Quarterly Market Commentary

July 8, 2010

Please direct any questions you may have about this publication to your local BMO Harris Private Banking Office by calling 1-800-844-6442.

Highlights

- Markets are grappling with three very specific and critical factors: sovereign credit risk, the stability of the U.S. economic recovery, and the pace of Chinese economic growth. We believe these issues are manageable, but we remain cautious and alert to these risks near term.
- Our asset allocation strategy is predicated on a stable credit environment, improved private-sector participation, and global monetary policy that continues to be supportive of growth.
- The state of sovereign credit risk is key to our outlook. We believe there's potential, within the next 12 to 24 months, for one or more smaller European nations to default, but these occurrences would be isolated and the impact contained.
- The private sector is expected to use its improved earnings and cash levels to fund the next leg of the recovery, specifically through job creation, which is a key driver of economic growth, and of consumer and investor confidence.
- Given relatively tame inflation expectations, the Bank of Canada (despite an early move in June) and the U.S. Federal Reserve are likely to remain on the sidelines and support the economy with accommodative monetary policy.
- There is still a great deal of capacity in the economy, credit conditions are still tight, and the labour market is still not in a position to push for higher wages. All these factors should help limit inflationary pressures.
- We are not concerned about China's government going too far in applying measures to slow their current high level of growth. Our view is that China will experience a soft landing, with annual GDP growth of 8% to 9%.
- Our outlook for the Canadian equity market over the medium and longer term remains positive. Over the next year, we expect equity gains to be modest, and largely driven by earnings growth. However, equity markets are expected to remain volatile over the next few months, with short-term investor sentiment as the primary influencer.
- We believe that a moderately higher-than-neutral allocation to equities is appropriate for a client with a balanced portfolio, particularly since cash and fixed income securities are expected to provide very low or flat returns over the next 12 months.

Holding steady: Focused on what's relevant

The markets are currently grappling with three very specific and critical factors: sovereign credit risk, the stability of the U.S. economic recovery, and the pace of Chinese economic growth. How will these factors play out over the next few months, and how they will impact equity and bond prices?

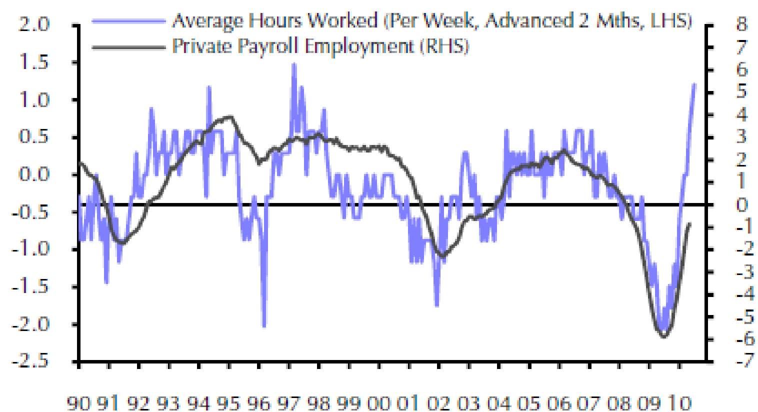
During this volatile quarter for equity markets, in which market sentiment sometimes ignored improving trends in economic data, we focused our outlook analysis on the potential of these factors to drive global growth.

At the beginning of the second quarter of the year, we based our asset allocation strategy on three major assumptions. In our view, the global economic recovery would require a stable credit environment, improved private-sector participation, and global monetary policy that continued to be supportive of growth. We factored these assumptions into our 12-month outlook for the economic and capital markets.

Now, at the end of the quarter, we believe these assumptions are even more critical as we approach the point when roughly half the U.S. public sector stimulus funds that fuelled our crawl out of the great recession have been spent. The private sector will have to take over from this point forward and spearhead an organic, sustainable recovery, one that is driven by companies growing their revenues and earnings without direct government support. In order to do so, the private sector will need a continuation of low interest rates and relatively accommodative monetary policies (designed to stimulate economic growth, most often by lowering short term interest rates, making money less expensive to borrow.)

