Quarterly Market Commentary

January 11, 2011

Highlights

- 2010 really was Canada's year. We weathered the Great Recession relatively well and rebounded early. In Q3, Canada's GDP continued to grow, albeit at a somewhat softer pace than the United States.
- The key economic factors that drove capital markets in 2010 – sovereign credit problems in Europe, economic growth in the emerging market countries, and the pace of the U.S. economic recovery – are expected to persist as the areas of focus in 2011.
- As economic conditions continue to improve, we expect business, consumer and investor confidence will heal further, leading to higher levels of hiring, spending and equity-market investing.
- As a result we expect the North American economy to grow by about 3.0% in 2011, and thanks to strength in emerging market economies, we anticipate that global growth will be greater than 4.0%.
- In 2011, the Bank of Canada is expected to raise short-term interest rates modestly, likely in the second half of the year. We do not expect the U.S. Federal Reserve to raise rates for some time. The Canadian/U.S. foreign exchange rate will likely hover around parity throughout the year.
- In terms of capital markets, equities closed Q4 and 2010 ahead, and with valuation levels that remain reasonable. We expect low double-digit equity returns over the next year. In contrast, the North American fixed income market pulled back in Q4, though it closed the year ahead of where it began.
- Our outlook remains positive for equities relative to bonds and cash, and we continue to favour Canadian equities over U.S., in large part due to the strength we expect to see in emerging market economies and the resulting support for commodity sectors and prices.
- While some longer term and structural risks remain to the equity market, we are confident the recovery will extend through 2011 and that equities will continue to provide better returns than fixed income investments in the coming year.

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Another Year of Repair and Recovery

2010 really was Canada's year. Our domestic economic health is far stronger than that of many developed countries. Add record gold medals at the Vancouver Olympics, a banking system that proved to be one of the globe's most robust, a stock market returning more than double world equity market returns (over the year in C$ terms) and anyone would be proud to wear big red mittens.

Canada weathered the Great Recession relatively well and rebounded early. The Bank of Canada raised interest rates three times last summer to keep pace with our country's economic growth and keep inflation in check. Although that growth has slowed somewhat (to 1.0% in Q3 from 5.6% in Q1), it continues. The U.S. economy is gaining ground and starting to catch up, with U.S. real GDP growing by 2.6% in Q3. Strength in the United States is good news for Canadians.

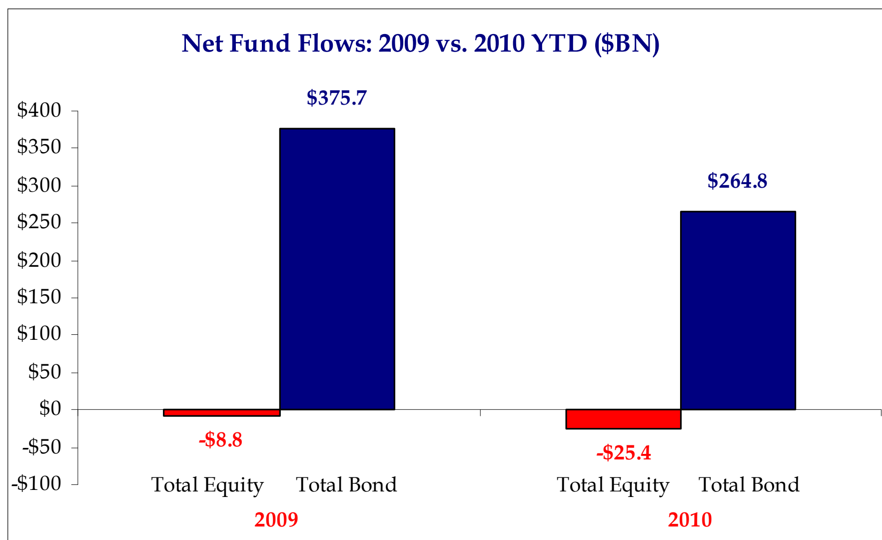
There were some scary moments along the way. Back in February, sovereign debt levels began to dominate investors' concerns, with Greece's credit problems leading the charge and the Irish crisis later in the year. Investors' nerves were further jangled on one unusual day in May when the world's equity markets experienced extreme turbulence (dubbed the "flash crash"). During the rest of the year, other events undermined investor confidence, including China's monetary tightening and potential for weaker economic growth, plus increasing U.S. unemployment levels. We continued to expect that each bout of equity market volatility would be short term – posing no material threats to the global economic recovery that was underway.

Many of the economic factors that drove capital markets in 2010 – sovereign credit problems in Europe, economic growth in the emerging market countries, and the pace and trajectory of the U.S. economic recovery – are expected to persist in 2011. We expect that improvements in these conditions will support global economic growth north of 4%; solidly in recovery mode. Throughout 2011, our focus will remain on these factors.

