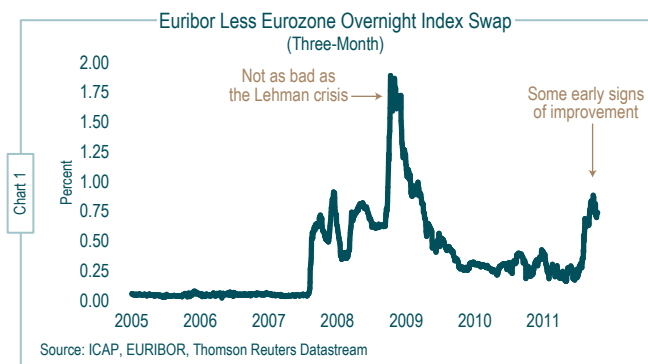


OCTOBER 2011

OVERVIEW

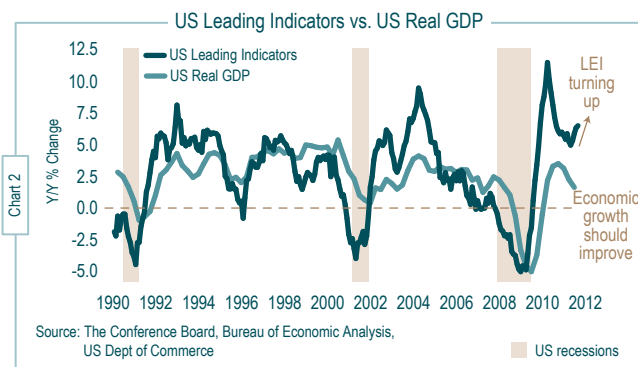
It's about macro, not micro when it comes to financial markets. Investors are currently focused on the bigger picture macro events while stock-specific fundamentals are taking a back seat. This has led to a high level of anxiety among investors because of the uncertainty surrounding three major macro factors: the European debt crisis, the prospects for a US recession and a hard landing in China.

In terms of the market's primary concern, the end game for Europe is near and the stakes are high. Bond and credit default swap (CDS) markets are now pricing in the absolute certainty of a default by Greece. This is forcing policy makers to come up with a plan that encompasses establishing the size of the haircut for Greece's debt holders, identifying how to protect Italy and Spain from a similar outcome while refinancing the European banking system. To this end, there are some tentative signs that plans may be in the offing as European policy makers have shifted their focus to shoring up the banking system and ring-fencing Italy and Spain versus trying to improve Greek finances. In addition, the European Central Bank (ECB) has revamped its liquidity support schemes and seems to be moving towards a November interest rate cut. Because of these developments, financial markets, while still in a state of heightened anxiety, have rallied recently with corporate spreads tightening and stock prices rebounding smartly. European bank stocks have led the way, which is not all that surprising given that they have been trading at levels that discount write-offs in the neighbourhood of a trillion Euros or some two to three times the level that most experts believe will be the actual case. Also, the recent decline in the Euribor/OIS spread (see Chart 1), which is an excellent indicator of financial distress, is an encouraging sign.



However, we are not out of the woods yet. European leaders facing local political pressures are prone to missteps which could result in a further loss of investor confidence and falling share prices. Signs of progress in resolving the European debt crisis would include amending the current Greek bailout package with debt write-offs in the neighbourhood of 50%, a plan for recapitalizing European banks through a combination of private sector, government and EFSF (European Financial Stabilization Fund) funding, a plan that would see the size of the EFSF increased at least 2½ fold to in excess of a trillion Euros, and some sign of moving towards European fiscal integration. This will require bold and decisive action on the part of European policy makers. We will have a better sense of their progress over the next few weeks.

