

OVERVIEW

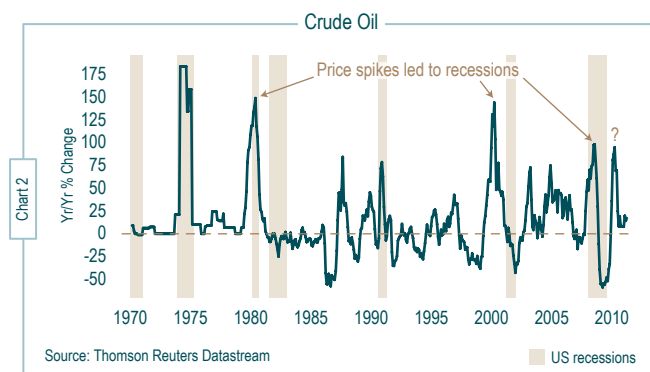
It is time for a little de-risking, even though our base case scenario for sustainable global growth accompanied by strengthening economic activity in North America is still in place (see our 2011 *Financial Markets Forecast*). In fact, the latest numbers released for capital spending, employment and consumer and business confidence have come in better than forecast, which coupled with a variety of leading economic indicators (see Chart 1) point to an economic expansion that has legs. Financial markets have also been acting as expected with stocks recently hitting new highs accompanied by a modest rise in interest rates. However, as encouraging as this may be, there are three developments that have increased the risk for a market pull-back. This has led us to take some profits and reduce risk within portfolios. The first development is the turmoil surrounding rising oil prices, the second is the looming removal of quantitative easing (QE2) by the Federal Reserve (Fed) and the third is the potential for a mis-step in fiscal policy by US lawmakers. Each of these factors present a fat tail risk (significant impact but low expected probability) for financial markets and the economy.



Political tensions in the Middle East and North Africa are putting upward pressure on oil prices as a geopolitical risk premium gets

factored into prices because of the potential for major disruptions in supply. This has come at a time when prices are already under upward pressure due to a rise in global per capita oil consumption and a decline in spare oil production capacity.

In recent times there have been five global oil shocks (when the price of oil goes up over 100% year-over-year) starting with the 1973 Arab embargo followed by major spikes in energy prices in 1979 (Iran), 1990 (Gulf War), 1999 and 2008 (speculation). In every case global recessions and falling stock markets soon followed the shock (see Chart 2). We are approaching the same situation today if the current escalation in oil prices persists.



Rising oil prices act as a tax on consumption by limiting discretionary spending which impedes economic growth. The situation is only manageable as long as the rise in prices is not too rapid or too extreme and/or it can be offset with rising incomes. Today, the situation is somewhat tenuous because the rise has been rapid, the potential for further increases remains elevated and the risk premium currently being built in is unlikely to subside any time soon given the unpredictability for further unrest in the Arab world. On the other hand, we take some comfort in the fact that energy consumption by US households has declined to around 5%

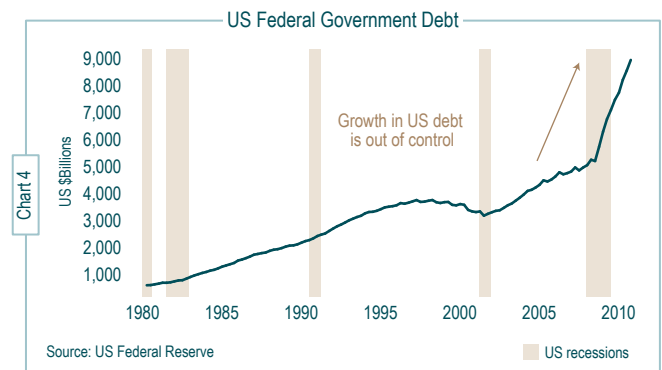
of disposable income from 7.2% in 2008 and consumers are in better financial shape today with debt servicing costs down and savings up. Also, the economy is picking up and employment is improving. While we rate the risk of a major oil shock to be relatively low (under 25%), the impact on the economy and in turn financial markets would be significant (fat tail event) should it occur.

The second risk is the uncertain impact of the conclusion of QE2. With economic growth starting to accelerate and, more importantly, some early signs of growing inflation pressures, as evidenced by rising emerging market inflation and North American manufacturers reporting a greater ability to pass through higher input costs, the Fed will be hard pressed to justify further quantitative easing (QE3). On the other hand, should the US economy start to succumb to an oil shock then the Fed will at the very least have to consider extending its quantitative easing program – this is a tough call.

The question right now is “what will happen when QE2 ceases in June?” The answer is highly uncertain, but we suspect it will be very dependent on whether or not the private sector has recovered sufficiently and if there is enough momentum to move the economy forward without the ongoing support of an overly accommodative monetary policy. Fortunately, as noted above, the prospects for a robust economic recovery look promising given the strength in recent economic data, consumer and business confidence and the signals emanating from a wide range of leading indicators. However, the potential negative impact from the energy sector cannot be dismissed. Also, we know that when QE1 came to a halt the Fed’s balance sheet started to shrink (by 12%) and the US economy faltered. In addition, equity markets retreated with the S&P 500 dropping by 12.5%, BAA corporate credit spreads

widened by nearly 60 basis points, commodity prices fell while the US dollar strengthened and 10-year US Treasury yields fell from 3.84% to 2.66%. The net result was a flight to safety and higher risk asset prices crumbled (see Chart 3).

