Q1 2012

Market Commentary

A Return to Equities

The global investment landscape became notably more optimistic in the first quarter of 2012. As fears about the eurozone credit crisis eased somewhat and U.S. economic data improved, investors demonstrated a renewed sense of confidence by returning to riskier assets. Equity markets around the world advanced as a result. Despite a number of persistent macroeconomic risks, we believe that North American economies will provide stable, moderate growth and global equity markets will continue to advance – although probably not at the pace we saw in Q1 (particularly in the United States). In the coming 12 months, we expect bond returns to be positive, but lower than equity returns. To align our clients' portfolios with this view, we will be modestly increasing their equity allocations relative to fixed income.

The Quarter in Review

Easing of eurozone concerns

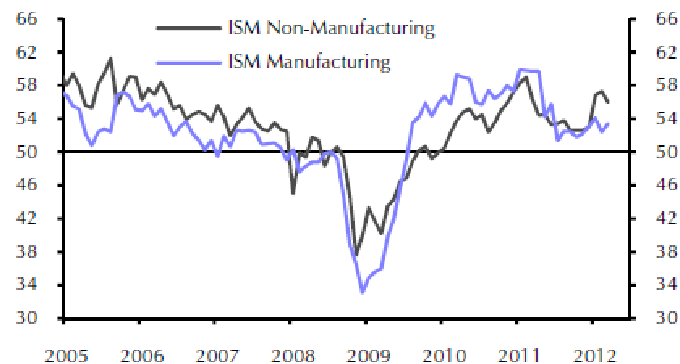
At the start of 2012, we identified the eurozone debt crisis as the most important factor driving capital markets. In Q1, several developments, including a new rescue plan for Greece and refinancing for European banks, helped make investors more confident that the crisis was being handled effectively. To assess the level of perceived risk in the eurozone credit market, we have been watching the Italian 10-year bond yield; because of its size, the Italian bond market is a reliable barometer for gauging investor confidence about the eurozone. Its yield fell from over 7.0% in November to 5.1% at the end of March, signalling that market participants no longer require a hefty risk premium on Italian debt. While overall credit conditions in the eurozone have improved, recent weakness in Spain's bond sales highlights that challenges will persist for some time.

Firmer U.S. data

Reports of U.S. economic activity continue to improve. Consumer spending has been improving steadily, although measures of consumer confidence continue to deliver mixed readings. The Institute for Supply Management (ISM) Manufacturing Index rose to 53.4 in March, which was higher than expected. The Non-Manufacturing Index fell slightly to 56.0. Any reading above 50 signifies expansion. The housing market is also showing signs of stability. While prices remain depressed, sales reports of new and existing homes have improved and inventory levels are coming down.

On the U.S. labour front, the The level of initial (new) jobless claims reached a four-year low of 357,000 at the end of March and the economy added 120,000 jobs in total (gaining 121,000 from the private sector and losing 1,000 from the public sector). Unfortunately, March's gain was much lower than expected, but it was a gain nonetheless, and helped push the unemployment rate down a notch to 8.2%. In Canada, the creation of 82,300 jobs was significant and above expectations; our unemployment rate moved down to 7.2%.

Both ISM indices of economic activity are above 50, the level that separates expansion from contraction



Source: Capital Economics

Modest slowing in China

China's red-hot economy slowed modestly in Q1, raising concerns that this key driver of the global recovery was faltering. Mid-quarter, China downgraded its economic growth forecast for 2012 to 7.5%. The downgrade had a definite negative impact on Canada's resource-heavy equity market: the Energy and Materials sectors both

sold off heavily in March. We believe fears are overblown that the downgrade will damage the global recovery, however. China's policymakers are well equipped to boost growth if it becomes necessary. It is worth noting that China is known for beating its own forecasts; the country's actual GDP growth for 2011 was 9.2%, significantly higher than the 8.0% it had forecast for the year.

Fixed income

Fixed income yields rose in Q1, as economic conditions improved and investors began unwinding some of the safe-haven allocations they had made in U.S. Treasuries in 2011. As a result, the U.S. Treasury yield curve steepened, with yields increasing 0.44% on 30-year bonds and 0.33% on 10-year bonds; short-term bond yields increased only slightly. Canada's bond yields followed a similar pattern. Overall, the Canadian bond market fell 0.21%, with the positive returns from corporate bonds offset by negative returns on government bonds.

