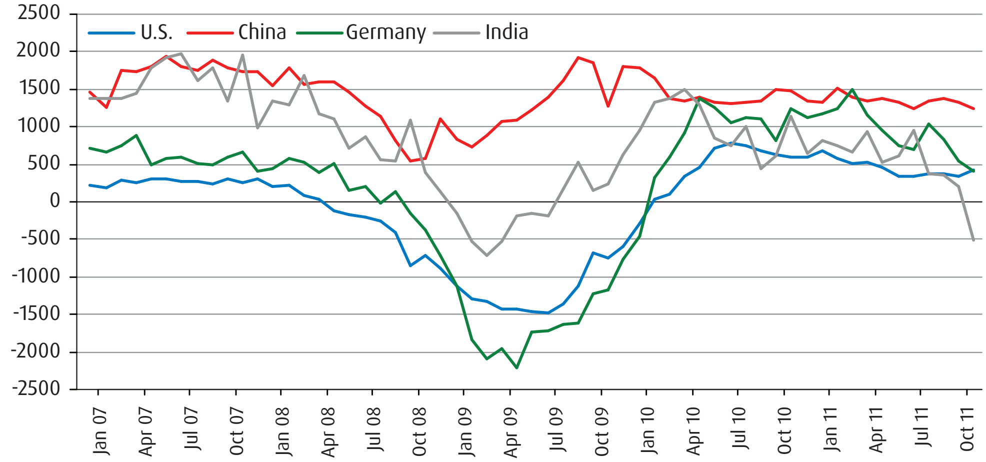
In the United States, sales, earnings, and operating margins have remained strong...

POLICY SHIFTS DID THEIR JOB

How well did these tools work? Below we take a look at some key measures of economic health.

- **Global industrial production.** Global industrial production has rebounded from its trough in 2009 (Exhibit 4). The recovery occurred across developed countries, such as the U.S. and Germany, as well as in emerging markets.

Exhibit 4: Global Industrial Production – Annual Percent Change



Source: Bloomberg

Exhibit 5: U.S. Corporate Performance — S&P 500 Index

	Peak June 2007	Trough March 2009	Now November 2011
Earnings Per Share	$89.84	$49.64	$95.12
Sales Per Share	$1,011	$886	$1,021
Trailing P/E	17.6x	10.1x	13.2x

Source: Bloomberg

- **U.S. corporate sector (Exhibit 5).** In the United States, sales and earnings have roared back, and are now higher than the 2007 peak. After two years of substantial progress, some slowdown in corporate results seems probable in 2012. At the same time, the trailing price/earnings ratio is very reasonable at 13.2x, compared with 17.6x in June 2007, and 10.1x at the trough in 2009.
- **European corporate sector.** Through 2010, corporations in Germany, France, UK, and the EU showed solid profit margins and higher earnings and sales. However, the pace of growth is now clearly slowing, and both earnings and sales are expected to close 2011 below the levels recorded in the first half. Still, the numbers are positive.
- **European consumer sector.** Consumer spending as a percent of GDP has remained relatively stable in all four representative regions from 2007 through the third quarter of 2011. This is a healthy sign and a show of steadiness from a key component of the global economy.
- **U.S. consumer sector.** Consumer spending in the United States has held up well through the recession and recovery at about 70% of GDP (Exhibit 6). Lower mortgage rates sparked a flurry of refinancings, and lower gasoline prices helped consumers redirect that spending elsewhere. As a result, retail sales growth is strong at nearly 7%. Credit card delinquencies have also come down as have financial obligations as a percent of disposable income.

Exhibit 6: U.S. Consumer Performance

	PEAK	TROUGH	NOW
Consumer Spending as % of GDP	70.5%	69.7%	70.8%
Mortgage Rates (30 Year)	6.7%	4.0%	3.9%
Retail Sales Growth	8.9%	-11.5%	6.7%
Change in Consumer Credit	5.9%	-4.5%	2.4%
Gasoline Price	$4.11	$1.61	$3.26

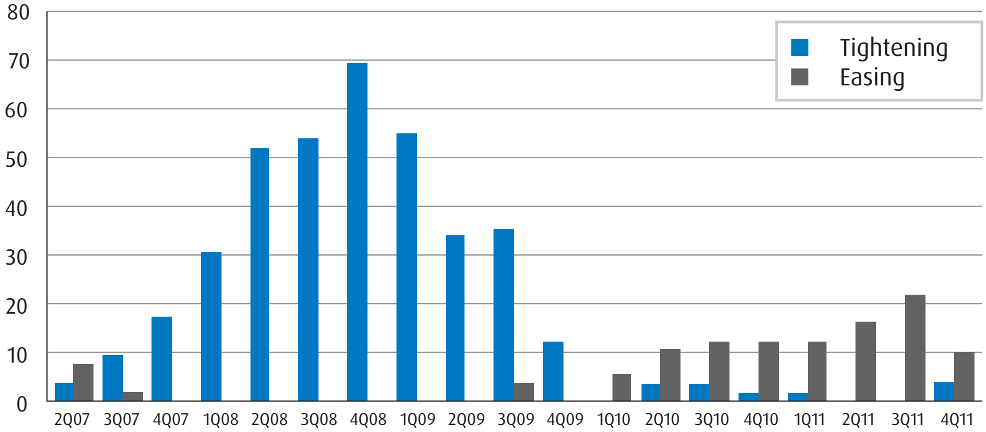
Source: Bloomberg.

