

First Quarter 2013

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Economic Outlook and Review

SLOW GROWTH BETTER THAN NO GROWTH

First quarter real GDP in the U.S. is tracking close to a 3% annualized growth rate thus far in 2013. This rate of growth is much faster than the meager 0.4% pace posted last quarter. It seems clear that future growth will be hindered by the fiscal drag emanating from Washington. So far, private sector activity has been strong enough to overcome this obstacle. Consumers are still spending more despite higher effective tax rates, while each passing day gives hope to business owners that this recovery is sustainable.

EMPLOYMENT PICTURE FAR FROM NORMAL

According to the Bureau of Labor Statistics, the pace of hiring has been flat since the end of the recession. The number of job openings per worker is rising, but companies appear to rather have their employees work longer hours or hire temporary workers over hiring new, unless there is a perfect skillset match for an open job. In February, the average production workweek climbed to 41.9 hours, the longest since the mid-1990s. Cutting back on training programs during the recession has caused the pool of qualified candidates for certain jobs to be scarce. Also, according to Manpower, more than half the employers polled reported that workers wanted more than what they were willing to pay. As the economy continues to recover, manufacturing firms will either have to be willing to pay more, further increase the use of automation, or choose to expand overseas.

Another difference from past recoveries is the stark job prospects for those unemployed for a period longer than six months versus those out of work for less time. There still are 5 million more unemployed people than before the recession, and 40% of them have been unemployed for greater than six months. Displaced workers over 55 years of age face further obstacles, but it is difficult to determine whether this is caused by a lack of necessary skills or age discrimination.

We have seen a significant decrease in weekly unemployment claims, both on a continuing and first-time basis. Recent

hiring has been broad-based across a fair number of industries. The latest jobs number for February seemed to confirm that weather and sequestration have not yet hampered the job market.

HOUSING ACTIVITY HELD BACK BY LACK OF HOUSING

Despite a continuing rebound in the housing market, recent existing home sales were a disappointment at 4.98 million annualized units and realtors blame low inventory. The supply of existing homes for sale is down to just 4.7 months; a six-month supply is more consistent with a healthy market.

New housing activity has been a bright spot in the economy and housing starts in February were at the strongest annualized numbers of this recovery. Permit activity typically leads new construction, but recent single-family permits have moderated while multi-family permit activity is up. Homebuilding activity could soften a bit in the months ahead as both building material and labor costs move higher. The production of some key inputs to construction such as cement and wood products has fallen behind current demand, creating bottlenecks in some areas. Builder confidence has recently moved a bit lower as buyers still are challenged by low appraisals of their existing homes and the lack of credit availability to all but the most secure borrowers.

RISING ASSET VALUES FED BY THE FED

Although some Federal Reserve critics think monetary policy has been too easy for too long, both borrowers and investors have clearly benefited from Fed largesse. Long-term interest rates have been driven lower via direct Fed purchase activity, which in turn has spiked other asset values. Major stock indices have more than doubled from their recessionary low points. This has done wonders as the current net worth of U.S. households reaches all-time highs.

Wealthier households tend to spend more as newfound confidence leads to less need for current savings. More underwater homeowners are resurfacing with the renewed ability to borrow home equity. Nobody is suggesting that home equity borrowing will soar to new heights, but at the margin, this type of lending will likely further stimulate consumption.

Financial Market Review *First Quarter 2013*

DON'T WORRY, BE HAPPY

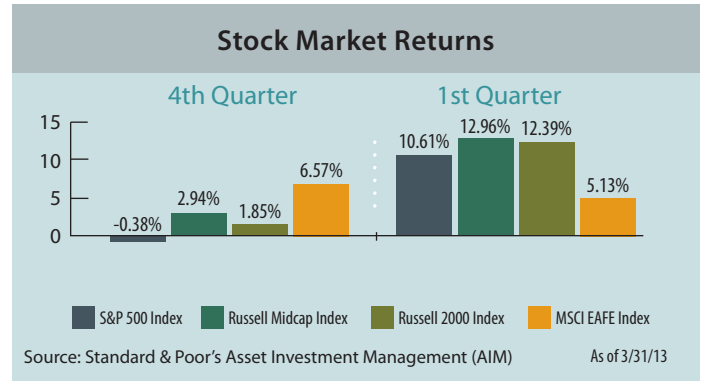
Both businesses and households were severely impacted by the last recession, causing most people to become overly cautious. Recent signs, however, indicate fear is subsiding somewhat. The bad memories are fading and people are willing to make larger scale purchases such as homes and automobiles. This renewed consumer spirit is the best reason of all to believe that our economic upturn, though slow-paced, is sustainable.