So far, so good on both fronts. Central banks around the globe are not likely to tighten the money supply in the near term. (Monetary tightening generally refers to central bank policies designed to curb inflation and growth, such as raising interest rates or increasing the reserves of commercial banks, thereby reducing the money supply.) Corporations across North America also have huge cash levels, strong revenue growth, and healthy operating margins. Corporations are also enjoying very high – but unsustainable – productivity levels. In order to keep productivity high, corporate North America will soon be forced to put all that cash back to work in their businesses, making capital expenditures and ramping up their hiring (see chart 1). We expect meaningful job creation from the corporate sector this fall, followed by improvements in consumer spending that are expected to result in improved GDP numbers.

Chart 1: With average hours worked at peak levels, companies will need to hire more workers. (%y/y)



Source: Capital Economics, Thomson Datastream

At the same time, we are closely watching the key risk upon which our outlook depends: the state of sovereign credit risk, or the likelihood that one or more European governments will default on their loans, or fail to honour other financial commitments. In our view, the sovereign credit situation could result in one of three outcomes within the next 12 months, with varying degrees of impact on the global economy and capital markets.

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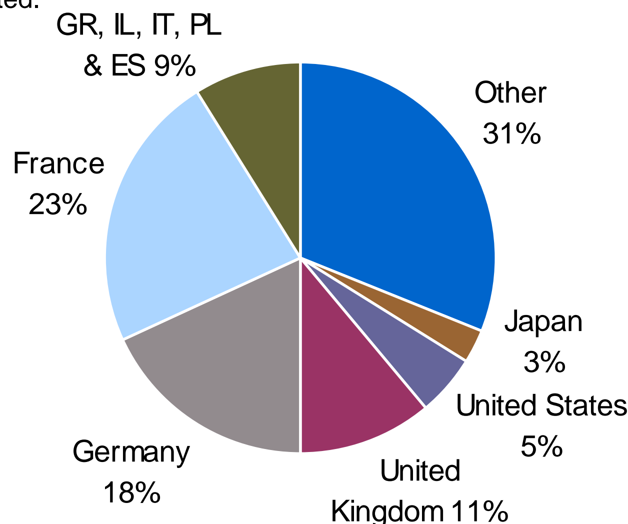
The ongoing sovereign debt crisis in Europe is already having short-term effects on North American financial markets. Equity markets are jittery. The OIS (Overnight Indexed Swap) rate has also widened. When financial markets price-in a high-risk environment, the spread widens in response. This spread is an indicator of stresses in the financial sector. The spread is still significantly lower than it was between mid-2007 and mid-2009; it was at its widest in the aftermath of the collapse of Lehman Brothers in September 2008.

The extent and nature of potential longer-lasting impacts depends on how the crisis plays out. In the best possible case (which we think has the lowest probability of occurring), none of the troubled European countries will default on their debt; they would receive funding from their knights in shining armour, the European Union and the International Monetary Fund, fully endorsed by the European Central Bank. In this scenario, we would not expect to see any collateral damage spill over to North American financial markets. Global economies could grow their way toward more manageable debt positions and a sustainable, organic recovery.

At the other end of the spectrum lies the worst-case scenario. In this version of the future, one or more smaller European countries default in a disorderly fashion. This could set off a chain reaction of defaults by larger and larger countries across Europe and, though unlikely, could spread to countries outside Europe. In addition, the resulting austerity measures that the European countries would be forced to enact would significantly dampen their GDP growth and would have a modestly negative effect on global growth. This would lead to lower consumer and corporate confidence globally, which, in turn, would somewhat slow the U.S. recovery. This scenario does not have the highest probability of occurring. Nevertheless, we believe that the odds of it happening have increased, given the recent mixed economic data and lingering sovereign debt issues.

