

# Spring Break

After a strong rally in Q1, global equity markets took a breather in April, reflecting the unsteady nature of the current recovery process. Our outlook over the next year is for global economic growth and moderate, positive equity market returns that outperform weak but positive fixed income returns. We are optimistic that a number of ongoing concerns – about credit conditions in the eurozone, the pace of the U.S. economic recovery, the ability of China’s leaders to control its growth – will cause only periodic slowdowns, as we have seen in April, and will not have a larger or sustained negative effect.

## Markets reverse

Equity market returns were negative for the month of April, with markets that had the biggest rallies in Q1, showing the biggest steps back. The S&P/TSX Composite Index pulled back the least, at -0.6%, while the S&P 500 Index fell 1.7% in Canadian dollars (-0.6% US\$).

## Fixed income

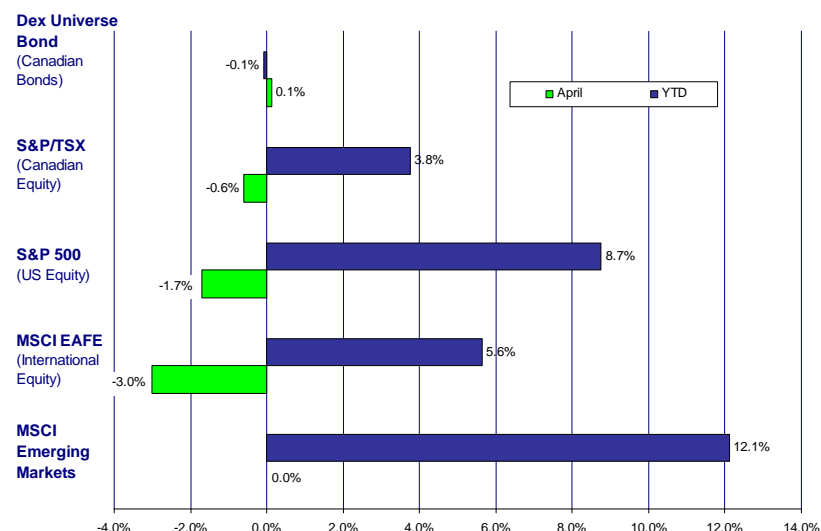
Fixed income markets also saw a reversal from Q1, with yields dropping and prices rising, to result in modest positive returns. The U.S. bond market is the safe haven that investors turn to whenever concerns flare (as they did this month about Spain and Portugal), and Canada’s bond market tends to benefit as well. In the Canadian bond market, government, provincial and lower-rated corporate bonds returned around 0.2%, while higher quality corporate bonds performed worst at -0.1%.

## U.S. economy exhibits moderate growth

The tone of U.S. economic data released during April was slightly weaker than in the past few months. Real GDP for Q1 was slightly lower than market expectations at 2.2%, but still relatively good for a recovery that is unfolding in the shadow of a major debt overhang. Employment figures were also somewhat disappointing. At 115,000, the number of nonfarm jobs added in April was less than the market had been expecting.

### Market returns in April and year-to-date

Total returns, C\$

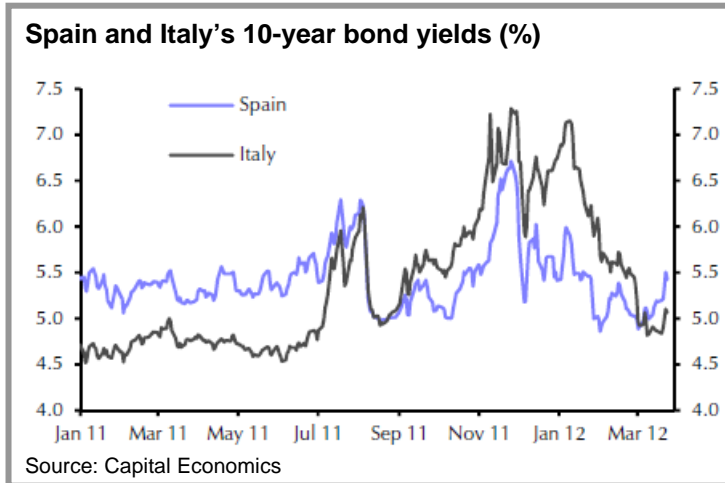


Source: BHIMI

Mitigating factors make this figure less grim than it first appears. One is the weather – the economy typically adds more jobs in warmer months than in cooler months. The unseasonably warm weather this winter gave an early boost to the employment figures that came out between December and February. Another factor is that the employment numbers for March were revised up by 53,000, substantially higher than the 121,000 initially reported. A revision to April’s numbers would not be surprising. To put these monthly ups and downs in perspective, the U.S. economy has added an average of 201,000 jobs every month in Q1, which is on pace with 2005, the best year for employment in the previous decade.