Our outlook for 2011 includes the possibility that another sovereign credit crisis could occur in one or more smaller European countries, echoing what happened in Greece and Ireland; together, these two countries represent only about 4.4% of the European Union's GDP. If such a crisis occurred, we expect it would be well contained and unthreatening to the global recovery; we continue to monitor this risk carefully. Overall, economic expansion for the EU is anticipated to be about 2.0%.

In the emerging markets, we anticipate continued economic growth. We expect China's GDP to grow by about 9.0%, fueling demand for the resources and materials that Canada produces, and providing further support to the Canadian economy and currency.

Chart 1: Retail investors, hesitant to return to equity markets, still have large sums sitting in bonds.



Source: Strategas

We feel the most crucial macroeconomic factor continues to be the commitment of U.S. policymakers to stimulus measures (and their multiplier effect) particularly in terms of supporting job creation. These measures are designed to instill confidence and

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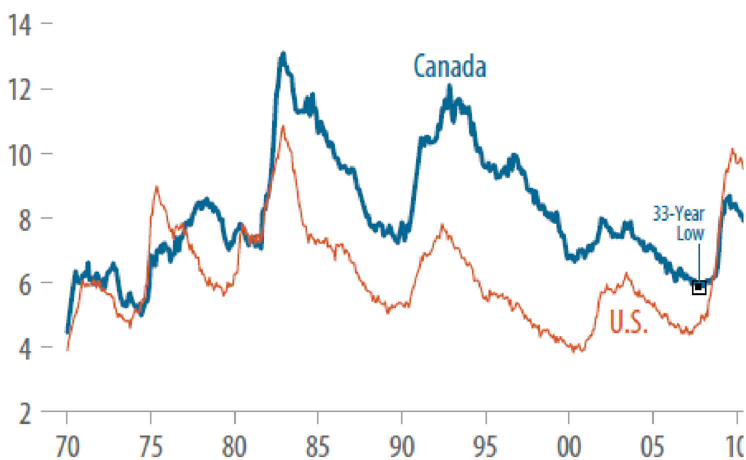
spur much-needed consumer and corporate spending. To date, these supportive fiscal and monetary policies have taken the form of maintenance of low interest rates, and the extension of U.S. tax relief (a.k.a. the "Bush Tax Cuts"), as well as additional monetary stimulus in the form of more quantitative easing (or QE2), which was announced in November.

Labour and housing-market worries have lingered for consumers. On the other hand, corporate balance sheets haven't looked this healthy in years; this is partly because many companies are still not operating at full capacity. As economic conditions continue to improve, we expect business, consumer and investor confidence will heal further, leading to higher levels of hiring, spending, and equity-market investing.

In December, the U.S. private sector created 297,000 new jobs – much higher than expected. This was the 11th straight month of increases. We expect that full-time job creation will average about 150,000 a month, bringing the unemployment rate closer to 9% by year end (from its current level of almost 10%). Across North America, we anticipate a somewhat faster rate of economic growth in 2011 than in 2010, close to 3% in both Canada and the United States.

Chart 2: Canada and U.S. jobless rates are falling (%)



Source: BMO Capital Markets

With Canada's improving economic health, the Bank of Canada (BoC) increased short-term interest rates by 75 basis points in 2010 (moving the overnight rate to 1.00%), while the U.S. Federal Reserve (the Fed) left its overnight rates unchanged at 0% to 0.25%. Over 2011, the BoC is expected to move short-term Canadian rates modestly higher, likely in the second half of the year. It should be noted that there is probably a limit to the spread that the BoC will entertain relative to its counterpart rate in the U.S., which will likely remain at its current low level this year. The Fed is not expected to increase rates for some time; until employment and consumer demand have strengthened, excess capacity in the U.S. economy shrinks and inflation is a threat. The year ended with the Canadian dollar priced above parity with the U.S. dollar; we expect the loonie/greenback rate to hover around parity throughout 2011. The good news is that Canadian companies are beginning to use the C$ strength to their advantage by making acquisitions outside of Canada and ramping up imports of production inputs and materials.

In terms of how we apply our outlook in managing our clients' portfolios, as we entered Q4, our asset mix strategy continued to favour equities, specifically large capitalization Canadian equities, as it has for the majority of the past several quarters. We took the opportunity to crystallize some gains in many of our clients' portfolios by reducing their significant position in Canadian equities.[1] In the near term, we may once again crystallize gains in many of our clients' portfolios in order to reduce their equity allocation, likely by reducing their Canadian equity holdings.

