To keep the global economic recovery intact, Europe, China and the U.S. must overcome a number of challenges. In 2013, we’ll be looking for them to take sufficient steps to harness several underlying positives.
Can the resources and resolve of the European Union turn the tide in Spain, Italy and Greece?

Will China’s economic policies jump-start growth? Can increased consumption help offset slowed exports?

Will the U.S. move in a sound fiscal direction? Can an upturn in housing, consumer confidence, and corporate execution continue and will it produce another good year for the markets?
More silver linings than clouds

Positive global trends could offset the negatives in 2013

Negative news makes the headlines, and investors have seen plenty in the recent past. Not trumpeted as loudly but still significant is the fact that U.S. consumers, corporate America, and stock and bond prices have performed strongly since the financial crisis. Stock prices today are substantially off their lows. For example, prior to the fiscal cliff anxiety, the Dow Jones Industrial Average (DJIA) had gone from 6,500 to 13,000.

Nevertheless, pessimism remains high, driven by ongoing headwinds in the U.S. as well as overseas. Investors are focused on three primary areas of concern: Europe, China and the U.S. Each of these regions faces its own set of challenges, from managing out-of-control deficits and stagnant economies, to controlling growth without killing it. However, each region also has its set of positive influences that have the potential to offset the negatives in 2013 and beyond.

In this report, we explore both the clouds and the silver linings in these three major world economies. We believe the success these regions have in overcoming their challenges will set the course for global growth. Meanwhile, investors can position their portfolios to participate and protect.

Outlook 2013

As the global economy continues to recover from the worst recession since the Great Depression, 2013 is likely to be another year of ups and downs. Overall we expect:

- Modest global economic growth that will include recession in Europe, slow growth in the U.S., slower growth in China, and solid strength from many emerging market economies.
- Fiscal progress in the U.S. and clarity regarding taxes to help support continued strong performance by U.S. companies and consumers.
- Low U.S. interest rates persisting throughout 2013, keeping investors pressed to search for higher yields and income.
- Ample opportunities in select equity markets, including attractively priced U.S. stocks, as well as select emerging markets and other areas of the developed world.
A look back to the depth of the recession reveals that stock and bond markets have indeed come a long way over the past few years. Both the S&P 500® and the DJIA peaked in 2007 before beginning a downward plunge that ended in March 2009. As of this writing, they had made up a good portion of those losses (see Table 1). The compound annual rate of return from trough to today is better than 23% for both indices. Moreover, looking back a full 10 years, both indices have returned about 6-7% annually. It hasn’t been a lost decade after all.

Meanwhile, interest rates have plummeted (see Table 2), but when interest rates fall, bond prices rise. So while the low level of yields scares those in need of income, the total returns have been quite positive.

Where does this leave us now? Lower interest rates helped boost both equity and fixed income markets. As yields fell, investors moved into riskier investments, like stocks or fixed income instruments, such as investment grade corporate bonds and, to a lesser degree, high yield bonds.
In spite of market strength, economic growth remains sluggish in the U.S., while Europe has ticked into recession, and this has contributed to less-robust growth in China as well. What lies ahead for these regions—and indeed for the world—depends on whether the nascent positives can overshadow the overhanging negatives.

**Europe**

Reforms vs. a mountain of debt

The European economy is in recession, with GDP down 0.1% in the third quarter of 2012, following a 0.2% decline in the second quarter. One of the biggest hurdles facing the European Union (EU) is debt in the southern countries (see Table 3). While Greece grabs the headlines, posting a 7.2% annualized economic decline in the third quarter, the much larger economies of Spain and Italy are in a mighty struggle to fix deficits via austerity while restarting growth—two seemingly contradictory objectives.

Over the past few years, several of these European countries added costly features to their health care and pension provisions for workers and retirees. Tax receipts, of course, fell during the recession of 2008 but expenditures did not. As a result, deficits skyrocketed, which in turn drove up interest rates. Yields on 10-year bonds more than quadrupled in Greece and nearly doubled in Spain, where the concerns are partially deficit related but also reflect a substantial housing crisis. While interest rates rose in Spain, Italy and Greece, German interest rates, like those of the U.S. Treasury, fell sharply.

High government expenses coupled with a drop in tax receipts drove deficits much higher in a relatively short period of time.