We believe the following scenario has the highest probability of playing out over the next 12 to 24 months: one or more isolated defaults will take place in smaller European nations (Greece, for example), but they will be contained (won't trigger contagion or a domino effect in other nations) due in large part to the goodwill and mutual interest of all of the European Union countries and the IMF. The result is expected to be a more stable credit environment. In this scenario, the private sector would take over from the public sector as the driver of the economic recovery. The gradual, synchronized global economic recovery will lead to somewhat firmer commodity prices. With inflation not expected to be a problem, given the slow and steady growth environment, central banks will be unlikely to risk derailing the recovery, and will remain very accommodative and supportive of the recovery. With a stable credit environment eventually emerging, and little negative impact on the North American economy (see chart 2), this scenario supports a positive outlook for equity market returns over the next year.

Chart 2: Outstanding foreign claims (% of total) on Greece, Ireland, Italy, Portugal, and Spain (GR, IR, IT, PL & ES). Direct North American exposure is quite limited.



Source: BHIMI

Setting aside the sovereign debt scenarios and their implications, we also mentioned earlier the important role of the private sector in leading the recovery forward. It must use its improved

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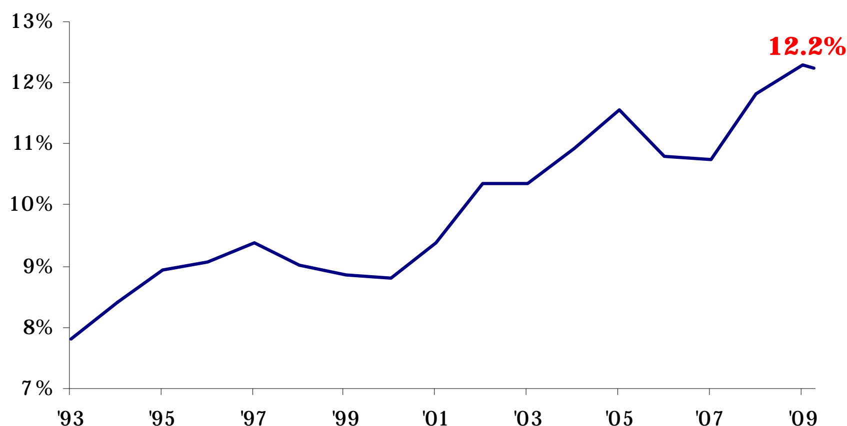
earnings and cash stash (see chart 3) to fund the next leg of the recovery, specifically through the creation of a sustainable labour market recovery. Job creation is crucial as a driver of both economic growth and consumer and investor confidence. The jobs recovery is long overdue.

Chart 3: S&P 500 cash as a percentage of total assets



Source: Strategas

While U.S. unemployment dropped to 9.6% in June, improved from 9.7% in May, jobless numbers are expected to remain elevated for some time. The U.S. private sector managed to add 593,000 jobs in the first half of 2010, with gains each month. In June alone, 83,000 private sector jobs were added, despite a total decline of 125,000 jobs. That decline included the elimination of temporary jobs related to the U.S. census; excluding that noise, the labour market has been steadily improving.

Canadian employment data for June will not be released before we go to print, but the May report showed an unemployment rate of 8.1% (unchanged from April), and a continued increase in total jobs (24,700 were added in May, on top of April's totals of 108,700), which includes 43,400 new private-sector jobs.

Some economic data, including a dramatic reduction in the Conference Board's June Consumer Confidence rating (down 9.8%), and a decline in the Institute for Supply Management's Manufacturing and Non-Manufacturing Indices, are signs that the momentum of the recovery may be slowing. Both ISM indices are still in expansionary territory, but the Manufacturing Index was down to 56.2 in June from 59.7 in May, while the Non-Manufacturing Index was down to 53.8 in June from 55.4 in May. Nevertheless, we believe that improvements in private-sector job creation will carry the momentum of economic growth.

The third core factor or assumption supporting our outlook for a sustained recovery is that global monetary policy will be supportive of growth. Given both the relatively tame inflation expectations and the tone in the announcements from policymakers on both sides of the border, both the Bank of Canada (despite an early move in June) and the U.S. Federal Reserve are likely to remain on the sidelines and support the economy with loose monetary policy. This is important to the private sector, but it also has particular relevance with regard to China.

