February 2012

Market Commentary

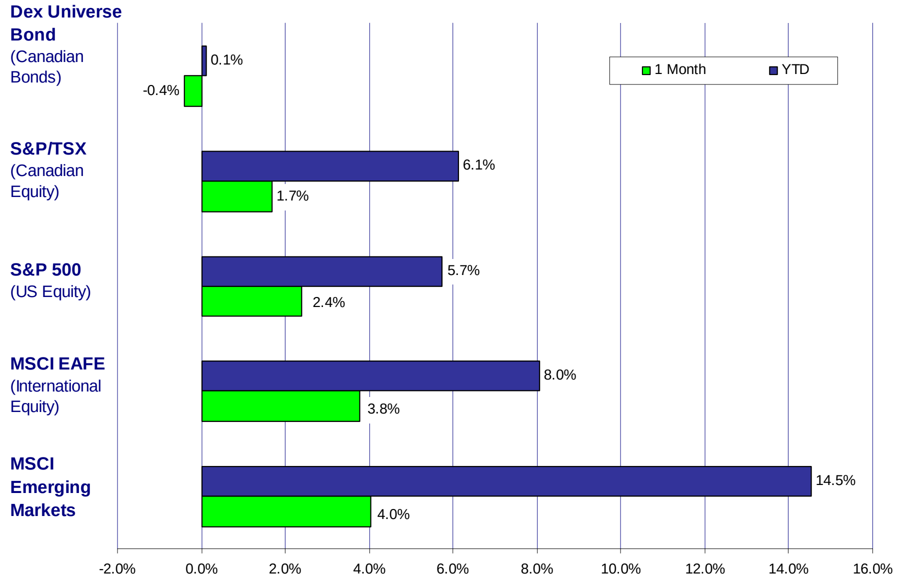
Equities Advance as Fears Ease

As fears about the eurozone credit crisis eased in February, capital markets participants reacted by returning to riskier assets. Equity markets across the globe continued to advance, though not at January's strong pace.

Coming into 2012, we identified the possibility of imminent default by Greece on its sovereign debt, and unsustainably high bond yields on other eurozone countries' sovereign debt of as the two major threats to equity markets. When evaluating the possible outcomes and their impact on global growth and capital markets, we identified the yield on Italian 10 year bonds as the key metric to assess whether risks were increasing or decreasing. At this time, Italian and other eurozone bond yields are down significantly, and Greece has secured additional funding. When considered with improving U.S. economic data and continued strength in emerging markets, the result is more optimistic investor sentiment and positive equity market returns.

Equity market rally continues in February

Total returns, C$



Source: BHIMI

Equity market rally continues

In February, emerging and international markets led the global equity markets with 4.0% and 3.8% monthly total returns. The U.S. equity market also did well; the S&P 500 Index reached levels not seen since 2008 with investors encouraged by economic indicators signalling better U.S. and global growth ahead, decent corporate earnings and low interest rates. Canada's equity market lagged global peers this month, returning 1.7%.

Fixed income

Canadian bond market returns in February, similar to the prior month, were driven far more by performance differences across bond sectors than by performance across terms. The overall bond market fell 0.40%; however, the dispersion of returns was significant across the various components of the Canadian bond market defined by term and sector. From a term perspective, the greatest downside protection came from short- and mid-term bonds, which pulled back (-0.18% and -0.29%, respectively) less than long bonds (10+ years), which experienced a negative 0.85% return. From a sector perceptive, corporate bonds did best with modest, positive returns (0.29%) that were offset by negative government bond returns (-0.65%).

The eurozone credit crisis

The optimism reflected in February's equity market advance was due in large part to positive developments in the eurozone. On February 21, a new rescue plan for Greece was announced, allowing its government to make a €14.5 billion debt payment due in March. The plan involves a second bailout from the eurozone, including €130 billion ($173 billion) in new financing, and an agreement to write down about €100 billion worth of Greek government bonds and swap them for new securities with lower interest rates. This write down will cost private bond holders about 53.5% of the bonds' nominal value. The deal provides Greece with short-term relief while it continues its attempts to trim debt. In an effort to make this commitment credible, the agreement called for eurozone officials (from the European Central Bank, European Union and International Monetary Fund) to monitor Greece's management of its economy, and for a constitutional change that will give debt repayment priority over the funding of government services.