## Eurozone distractions continue

In the eurozone, the ability of smaller economies to manage their sovereign debt continues to be a worry. In April, the yields on Spain’s 10-year bonds rose alarmingly, though not to the dangerous highs reached by Italian bonds late last year.



## Our Investment Strategy in Review

After having reduced our clients' holdings in Canadian equities twice in 2011, we took the opportunity this past month to lock in a "sell high, buy low" advantage by increasing our clients' holdings in Canadian equities at a point when the S&P/TSX Composite Index was trading at a significantly lower level than when we had sold. We chose not to increase the allocation to equity through U.S. equities at the time because the rally in the S&P 500 Index had been very steep and we felt that the Canadian market offered better relative value.

The increased allocation to equities, while modest, supports our 12-month positive outlook for stocks; we remain cautious at this time because the risks posed by the eurozone, while easing, still exist.

## The Outlook Ahead

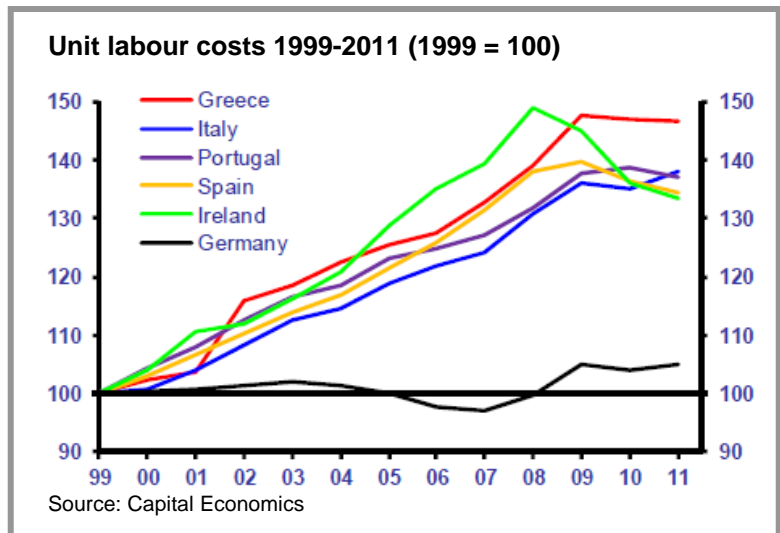
Our outlook is unchanged from the end of Q1. We expect moderate economic growth in all regions except Europe, where we expect to see a modest recession caused by the difficulties of balancing austerity measures with economic growth. Aside from Germany, most eurozone countries are struggling to generate growth with economies that are far from competitive, as can be seen in a comparison of labour costs.

In anticipation of recent elections, political uncertainty over potential changes in eurozone governments and their commitment to fiscal austerity has been on our radar for some time, and has been a general concern for market participants. In April, the Netherlands' government resigned over a failed budget, bringing that country's commitment to austerity into doubt.

On May 6, new governments were elected in France and Greece. The French people elected Socialist François Hollande rather than re-electing the more conservative Nicolas Sarkozy. M. Hollande has vowed to overcome German resistance to renegotiating the EU fiscal pact to include measures to promote economic growth rather than just austerity.