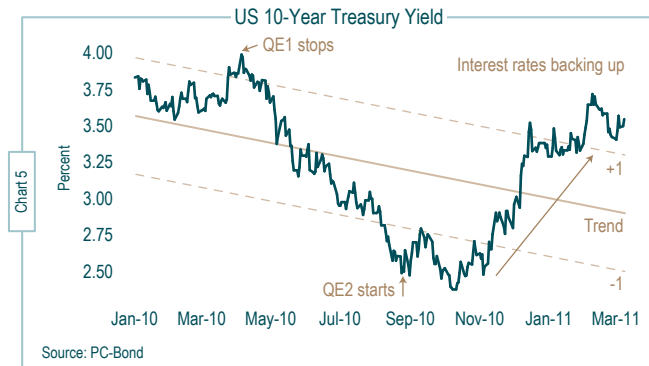
The third risk is also political in nature but resides in the US instead of the Middle East. In the short term, if the Republicans and Democrats cannot see their way forward to some form of compromise on cutting the deficit, then the resulting shutdown of the US Government would be highly disruptive to financial markets. Furthermore, investors are increasingly looking for some solution to the country’s looming deficit crisis because they intuitively know that if something is not done the debt time bomb will ultimately kill economic growth, not unlike what is happening in Greece and other European peripherals (see Chart 4). As politically challenging as it may be, lawmakers at some point are going to have to deal with the three largest components of Federal spending (defense, medicare and social security) which make up over 70% of total outlays. While we believe there is a certain amount of political will to deal with the country’s fiscal problems, anything and everything is possible when it comes to politics, and the wrong outcome will be unsettling for financial markets.



CAPITAL MARKETS

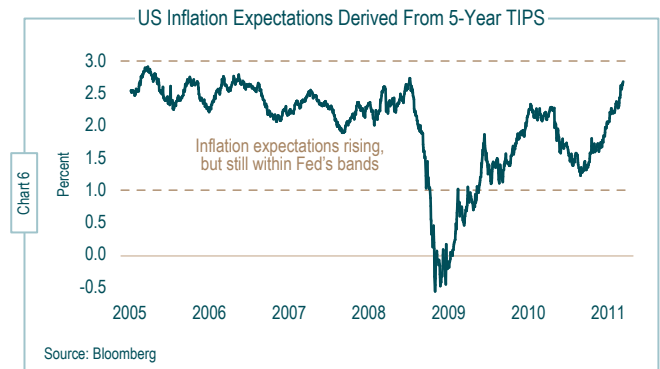
Equity markets have been moving up pretty much in a straight line (see Chart 3) ever since the Fed announced its plans for another round of quantitative easing (QE2) last August while bond prices have been declining as interest rates have moved higher (see Chart 5). The strong upward trend in stock prices over the last six months

has been spectacular. Market lore which states “the trend is your friend” has been very much in play but with the above-noted risks looming there is less certainty that these trends can continue.



Historically, whenever oil prices have doubled over a 12-month period (see Chart 2) equity markets have typically seen a 30% correction starting on average two months after oil prices have increased in excess of 100% on a year-over-year basis. Currently prices are up over 50% and would have to approach the 2008 highs of \$148 a barrel before a really severe correction sets in. However, a more muted pull-back in stock prices is not out of the question given the impact that rising energy costs have on corporate profits. It is estimated that for every 10% increase in the price of oil, earnings per share growth for the S&P 500 declines on average approximately 1%, leading to a lower level of earnings than investors are anticipating and/or a reduction in the market’s price earnings multiple (P/E) as growth assumptions are ratcheted back. This is already happening in emerging markets where energy represents a much higher proportion of a consumer’s disposable income as does food where prices have also been rising. As such, investors are already starting to discount a drop in domestic demand and in turn domestic corporate earnings. Whether such a situation develops in the industrialized world will need close monitoring.

Bond yields typically decline (prices rise) after the 100% price threshold in oil prices is breached in anticipation of a recession. However, in the interim interest rates can rise because of rising inflation expectations. Currently the TIPS market (see Chart 6) and investor inflation expectations have been rising and companies are increasingly reporting the ability to pass along rising input costs.



PORTFOLIO STRATEGY

In our 2011 *Financial Markets Forecast* we noted that there were a number of potential risks that could derail our positive outlook for economic growth and rising equity markets which included geopolitical unrest and a spike in oil prices. With these two factors pushing to the fore, as noted in our opening paragraph, it is time for a little de-risking. From an asset mix perspective this means reducing a portfolio’s exposure to equities. Specifically, we are scaling back foreign equities because of the heightened vulnerability of those markets to an oil shock, and in the case of the US to the conclusion of QE2 and political gridlock which may lead to a mis-step in policy. The overweight in Canadian equities remains in place as a hedge against an oil shock while still leaving portfolios exposed to future growth should the above-noted risks subside.

From a fixed income perspective, an overweight in bonds at this point in time is not warranted because it is not a given that we will experience an oil shock and, as noted above, the timing of such a move could be better after higher oil prices are realized. In addition, fixed income markets have rallied recently (yields lower) thus pricing in some of the adverse effects of rising oil prices leaving less room (already discounted) for yields to fall further (see Chart 5).

It also strikes us that if there is an oil shock the Fed will find itself between a rock and a hard place as it weighs the short-term benefits of supporting the economy versus the longer-term implications for higher inflation, which could unsettle markets.

Finally, while some de-risking is in order, our base case scenario for sustained global growth and a solid expansion in North America is still the most probable outcome for 2011. As such, an overweight to risk assets is still warranted – just not as much and preferably to those markets that will fare relatively well under more dire circumstances.