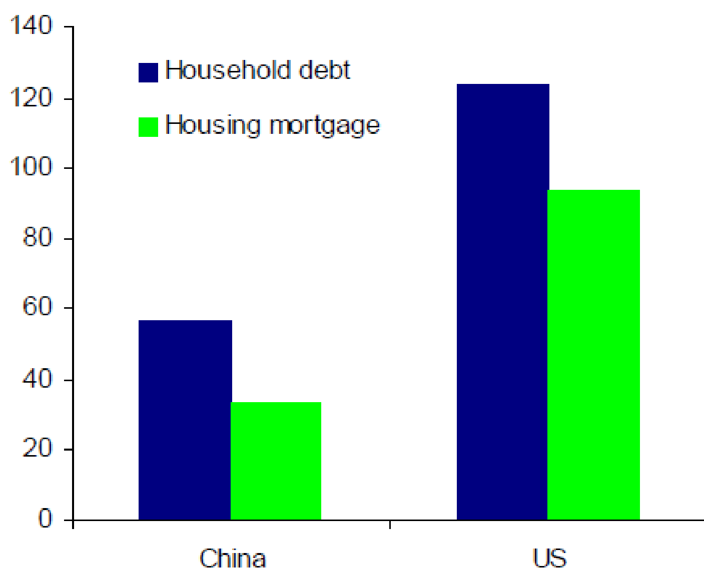
The pace of China's growth has also recently jangled the nerves of skittish investors. China has been a meaningful source of growth globally, and there are concerns that its government may go too far with measures to slow the country's current high level of growth. We do not share these concerns. Growth in the high single digits (between 8% and 9%) is still growth. That's positive for the world economy. China exerts a big influence on commodity prices, which are critically important to Canada's economic health.

In China, policymakers have signalled their intention to slow the rapid pace of growth (currently 11.9% GDP growth year-over-year). This sparked concerns in global financial markets that a hard landing in China would threaten the global economic recovery. We suggest some perspective is appropriate in this

case. Recent data from government sources, including the Purchasing Manager's Index (PMI) and the Conference Board Leading Index, point to the fact that China's growth probably peaked in the second half of 2009, and that the country's economy has been cooling for some time. The financial markets have been slow to pick up on this, and are only reacting now to the more recent sensationalist headlines.

Our view is that China will experience a soft landing, with annual GDP growth ranging between 8% and 9%. The savings rate remains strong, household debt is still not very high, and we do not see the Chinese housing market overheating (see chart 4). Furthermore, fading inflation pressures and a strong budget position mean that China's credit and fiscal policy could be loosened further if the slowdown threatened to become a hard landing. Bottom line: we expect that buoyant Chinese demand will continue to lift commodity prices, providing support to commodity-reliant economies such as Canada.

Chart 4: Comparatively low levels of household debt as a percentage of disposable income suggest that China is not at risk of a housing bubble. (%, 2009)



Source: CEIC, Haver, UBS Estimates

INVESTMENT STRATEGY: APPLYING OUR VIEW IN PRACTICE

The rear-view mirror

In Q2, investors had many concerns about the health of the economic recovery. The equity markets responded accordingly, with sell-offs in most major markets around the globe. Over Q2, global equity markets traded down; market participants let their trading actions reflect their feelings about some of the risks we outlined above. The MSCI World Index dropped 12.7% in total return U.S. dollar terms (-8.8% C$).

From an asset-mix perspective, near the beginning of the quarter we modestly increased the equity allocation for some of our clients' portfolios that are more capital-preservation biased. But we decided not to alter the equity allocation for portfolios with a more capital-appreciation objective, as their equity positions were already close to the high end of their associated equity range.

In anticipation of potentially rising interest rates, we made some portfolio shifts to reduce the duration (the sensitivity of bond prices to interest rate moves) of the fixed-income position within many of our clients' portfolios. This shift was initiated as a hedge against negative bond price moves expected at the long end of the yield curve.

Overall, by the quarter's end, the equity exposure across our clients' portfolios moved lower, in tandem with the retreats in global equity markets. Since the potential for near- to mid-term downside increased, we have not rebalanced our equity exposure upward.

