

Investment Outlook

January 2012

Looking Back on a Tumultuous Year

If all one looked at was the principal U.S. stock market benchmark, the S&P 500 Index, one might assume that 2011 was a pretty uneventful year. The Index started the year at 1,258 and ended the year at precisely the same 1,258 level. What's even more interesting is that this is a rare event. The total annual return on the S&P 500¹ has fallen in the range of -5% to +5% only nine times since 1928.²

Of course, anyone with their eyes open and heart beating knows that 2011 was anything but mundane. Markets were generally strong through the first half of the year, sold off dramatically in August and September, and recovered nicely into year-end. After a decade of strong outperformance by the Canadian stock market relative to the U.S., the U.S. fared considerably better in 2011. In Canadian dollar terms, the S&P 500 provided a total return of +4.4% as compared to the -8.7% return for the TSX Composite. In fact, the U.S. market was one of the only stock markets in the world to provide a positive return in the year. Almost every other bourse posted significant losses, including juggernauts like China and India, which both saw their stock markets decline about 20%.

Volatility throughout the year was high. Some will have heard us reference the idea of an "all-or-nothing day", which is defined as a day when at least 400 of the 500 S&P 500 stocks move in the same direction. Up to Dec 16, there were 67 all-or-nothing days in 2011, which is the same number that was recorded in total over all the years between 1990 and 2004.³ The market lurched a lot in 2011!

Another notable feature of 2011 was how wrong so many of the "experts" were. Examples abound. In the U.S., high unemployment, a weak housing market and squabbling politicians led most to believe that investing in U.S. stocks would be a road to perdition. Yet, as we outlined above, the U.S. stock market was one of the best in the world. Second, considering incredibly low interest rates, enormous fiscal imbalances, and the irresponsible printing of money in Washington, it was widely agreed that U.S. Treasury bonds would be a terrible investment. But the 30-year U.S. Treasury provided a return of more than 30% in 2011. Lastly, driven by the rapid and ongoing growth in demand from emerging economies around the world, many thought commodities were a safe bet. However, the widely-followed Commodity Research Bureau Index declined about 8% on the year. Overall, it was a year that reminded investors of Bernard Baruch's famous observation that "the purpose of the stock market is to make fools of as many men as possible."

Challenges from Abroad

The tumult of 2011 is understandable in the context of the various crises that unfolded around the world during the year. Whether it was the tsunami and nuclear accident in Japan early in the year, the debt ceiling crisis that nearly shut down the U.S. government in early August, or the ongoing and unrelenting sovereign debt fiasco in Europe, investors were never without the heavy burden of worry.

As we consider the investment environment for 2012, a number of these challenges remain. Europe continues to wrestle with its debt crisis, and the measures of austerity implemented by a number of countries seem likely to drag much of the region into recession in the coming year. Indeed, the greatest economic risk to investors around the world remains the potential for a disorderly collapse of the eurozone and the

¹ That is, the increase (or decrease) in index price level plus dividends.

² *Barron's*, January 2, 2012.

³ Bespoke Investment Group, quoted in *Barron's*, December 24, 2011.

European currency. It is not an outcome that we expect, but a situation that every investor must monitor carefully.

Another focus for investors in 2012 will be on the demand for Canadian exports from developing countries. After many years of unsustainably fast economic growth, many countries in the developing world worked diligently in 2011 to slow the pace of economic expansion, and to control inflation and excess credit expansion. It seems that China in particular has achieved some success in its efforts and that growth is headed for a “soft landing”. A more abrupt slowdown would have serious consequences for most developed countries in the world.

Lastly, the dark shadow of geopolitical risk has shifted, but remains a potentially upsetting force. Perhaps the greatest threat is the increasing tension between Iran and the U.S. Concern is growing that Iran may try to close the Strait of Hormuz, through which much of the world’s seaborne crude oil is shipped. Such a move would certainly elicit a strong response from the U.S. and other countries, and potentially open up another military chapter in the Middle East. As well, the transition of power in North Korea is another saga that will require careful observation in 2012. While the political theatre in North Korea is comical in many respects, the fact that this regime has a nuclear capability significantly elevates the threat it poses to regional stability. The two charter members of the “Axis of Evil” are almost certain to be in the news in the months ahead.