The bright side of this picture is that in late 2011 and forward, the European Central Bank (ECB) and EU began aggressive measures to address these problems. They developed plans and secured funding commitments from EU members to support emergency lending mechanisms that could assist countries in need of a financial backstop. In addition, a regulatory system to oversee the EU banking community was outlined and accepted. Since taking these initiatives in mid-2012, interest rates in Italy and Spain have fallen, and Europe’s stock markets rallied nearly 20%.

- **Interest rates came down** significantly in Greece, Portugal, Ireland, Spain and Italy (see Chart 1 on Page 4). Plus, the ECB has slashed rates from a high of 4% to 0.75% currently. As a result, borrowing costs are down substantially.

  - The ECB has established emergency reserves, including the Emergency Financial Stability Facility (EFSF) and the Emergency Stability Mechanism (ESM). These two facilities have a combined lending ceiling of €700B. ECB President Mario Draghi promised to “do whatever it takes to preserve the Euro.”

  - The ECB will become bank supervisor for the EU. Although the final structure has not yet been determined, this is a significant step toward greater financial stability and fiscal integration across the region.

  - The German and French economies continue to grow, albeit modestly. Since these two countries represent such a large part of the EU, maintaining positive growth is a major plus.

  - The STOXX Europe 600 Index rebounded strongly, rising over 20% since mid-July 2012 after the more aggressive actions and language by the EU and the ECB.
Europe’s clouds

- Negative overall economic growth.
- High debt-to-GDP ratios.
- High interest rates.

Europe’s silver linings

- Economically significant Germany and France continue to grow.
- The EFSF and ESM can provide emergency lending capacity.
- Interest rates in Spain, Greece and Italy are down and thus borrowing costs are lower.
- The ECB will become the bank supervisor for the EU, adding stability to the region.
- ECB rates are down to 0.75% from 4% in 2007, a dramatic reduction in borrowing costs.
- Stock prices have started to turn up.

China

Improving industrial and consumer sectors vs. slowing overall growth

China emerged from the global recession growing at a much stronger pace than the developed world. However, double-digit growth rates in turn drove consumer prices higher. The Consumer Price Index (CPI)—a measure of the cost of goods in the country—increased from 2.2% in the first quarter of 2010 to 6.3% by the third quarter of 2011. In response, the Chinese government raised interest rates and reserve requirements in an attempt to moderate the pace of growth and inflation.

Unfortunately, these actions occurred simultaneously with the weakness in Europe, which accounts for 20% of China’s exports. China suddenly went from an economy growing by 10–12% to one growing at 7–7.5%. Export growth, which rose 26% in the first quarter of 2011, had slowed to 14.3% year-over-year by the end of 2011. GDP followed suit and ended 2011 at 8.9%, compared with 11.9% growth at the beginning of 2010.

Industrial production in China has rebounded while inflation pressures have eased.
Current real GDP growth in the second and third quarters of 2012 has stabilized at 7.6 and 7.4%, respectively. Although this is a much slower pace than two years earlier, it’s a far cry from the tepid growth seen elsewhere in the developed world. With this slowdown, the government reversed course, lowering reserve requirements and interest rates in order to jump-start demand.

The early return from these efforts is encouraging. We see a number of positive trends that have the potential to turn the tide and set China back on a steady growth trajectory (see Table 4).

- **Lending rates are down** from a year ago and bank reserve requirements are lower. China’s leaders, including newly installed leadership, clearly understand the value of pro-growth policy initiatives.
- **Year-over-year growth in exports has been erratic but positive.** For example, exports rose 10.5% in the second quarter of 2012 and 4.5% in the third quarter.
- **Retail sales rose 9.9% year-over-year in the third quarter of 2012.** This is a significant turn from an 11.8% decline in the first quarter. We believe it signifies the results of a growing effort to stimulate consumer demand. Private consumption represents only 35–40% of GDP in China. In contrast, it represents 71% in the U.S.
- **The emerging markets in aggregate remain healthy** and are home to the world’s largest population and greatest purchasing power. These markets represent an important element of China’s exports (see Table 5 on page 6).

**Consumer growth is helping to complement the large export component of China’s economy.**

### Table 4 | China—Key Indicators

<table>
<thead>
<tr>
<th></th>
<th>3Q11</th>
<th>4Q11</th>
<th>1Q12</th>
<th>2Q12</th>
<th>3Q12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-Yr Lending Rates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports (year-over-year)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail Sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg; data as of 10/26/12
Although the slowdown in Europe hurt China’s exports, the majority of the world’s population—and purchasing power—lies in the emerging markets.

