January 2012

Market Commentary

New Year, New Optimism

In the first month of the New Year, we were pleased to see a number of reasons to be optimistic about the global economy and the outlook for capital markets in 2012.

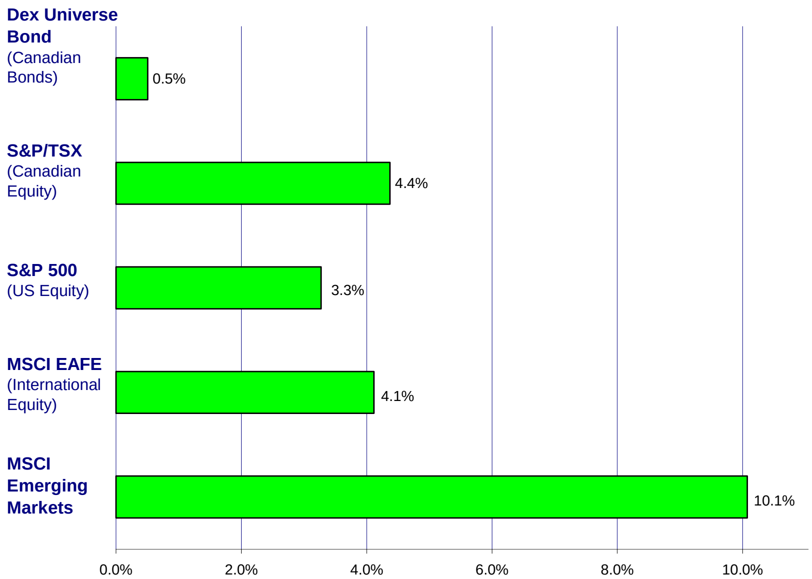
Equity markets up, volatility down

Equity markets around the world rallied impressively, advancing 3.8% C$ (5.0% US$), according to the MSCI World Index. The emerging markets were the stars, gaining just over 10% as measured by the MSCI Emerging Markets Index. In contrast, Canadian bond returns were modest at 0.5%; bond yields rose as the flight-to-safety effect eased in reaction to improving eurozone conditions.

The level of equity market volatility that characterized the second half of 2011 was also greatly reduced in January. Volatility last year was generally attributed to market participants reacting to headlines about macroeconomic events, such as the eurozone sovereign debt situation, rather than focusing on microeconomic factors, such as positive U.S. economic and corporate data. January's more moderate level of volatility may suggest that market participants have started to feel more confident about the mid to longer term outlook for Greek debt restructuring talks and a satisfactory resolution to the credit problems in the eurozone.

January's global equity market rally

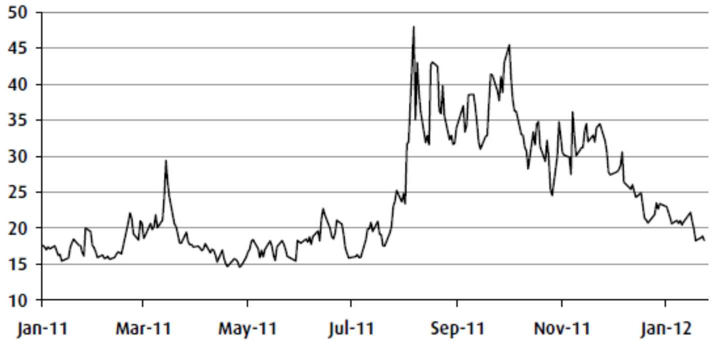
One-month total returns, C$



Source: BHIMI

Equity market volatility falls from Q4 2011 levels

CBOE Volatility Index (VIX)



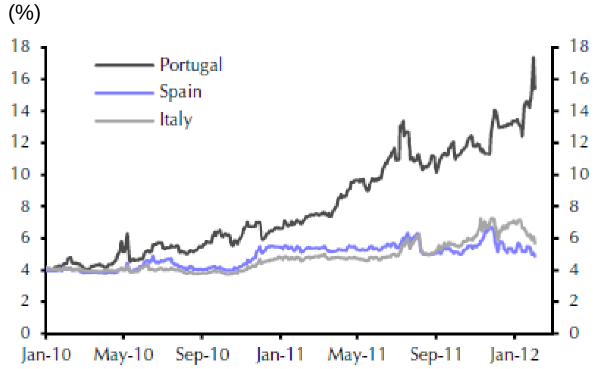
Source: *Basic Points*, Coxe Advsiors LLP

Lower perceived risk in the eurozone

To gauge the overall health of the eurozone, we have been watching the yield on 10-year Italian bonds. In early February, the yield fell to 5.7% (from over 7.0% in Q4), which signals lower levels of perceived risk and improving conditions. The Italian bond market is a good indicator of confidence levels regarding the eurozone overall, due to its size. We note that yields on other eurozone bonds also dropped in January.