Global equity market rally

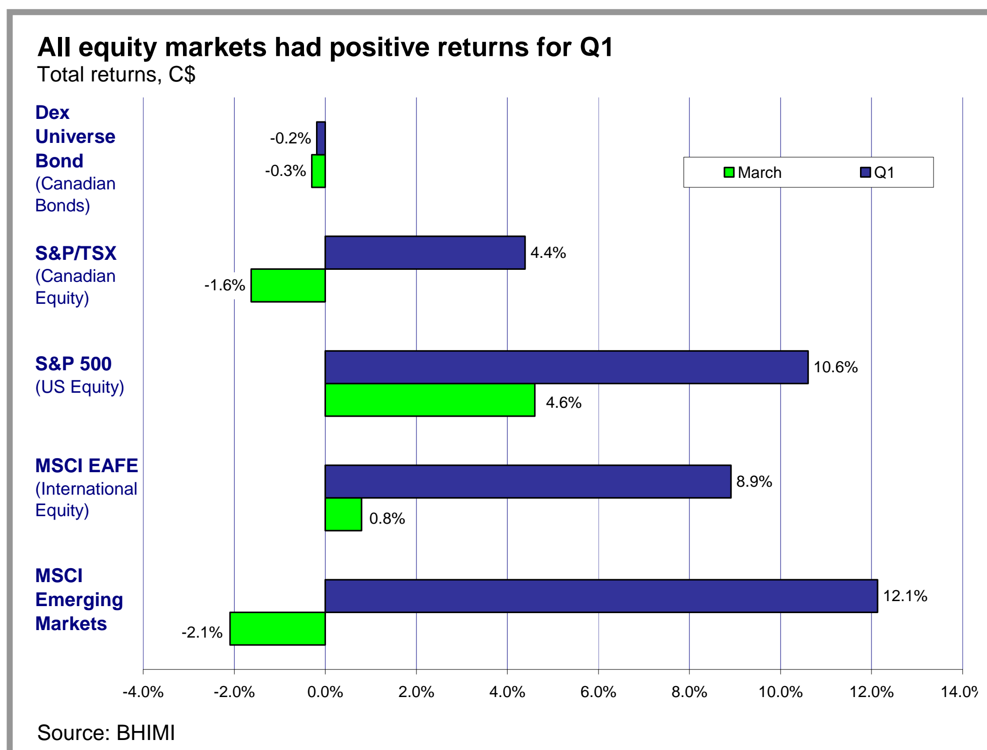
Emerging markets led the global rally in equities, with a Q1 return of 12.1% (14.1% US$), followed closely by the S&P 500 Index's surprisingly strong quarterly return of 10.6% (12.6% US$). The U.S. equity market's performance was helped considerably by two factors: the Financials sector (up 19.9% in C$, 22.1% US$), which surged after the U.S. Federal Reserve released positive results from its stress tests on banks; and the spectacular run up in the value of Apple Inc. shares (48.2% in Q1). These factors contributed significantly to the U.S. market outperformance versus its Canadian counterpart. The S&P/TSX Composite Index returned 4.4% for Q1, despite slowing in March on concerns about China's growth prospects and the potential impact on Canada's resource-dependant market.

Oil

In Q1, a near-term macroeconomic risk re-emerged as Iran expressed nuclear ambitions and the threat of conflict loomed in the Persian Gulf. Oil is a strategic resource; many factors drive its price, a number of which are unpredictable. The possibility of supply disruptions has already sent oil prices higher. The Iran situation has the potential to deteriorate in a variety of ways, with significant consequences. Nevertheless, we believe a long-term economic impact will be avoided, based on our expectation that military reaction would be swift and that sizeable emergency oil reserves would be released. A deeper look at how trouble in the Persian Gulf would impact oil prices can be found at the end of this commentary.

Our Investment Strategy in Review

All equity markets had positive returns for Q1
Total returns, C$



Source: BHIMI

At the end of 2011, we were very mindful that the eurozone credit crisis posed some risk to the global economy. We felt the worst was likely past, however, and that the likelihood of a severe negative outcome was decreasing. In terms of economic performance, we were confident that the U.S. recovery would continue, China would grow at a steady pace, and Europe would experience a recession. In that environment, we expected corporate earnings would rise and price-to-earnings multiples would remain steady, resulting in better returns for equities relative to bonds.