On February 29, the European Central Bank conducted a second long-term refinancing operation (LTRO) to provide European banks with liquidity and keep their local credit markets functioning. The first LTRO, held in December, injected €489 billion into the financial system and was successfully followed by a drop in inter-bank lending rates. The second LTRO saw banks borrow €529 billion from the ECB. Despite the added liquidity, banks will likely continue to be cautious in their lending, given that Europe's economy is facing a recession. In February, both the eurozone's manufacturing and services purchasing managers' indices (PMIs) were below 50.0, the level that indicates future expansion. In Q4, the region's GDP fell by 0.3%.

Greece's bailout and the LTROs are clear indications that the eurozone's policyleaders are committed to resolving their credit crisis, and equity markets agreed. Most notably, the Italian 10-year bond yield has fallen from over 7.0% to below 5.0%, a clear sign that market participants see less risk in the area's sovereign debt.

U.S. economy strengthening

The U.S. economic recovery has proven to be stronger than we had expected late in 2011. U.S. Q4 real GDP was revised up to 3.0% and the full year 2011 growth rate was 1.7%. For comparison, Canada's Q4 real GDP was 1.8% as expected, with 2.5% full year growth.

Reports of U.S. economic activity continue to be mixed, but the trend is improving and clearly inconsistent with an imminent return to weak growth. In February, the Conference Board's Consumer Confidence Index rose to 70.8, and auto sales, another indicator of consumer confidence, were also strong, reaching their highest level since February 2008. The Institute for Supply Management's nonmanufacturing index rose 0.5 points to 57.3, its highest point in a year. On the other hand, the ISM's manufacturing index fell 1.7 points to 52.4. In February, 227,000 nonfarm jobs were created, and the unemployment rate held steady at 8.3%.

A new macroeconomic risk emerges

The sour note in February's news was the emergence of a near-term macroeconomic risk posed by Iran's nuclear ambitions. The possibility for conflict in the Persian Gulf has the potential for broad, negative implications on the global economy, particularly for the price of oil. Oil prices have already risen on heightened concerns over possible supply disruptions in Iran, notably in the vital Strait of Hormuz waterway, which moves about 20% of global daily supply.

The effects of oil supply shocks are difficult to predict, but taking Iranian supply out of the market would invariably tighten global supply at a time when spare capacity is scarce. From a current crude oil price of around US$106 per barrel for West Texas Intermediate, such an upheaval has the potential to trigger oil price hikes to the US$130-$200 level, based on previous historical price shocks. We believe, however, that such a price move would be short-lived, based on our expectation that military reaction would be swift and that sizeable emergency reserves would be released for consumption.

Our Investment Strategy in Review

At the end of 2011, we were mindful of the risk posed by the eurozone credit crisis, but felt the worst was probably behind us and that the likelihood of a negative outcome was decreasing. We were also confident that the U.S. economic recovery would continue, China's growth would continue at a steady pace, and Europe would experience a recession. In that environment, we expected that corporate earnings would rise and price-to-earnings multiples would be flat. Our conclusion was that equity markets would have relatively better returns than fixed income.

At that time, equity valuations were compelling, and we were beginning to think about moving again to an overweight position in equities, from our current neutral position. However, we remained acutely aware that the consequences of a negative outcome in the eurozone would be very damaging to the global economy. We decided to be prudent and wait for further confirmation that the macroeconomic risk was abating.

Two months later, our outlook still appears to be accurate. Our expectations for stabilizing eurozone credit conditions accompanied by moderate U.S. economic growth have been supported. As we expected, equity markets have advanced, and the neutral equity position we have maintained in most clients' portfolios means they have been able to participate in the rally.

The Outlook Ahead

We believe that the eurozone situation will continue to improve and that the risks posed by the sovereign credit crisis will continue to diminish. We will remain cautious, however, because those risks, while smaller, still exist. Greece needs to implement unpopular austerity measures and will have to negotiate further bailouts to address future debt payments. Adding to the uncertainty is Greece's upcoming April elections, in which the current coalition government faces significant losses. The parties predicted to make gains in the elections are opposed to the bailout deal.