In mid-January, ratings agency Standard & Poor's downgraded several European countries including France, Italy and Spain. The market reaction to these sovereign credit downgrades was muted, perhaps because this news was hardly surprising. These countries continue to be able to raise money through debt auctions, and yields don't seem to be rising, suggesting that the market does not perceive a higher risk. Portugal recently had a €2-billion auction that was significantly oversold and at lower yields than their previous auction. France, Spain and Italy also had successful debt auctions, with much lower spreads relative to Germany's yield (seen as the lowest-risk European bond) than in recent months.

Key eurozone 10-yr bond yields ease



Source: Capital Economics

While we continue to expect that Europe will experience a recession in 2012, some recent economic data has been encouraging. Germany's Purchasing Mangers' Index (an indicator of economic expansion) recorded a six-month high of 51, though Greece, Italy and Spain all remained below the threshold reading of 50.

U.S. economy improvements continue

In the United States, economic data has shown many improvements. U.S. real GDP grew 2.8% in Q4 2011, putting the total year's growth at 1.7%. Ongoing cuts in government spending weighed on growth in the fourth quarter, but spending by consumers and businesses increased. The Institute for Supply Management's non-manufacturing index rose more than expected, to 56.8, its 25th consecutive month above 50. On the jobs front, nonfarm payrolls also beat expectations, adding 243,000 jobs in January, and the unemployment rate fell to 8.3%. To compare, the average monthly jobs gain in 2011 was 152,000 and in October 2009, the unemployment rate was 10.0%. Job creation is a key indicator that the U.S. economic recovery is gaining traction.

Our Investment Strategy in Review

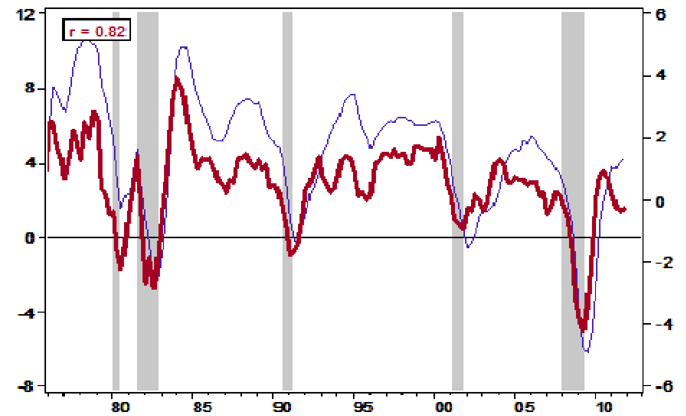
At the end of 2011, we felt that the most likely outcome for 2012 overall would be a positive one for equity investors. We also had to recognize that a serious risk remained in the eurozone sovereign credit situation, which needed to be acknowledged in a prudent investment strategy. We believed then, and continue to believe now, that in the coming year we will see an effective resolution to the eurozone situation, improved economic activity in North America and the emerging markets, and moderately positive returns from equity markets. Nevertheless, the current lack of clarity around the eurozone debt situation and its hoped-for resolution, and the likelihood of continuing market volatility as result, has led us to temper our optimism and maintain a cautious asset allocation position in our clients' portfolios. We held the tactical asset mix at a neutral position in most clients' portfolios, with equities neither under nor overweight relative to their allocation to fixed income.

We have also increased the defensive positioning of our clients' portfolios by favouring the market sectors less likely to be affected by business cycles, high quality companies with large market capitalizations that could better withstand difficult economic conditions.

Although we recognized risks, we also identified opportunity in the equity markets. The equity market rally in January has validated our decision to maintain a neutral equity weight, rather than reducing equities relative to fixed income or cash. At this juncture, we believe that we've managed to effectively balance prudence and opportunity for our clients' portfolios.