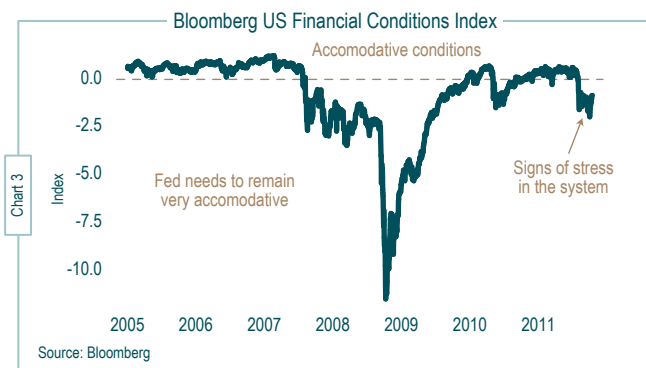
A secondary but equally important macro concern is the health of the US economy. We are still in the camp of no double-dip recession, despite the coming slowdown in government outlays and a dysfunctional Washington political climate. The US economy is showing some signs of life as retail sales have picked up, especially in the auto sector; unemployment claims are edging down; house prices have had a modest rise; both the service and manufacturing portions of the Institute of Supply Management (ISM) are doing better than expected; and the index of Leading Economic Indicators (LEI) has turned back up (see Chart 2).



Also, food and energy prices have been falling which is a welcome relief to embattled consumers who have been slowly repairing their balance sheets. Household sector debt has come down from a peak of 130% of disposable income three years ago to around

115% today, while the personal savings rate has risen from a low of 1% to 5%. While this is good progress, both measures are still far from their 30-year historical averages of 75% for household debt and 8% for savings. This is, of course, part of a larger global problem where there is somewhere between \$6 trillion and \$8 trillion in excess leverage (debt) in the developed world. Only through selective write-offs and negative real interest rates across the yield curve will the situation be resolved. This means that the de-leveraging process will be long and drawn out which in turn means economic growth will be subpar, but it does not necessarily mean the economy will slump back into recession.

Other factors such as the ending of Japanese global supply chain problems, an improvement in private sector credit growth, a slight lift in small business and consumer confidence and ongoing accommodative monetary policy, are helping keep recessionary forces at bay. In terms of monetary policy, it remains very loose with short-term interest rates pegged near zero for an indefinite period, "Operation Twist" (where the Fed buys longer-dated bonds and sells shorter-term bonds) is in full swing and US money supply is growing at double-digit rates. These are important offsets to the recent widening in corporate bond spreads and a fall in the money multiplier which has pushed the Bloomberg Financial Conditions Index into negative territory (see Chart 3). At the end of the day, there is no quick fix to the debt problems plaguing the US.



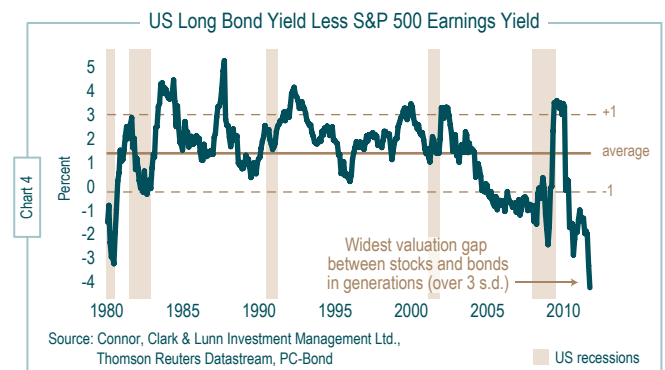
The third macro concern revolves around the notion of a hard landing in China due to a growing property bubble, rising non-performing bank loans, excessive underground lending and slowing export growth. In terms of the property bubble, it is problematic, but supply should be absorbed in time with over 15 million citizens moving from rural to urban areas each year. Also, real estate speculation is now being dampened by the government's action of limiting multiple property purchases and raising the required down payment for second homes to 50%. As for the rise in non-performing bank loans, it appears that Chinese banks have lots of liquidity with loan-to-deposit ratios of only 65% today versus

120% the last time they ran into trouble. Finally, the decline in export growth may in fact be a positive as the authorities turn to stimulating internal (consumer) consumption which will help lift the standard of living in China while promoting export growth from other developing and developed nations.

In general, as we look around the world we see a new easing cycle starting with most global bankers either positioned with a neutral or easing bias. A stronger US dollar and weaker commodity prices are setting up the right conditions for expansionary policies. The fall in commodity prices is also leading to a pick-up in consumption as disposable incomes rise at the same time that inflation is peaking around the world.