Safe Harbour at Home

Economic growth and the outlook for financial markets depends more on these external forces than is usually the case. Apart from these risks, we have a reasonably sanguine outlook for Canada and the U.S. The U.S. economy continues to exhibit signs of a more rapid recovery than many observers expected. As an example, early in January, the U.S. labour market report for December surprised most analysts with its strength. Considerably more jobs were created than expected (200,000), the average work week lengthened, and the official unemployment rate dropped to 8.5%. The broader employment measure we also follow, the U-6⁴, dropped to 15.2%, the lowest in three years. While this is still high by historical standards, its continued improvement is evidence that the labour market is on a slow march to better health. Additionally, the widely-followed ISM survey of purchasing managers also surprised analysts to the upside. While its level does not suggest rapid economic growth, it supports the notion that the U.S. recovery may be more durable than many expected.

The Canadian economy continues to be one of the strongest in the G8, although we believe that position may have eroded a little over the last 12 months. Our economy shed 55,000 jobs over the last quarter and the unemployment rate rose to 7.5%. Over the course of the year, there has been little improvement in labour market conditions. Other measures are similarly lackluster. The recent release of the Ivey Purchasing Managers’ Index still suggests economic expansion, but was weaker than most economists expected. Early in January, a Bank of Canada survey of senior business executives surprised by being somewhat downbeat on the prospects for sales in 2012. In all likelihood, the caution among business executives reflects the global turmoil we have outlined above, together with concerns over the record level of household debt that has been accumulated in recent years. The Canadian economy remains stronger than most, but the bloom may be coming off the rose.

There is little that we have described that would suggest great excitement for financial markets in the period ahead, but we remain optimistic about the prospects for long-term investors. Any one of the risks we have discussed could pose significant turbulence in the short term. However, the prospects for the long term remain strong. The century started (i.e., 2000) with the S&P 500 trading at 20x the next 12 months’ earnings. Today the S&P 500 trades at about 12x forward earnings and corporate balance sheets have never been stronger. As we said last quarter, so long as investors have the patience and discipline to endure this current period of volatility, we are as confident as we ever have been that good investment returns will be realized over time.

⁴ The U-6 adds to the “officially” unemployed those who have taken part-time work only because they cannot find full-time work, and those who have given up looking for a job because they can’t find one.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>December 31, 2011</u>	<u>December 31, 2010</u>
TSX Composite Index	11,955	13,443
91-Day T-Bill Yield	0.81%	1.05%
30-Year Gov't of Canada Bond Yield	2.51%	3.53%
Prime Rate	3.00%	3.00%
Exchange Rate (US\$/1CDN\$)	\$0.9833	\$1.0054

United States

Dow Jones Industrial Average	12,218	11,578
Standard & Poor's 500 Index	1,258	1,258
30-Year U.S. Treasury Yield	2.92%	4.33%

Market Returns For Periods Ended December 31, 2011 ⁽¹⁾

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years ⁽²⁾</u>	<u>Last 10 Years ⁽²⁾</u>
DEX 91-Day T-Bill Index	0.2%	1.0%	2.0%	2.4%
DEX Universe Bond Index	2.1%	9.7%	6.4%	6.5%
TSX Composite Index	3.6%	-8.7%	1.3%	7.0%
S&P 500 Index (C\$)	9.5%	4.4%	-2.9%	-1.6%
MSCI EAFE (C\$)	1.2%	-10.2%	-7.3%	0.1%

Footnotes:

⁽¹⁾ Represent total returns, including income and capital appreciation (or depreciation).

⁽²⁾ Compound average annual return.