At that time, equity valuations were inexpensive and we were beginning to think about returning to an overweight allocation in equities, a change from the neutral position we had held in most

clients' portfolios since mid-2011. We remained acutely aware, however, that the consequences of a negative outcome in the eurozone, although less likely, could still be very damaging to the global economy. We decided to take the prudent course of action and wait for further confirmation that that macroeconomic risk was abating. One quarter later, our outlook appears to have been accurate. As we expected, eurozone credit conditions are stabilizing and the U.S. is experiencing moderate economic growth.

Compared to their benchmarks, our fixed income strategies continued to have a lower weight in corporate and provincial bonds and a higher credit quality on average. A better-than-expected outlook for the U.S. economy resulted in narrower corporate credit spreads (the amount of extra yield that a corporate bond needs to offer over the yield of a Government of Canada bond with a similar maturity) and better performance for that sector. Our lower corporate bond weight had a negative impact on performance.

Our 12-Month Outlook

Our outlook for the next 12 months is for moderate economic growth in all regions except Europe, where we predict a modest recession caused by difficult austerity measures and significant downward momentum in many European economies. In developing our outlook, we considered a number of factors that will drive capital markets.

Eurozone concerns lessen

It is likely that the eurozone's sovereign credit situation will continue to pose some kind of risk for several years. The most immediate concerns are the upcoming elections in Greece and the potential for its recently implemented rescue plan to come undone if a more extreme government takes the reins. Nevertheless, recent actions by the region's policymakers support our belief that they are committed to avoiding systematic damage. Since last quarter, we are more confident that the situation is slowly moving toward stability. In fact, the situation has improved so much that we no longer think the eurozone crisis will be the dominant factor driving the global economic and capital market outlook over the next 12 to 18 months. Periodic flare-ups will continue to occur, such as the current issues in Spain. We do not expect them, however, to alter the improving momentum that is developing.

China's growth is healthy

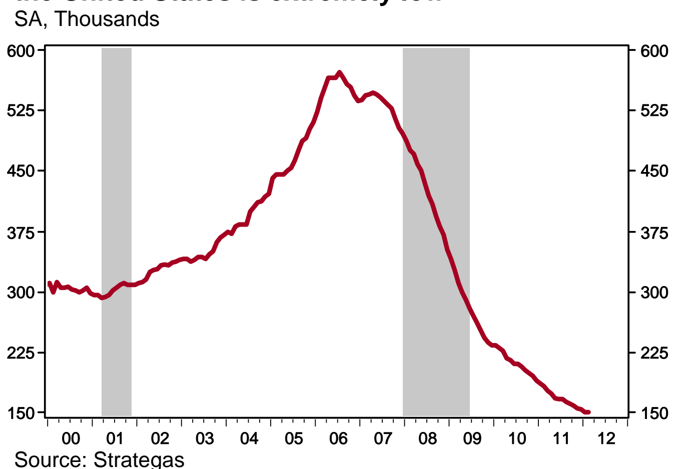
We expect China's economic growth to be between 8.0% and 9.0%, a level that will continue to provide a supportive backdrop to the global recovery and Canada's resources sectors. Concerns about a hard landing are overblown in our view, but if China's economic growth does slow more than expected, the country's officials have powerful monetary and fiscal tools at their disposal.

Virtuous cycle on the horizon for the U.S.

A strong housing market, low unemployment and economic growth are three interconnected factors that depend on and reinforce each other, creating a virtuous cycle (a beneficial cycle of events where each positive outcome supports the other). In the recovery to date, the housing market has been slowest to revive. House prices haven't yet stabilized (the Case-Schiller Index showed a 3.8% year-over-year decline in January), and a substantial inventory of foreclosed homes (about 3.4% of all homes with mortgages) waits to be cleared. There are signs, however, that the housing market is finally reaching bottom: inventories of new homes are nearly exhausted and building permits have increased.

The inventory of new one-family homes for sale in the United States is extremely low

SA, Thousands



Source: Strategas

Without the participation of the homebuilding and residential real estate industries, job creation remains below historical norms. Nevertheless, the private sector is creating enough jobs to offset continuing public sector job cuts. When federal and state governments finish trimming their payrolls, we can expect job creation to accelerate. Manufacturing, auto production and consumer spending are all improving. We don't see any strong reasons to think that the U.S. economy will deteriorate in the near term. Combined with the U.S. Federal Reserve's commitment to an accommodative monetary policy until at least 2014, this picture leads us to expect GDP growth of around 2.0% over the next 12 months.