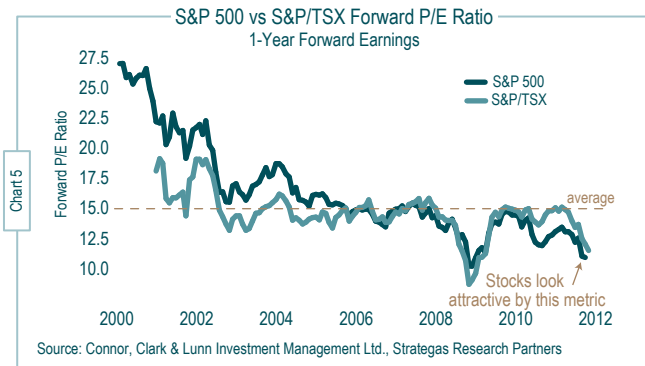
CAPITAL MARKETS

North American equity markets are attractive from a valuation perspective. Trailing and forward P/E ratios are historically low, especially when set against inflation. Equity risk premiums in turn are high, as are earnings and dividend yields when compared to government bond yields, which makes stocks look attractive. In fact, the spread between earnings and bond yields is the widest it has been in history (see Chart 4). However, we only see this changing gradually over the long term. Over the last 50 to 60 years there has been a strong inverse correlation between inflation and interest rates versus P/E ratios. Standard metrics such as the Fed Model and the Rule of 20 have served investors well and are currently signalling that P/E multiples should be higher. However, it would appear that investors today believe that the structural problems facing many developed nations, and in particular the US (too much debt and an unsustainable current account deficit), are so great that the only solution is outright deflation or hyperinflation. The spread between these two extremes and the potential volatility of inflation between these two extremes is so great that investors are left with no choice but to heavily discount the multiple of stock earnings.



With limited upside for multiple expansion, even though P/Es are at historically low levels (see Chart 5), we expect stock prices to

rise and fall in line with earnings growth. To this end, we expect earnings going forward will probably increase at the rate of nominal GDP. This would suggest that long-term returns will be in the neighbourhood of 6% made up of 4% nominal GDP and a 2% dividend yield. Over the next six months earnings will rise at a faster rate than nominal GDP, but P/E multiples will remain under pressure until the ISM and LEI indicators turn, which as noted above appears to be on the horizon.



On the other hand our bond models are signalling that fixed income securities, particularly government bonds, look expensive. Investors have driven yields down in their search for a safe haven from equity market volatility and the threat of a looming recession. One of our models, which incorporates a GDP forecast, inflation forecast, inflation expectations and quantitative easing, points to a 3.0% yield as fair value. A second model, which incorporates ISM, ISM non-manufacturing, National Federation of Independent Business Survey, core inflation and inflation expectations, puts 10-year Treasuries at 3.2% as fair value versus 2.2% today.

From a technical perspective the picture is a mixed bag. Government bonds look overbought while corporate bonds look oversold given that they are currently priced for a recession, which we don't foresee. The picture for equities is much the same. Our moving

average models are all registering sell signals, as are our breadth and Coppock models, while the Citi Economic Surprise Index, our long-term trend logarithmic models and our sentiment models are all in bullish territory. From a technical perspective this suggests range bound equity markets (see Chart 6 – the S&P/TSX Composite is expected to range between 11,500 to 13,000 while the Canada 10-year bond yield is expected to rise to 3.0% – see Chart 7).

PORTFOLIO STRATEGY

Summing it all up, we see below trend economic growth in both the developed and emerging economies with material downside risks due to potential missteps by policy makers. Monetary policy is very accommodative in the developed world and somewhat restrictive in emerging markets. Liquidity appears to be ample, but the cost is going up for many countries that have onerous debt structures. Inflation expectations are improving with the recent decline in food and energy prices, but oil is always a bit of a wild card. Equities from a valuation perspective look attractive, but secular factors, such as de-leveraging and poor demographics, are major limiting factors while bonds look expensive unless we go into a prolonged recession.

Major risks include: European banking crisis, US recession and a China hard landing. Catalysts for further market disruptions include market volatility crushing investor, consumer and business confidence; central bankers running out of monetary bullets; extreme fiscal austerity; and political paralysis.

In balancing all the factors at play we still believe equities are the preferred asset class at this point in time. However, our commitment to stocks is cautious because of the inherent risks facing markets going forward. Until there is more clarity as to how the three macro factors discussed above play out, asset mix in balanced portfolios will remain slightly overweight equities but with less than half the normal risk exposure.