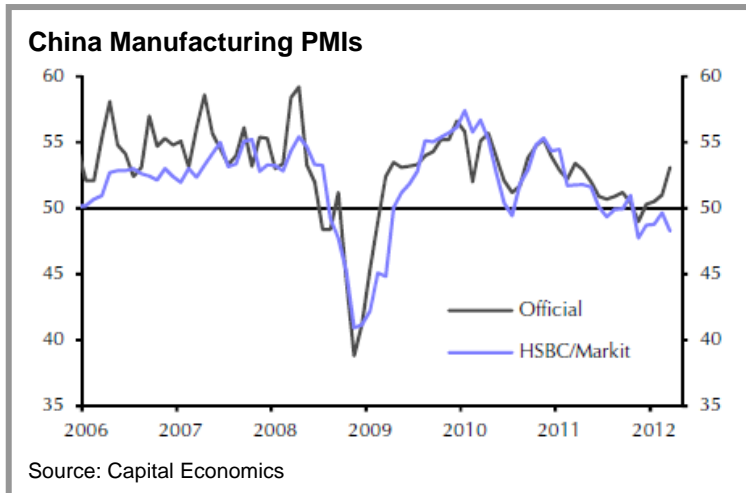
In Greece, voters elected more extreme parties, from both the right and left, at the expense of the incumbents. It remains to be seen whether the disparate parties can put together some kind of coalition and form a functioning government. If not, it casts serious doubt on Greece's ability to present the Troika (the European Commission, the International Monetary Fund and the European Central Bank) with a credible budget with savings worth 7% of GDP this June. Missing this target might delay the payout of Greece's next lot of bailout funds.

We believe that the eurozone situation will improve and that the risks posed by the sovereign credit crisis will diminish. We do, however, expect there to be further noise from the eurozone – including political upheavals, civil unrest and perhaps even the departure of Greece from the monetary union. Ultimately, we continue to believe that policymakers have the will and ability to prevent systemic damage to the global financial system.



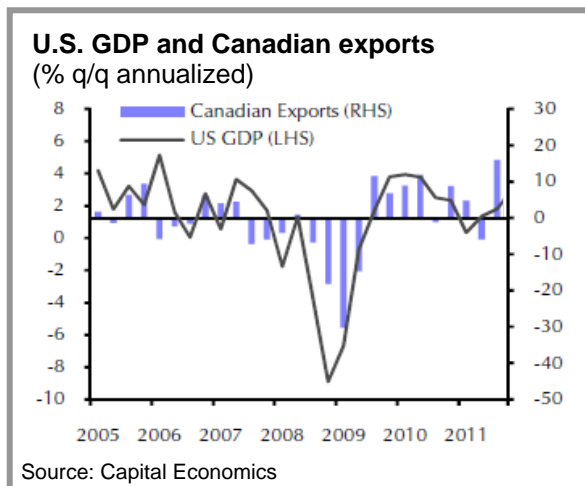
We anticipate the U.S. economy will grow at a modest pace, with particular strength in manufacturing. The Institute for Supply Management's Manufacturing Index rose 1.4 points to 54.8 in April, and though the Non-manufacturing Index dropped 2.5 points to 53.5, any reading over 50 signals economic expansion.

China will likely continue providing a solid backdrop to the global recovery. We expect to see GDP growth of at least 7.5%, as the country's leaders continue to manage their economy's carefully orchestrated slowdown. Indicators of manufacturing activity are still solid, suggesting that a "hard landing," in which growth crashes, is unlikely.



While we continue to expect equity markets to have positive returns over the next year, with the S&P/TSX growing between 5% and 10%, we do anticipate a slow summer given the issues in the eurozone and market reaction to the U.S. election process gearing up. As the old adage, "sell in May, and go away," indicates, there may also be a seasonal effect to bear in mind over the next few months.

In terms of the Canadian fixed income market, our outlook calls for modest positive returns. The Bank of Canada's most recent comments suggested that interest rates might increase sooner than previously expected; perhaps even in 2012, but any increase is expected to be small. As recently as the beginning of the year, some



forecasters were wondering whether the Bank would need to add more stimulus to support growth, but Canada's economic prospects are improving, in large part thanks to improving GDP growth in the United States.

### Our Investment Strategy Looking Forward

Given our outlook for economic growth and for equities to outperform bonds over the next 12 months, we are comfortable with the extent of the current equity overweight in most of our clients' portfolios and will maintain the current focus on higher quality issues and defensive positioning in fixed income investments.

We believe that the U.S. economy will be the key driver of capital markets in the coming year, despite occasional overseas distractions. The overhang of debt and upcoming fiscal challenges in the United States, coupled with it being an election year, means we can expect further periods, like April, when the recovery process is somewhat distracted. We will be watching for opportunities to add to our allocation to U.S. equities at attractive valuations.

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