Stock Market Review

Another good start to the year has investors moving money into stocks hoping to participate in this year's rally. Generally speaking, value stocks outpaced growth stocks and foreign stocks lagged their U.S. counterparts. Even within the growth sector, healthcare stocks led the market, while technology stocks continued to struggle. There were a number of reasons for the U.S. dominance this quarter, not the least of which was a banking crisis in Cyprus that further undermined confidence in the European markets. Large cap stocks (S&P 500® Index) were up 10.6% for the quarter. Small and mid-cap stocks as represented by the Russell 2000® Index and the Russell Midcap® Index showed even stronger returns as they increased 12.4% and 13.0%, respectively. International stocks in developed markets (MSCI EAFE Index) rose 5.1%, led by Japan's 19% return for the quarter. However, stocks in the emerging markets (MSCI EM Index) showed a negative return of 1.6%.

The stock market recovery that started in March of 2009 is officially four years old with few signs of the excesses often apparent at market tops. Investors have slowly inched back into stocks as the Federal Reserve keeps interest rates artificially low and corporate earnings continue to grow. This leaves us with a stock market that has more than doubled in price off of its lows, but still looks to be trading at a reasonable valuation. The S&P 500 sells at less than 15 times expected earnings equating to an earnings yield of 6.6%. Historically, this earnings yield may be about average, but looks attractive versus the 1.8% yield available on a 10-year Treasury note and almost irresistible next to a money market fund yield of 0%. The longer interest rates stay this low, the more pressure investors feel to look for alternatives to these low yields. There is a lot of talk about a rotation out of bonds and into stocks. Yet the evidence, so far, is more likely a movement from cash reserves to stocks. Investors tend to focus more on current conditions than what might happen down the road. Bond portfolios invested in corporate or high yield securities have continued to experience positive returns. Higher quality bond portfolios dominated by Treasury securities actually showed a modest negative return for the quarter.

It has really come down to a backdrop of global Fed easing trying to stimulate stronger economic growth by keeping interest rates low in virtually every major country. These



conditions are conducive to risk assets such as equities and corporate bonds. The Fed's determination to keep interest rates at these levels is working to move investors out of low risk investments. This will eventually change, but not until we see stronger economic growth and better job creation. Corporations are finding themselves in the enviable position of having excess cash on their balance sheets. This is leading to broad dividend increases and share buybacks. Even technology stocks are becoming a rich source of dividend income with companies such as Cisco Systems, Microsoft and IBM raising their payouts. There was an increased dollar volume of mergers and acquisitions versus last year, but actually a fewer number of deals. Not unlike investors, corporations are weary of committing to a major acquisition in the face of so much uncertainty. The effect of low rates on these large cash balances keeps pressure on corporations to either pay more out to shareholders or find higher return opportunities.

Most investors find a disconnect between slow economic growth, high unemployment, and a strong stock market. Many continue to look over their shoulder, afraid of another credit crisis or significant downturn. In our opinion, the most successful program for most investors is to ignore the daily price movements and target an asset allocation appropriate for their unique circumstances. It is likely that the pace of the sharp rise in prices we saw in the first quarter is not sustainable. However, historically, long-term stock returns are made up of short movements like we just experienced, and corrections are normal – just unpredictable.

Fixed Income Market Review

WHAT? BONDS CAN LOSE MONEY?

Economic data generally came in stronger than expected during the first quarter. The unemployment rate dropped to 7.7% and the housing market continued its recovery. Unexpected strong growth typically weighs on bond prices, especially in this environment where investors react to the slightest hint the Fed may begin to curtail its quantitative easing strategy.

For the quarter ended March 31, 2013, the Barclays U.S. Aggregate Bond Index (BCAGG) lost 0.12%, its first quarterly loss since 2006.