The road ahead

We expect that there will be continued moderate, sustainable – but choppy – North American economic growth over the next year. Further equity market weakness in the next few months is likely, but we also think it is likely that equity market indices will be higher in 12 months relative to where they are now. Accordingly, we believe that for a client/investor in a balanced

portfolio, a moderately higher-than-neutral allocation to equities is appropriate. This is particularly compelling, given that the available investment alternatives – cash and fixed income securities – are expected to provide very low or flat returns over this time frame.

That being said, we believe that the downside risk, whether from sovereign credit contagion or further significant weakness in U.S. economic data, has increased, relative to the view we articulated in January. This led us to adjust our outlook for the risk/return trade-off across asset classes, and we are reducing our target equity allocation somewhat. The best way to describe our process and thinking is through an example. Consider a core, balanced portfolio, with a benchmark asset mix of 50% equities and 50% cash and bonds. The equity allocation for this portfolio may move across a range between 40% and 60%. Earlier this year, we were very comfortable to let portfolios sit at a deliberate tactical equity position of about 58%. As the market drifted lower, and moved this equity allocation closer to the 55% level, we monitored the asset-mix trajectory all the way through. We determined that having a modestly overweight allocation to equities (relative to a neutral benchmark weight of 50%) is an appropriate positioning, given both our 12-month outlook (which is biased toward equity markets) and the fact that the equity markets are now at a much lower point.

With equities currently trading at lower levels, we do not plan to unilaterally reduce our equity holdings in the near term. Rather, we will look for opportunities in market rallies to trim our equity positions. At the same time, should we see the equity weight reduce further and approach the neutral level, we will consider buying into equities in order to maintain an exposure weight above neutral.

In particular, we are focused on individual securities holdings. We are carefully monitoring the companies whose shares are held in our clients' portfolios, looking for good buying opportunities in the companies that we feel have very strong prospects and that may be trading at unusually low prices.

From a geographic perspective, we plan to continue our current position, with Canada overweight relative to other geographic allocations within our clients' portfolios. We think it is likely that Canada will continue to perform well relative to the United States, and that North America will continue to perform better than other markets. We will remain overweight in Canadian holdings and neutral in terms of U.S. and non-North American portfolio exposures.

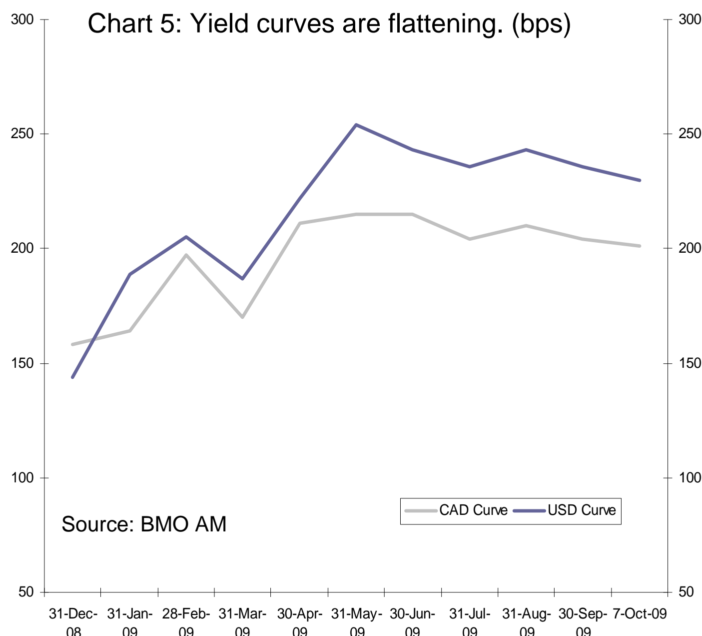
FIXED INCOME MARKET REVIEW

In Q2 of 2010, financial markets were sharply focused on concerns ranging from slowing economic growth to fears that a double-dip recession was possible, plus worries that sovereign credit risks in some European countries could spread.