Consumer Spending as % of GDP as of 9/30/11, Mortgage Rates as of 12/31/11, Retail Sales Growth as of 12/31/11, Change in Consumer Credit as of 12/31/11, Gasoline Prices as of 12/26/11.

What's the hangup?
In a word, debt.

- **Bank lending.** One of the most serious effects of the Great Recession was the tighter lending standards that banks implemented. According to the Senior Loan Survey (Exhibit 7), in sharp contrast to 2008 and 2009, we now see early signs of credit standards easing.

Exhibit 7: Senior Loan Survey



Source: Bloomberg

- **Inflation.** Although there has been a pickup in some prices since the trough of the recession, the core inflation rate is nearly a full percentage lower than it was in June 2007. Key products, including wheat, copper, gasoline, and oil, are more affordable today than they were four years ago. While lower prices are good for corporate profits and for the consumer, some pricing pickup is good too as it indicates demand.
- **The financial markets.** From the start of 2009 through 2011, the compound annualized rate of return for U.S. Stocks (S&P 500) was 14.1%, 10-year U.S. Treasury bonds was 4.5%, a broad bond index (Barclays Aggregate) was 6.8%, non-U.S. stocks in developed countries was 8.2% and emerging market stocks was 20.2%.

  However, in 2011, stock returns eased while bond returns stayed positive. The Dow Jones Industrial Average was up 8.3% while the S&P 500 Index was up 2.1% for the year.

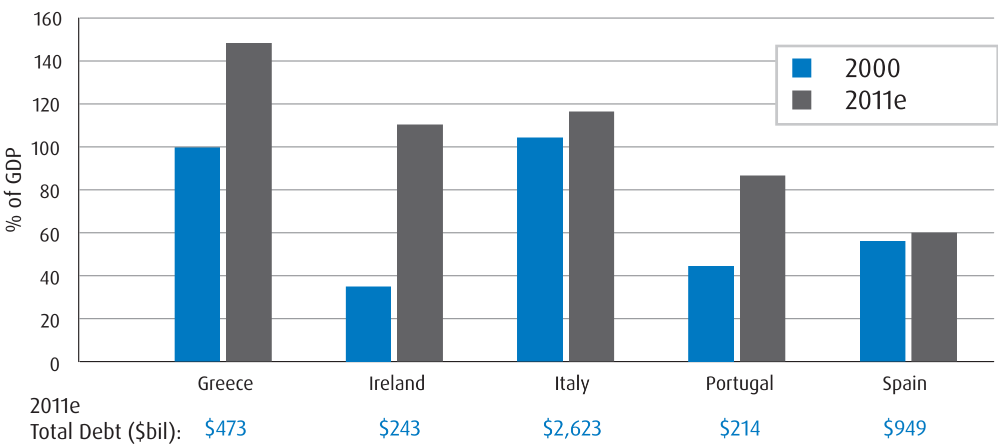
ARE WE STALLING…OR WORSE?

At this point, there's mounting evidence that the pickup in growth since 2009 is slowing. Quarterly GDP growth is barely positive to slightly negative in many regions of the developed world, including the EU, UK, France, Germany and Spain. Compared with those nations, the United States grew at 1.8% in the third quarter of 2011 and is expected to grow more than 2.5% in the fourth quarter.

What's the hangup? In a word, debt. Specifically, accumulated deficits in Greece, Ireland, Italy, Portugal and Spain (GIIPS) are close to or above 100% of GDP (Exhibit 8). As debt levels rise, so does the risk of default, which drives the cost of debt (interest rates) higher. It's a dangerous cycle threatening financial stability in these countries. In turn, several European banks that lend to these countries are also under pressure.

The markets have responded accordingly, with the European SXXP Financial 50 Index down close to 30% and the S&P 500 financials sector down 18.4%. Our guess is that once financial stocks show persistent improvement, it will be a signal that the worst may be behind us.

Exhibit 8: **Deficits in GIIPS – General Government Gross Debt, % of GDP**



Source: International Monetary Fund

EUROPE: POSITIVE STEPS TAKEN BUT MORE HELP NEEDED

There have been stepped up efforts to stem the slowdown. So far we've seen more than €1 trillion of capital commitments — short of what's needed but an encouraging series of actions to help provide liquidity to the region.