Elections and fiscal drag

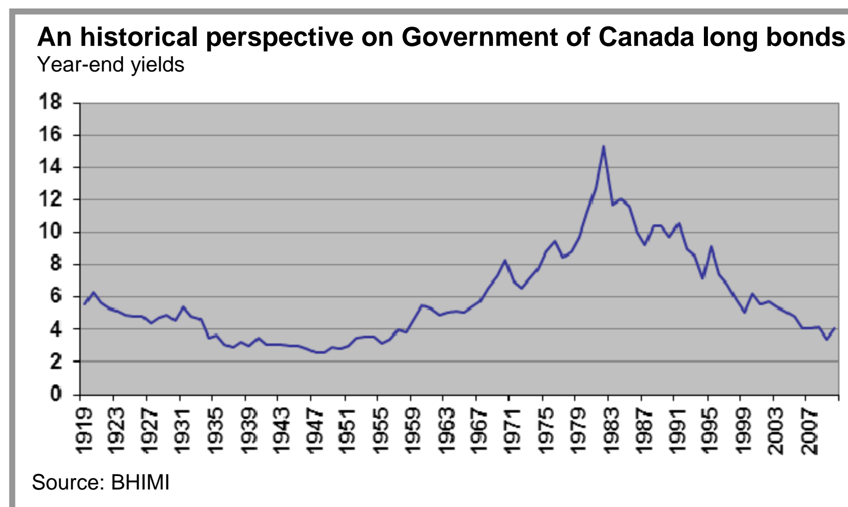
One shadow on the horizon for the U.S. economy is the presidential election and the anticipation of "fiscal drag," which is the potential for tax-related measures to dampen U.S. growth. We expect this concern to grow as November nears. The Bush-era tax cuts for high-income earners are set to expire in December 2012, and automatic spending cuts in the Budget Control Act are scheduled to begin in 2013. The timing and impact of the spending cuts will depend greatly on the outcome of the elections, but a worst-case scenario would produce a fiscal drag of more than 3% of GDP beginning in 2013. Although the relevant fiscal measures won't have a direct impact until next year, capital markets' participants will price in their expected impact ahead of time. We will be monitoring developments closely and will continue to consult regularly with experts in this field.

Still room for earnings growth

After two years of strong growth, we believe the current business cycle is maturing to a stage where corporate earnings growth typically slows. The consensus of market analysts is that corporate earnings will continue to expand this year. We also expect that earnings will expand on a year-over-year basis, though at a slower pace than the strong growth of recent years. Whether companies' profit margins expand slightly, stay flat, or compress slightly this year, with 2.0% expected GDP growth, we think that top-line revenues still have the potential to grow and that their price-to-earnings ratios can expand. We expect mid-single digit earnings growth over the next year in the United States and Canada.

Modest expectations for fixed income

We expect to see modest positive returns from Canadian fixed income investments in the next year. A slight increase in interest rates is possible, but rates will likely remain low for some time. We believe the 1960-2000 period of high interest rates was an anomaly; we may be heading into a period more reminiscent of the 1940s and '50s, when interest rates moved in a fairly narrow band between 2.5% and 4.0%. We continue to believe that mid-term bonds have the most favourable outlook compared to short- or long-term bonds.



Source: BHIMI

Our Investment Strategy Ahead

We reduced our clients' holdings in Canadian equities at two points in 2011 in order to manage risk. We sold in March, when the S&P/TSX Composite Index was trading at 14,300, and in July, when it was trading at 13,400. "Sell high, buy low" being one of the basic principles of successful investment management, we have been looking for an opportunity to re-enter the market at a lower level in order to lock in that advantage.

Since the beginning of the year, the macroeconomic concerns that kept us from taking a higher equity position have eased significantly. With the S&P/TSX currently trading at just under 12,500, we feel this is a good time to act, and intend to increase our clients' equity positions by increasing the allocation to Canada.

We feel it is prudent to add Canadian equities rather than U.S., primarily because the recent rally in the S&P 500 Index has been so strong and so fast. The rally in the S&P/TSX has been more moderate to date. There may be some additional volatility in the S&P 500 over the next several months caused by seasonal slowdowns and the political and fiscal drags noted above. That volatility may present attractive opportunities for adding to our U.S. positions. In the meantime, thanks to the recent rally, most clients' portfolios have a slight overweight to U.S. equities, relative to Canadian and non-North American holdings. We are satisfied with that level of participation at this time. In our clients' fixed income holdings, we will maintain a focus on quality and a defensive position in terms of exposure to corporate bonds. We believe credit spreads are too narrow, and they will have to widen before corporate issuers can attract investors (i.e., receive financing). We will be monitoring this position carefully.