We also believe that growth in the U.S. economy will continue, but at a moderate pace, given the headwinds posed by the country's large stock of debt. That headwind will likely constrain economic growth in developed countries for years to come. The steady growth of emerging markets economies will likely continue, supporting the global economic recovery. China recently lowered its 2012 growth forecast to 7.5%, which we take to be further confirmation that China is successfully managing to control economic growth.

Looking forward, we continue to expect the short end of the bond yield curve (bonds with 1-5 years to maturity) to hold steady. There is a chance the Bank of Canada may cut rates this year, but likely only if we begin to see much weaker economic numbers. The long end of the yield curve (for bonds with more than 10 years to maturity) will continue to react to news from Europe and the United States. We think it is more likely than not that long rates will increase, but not by very much. The combination of relatively fixed short term rates and higher long term bond rates means we will probably see the yield curve steepen, which would favour mid term bonds.

We think that equity market returns will continue to outperform fixed income, with mid to high single digit returns.

Our Investment Strategy Looking Forward

For some time, we have been expecting that the eurozone debt situation would be resolved slowly, though probably not steadily, over many months. We believe that equity markets will continue to react positively to incremental improvements in the eurozone, as has been the case this month, and we will continue to look for attractive opportunities to add high-quality stocks to our clients' portfolios.

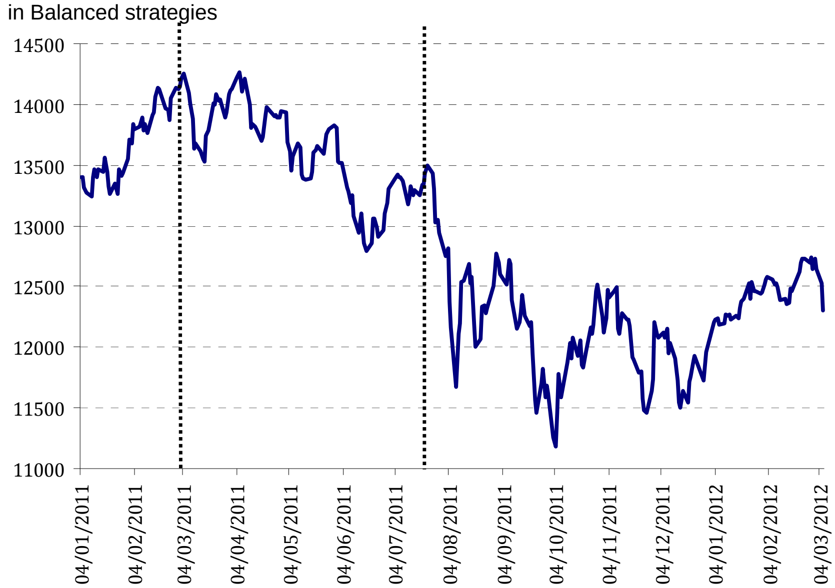
In clients' fixed income holdings, we may increase the allocation to mid term bonds, and will continue to favour issuers with high credit ratings.

At this point, we remain mindful of the risk/return trade-offs inherent with exposure to the equity market, but we are looking for the right opportunity to shift from a neutral asset allocation position to an overweight position in equities. Any increase in equity allocation would most likely be directed to North American markets where valuations are still relatively attractive, though not as cheap as they were at the end of 2011. European equity valuations are also cheap, but for good reason.

We began 2011 with an overweight allocation to Canadian equities, but lowered that to neutral relative to fixed income and cash as risks increased, primarily through reductions to Canadian equity. Ideally, we would re-enter the Canadian market at a point or points when the S&P/TSX Composite Index is below the levels at which we sold in 2011 (at about 14,300 in March, and 13,400 in July). U.S. stocks are also attractive investment candidates for an allocation because of the room for improvement in their valuations. When making allocations outside of Canada we also need to consider currency movements. We expect the Canadian dollar to strengthen only slightly relative to the U.S. dollar, and as such will not be a significant drag on a portfolio's U.S. equity allocation.

S&P/TSX Composite Index performance

Dotted lines indicate points in 2011 at which Canadian equity allocations were reduced in Balanced strategies



Source: BHIMI