<table>
<thead>
<tr>
<th></th>
<th>Population (millions)</th>
<th>Purchasing Power</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>500</td>
<td>20.0%</td>
</tr>
<tr>
<td>Emerging Markets (Including China)</td>
<td>3,900</td>
<td>40.2%</td>
</tr>
<tr>
<td>U.S.</td>
<td>300</td>
<td>19.1%</td>
</tr>
<tr>
<td>Japan</td>
<td>100</td>
<td>5.7%</td>
</tr>
<tr>
<td>World</td>
<td>6,900</td>
<td>100%</td>
</tr>
</tbody>
</table>

The International Monetary Fund (IMF) projects these emerging market economies will grow by 5.5% in 2013.

Sources: International Monetary Fund, World Economic Outlook, April 2012; World Federation of Exchanges; OECD; CIA World Factbook

**China’s clouds**
- Slowing economic growth.
- Slowed exports.
- Inflation concerns.
- Exposure to Europe.

**China’s silver linings**
- Accommodative monetary policies are in place.
- Exports, while slower, are holding up; emerging markets still have tremendous buying power.
- Retail sales have turned into positive territory.
- Real GDP growth remains healthy at 7.4%.
- The CPI has slowed.

**U.S.**

**Strength from the consumer vs. a fiscal cliff**

In the United States, the story is the need to increase the pace of economic growth. GDP growth rates of 1.5–2.0% remain too weak. Despite quite remarkable corporate and consumer results, the nation experienced a pullback in corporate sales and earnings in the third quarter of 2012. This, coupled with the fiscal cliff, is creating apprehension about U.S. growth prospects.

The immediate fiscal cliff includes approximately $600 billion of tax increases and spending cuts in 2013 alone. Among the policies at issue are:
- The expiration of the Bush tax cuts.
- Government spending cuts to more than 1,000 programs, including defense and Medicare.
- The end of temporary payroll tax cuts (resulting in a 2% tax increase for workers).
- A return to prior unemployment benefit levels.
Alternative minimum tax extended to many more households.

The start of taxes related to the Affordable Care Act health care law.

Avoiding or downsizing the fiscal cliff is critical to prevent another recession. Lawmakers know they must act quickly and decisively or risk serious implications to the economy. Although it will be a challenge to create bi-partisan solutions, we expect the U.S. Congress and the Administration to take the necessary steps to avoid a more dangerous outcome.

In the meanwhile, the U.S. is benefiting from powerful trends tied to consumer confidence and a long overdue uptick in housing. As the biggest component of the nation’s GDP at 71%, the consumer has enormous capacity to drive economic activity.

**Consumer confidence is on the rise.** The University of Michigan Consumer Sentiment Index now stands at a five-year high (see Chart 3). This growing willingness to spend is an important source of fuel for the economy.

**Retail sales rose 5.4%** in the third quarter of 2012, helped by double-digit growth in light truck and auto sales. Strong consumer spending continued in the fourth quarter over the all-important Thanksgiving weekend.

**Housing looks to have turned the corner.** Housing starts trended higher throughout 2012, as did new home sales and prices of new homes. Currently, there are only 5.9 months of houses in inventory, the lowest since 2006. The National Association of Home Builders Housing Market Index, one of the timeliest indicators of housing activity, has climbed higher since mid-2011 (see Chart 4 on page 8).

**Employment continues to rise,** albeit slowly, non-farm payrolls have averaged 170,000 over the last three months (as of 11/30/12).

**Manufacturing activity remains positive.** The latest Institute for Supply Management (ISM) PMI—a measure of the economic health of the manufacturing sector—came in at 51.5%, just barely positive but an important move in the right direction.

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**Chart 3 | U.S. — Consumer confidence on the rise**

Consumer confidence has reached its highest level since the onset of the recession.

Source: University of Michigan; data as of 11/19/12
Corporate operating margins remain solid and impressive at 20.5%. Margins have remained close to 20% since the economy emerged from recession. Analysts are estimating continued gains in both sales and earnings of S&P 500 companies in 2013 (see Table 6).

U.S. clouds
- Slowdown in corporate sales and earnings late in 2012.
- Fiscal cliff concerns.

U.S. silver linings
- Rising consumer confidence.
- Retail sales moved higher in the third quarter of 2012.
- Housing starts, new home sales and prices are in an up-trend.
- Employment continues to rise gradually.
- Manufacturing indicators remain positive.
- Corporate operating margins are solid; balance sheets are strong and free cash flow is high.