Greece's large burden of deficit and debt – similar to the burdens of Ireland, the United Kingdom, Spain, and Italy – drove the cost of government borrowing dramatically higher, resulting in higher interest rates across Europe. Stringent austerity programs imposing lower government spending were announced to help rein in those financing costs. The combination of higher interest rates and lower government spending, during a time when economic growth was already considered fragile, sparked greater investor anxiety over the possibility that many of the world's economies would have difficulty returning to a sustainable growth path.

Disappointing U.S. housing and employment data also caused concern, leading to many flight-to-safety trades (selling equities and buying bonds), putting downward pressure on equity markets globally and on government bond yields in Canada and the United States (see chart 5). In the quarter, the yield curve flattened so that longer-term bond interest rates (10-to-30-year maturity) were lower than those for shorter maturity bonds (two-to-five year maturity).

As equities sold off, volatility increased, and the spread (the amount of interest a corporate bond issuer has to offer in excess of Government of Canada bonds in order to receive financing) on corporate bonds widened. As a result, Government of Canada bonds outperformed corporate bonds. At this stage, the widening has not been particularly dramatic, however.



CANADIAN BOND STRATEGY

We do not foresee returns on money market investments being more than modestly above zero in the next 12 months. For bonds, too, we expect very limited returns.

In a gradual recovery, corporate bonds would likely continue to outperform government bonds. If, on the other hand, the current economic situation worsens, the flight-to-safety effect will help boost government bond prices.

Given the likelihood of a very modest, gradual economic recovery, we remain optimistic that inflation will not be a problem over the next year. There is still a great deal of capacity in the economy, credit conditions are still tight, and the labour market is still not in a position to push for higher wages. All these factors should help limit inflationary pressures.

The size of budget deficits – particularly in the United States – is a concern, but we feel it is a longer-term worry that will be addressed after excess capacity is removed, lending conditions improve, and wages start to increase consistently. In fact, we believe the bond market's current expectations for inflation are excessive and will be lowered in the coming months. As the market lowers its inflation expectations, interest rates will have room to move lower. We feel the decrease will be modest, but a bond portfolio with more interest-rate sensitivity than its benchmark will benefit from such a move. We will look to maintain higher interest-rate sensitivity in our clients' bond portfolios modestly above that of the benchmark.

While we have been reluctant to remove much of our clients' bond portfolios' exposure to corporate bonds, and have respected the formidable momentum in that market, we do not feel that corporate bonds can continue to outperform Government of Canada bonds at the rates experienced in the second half of 2009 and the first quarter of 2010. There is still a lot of uncertainty in the economic picture; we are not convinced that this uncertainty, or risk, is properly reflected in corporate bond spreads. We will continue to look for opportunities to reduce risk in the corporate sector of clients' bond portfolios, particularly if the economy continues to show signs of weakness.

EQUITY MARKET REVIEW

The S&P/TSX Index posted a loss of 5.5% in Q2 of 2010. The quarter was characterized by extreme market volatility and heightened investor anxiety. Investor sentiment turned decidedly bearish on concerns that global economic activity would slow markedly, primarily as a result of fears that the sovereign-debt issues plaguing Greece would spread. In addition, investors grew increasingly concerned that the U.S. economy might experience a

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double-dip recession following weak U.S. housing sales numbers.

In the United States, after the new home buyer program ran out at the end of April, housing data started to soften. Housing prices, sales, and the inventory of homes were all below investor expectations. On the employment side, the market was primarily troubled by the lack of private-sector job growth. Housing and employment directly affect consumer finances; the consumer represents approximately two-thirds of the U.S. economy. The fact that both housing and employment numbers were disappointing cast doubt on the prospect of economic recovery and highlighted the fragility of current economic growth.

As well, the capital markets wondered whether China's economic activity would slow significantly. Of particular interest to Canada is the commodities market. Over Q2, most commodities were weaker, given the concerns over slower economic growth in China. Aluminum, copper, nickel, and zinc prices were down 15%, 16%, 21%, and 25%, respectively. Oil (West Texas or WTI) lost 9%, while natural gas prices moved 19% higher. Gold rose 12%, benefiting from investor anxiety related to the euro, which was weaker as a result of sovereign-debt concerns in Greece.