These efforts illustrate the global commitment to support Europe and the EU. Importantly, these steps enjoin not only European countries and related authorities, but also the International Monetary Fund (IMF), the U.S. Federal Reserve & Treasury, Bank of Japan, Bank of England, National Bank of Switzerland, the ECB, and others. Structures such as the Emergency Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF), low interest multi-year loans to EU banks, dollar liquidity access, and more represent very much of an all-hands-on-deck approach.

Year-over-year growth rates in industrial production and advance retail sales are solidly on the plus side.

As positive as these steps are, additional work is needed. Today, countries in the eurozone share a single currency, but each nation has fiscal autonomy. In our view, fiscal integration among these countries is necessary. That will require changes to the existing treaties, which might result in a greater range of policy options for the ECB. In a fiscally integrated Europe, the ECB might feel freer to act, and to consider additional actions and alternatives.

THE U.S.: HOLDING UP WELL

While economic growth in some European countries appears to be stalling, the United States is holding up generally well (Exhibit 9). The index of Leading Economic Indicators (LEI) has been on the rise for eight months in a row and, at 118.0 as of November 30, 2011, it's now well above the trough level of 97.4 and the prior cycle peak level of 104.7. Year-over-year growth rates in industrial production and advance retail sales are solidly on the plus side. Even initial jobless claims are in better shape now than they have been for some time.

Exhibit 9: 2011 Trend in U.S. Economic Indicators

LEI Index		Industrial Production (YoY)		Advance Retail Sales (YoY)		Initial Jobless Claims (000's)	
12/31/10	112.3	12/31/10	6.74%	12/31/10	7.6%	12/31/10	418
3/31/11	114.3	3/31/11	5.31%	3/31/11	7.5%	3/31/11	392
4/30/11	114.3	4/30/11	4.51%	4/30/11	7.2%	4/30/11	478
5/31/11	114.8	5/31/11	3.44%	5/31/11	7.9%	5/31/11	426
6/30/11	115.2	6/30/11	3.46%	6/30/11	8.2%	6/30/11	432
7/31/11	115.8	7/31/11	3.72%	7/31/11	8.5%	7/31/11	402
8/31/11	116.2	8/31/11	3.77%	8/31/11	7.5%	8/31/11	412
9/30/11	116.4	9/30/11	3.48%	9/30/11	8.1%	9/30/11	405
10/31/11	117.4	10/31/11	4.28%	10/31/11	7.5%	10/31/11	400
11/30/11	118.0	11/30/11	3.74%	11/30/11	6.7%	12/31/11	381

Source: Bloomberg

WHAT'S NEXT? OUR BEST GUESS IS SLOW GROWTH

In the beginning of 2011, the IMF issued growth forecasts for various regions of the world for 2012. Together, they resulted in average growth of 4.51%. The EU represents about 20% of world GDP. If you multiply that by the IMF's projected growth rate for the EU of 2.08%, the EU would have contributed 0.42% to GDP in 2012. Although the IMF numbers are no longer a viable forecast, they can provide a framework for a more plausible outcome.

For example, assume the EU grows at only half the IMF's projected rate. Its contribution would drop to 0.21% but the combined world growth would still be in excess of 4%. Further, what if growth in all the key regions of the world came in at half the IMF's forecasted rate? Under that scenario, the hypothetical world growth rate would still amount to 2.25% (Exhibit 10, Scenario A). Not great but far from recession territory.

To assume an even worse scenario, what if Europe enters recession and GDP there contracts by -2%, while growth in the other regions is only moderate? Even in that case, economic growth would remain positive (Exhibit 10, Scenario B). In our view, slow growth is the likely glide path for 2012.

Exhibit 10: Two Scenarios of Potential GDP Growth in 2012

Major Regions/ Countries	Share of World*	Projected 2012 Growth		2012 Contribution	Hypothetical Alternative Scenario A What if 50% Redution
EU ($17.4 tril)	20.0%	2.08%	=	0.42%	0.21%
U.S. ($15.2 tril)	19.4%	2.87%	=	0.56%	0.28%
EM ($20.0 tril)	40.0%	6.15%	=	2.50%	1.25%
Japan ($5.8 tril)	5.7%	2.07%	=	0.12%	0.06%
World ($68.6 tril)	100.0%	4.51%	=	4.51%	2.25%

Major Regions/ Countries	Share of World*	Hypothetical Alternative Scenario B Projected 2012 Growth		Hypothetical Alternative Scenario B 2012 Contribution
EU ($17.4 tril)	20.0%	-2.00%	=	-0.40%
U.S. ($15.2 tril)	19.4%	2.00%	=	0.40%
EM ($20.0 tril)	40.0%	5.00%	=	2.00%
Japan ($5.8 tril)	5.7%	1.00%	=	0.06%
	85.1% of World Total			**2.06%**

Source: International Monetary Fund

* Based on Purchasing Power Parity (PPP) weight.