Table 6 | 2013 Projected U.S. sales and earnings growth for S&P 500 companies

<table>
<thead>
<tr>
<th></th>
<th>2013e ($)</th>
<th>2013e (%)</th>
<th>1Q13e (%)</th>
<th>2Q13e (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales/Share</td>
<td>1,130</td>
<td>3.9</td>
<td>0.6</td>
<td>3.1</td>
</tr>
<tr>
<td>Earnings/Share</td>
<td>115</td>
<td>9.8</td>
<td>3.7</td>
<td>9.1</td>
</tr>
</tbody>
</table>

Source: Bloomberg; data as of 10/30/12
According to the International Monetary Fund (IMF), the emerging markets will produce the fastest economic growth of 5.5% in 2013. The U.S. is expected to continue on a growth path of 2%, while the IMF predicts the EU will avoid recession and eke out 0.5% growth.

In our view, the U.S. will:

- Limit the effects of the fiscal cliff through legislative actions.
- Maintain steady support from consumers.
- See continued strength in housing.
- Benefit from effective execution from corporate America.
- Continue a central bank policy of cheap money in abundant supply.

Meanwhile, we expect Europe to maintain their resolve, and that China will orchestrate a "soft landing" for their economy.

We’ve summarized our assumptions in Table 7, alongside selected risks to those assumptions. If some or all of those risks occur, or the IMF forecasts prove too optimistic, we still believe we can avoid recession in the U.S. and globally. In Table 8 on page 10, we illustrate what we believe to be a "weak-case" scenario for world growth. Even assuming slow growth rates and a recession in Europe, we expect the U.S. to avoid recession and global GDP to grow slowly.

### Table 7  |  Our assumptions and the associated risks

<table>
<thead>
<tr>
<th>Base Case</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slow global growth</td>
<td>Spain, Italy and/or Greece implode</td>
</tr>
<tr>
<td>Slow U.S. growth</td>
<td>Longer-term fiscal issues remain unresolved</td>
</tr>
<tr>
<td>Fiscal cliff is a partial drag</td>
<td>No softening of the political divide/the economy takes the cliff dive</td>
</tr>
<tr>
<td>China orchestrates a soft landing</td>
<td>Exports fall substantially and consumer spending slows</td>
</tr>
<tr>
<td>U.S. consumer remains steady</td>
<td>Consumer confidence falls</td>
</tr>
<tr>
<td>U.S. housing on the mend</td>
<td>Refinance and new buying activity weakens</td>
</tr>
<tr>
<td>U.S. corporate results:</td>
<td>Capital expenditures weaken</td>
</tr>
<tr>
<td>EPS growth 5-6%</td>
<td>Profit margins compress</td>
</tr>
<tr>
<td>Valuations 13x-15x P/E</td>
<td>No demand pick-up</td>
</tr>
<tr>
<td>Low U.S. inflation</td>
<td>Food/energy prices spike</td>
</tr>
<tr>
<td>U.S. yields remain range bound</td>
<td>Inflation/deflation causes a spike, moving rates higher or lower</td>
</tr>
</tbody>
</table>
Table 8 | Projections under a hypothetical “weak-case” scenario

<table>
<thead>
<tr>
<th>Major Regions/Countries</th>
<th>Share of World*</th>
<th>Projected 2013 Growth</th>
<th>Hypothetical Alternative Scenario 2013 Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU ($17.4 tril)</td>
<td>20.0%</td>
<td>-2.0%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>U.S. ($15.5 tril)</td>
<td>19.1%</td>
<td>2.0%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Emerging Markets (Including China) ($20.9 tril)</td>
<td>40.2%</td>
<td>5.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Japan ($5.8 tril)</td>
<td>5.7%</td>
<td>1.0%</td>
<td>0.1%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2.1%</td>
</tr>
</tbody>
</table>

Even under this weak global scenario, the U.S. and the overall economy should avoid recession and grow slowly in 2013.

Source: International Monetary Fund.

Portfolio positioning

Although a number of challenges remain, we believe the silver linings outlined in this report may enable the overall global economy to grow slowly in 2013. Europe has pockets of strength and the EU and ECB have moved aggressively in the past year or two to provide a financial backstop for the region. China remains an export giant with growing strength in the consumer sector. And the U.S. is benefiting from rising consumer confidence, an upturn in housing and effective corporate execution. While we acknowledge the fiscal cliff and other risks to our outlook, we also see investment opportunities.

