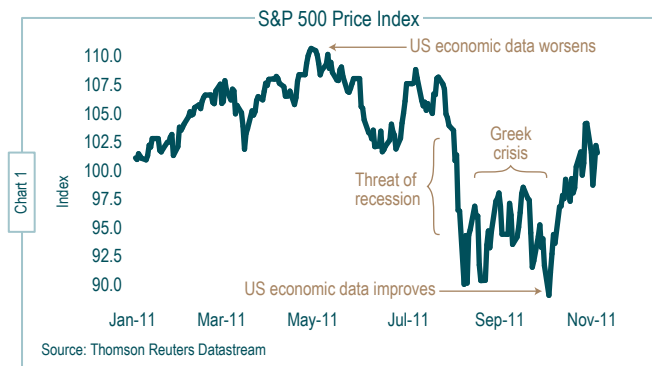


## OVERVIEW

### The US is setting the trend and Europe is adding the volatility.

We believe that the general price trend for North American equity markets is being determined by the outlook for the US economy, but accompanied by a big dose of volatility emanating from policy pronouncements out of Europe (see Chart 1).

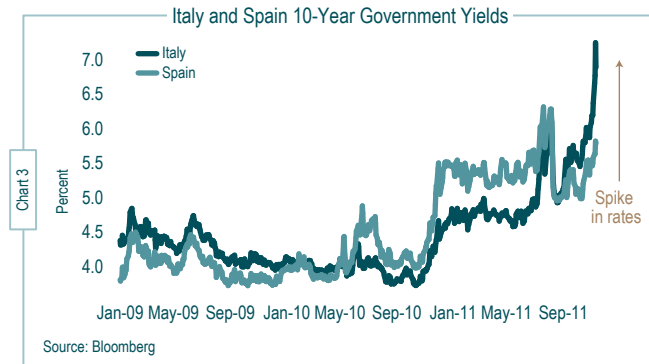


North American equity markets first came under pressure in early April as the brunt of supply chain disruptions out of Japan, rising energy and food prices and a global inventory correction started to hit the global economy. These factors weighed heavily on the prospects for sustained US economic growth, and investors were constantly surprised at how weak the economic data was in comparison to expectations (see Chart 2). However, this did not last, and in early October stock markets started to rally as the influence of the prior headwinds to growth faded and US economic data started to show improvement. The recent upward turn in a series of leading economic indicators, including the ISM Manufacturing Index, ECRI Weekly Leading Index and the US Leading Economic Index, has bolstered confidence in the sustainability of the current expansion. Historically, the onset of a recession has seen leading indicators falling in absolute terms (currently rising), real interest rates above 2% (currently



negative) and inventories above trend (currently below trend) – none of these preconditions are in place today.

While an improving economic environment underpinned the latest rally in stocks, the trend was not particularly robust. A steady stream of news out of Europe has kept financial markets on edge and volatility has remained elevated as markets continue to respond in knee-jerk fashion (see Chart 1) to every piece of news out of Europe as policy makers attempt to contain the sovereign debt crisis. Some signs of progress have emerged including the announcement of a plan that would see the voluntary write-down of Greek debt by 50%, an increase in the size of the European Financial Stability Facility (EFSF) by one trillion Euros and recapitalization of European banks to the tune of 106 billion Euros. These initiatives are a step in the right direction, but many more details still need to be worked out. A sober reassessment of recent developments has left investors wanting more, resulting in further stock market volatility and rising peripheral European sovereign bond yields (see Chart 3). No doubt further pronouncements will be forthcoming. While we expect that the increase in daily market volatility will continue, we also anticipate that equity markets will begin to reflect the improving economic fundamentals and trend higher, at least in North America.



The recent pick-up in economic activity in the US should help support equity prices, but this will not be the case when it comes to Europe. Fiscal austerity and the coming contraction in bank credit, as European banks shore up their balance sheets, will likely push Europe into recession. Europe's government policy makers, who appear to be long on rhetoric and short on detail, will probably not help the situation all that much as they continue to stumble along. Fortunately, the European Central Bank (ECB) is supporting the bond markets and banking sector without totally letting the politicians off the hook. The latest cut in the bank rate and the purchases of Italian bonds after the last European summit are cases in point.

Investors should also take some comfort from emerging economies because the BRIC nations are in good financial health with strong import/export sectors and accommodative monetary policies. The only real concern is with China. The quality of capital spending in China has been deteriorating for the last couple of years as more monies have been diverted into speculative real estate projects versus investment in new plant and equipment. This is not only a misallocation of capital into less productive assets, but it also lowers the level of economic productivity. Combining this with what has been a restrictive monetary policy to date will result in China's GDP growth slowing to 8% from 9.5% over the next six months.