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The real underlying performance story within the BCAGG has to do with the composition of the index itself. Nearly 37% of the index is composed of U.S. Treasury securities, and longer maturities suffered losses in excess of 2% for the quarter. Clearly it doesn't take much of a move higher in rates to generate losses when beginning yields are so low. For example, the yield on the 10-year Treasury note ended the quarter at 1.85%, only slightly above the December 31 yield of 1.76%. Yet the 10-year lost 31 basis points for the quarter. And that doesn't even tell the whole story. U.S. 10-year yields reached an 11-month intra-day high of 2.08% on March 8 as speculation abounded over whether the Fed would curtail its easy money policies earlier than expected. Soon thereafter the Cyprus problem rekindled European debt crisis concerns and Treasury yields fell as the typical flight to quality ensued.

The mortgage component of the index underperformed Treasuries because the yield spread was too narrow to protect this sector from the impact of higher rates. With the Fed buying \$40 billion per month in the mortgage market, net new issuance is close to zero. This will tend to hold rates on mortgage product down, making the mortgage-backed securities market unusually sensitive to any change in Treasury yields.

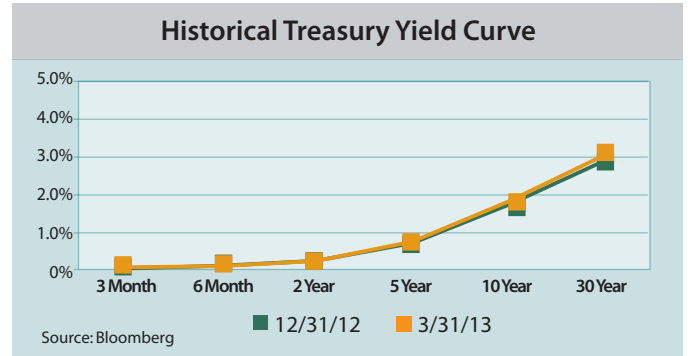
INVESTMENT GRADE CORPORATE BONDS LAGGED HIGH YIELD CORPORATE BONDS

Investment grade corporate bond yields are no longer particularly attractive despite continuing strong underlying fundamentals such as earnings growth and balance sheet health. Investor enthusiasm in investment grade bonds has waned due to low absolute yield levels, continuing narrow spreads to Treasury bonds, and fears of a global growth slowdown. At the end of the quarter, the BofA Merrill Lynch U.S. Corporate Master Index showed an effective yield of 2.79%, the lowest level in history.

High yield bonds performed very well in the first quarter, exhibiting the typical positive correlation to a very robust stock market. Clearly, the Fed-induced demand for yield has played a major role in the continuing popularity of the high yield market. According to the BofA Merrill Lynch High Yield Index, this sector produced a return of 2.90% for the quarter, far outpacing the BofA Merrill Lynch Corporate Bond Index return of 0.05% over the same time period. It should be noted that the future potential upside in high yield is growing more limited as yield levels are near record lows. It stands to reason that as junk yields are so low, average prices are at record highs, which also limits further significant appreciation.

MUNICIPAL BONDS REFLECT WARINESS OVER WASHINGTON POLICY IDEAS

Municipal bond volatility increased during the quarter as budget battles in Washington include some rhetoric surrounding the curtailment of tax exemption in one way or another. Municipal bonds actually rebounded in January and



February after a dismal December showing late last year, but faded in March as policy worries returned together with seasonal selling pressures as we edge toward April 15 tax payment needs. For the quarter, shorter maturities outperformed longer maturities consistent with taxable bond performance patterns. Lower quality investment grade municipal bonds also mimicked their taxable counterparts with BBBs performing much better than higher quality AAs and AAAs.

EMERGING MARKET GOVERNMENT BONDS OFF TO WORST START SINCE 1995

Emerging market (EM) government bonds lost 2.3% for the quarter according to the JP Morgan Chase EMBI Global Index. Toward the end of the quarter, investors shifted their government exposure back to the developed U.S. as interest rates increased enough to attract some buyers away from EM government debt which came under pressure as the Cyprus fear spread into Europe once again. Also depressing enthusiasm for EM government debt was the fact that China, Brazil and India all displayed sub-par growth relative to expectation.