Past performance shown is not a guarantee of future results. Information is subject to change.
We do not undertake to advise the reader as to changes of our views in the future.

The past can offer us important context.

Clearly, the markets draw a big distinction between slow growth and recession.

IMPLICATIONS FOR THE FINANCIAL MARKETS

What does slow growth imply for the financial markets? Again, the past can offer us important context (Exhibit 11). From 1970 through June 2011, there have been 166 total quarters. Of those, 40 were marked by slow economic growth of 2.5% or less. During those slow-growth quarters, the average return from the S&P 500 Index was 3.2%. Of the 40 quarters, the S&P return was positive in 31 of them, with an average return of 6.3%. Only nine quarters were negative, and the average return for those was -7.5%.

Recessions are a different story. The economy has contracted during six periods from 1970 through 2010. The average decline for the S&P 500, from peak to trough, was 34.3%. That compares with an 11% gain from 7- to 10-year U.S. Treasury bonds. Clearly, the markets draw a big distinction between slow growth and recession.

Exhibit 11: Summary of Slow Growth (0-2.5%)

Total Quarters (1970-6/30/11)	166
# Strong Growth (>2.5%)	96
# Recession	30
# Slow Growth	40
Average Return in Slow Growth	3.2%
# Qtrs Positive S&P Perf.	31
Average Positive Return	6.3%
#Qtrs Negative S&P Perf.	9
Average Negative Return	-7.5%

Source: Bloomberg

Past performance shown is not a guarantee of future results. Information is subject to change.

Even in this slow-growth environment, we see upside potential in U.S. equities. Final 2011 full-year profits for the S&P 500 are not yet tallied. As of December 31, 2011, the S&P 500 stood at 1258, and estimated 2011 earnings per share for S&P 500 companies was $95. In Exhibit 12 we illustrate two hypothetical S&P return scenarios. Scenario A uses the consensus earnings growth estimate from Bloomberg for 2012 of 10%. That would take earnings from $95/share to roughly $105/share. We then multiply the $105 by the current (2011) price paid per dollar of profit (P/E ratio) for stocks in the S&P 500, which is approximately 13. The result ($105 x 13) is 1359. This illustrates one possible 2012 year-end value for the S&P. Scenario B assumes the same growth rate but increases the P/E ratio to 14. These are not predictions but rather a means by which to frame expectations.

Exhibit 12: S&P 500 Index — 2012 Hypothetical Return Calculations

	Scenario A	Scenario B
Consensus* EPS for 2012:	$105	$105
Current P/E for 2011:	x 13x	x 14x
Est. 2012 Year-End Level:	1,359	1,463
2011 Year-End Level:	- 1,258	- 1,258
Est. 2012 Level Increase:	101	205
Est. 2012 Gain:	**7%**	**14%**

* Bloomberg Consensus estimates.

Source: Bloomberg, data estimates as of 12/31/11.

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HOW TO INVEST IN A SLOW GROWTH WORLD

As in most economic environments, there will continue to be opportunities for investors in 2012. In our view, investors can position their portfolios in these ways:

- **Emphasize larger U.S. companies.** These are more defensive in nature, have cheaper valuations, a global footprint and higher dividends — in many cases, higher yields than on 10-year Treasury bonds.
- **Keep some exposure to mid- and small-sized companies.** Earnings and sales results have been strong here and prices pulled back in 2011.
- **Pay careful attention to the financial sector in Europe** and selectively in the U.S.
- **Stay neutral to slightly positive on emerging markets.** Interest rates are coming down in several countries and growth remains decent. As in 2011, country weights will be important.
- **Limit direct exposure to Europe.** We believe recession in Europe is likely in 2012.
- **Consider varied sources of fixed income.** This might include U.S. corporate investment grade securities, U.S. corporate high yield, and emerging market corporate and selected sovereign debt.
- **Limit exposure to TIPS and floating rate bonds.** If inflation stays in check there is less reason to own inflation-protected instruments.
- **Explore carefully selected alternative investments** including real estate investments and master limited partnerships as income generators; and commodities.

Though challenges clearly remain, many of the world's economies, particularly the U.S., are in better shape today than they were in 2009. The action steps implemented thus far have produced beneficial results, and both U.S. businesses and consumers are holding up well, generally. To be sure, the European debt crisis is a serious issue with worldwide implications. Nevertheless, we believe investors can navigate in this environment by taking a balanced approach focused on larger companies, select emerging markets, varied fixed income, and certain income-generating alternative investments.

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