While investors should be encouraged with recent developments in the US and emerging markets, there are still a number of risks that need monitoring. At the top of the list is the European sovereign debt crisis. There is a real lack of detail as to how the EFSF will be funded, how the voluntary write-downs of Greek debt will be managed and who will recapitalize the European banking system and to what degree. Secondly, fiscal tightening by governments in North America and Europe will be a drag on economic growth. Finally, the potential for a hard landing in China, even though the odds are low, is still a possibility as is a further rise in energy and food prices. These risks will continue to weigh on investor sentiment, keeping equity risk premiums high and fixed income risk premiums in the negative column, while the news flow out of Europe will ensure that market volatility remains elevated.

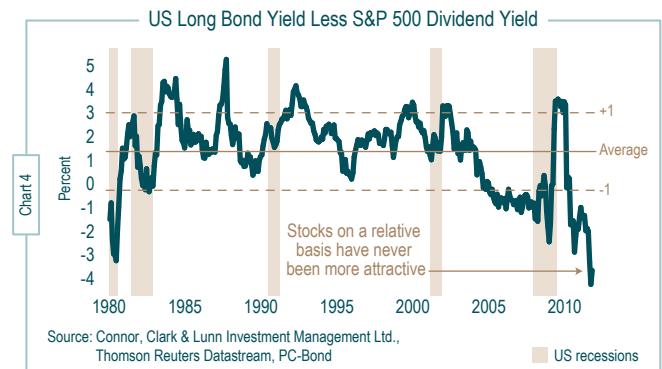
## CAPITAL MARKETS

Financial markets thrive on accommodative monetary policies, and it appears that central bankers around the globe are gearing up to make monetary policy more expansionary in response to the recent downturn in global growth and some easing of inflation. This is particularly true in North America where short-term interest rates will remain pegged at historically low levels for the foreseeable future. "Operation Twist" in the US (exchanging short-term maturities for longer-term maturities) is in full swing, and if that is not enough, US Federal Reserve Chairman Ben Bernanke has clearly stated that "we have the tools and the willingness to further policy support if needed". In Europe Mario Draghi, the new president of the ECB, has already lowered administered rates and has stated the ECB would stand in and "prevent the malfunctioning of the money and financial markets". Also, China's Premier Wen Jiabao has hinted at policy easing by seeking "well timed and measured proactive fine tuning". All of this is supportive of future economic growth and financial markets.

## PORTFOLIO STRATEGY

Equity markets throughout the year have appeared to offer good value when seen through the prism of P/E multiples, equity risk premiums and relative valuation models (see Chart 4). Furthermore, corporate profit growth has been very robust, and with economic

growth likely to hover around 2.5% over the next year, profit growth will remain positive. There is some concern that earnings momentum is fading; however, an outright decline in earnings is usually associated with growth below 1.5% or when margins come under pressure because of rising labour costs. This typically happens when wage growth is in excess of 3.5% and employment is strong – something that is not in the cards.



Unfortunately, good valuation metrics and strong profit growth did nothing to stop the dramatic fall in prices from April to September as worries about the possibility of a double-dip recession in the US and a collapse of the European banking system led to widespread de-risking of portfolios. However, an improving economic climate, easier monetary conditions and improving investor sentiment, should lead to positive returns going forward. We believe that the market pullback is behind us and that the October rally (best one-month gain since 1991) will probably extend into the New Year after some consolidation.

The outlook for fixed income markets is less rosy. Bonds have clearly been the default investment in a high risk environment. They have provided short-term safety of capital with a modest yield and some capital gains which has made them an attractive investment. The dilemma for investors throughout this cycle is that bonds have continually looked expensive, and even more so now. Nominal interest rates are at 1940's lows and real yields are in negative territory at a time when the US Federal Reserve is determined to lift the rate of inflation. This is a clear signal to us to that the risk profile of the bond market has increased and that a defensive duration position is warranted. On the other hand, corporate credit looks relatively attractive given the strength of corporate balance sheets and favourable earnings outlook. With corporate spreads well above average and near previous recessionary levels, an overweight in credit remains compelling.

Our asset mix positioning within balanced portfolios remains unchanged over last month with portfolios modestly overweight stocks versus bonds because of our positive view towards equities and lukewarm take on fixed income markets tempered by elevated levels of market volatility.