The top-performing Canadian equity sectors included Health Care (+11.3%), Telecommunications Services (+3.8%), and Consumer Discretionary (+1.6%). The sectors with the poorest performance over the quarter were Consumer Staples (-9.1%), Financials (-9.8%), and Information Technology (-25.0%).

Outside Canada, the S&P 500 Index lost 11.4% in US$ terms. In C$ terms, the S&P 500 declined by 7.5%, as the U.S. dollar strengthened relative to the Canadian dollar, offsetting some of the local currency losses. All the S&P 500 Index sectors posted negative returns in the quarter, with the Energy (-12.8%), Financials (-13.3%), and Materials (-15.3%) sectors experiencing further pullback.

The equity markets for developed countries outside North America declined 14.0% in the quarter, including dividends and in US$ terms (-10.2% in C$), as measured by the MSCI Europe Australasia and Far East Index. Emerging market equities as measured by the MSCI Emerging Market Index declined 8.3% during the quarter in US$ terms (-4.2% in C$).

CANADIAN EQUITY STRATEGY

We believe equity markets will remain volatile over the next few months, with short-term investor sentiment as the primary influencer. Our outlook for the Canadian equity market remains positive, however, over the medium and longer term. We expect equity prices to gradually improve over the next year. The stronger gains realized since the markets hit their lows in March 2009 were fuelled primarily by a revaluation of equities as a result of significant improvement in investor sentiment and a recovery in earnings from depressed levels.

Over the next year, we expect equity market gains to be more modest, and largely driven by earnings growth as the economy continues to improve (see chart 6). Equity-market volatility during this time will likely be high as the economic recovery is expected to be gradual. In addition, there will be periods when leading economic indicators appear mixed and economic activity softens. This is a normal part of the recovery phase, since economic activity generally does not improve in a linear fashion coming out of a recession.

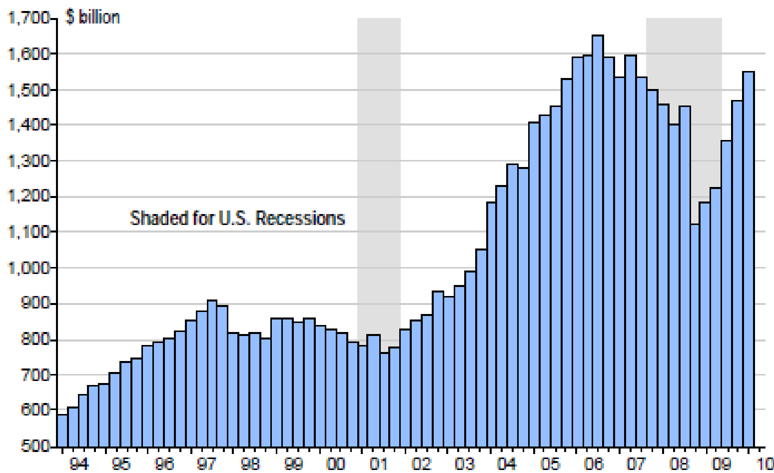
As our confidence in the global economic recovery grows, we will continue to look for opportunities to increase our allocations to economically sensitive sectors that will benefit from strengthening global demand.

THE CLOSE

While we are optimistic that global economic activity will continue to improve at a more modest pace over the next year, we remain cognizant of the headwinds and risks that have

the potential to derail the recovery. Specifically, we continue to monitor the sovereign-debt issues in Europe, the health of the U.S. economy, and the pace of economic growth in China. We believe these issues are manageable, but we remain cautious and alert to these risks near term.

Chart 6: U.S. Corporate earnings are almost back at pre-recession levels.



Source: NBF Economy & Strategy

Our strategy remains focused on building wealth for our clients over the long term. To that end, we continually review and monitor the holdings across our clients' investment portfolios to ensure that the securities we hold are attractively valued, and are supported by solid underlying fundamentals. In the face of the shorter-term challenges that may still lie ahead, we will remain broadly diversified by sector. In addition, we will continue to emphasize higher-quality companies with strong balance sheets; these securities are expected to weather unexpected challenges and emerge stronger as the economy continues to improve.

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