Our outlook remains positive for equities relative to bonds and cash; as markets move, we will continue to carefully consider the asset class mix within our clients' investment portfolios. We continue to favour Canadian equities over U.S. equities, in large part, due to the strength we expect to see in the emerging markets and the resulting support for commodity prices. This will bolster the Canadian equity market because it is heavily weighted to the commodity-based Materials and Energy sectors. Together, they make up 50% of the S&P/TSX Index, in market capitalization terms.

Fixed Income Market Review

In general, the bond market pullback over Q4 (a drop of 0.7% in Canada) was felt more by longer-maturity bonds (down 1.2% in Canada) than by the shorter-term sector of the Canadian bond market (down 0.3%). Nevertheless, for the full year, the long-bond segment of the Canadian bond market more than doubled the positive performance of the short-term sector. In terms of sectors, all lost ground, but Government of Canada bonds performed worse than corporates and provincials.

The broad U.S. bond market also pulled back, posting a loss of 2.2% as measured by the Merrill Lynch U.S. Corporate & Government Master Index.

After witnessing a deflation scare mid year, the Fed pulled out all the stops to prevent the economy from slipping into a deflation trap. In addition to its standard tool of keeping short rates low, the Fed also used non-conventional means such as QE2 in order to extend its influence to interest rates on longer-term bonds. Until consumer demand and employment are clearly recovering, it's unlikely the short end of the U.S. yield curve will move up. The expectation of inflation (or lack thereof) will continue to drive the long end, as will the success or failure of the various programs designed to keep long rates as accommodative as possible.

Although the U.S. long-term bond yields spent the last four months of 2010 climbing to a level just slightly below their yields at the beginning of the year, most of the yield increase was an unwinding of an overly pessimistic deflation scare and, more recently, an overly optimistic expectation the Fed would buy long bonds in the QE2 program.

Looking ahead, it is reasonable to say rates in the U.S. will head higher, with the exception of the very short end. But until final demand picks up, the magnitude of the move could be fairly modest.

Canadian Fixed Income Strategy

In addition to the view that bond yields had room to move lower in 2010, we have maintained a bias towards yield curve flattening within the fixed income portfolios for many of our clients. Yield curve flattening describes the situation where longer-dated bonds (10-year bonds, for example) outperform bonds with shorter maturities (two-year bonds, for example). Thus our bond portfolios were more heavily weighted toward longer-term bonds, relative to the benchmark. Yield curve flattening was very modest in Q4 but generated enough activity that our bond portfolios' yield curve exposures contributed to positive returns in Q4.

In terms of credit considerations – provincial bonds and corporate bonds – our bond portfolios maintained a defensive stance and we favoured bonds with higher credit quality. We took this position based on our view that lower-rated Canadian bond issues didn't offer enough spread (the amount of increased yield a provincial or corporate borrower must offer compared to a Government of Canada bond in order to receive financing) to justify their inherent risk level. However, the market consensus was that global economic growth would improve over Q4. Therefore, riskier assets like lower-rated provincial and corporate bonds tended to outperform less risky Government of Canada bonds. As a result, the defensive posture we took in our bond portfolios detracted from their performance.

Taking these factors into consideration, and despite the additional yield available from investing in bonds within the credit sectors, at this time we continue to think their higher risk does not warrant an increased allocation within our fixed income portfolios. We expect to maintain a defensive posture for the credit portions of our bond portfolios for two reasons: the levels of economic uncertainty that still exist; and the potential for a relatively small widening in credit spreads to cause the credit sectors of the Canadian bond market to underperform Government of Canada bonds.

We also continue to monitor the level of credit expansion (bank lending, for example), labour market conditions, and the amount of unused capacity in the U.S. economy as we assess the likelihood of increased inflation; we don't expect any of these three factors to force inflation materially higher. Inflation is a key driver of interest rates, particularly for interest rates associated with bonds that have very long maturities (30 years, for example). Higher inflation usually means higher interest rates; lower inflation tends to be consistent with lower interest rates. Our bias for our bond portfolios is to maintain an interest rate sensitivity greater than the benchmark and as a result we continue to hold a higher allocation of long-term bonds. This is consistent with our view that rates have room to move lower and that the yield curve will continue to flatten.

Equity Market Review

Equity markets prospered, despite a string of short-lived events that spurred market volatility, coupled with sluggish economic conditions in the United States. World equity markets, as measured by the MSCI World (Net) Index, returned 5.2% for the quarter and 6.2% for the year, in C$ terms (9.0% and 11.8% in US$ terms). Equity markets remained strong on the back of a second round of quantitative easing in the U.S., plus robust economic growth in China. This provided the support for firmer commodity prices in Q4; gold, aluminum, copper, nickel, and zinc prices were up 9%,

6%, 21%, 6%, and 13%, respectively. Oil (West Texas or WTI) gained 14%. Natural Gas prices climbed 11%. Canada has lots of what the world wants: we are the world's number-one producer of potash, number-two producer of nickel, number-five producer of diamonds and zinc, and number-six producer of oil.