U.S. and international equities outlook

With solid prospects and profits that are not too dear in terms of valuation/prices, we see a good opportunity in equities — not only in the U.S. but also selectively around the world.

In many sectors, the appeal of stocks is heightened by dividends that equal or exceed yields on U.S. Treasury securities. Therefore, investors can own quality companies with strong dividend growth prospects as well. Although tax policies may limit the appeal of dividends, we believe that even tax-adjusted, the dividend story is too big to ignore.

For U.S. investors, we recommend that U.S. equities be the largest portion of the stock portfolio. Among U.S. stocks, we continue to favor the larger companies with solid execution and global business models that are selling at reasonable prices.
The prices for these companies by historical norms remain attractive. It’s a pretty close call on growth stocks vs. value stocks in this category, but we give a slight nod toward growth.

Small companies lagged larger companies in terms of stock price appreciation in 2012. However, these smaller companies sell at a discount to their historical valuations and, for the most part, are beating earnings and sales growth expectations. In addition, they tend to have more domestic exposure than big companies— making them a little less exposed to the risks in Europe and China.

Currently, the resolution of the fiscal cliff, as well as the future for tax rates on dividends and capital gains, remains unclear. Historically, raising capital gains taxes has not been good news in the short run for stocks.

In addition, there are many emerging markets that offer even cheaper valuations (stock prices that are lower relative to profit expectations) compared with the U.S. They also include an abundance of companies that are performing well across many measures. In Europe, we recommended investors avoid finance stocks and stay clear of the troubled headline countries; that guidance has generally paid off. However, Europe does provide select opportunities to buy quality companies with solid metrics of achievement.

**Fixed income outlook**

Fixed income markets in the U.S. and in several countries or regions around the world are benefiting from monetary accommodation, falling interest rates, low rates and, in the U.S. and much of Europe, low inflation.

In the U.S., three rounds of quantitative easing by the Federal Reserve (Fed) have put enormous amounts of money into the economy — with the stated intent to keep rates low until 2015 in order to stimulate economic traction and employment. In response to falling and low rates on U.S. Treasury and mortgage-backed securities, rates of other credit sectors have tumbled as well, including high yield, corporate investment grade, municipals and even emerging market debt.

While U.S. Treasury securities remain a safe haven of choice, investors seeking more income have moved significantly to riskier fixed income sectors. Hopefully, they are aware of the risks of such a move — primarily the effect of a rise in interest rates, plus the assumption of more credit risk.

We still consider taking credit risk a viable portfolio opportunity. We would emphasize that using the best of credits in any sector is good advice. For example, investors in high yield should screen carefully to minimize default risk. Those in emerging market debt should be choosy by issuer, sector, country and currency denomination, etc. And even in investment-grade bonds — one of our favorite sectors — selectivity is key.

The last piece of portfolio protection is to keep maturities/duration in the shorter-to-intermediate range to help protect principal should rates move higher. The efforts of the Fed may be nearing the end of their effectiveness. However, the present policies are ones to which the Fed remains committed for the next two years.

As we look forward into 2013 and beyond, we acknowledge the challenges that lie ahead, but point to the silver linings around each cloud. We believe those positives are powerful enough to support slow growth in the global economy overall. They’re also widespread enough to create ample opportunity for equity and fixed income investors.
Dow Jones Industrial Average (DJIA)
A price-weighted average of 30 significant stocks traded on the New York Stock Exchange and NASDAQ.

S&P 500® Index
An unmanaged index of large-cap common stocks.

BofA Merrill Lynch Corporate Master Index
Tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market.

BofA Merrill Lynch U.S. High Yield Master II Index
A broad-based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding amount of $100 million and maturing over one year.

BofA Merrill Lynch 7-10 Year US Treasury Index
The BofA Merrill Lynch 7-10 Year US Treasury Index is a subset of The BofA Merrill Lynch US Treasury Index including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

STOXX Europe 600 Index
Represents 600 large, mid and small capitalization companies across 18 countries of the European region.

National Association of Home Builders Housing Market Index
An index of more than 300 home builders showing the demand for new homes. The index ranges from 0 to 100 where a rating of 50 indicates that demand for new homes was average.

University of Michigan Consumer Sentiment Index
Published monthly by the University of Michigan and Thomson Reuters and based on the results of at least 500 telephone interviews conducted each month of a continental United States sample (Alaska and Hawaii are excluded). The index has a value of 100 in December 1964.

CPI Index
The Consumer Price Index is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

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