

While Europe's political leaders held ever more meetings to devise a plan to avoid the financial crisis stalking them, the economic statistics improved slightly in the United States. The Europeans have not reached a convincing agreement but the stock markets were up just the same in the fourth quarter.

With Europe entering recession, it is now clear that global economic growth will be slow in 2012. Interest rates should remain very low throughout the year because monetary policy will continue to be extremely expansionary in Europe and the United States. Moreover, China may ease its monetary policy in 2012.

For investors, the risks lie not with the economy but rather with US and European policy. In the United States, the two political parties still have not managed to agree on a budget policy for 2012, and, if the existing legislation is not amended, this year the federal government will have to impose a tax hit equivalent to more than 2% of GDP. The stubbornness of the parties will no doubt prevent them from adopting job-creation solutions; at least they have managed so far to reach a last-minute agreement to avoid damaging the economy. In all likelihood, the situation will drag on until the elections next November.

Returns as at December 31, 2011

	4th quarter		2011	
	CAD \$	Local currency	CAD \$	Local currency
Canadian equities	3.6%	3.6%	-8.7%	-8.7%
US equities	9.3%	11.8%	4.4%	2.1%
Europe and Pacific equities	1.1%	3.4%	-9.7%	-11.7%
Emerging markets	2.1%	4.4%	-16.5%	-18.4%
Bonds	2.3%	2.3%	9.7%	9.7%
Real estate investment trusts	6.8%	6.8%	21.4%	21.4%

The political risks are far greater in Europe, where a financial crisis may erupt at any time, given that it is far more difficult to get 17 parties to agree, as opposed to only two, especially as a convincing agreement will require that each party renounce its sovereignty over fiscal matters. Even though investors are prepared to buy US treasury bonds offering interest rates lower than the rate of inflation, investors are demanding high rates to lend to the peripheral members of the euro zone. Clearly these countries will not be able to get by without help from the more solid countries, such as France and Germany; but assistance will depend on guarantees that will have to be ratified by the legislature of each country.

With or without an agreement, fiscal policy throughout Europe will have to be restrictive for several years, as governments try to achieve balanced budgets. What happens when an economic zone undergoes restrictive fiscal policy and expansionary monetary policy? The exchange rate must go down, otherwise the zone will go into an even deeper recession. We therefore expect the euro to decline against the US dollar and the yen this year – and the sooner the better.

Given these risks, it is not surprising that investors are quite pessimistic about the economic outlook. In fact, equities and bonds are factoring in very weak economic growth along with a slight but constant decline in prices over the next few years. In the United States, for example, monthly mutual fund data show that individuals are selling their equity funds at the same rate as they did during the 2008 financial crisis. Pessimism is so strong that dividend yields now exceed bond yields. This is the scenario that Japan has known for 20 years. We believe this outlook is far too pessimistic. Such a scenario could materialize in Europe, but it is far from a foregone conclusion. As for the United States, it does not have Japan's aging population, its markets are more robust and its exchange rate is more competitive.

Equities are as inexpensive as we have seen them in a long time, and it is quite possible that politicians will succeed in adopting policies that calm the markets. After all, that is what they do when their backs are to the wall.

We conclude that a diversified portfolio should hold a moderate proportion of equities, especially well-established Canadian and US companies that pay high dividends as well as emerging market equities.

US ECONOMY

We stated in our previous Market Review that the slowing of the US economy was only temporary and that there would be no new recession. The economic indicators did indeed improve recently and analysts agree that recession has been avoided. That does not mean there will be an economic boom, but growth of 2.5% to 3% can be expected in 2012.

US CORPORATE EARNINGS

US corporate earnings held up in 2011 despite the slowing economy, confirming once again that we are in an environment that is favourable to corporations. First it was banks that benefited, but the new regulation in the United States and Europe will significantly restrict their operations. It is now the turn of non-financial

Market Review

Fourth quarter 2011

corporations to take advantage of this favourable period, which could last a decade.

US STOCK MARKET

Ten years ago, the S&P 500 Index was trading at 1500 and the earnings of the companies in the index were \$42 a share. In 2008, the index was again at 1500 but earnings were \$60. Today the index is at only 1250, even though earnings have climbed to \$100. And these are quality earnings. Companies pay \$26 in dividends and spend \$26 buying back their shares, which is equivalent to a 4% short-term return for shareholders. The remainder is reinvested in the company.

CANADIAN ECONOMY

The Canadian economy is slowing and is becoming increasingly dependent on crude oil. Canada is the only part of the world where a large volume of oil is produced without direct government involvement. The result is a dynamic exploration and production sector that, year in and year out, generates a balance-of-payments surplus equal to 4% to 5% of GDP. Unfortunately this situation has kept the Canadian dollar at an excessively high level for several years, and the result is a rising trade deficit, when energy is excluded. The deficit has been about 5% of GDP for two or three years. Canada is no longer competitive in the production of goods.

This situation is now showing up in the employment statistics. For the past two or three years, most of the jobs created have been in the public sector and in construction (which has received significant support from public spending), whereas employment in the manufacturing sector has been falling since 2005-06.

During this time, Canadians have continued taking on debt to the point where the Bank of

Canada has become concerned and is urging them to exercise caution and cut back on spending. The Canadian economy already started to slow toward the end of 2011, and the restrictive fiscal policies of the federal and provincial governments are not helping sustain it.

CANADIAN DOLLAR

We have maintained a positive attitude toward the Canadian dollar for several years because, since 2002-03, Canada has enjoyed significant income from natural resources, especially oil. In all likelihood this income will not increase in the years to come for two reasons. First, the slowing of the global economy could cause the prices of natural resources to soften. Second, it appears to be increasingly difficult for Canada to increase its exports from the oil sands.

Several countries have balked at importing crude from oil sands for environmental reasons. Moreover, oil sands are very costly to exploit, and immense shale gas discoveries throughout the world will tend to hold oil prices down in the years to come.

We must conclude that the Canadian dollar is at risk of decline.

CANADIAN STOCK MARKET

The Canadian stock market underperformed the US market in 2011 for the first time since 2003. Since the Canadian equity market depends to a great extent on the prices of natural resources, it now looks more risky than its US counterpart, especially with its strong weighting of natural resource stocks.

DASHBOARD

December 31, 2011	
Canada	
Canadian dollar vs. US dollar	0
Corporate bonds	++
Long-term government bonds	-
S&P/TSX 60	+
Small caps	-
REITs	+
United States	
US dollar vs. euro	+
Long-term treasury bonds	--
S&P 500	++
Nasdaq	+
Small caps	-
Europe	
Euro vs. US dollar	-
MSCI EMU	0
Asia	
Yen vs. US dollar	--
MSCI Japan Index	0
Emerging markets	
MSCI Emerging Markets	+

0: neutral +: overweighted -: underweighted