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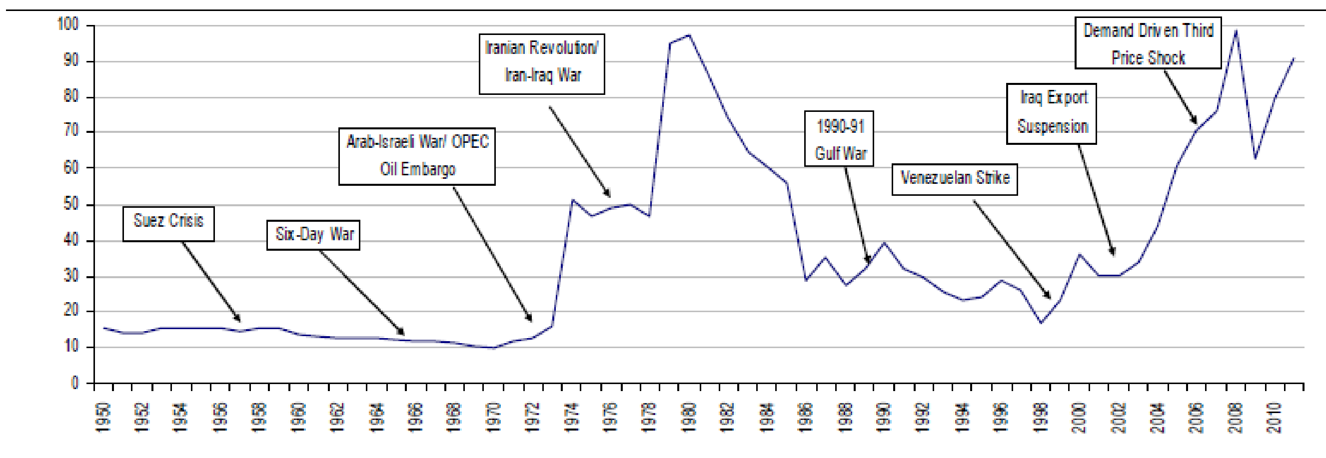
Trouble in the Persian Gulf – the impact on oil prices

The Arab Spring of 2011 set in motion a series of geopolitical events that helped propel crude oil prices to levels not seen since the onset of the credit crisis. Understanding the impact of these events is critical, given the West's reliance on the Persian Gulf region for oil.

Iran's push to develop nuclear-grade weapons is of great concern to Israel and a number of Western governments. In addition to the immediate security threat, investors are concerned about the possibility of a supply shock and the implications for global crude oil markets if conflict erupts in the Gulf, the world's largest oil-producing region. The greatest risk is to the Strait of Hormuz, the seaway through which 17% of global oil output moves daily. Iran has threatened to block the Strait if attacked. A disruption there would have a material impact on oil markets, as would a shutdown in Iran's export capacity. Iran is the third-largest global oil exporter and the world's fourth-largest producer.

To understand the impact of a supply shock on crude oil pricing, it is important to consider whether such a shock would lead to a sustained imbalance in demand and supply, and what remedies are available to offset this lost supply. Iran produces four million barrels each day (and exports 2.5 million). A complete freeze of this supply would be consistent with previous supply shocks that have occurred since the 1956 Suez crisis. We believe that current oil prices (US$103 per barrel at the end of March) already reflect the market's anticipation of European Union trade sanctions against Iran (scheduled for this summer). If these sanctions are effective, 400,000 barrels a day would vanish from the global supply. Any further decrease in supply would likely result in oil price increases of US$15 to $16 per barrel, depending on the severity of the shortfall.

Historical supply shocks and crude oil prices (in 2010 US$ terms)



Source: UBS

That said, we believe that a supply disruption in the Persian Gulf would have only a short-term impact; it would not create a sustained imbalance because there is enough spare global production capacity and strategic government inventories to meet market needs. The Organization of the Petroleum Exporting Countries (OPEC) has roughly four million barrels per day of spare capacity that could be brought on-stream over a 30-day timeframe. In addition, the International Energy Agency (IEA), along with key Western governments, has been stockpiling hundreds of millions of barrels in strategic inventory programs for years in case of just such an emergency. In our view, an oil blockade in the Strait of Hormuz is not a major threat to the markets. This narrow passage is of such vital importance to global trade that the United States would have little tolerance for Iranian interference. Given the strong U.S. military presence in the region, it is unlikely that Iran would be able to close the Strait for more than two to three weeks.

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