Job creation and economic growth move together

Thick line: real GDP % change y/y; thin line: total nonfarm payroll % change y/y



Source: Strategas

The Outlook Ahead

The key issue for capital markets continues to be the eurozone, and determining how that situation will be resolved. In our research and strategy work, we look at different possible outcomes over the coming 12 months, and their likely consequences for capital markets. We have divided the eurozone situation's potential outcome into two broad categories – one is an unstable credit situation, associated with one or more countries having a disorderly default, and the other is a stable credit environment.

With every passing day, the unstable scenario appears to be less and less likely. Having come through 2011, however, we need to be realistic and recognize that it remains a possibility. Conditions could still worsen, and a disorderly default in the eurozone would be extremely disruptive to the financial system; there would likely be a vacuum of liquidity and a global economic recession. This possibility is why we have strengthened the defensive characteristics of our clients' portfolios as described above.

Our view is that the probability of that dire outcome is now even lower than it was at the end of Q4, when a key indicator of markets' confidence in eurozone stability, the 10-year Italian bond yield, was up around 7% (a level at which other eurozone countries required bailouts). Since the end of the year, the 10-year Italian bond yield has dropped significantly, to about 5.7%, signalling that capital markets' investors believe the eurozone policymakers have a coherent strategy and that there is commitment to resolving the situation.

We continue to expect a European recession, but we also believe that there will be some economic decoupling in 2012 in that the United States and emerging markets' economies will be able to post positive results despite Europe. The U.S. economy is showing signs of moderate growth, and we think its GDP could grow by 2.00% to 2.25% in 2012.

The positive trajectory expected for global growth, outside the eurozone, will likely provide a decent backdrop for equity markets. Earnings for companies in the S&P 500 Index could expand slightly, and in this environment we would expect equity markets to react positively with a price-to-earnings multiple at or slightly above current levels. We could also expect to see some advance in the Canadian equity market, with commodity prices at or slightly higher than current levels.

We expect that bond yields will remain at current levels or maybe slightly higher, and continue to expect the short end of the bond yield curve to hold steady. There is a chance the Bank of Canada may opt to cut rates this year but only if we experience some very weak economic numbers. The U.S. Federal Reserve has announced its intention to keep rates low until 2014. We believe it is possible that the long end of the yield curve may increase slightly this year. The combination of higher long term bond rates and relatively fixed short term rates means we will likely see the yield curve steepen, which would favour mid term bonds.

Generally, the future looks brighter for the global economy, and we expect to see positive returns in equity and fixed income markets with relatively stronger returns in equities.

Our Investment Strategy Looking Forward

As we come into 2012 we continue to manage our clients' portfolios in a neutral asset mix position. We don't believe that the current conditions of capital markets or the global economy warrant a reduction in equities. In fact, we're looking very closely at the equity market for buying opportunities. Modestly increasing our clients' allocation to equities is the more likely next move we'll make. We continue to look for attractive opportunities to add high-quality equity holdings to our clients' portfolios, and will remain broadly diversified by sector and geography. In fixed income, we will likely increase the allocation to mid term bonds, and will continue to favour issuers with high credit ratings.

Snapshot of a diversified Canadian bond portfolio – from belly to wings

January's bond market returns were driven more by sector than duration (interest rate sensitivity). Every month we review the returns versus the duration for the various subsectors of the DEX Bond Universe Index. The index is broken down into three term categories: short bonds (1-5 yrs), mid bonds (5-10 yrs) and long bonds (10+ yrs). Each of these categories is further broken down by major issuer types such as Government of Canada, provincial and corporate issuers with different credit ratings.

Although we always manage our clients' fixed income holdings on a portfolio basis, by reviewing how individual subsectors performed, we can better understand what has happened over a particular period of time. For example, the clear winners in January were long corporate bonds with returns around 1.7%, and the worst performers were long provincials returning 0.22%. From a term perspective, the best performer was the mid term bond category of the yield curve. With an overall bond portfolio perspective, these pieces of information paint a picture of a market in which there was greater demand for mid term bonds than for short and long bonds, as well as an appetite for additional credit risk, achieved with corporate bonds. In January the mid term part of the curve returned 0.91%, while the short end returned 0.29% and the long end gained 0.52%. In bond management parlance this is known as the belly of the curve doing better than the wings.