

# Our outlook for 2012



*A year ago, in January of 2011, commodities, led by food and energy, had risen sharply, economic growth was strong, sentiment was positive, markets were powering ahead and the seas looked calm. Expectations on almost all fronts were running high. And yet what we got was a pretty tough year in the markets.*

*Today it's exactly the opposite. Economic growth is cooling, commodity prices have fallen, markets are volatile, risk aversion is on everyone's mind and expectations are low if not negative.*

*So, does this mean we're about to have a great year in 2012? If only such a neat and simple conclusion could be made about the direction of capital markets. No, the truth of the matter is that the investment scene is troubled and the impediments to growth are serious. Our general view is we may very well be in for a better year, but the volatility along the way will surely test the conviction of all investors. Here is why:*

## **GREED IS ... NOT GOOD**

A bright spot in 2011 was the performance of assets that provided safety and yield. Prices have now moved to reflect that strong demand. Consider government bonds: 10 year Canada bond yields fell 150 basis points and settled below 2% – a record. Today, inflation expectations are hovering around the same 2% number. Therefore, by purchasing a government bond today, investors are accepting that, for the next ten years, they will be sacrificing all of their purchasing power! The return “of” capital is trumping the return “on” capital – the fear of losing money is overwhelming the desire to make money.

Consider another example: stocks within the S&P 500 stock index paying the highest dividend yields have only been priced this expensively once before in modern history (2008). Said another way, investors are on defense and only care about income. They are not willing to pay much for the growth prospects of the rest of the market. Our own internally managed portfolios are confirming this trend. In 2011, the performance of our dividend strategy beat our cyclically-oriented equity portfolio by 20% – another record.

## **CURRENT CONCERNS ... AND WHAT TO DO**

Concern about the future and the lack of confidence, not fundamentals, are the big drivers of asset prices in this environment. The logic of these concerns is compelling. Investor psychology has been shaped by multiple pressures,

two punishing bear markets, an end to the secular run up in consumer and government leverage, the US mortgage mess and the European debt crisis. This is occurring at a time when baby boomers are confronting the transition to retirement and the replacement of active employment income with investment income.

## **INVESTORS WANT IT ... BUT WILL THEY GET IT?**

The heightened importance of investment income to meet spending needs coupled with the greater volatility of stock markets is a potent mix. Images of a return to strong growth look opaque to say the least. Low growth and low inflation are going to continue to characterize the investment environment for the foreseeable future. The unflagging demand for safety and yield are reflected in asset prices, limiting their potential to outperform. We don't see an imminent reversal of this trend.

## **EUROPE ... OH DEAR!**

Despite being a well known problem, Europe remains the focus of investors today, even in asset classes that would not normally be affected by offshore issues. The ECB, after raising rates in 2011, is now engaged and easing. Recent economic releases show the Eurozone is almost certainly experiencing another recession, which will only serve to compound the problems. It is against this backdrop that a massive amount of capital needs to be raised by governments and banks. For example, banks will have to refinance a large

amount of maturing debt while simultaneously increasing capital ratios. Countries must cut spending, and refinance hence the coming wave of debt auctions will be frequent. For all this to work, a credible financing plan needs to emerge, and that is not at all a sure thing. On top of the financing and liquidity challenges, reforms need to be implemented to restore growth. It remains to be seen if the political will exists to make the necessary changes.

### CHINA ... ON TRACK

China is showing they are not immune to slowdowns either. Interest rate increases in 2010 and 2011 coupled with the weaker environment in Europe (one of China's largest trading partners) are reducing growth rates and causing disinflation (slower rate of increase in prices). As China begins its new year on January 23rd, inflation is cooling fast and policy is becoming more supportive in response. We do not expect a collapse of growth in China. We do expect growth to stabilize at a lower rate and provide a catalyst to stabilizing growth in the rest of the world. China will undergo a transfer of power in 2012, which will occur simultaneously with a US election for the first time in 20 years. China is showing signs that the focus on exports is gradually shifting. New programs have been designed to reduce reliance on export-led growth in favour of internal growth and this move is supported in the most recent five year plan. This will take time to implement but will ultimately be good for global growth trends.

### US ... WHAT A SURPRISE

By contrast, the situation in the US is looking better. We have seen growth rebound just as gasoline prices have fallen. Consumer spending is holding in, employment is more solid and small business improvement is pointing to further payroll gains. A presidential

election this year will mean plenty of uncertainty, but the prospect of better growth will provide ballast to the rest of the world. This should support stocks and, paradoxically, lead to modest weakness in the US dollar which, despite every reason to fall in 2011, again took on the safe haven role.

### SO ... WHERE ARE THE OPPORTUNITIES?

We continue to find the high yield bonds of strong companies very attractive - yields are in the 8-9% range while volatility is low relative to stocks. Corporations are in good shape and animal spirits are in check.

We remain committed to equities and have had a focus on US equities and Canadian dividend paying companies for some time. Both have performed well.

Government bonds do not look attractive and will only benefit from extreme risk aversion. We can't help but wonder when we will see significantly negative returns in bonds given the low yields. Despite that view, the toxic mix of global problems, coupled with weak investor confidence, seems set to keep the bond party going for some time to come. Beyond the short term, however, they offer little upside.

Overall portfolio returns in 2012 will be positive. The mix of low expectations, reasonable valuations and improving cyclical conditions in the US and China should mean 2012 is a year to be optimistic.

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