EM corporate bonds were less sensitive to Treasury moves than EM government debt. EM corporate debt yielded a positive return for the quarter, as the higher beginning yields supported demand from individual and corporate buyers.

GREAT ROTATION YET TO BEGIN

Many professional investors anticipate a major shift away from bonds and into stocks as the year progresses. This so-called "Great Rotation" hasn't shown up yet in terms of bond outflows. Sentiment remains clearly in favor of equities as there is no shortage of forecasts for higher interest rates during the balance of 2013. But so far, the year has been relatively quiet and the losses experienced in the first quarter haven't created any indication of panicked selling out of bonds. Unless the Fed is anticipated to end the cycle of easy money, we would expect the range of yield changes to be rather limited.

Alternative Investments Review

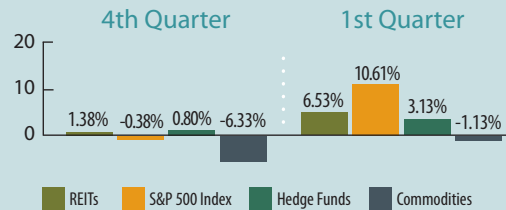
Investors continue to engage in a love/hate relationship with risk assets. As the major U.S. equity market indices recaptured their peaks last seen in 2007, many discovered that their underweight equity exposures beckoned a fresh embrace of risk, while others looked at the global picture of geopolitical unrest and European economic policy discord as harbingers of a major market retrenchment.

Alternative investments should have provided a hiding place for those most cautious about bonds and equities, yet the Q1 performance from many alternatives continued to lag. The HFRX Global Hedge Fund Index returned 3.13% with most of the gains achieved in January. Most hedge fund managers have been hurt by Apple's quick retreat, as its huge cash hoard did little to buffer the decline. Though hedge fund managers usually prefer anonymity, Apple's distress prompted some managers to publicly demand that some of that cash be distributed in special dividends.

Absolute return hedge fund managers – mostly arbitrage managers – have been limited by the tightness in credit spreads and the historically low volatility in day-to-day trading as evidenced by the 12% VIX. The incremental yield picked up from holding a lower quality bond versus a higher quality credit no longer provides a good risk/reward profile. As such, short-term trading prevails amidst choppy conditions.

The rising equity tides have lifted private equity valuations some, though deal activity is moderate. Venture funding continues to lag, as institutional investors remain more concerned about current cash flow than long-term appreciation potential.

Selected Alternative Indexes vs. S&P 500 Index



Source: REIT returns represented by the Wilshire U.S. REIT Index, Hedge Funds represented by the HFRX Global Hedge Fund Index and Commodities represented by the Dow Jones UBS Commodity Index. As of 3/31/13

As housing activity and valuations show steady improvement, many investors have returned to real estate – likely encouraged by the low borrowing rates that the Fed has sponsored. Commercial real estate investors have crept up the risk spectrum, now seeking out growth as well as income.

Commodity markets are not keeping up with equities – perhaps indicating that global commercial demand is soft and that the recent equity market rise is mostly a monetary phenomenon. In the quarter, the DJ UBS Commodity Index has fallen (1.13%), while gold prices are down (4.5%) since year-end 2012.

Monthly Updates:

Readers are reminded that our detailed Monthly Economy and Markets publication is available from our websites at bmogamus.com and bmofundus.com.



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Past performance is not necessarily a guide to future performance.

S&P 500® Index is an unmanaged index of large-cap common stocks. The **Russell 2000® Index** is an unmanaged index that measures the performance of the smallest 2000 U.S. companies in the Russell 3000® Index. The **Russell Midcap® Index** measures the performance of the smallest 800 U.S. companies in the Russell 1000® Index. **MSCI EAFE Index** Europe, Australasia, and Far East Index (EAFE) is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International. The **HFRX Global Hedge Fund Index** is designed to measure the performance of the hedge fund universe. It is comprised of all eligible hedge fund strategies. The **Dow Jones UBS Commodity Index** is comprised of futures contracts of commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc. The index reflects the return on fully collateralized positions in the underlying commodity futures. **Wilshire U.S. REIT Index** measures U.S. publicly traded Real Estate Investment Trusts. Investments cannot be made in an index.

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