Because Canada's prosperity relies so heavily on the commodities market, Canadian equity markets advanced. The S&P/TSX Composite Index was up 17.6% on a total-return basis for 2010, and 9.5% over Q4. Not surprisingly, leading the way in Q4 were the Index's Materials (+14.2%) and Energy (+13.6%) sectors. The Information Technology (+13.1%) and Health Care (+11.7%) sectors followed as performance leaders, although they are a much smaller portion of the market. Lagging the market in the quarter were Consumer Discretionary (+6.9%), Financials (+5.1%), Consumer Staples (+4.9%), Industrials (+4.9%), Utilities (+4.8%), and Telecommunication Services (+0.5%).

Global economic activity continued to strengthen in Q4 as the emerging market economies, particularly China, grew at a brisk pace (9.6% in Q3). In addition, the Fed remained supportive of the recovery by providing further stimulus. In 2010, the S&P 500 Index returned 15.1% in US$ (9.4% in C$) for the year and 10.8% in US$ (7.0% in C$) for the quarter. Outside North America, developed market equities advanced 7.8% in US$ (3.0% in C$) for the quarter and 6.6% in US$ (2.4 in C$) for the year, as measured by the MSCI EAFE (Europe, Australasia, and Far East) Index. Emerging market equities (as measured by the MSCI Emerging Market Index) rose 19.2% in US$ (13.3% in C$) over the year, and 7.4% in US$ (3.7% in C$) over Q4.

Canadian Equity Strategy

Heading into 2011, we believe the recovery has the potential to gain further momentum. Businesses continue to build up significant levels of cash on their balance sheets. With an improving economy and business confidence as the backdrop, we believe businesses will accelerate their spending and hiring plans. We expect this to result in lower unemployment and improved consumer spending. While the trend of U.S. consumers reducing their debts (deleveraging) is expected to dampen U.S. growth, the accelerating pace of development in emerging markets, particularly China and India, is expected to drive sustainable global growth and firm commodity prices.

Despite the rise in equity markets over 2010, valuation levels remain at reasonable levels, given the sharp improvement in earnings over the 12 months, and the prospect for further earnings growth in 2011. We are expecting low double-digit equity market returns over the next year. While a near-term setback in equity markets is possible, we believe that underlying corporate data, driven by continued improvement in global economic activity, will support higher equity prices in 2011. We continue to favour economically sensitive sectors, particularly Energy, which is likely to benefit from higher crude oil prices over the next 12 months.

Our strategy continues to focus on building wealth for our clients over the long term. In the short term, there will be risks. Therefore, we remain broadly diversified by sector. Our emphasis continues to be on higher-quality companies with strong balance sheets. These securities are expected to weather unexpected challenges and emerge stronger as the economy continues to improve.

Our Canadian equity portfolios benefited from the rally in cyclically oriented securities in Q4. In particular, securities in the Materials and Energy sectors performed quite well, although larger capitalization securities benefited to a lesser extent than smaller capitalized securities.

The Close

Overall, we are optimistic regarding the prospects for the economy and equity markets in the year ahead, but remain aware of the risks to the macroeconomic environment. Specifically, the European sovereign debt crises are likely to persist in 2011. While these types of problems could lead to shorter-term equity market volatility, we believe they are manageable and unlikely to detract from longer-term global economic growth.

Given the large sums of money that have retail investors globally have sitting in cash and bonds since the Great Recession, it is clear that many are hesitant to return quickly and fully to the equity markets. While some longer term and structural risks remain to the equity market, there are also inherent risks in fixed-income investing. These risks include low yield levels and the fact that interest rates will eventually go up, which will have a negative impact on bond market returns.

We are confident that the recovery will extend through 2011, and that equities will still provide better returns than fixed-income investments in the coming year. We continue to manage our clients' portfolios with that outlook in mind.

[1] What does our strategy mean in terms of a typical diversified portfolio? Consider a representative balanced portfolio with a strategic 50/50 allocation to equities and fixed income, with each asset class weight ranging between 40% and 60%. Eighteen months ago, we acted to increase the portfolios' equity weight, then the rising equity markets carried portfolio even higher, toward the 60% end of the range; in October, we then took the opportunity to crystallize some of the gains generated in balanced portfolios by slightly reducing the allocation to large capitalization Canadian equities, which had been outperforming U.S. and non-North American equities. Despite this move, equities continued to be emphasized in balanced portfolios, simply at a more modest level. Finally, as equity markets continued to rally through to year-end, the balanced portfolios' total equity allocation once again moved higher.

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