



Forecast 2012

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EXECUTIVE SUMMARY

SECULAR ENVIRONMENT

We believe there are five broad themes that will play out over the next decade:

1. Post-crisis expansion: A decade of slow growth, low inflation and structural deleveraging will be the norm in developed markets.
2. Divergence: Developed and emerging markets will have different growth and inflation profiles.
3. End of the Great Moderation: Business cycles in developed markets will become shorter and more volatile in nature with recessions occurring a third of the time.
4. Financial repression: Interest rates will be held down by central bankers to avoid deflation while liquidating debt in a stealth manner.
5. Demographics: Aging populations will inhibit productivity growth and stretch government resources as the dependency ratio decreases.

FINANCIAL MARKET IMPLICATIONS

- Interest rates will remain low offering meager returns
- Top-line corporate revenue growth will be constrained due to sub-par growth in GDP
- Demographics will tilt the odds in favour of labour, resulting in margin compression
- Equity market returns will be volatile and provide below average returns

SECULAR FORECASTS

Table 1

Region	GDP	CPI	Trailing P/E	Risks
United States	2.0-2.5%	2.0-2.5%	11x	Large nominal debt, earnings volatility
Canada	2.0-2.5%	2.0-2.5%	12x	Large debt overhang
Europe	1.1-1.4%	1.2-1.8%	9x	Deflation, poor demographics, economic volatility
China	7.0-7.5%	4.0-5.0%	10x	Slowing growth, increasing inflation

CYCLICAL ENVIRONMENT

The business cycle at times will run counter to the secular trend, providing above average investment opportunities, but with more frequent recessions, risks will be elevated.

UNITED STATES – ECONOMY IS IMPROVING

- Consumer and corporate balance sheets are in decent shape
- Employment should continue to improve
- Capital spending will remain robust
- Housing market will bottom
- Public sector debt levels are the biggest problem (risk)
- Monetary policy will remain accommodative with a 30% chance of further quantitative easing
- The US dollar will trade between 72-80 on the Trade-Weighted Dollar Index

CANADA – PROSPECTS ARE MIXED

- Sound fiscal environment and banking system
- High commodity prices and improved outlook for US economy will help Canadian growth
- Household debt levels are worrisome
- Consumer spending is forecast to slow as will employment and wage growth
- The Canadian dollar will remain firm, trading within a range of US\$0.95-US\$1.02
- Monetary policy will remain easy with the bank rate unchanged

EUROPE – SLIDING INTO RECESSION

- Austerity measures will result in a 1.25% drag on GDP
- ECB remains supportive with a massive 2-3 year Long Term Re-financing Operation (LTRO) for banking
- Simultaneous public and private sector deleveraging is producing a negative feedback loop
- Risks of a hard landing are around 40%
- Monetary policy to remain accommodative with the ECB and BoE lowering rates to 50bps

CHINA/EMERGING MARKETS – SOFT LANDING

- Emerging markets will be affected by bank funding problems in the Eurozone
- Lower growth and inflation rates
- China GDP growth forecast to be between 8%-8.5%
- Monetary policy to be supportive of future growth

OVERALL

- Growth rates (GDP) will diverge in 2012
- Monetary policy will be very accommodative in almost every region of the globe and there will be a coordinated effort to protect the financial system
- Inflation is forecast to be relatively benign in the coming year

- S&P/TSX and S&P 500 will be range bound (11,800-14,000 and 1200-1400 respectively) but with a bias to the upside, providing a return somewhere between 9% to 14%
- Stock selection will be key in 2012
- Bonds are expensive based on fundamentals and should be trading north of 3% with total returns somewhere between 1% and 4%

FINANCIAL MARKETS FORECAST:

- US corporate profits will expand but growth rates will slow while growth in Canadian corporate earnings will be robust
- Equity risk premiums will stay elevated until the structural imbalances facing the developed world are rectified
- Dividends offer mild support surpassing yields on US Treasuries and Canadian bonds

FINANCIAL MARKETS THESIS

- We are taking a constructive stance toward risk assets but keeping the amount of risk low as the potential for any number of negative macro events unfolding remains high (tail risks – greater than a three standard deviation move).
- Major downside risks are centred in Europe, while a hard landing in China, a surge in energy prices and a liquidity trap cannot be discounted.

CAPITAL MARKETS SCENARIO (12-month Forecasts)

Table 2

	Base Case (60%)	Major Slowdown (15%)	Recession (10%)	Acceleration (15%)
Environment	<ul style="list-style-type: none"> • Below trend growth • Accommodative monetary policy • Benign inflation • Elevated macro tail risk 	<ul style="list-style-type: none"> • Europe enters deeper recession but no global crisis • Mild global slowdown • China hard landing 	<ul style="list-style-type: none"> • Europe enters deeper recession and global crisis ensues • Global trade freezes • No policy response available in developed markets 	<ul style="list-style-type: none"> • Strong US private sector • Emerging market slowdown and inventory correction • Europe surprises to the upside • Low rates, easy monetary policy
GDP (%)				
Global	3.5-4.0	2.5-3.0	0	4.5-5.0
US	2.75	1.75	-2.0	3.5
Canada	2.2	1.2	-2.5	4.0
Eurozone	-0.7	-2.5	-3.5	1.0
China	8.0	<7.0	<5.0	10.0
Bank rate (%)				
Fed	0.25	0.25	0.25	0.5
BoC	1.25	0.75	0.25	1.75
ECB	0.75	0.5	0.25	1.0
10-year bond rate (%)				
US	1.75-2.75	1.25-1.75	1.0-1.65	2.75-3.75
Canada	2.0-3.0	1.6-2.1	1.25-1.75	2.75-3.75
Germany	1.75-2.75	1.25-1.75	0.9-1.5	2.25-3.25
Italy	6+			
Earnings growth (%)				
US	5	-18	-35	15
Canada	12	-25	-35	20
Eurozone	-20	-30	-35	10
P/E multiples				
US	13.5x	12x	12x	14.5x
Canada	14.5x	13x	12x	15.5x
Eurozone	11x	10x	10x	13x

INTRODUCTION

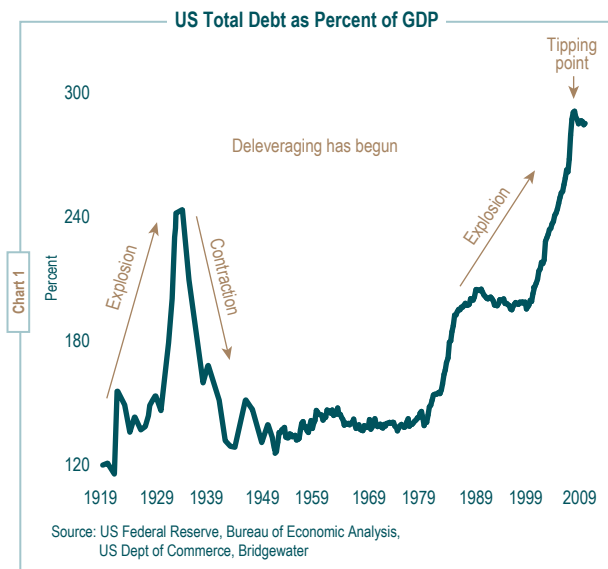
This year's *Financial Markets Forecast* looks at the secular themes that are underpinning global economic growth and financial markets. In addition, we also address the cyclical factors that are impacting the outlook for the economy, inflation and monetary policy. Finally, taking into account the secular and cyclical forces at play, we look at market valuations and examine technical conditions in order to set the framework for our portfolio strategy. Our *Forecast* will be kept current through our monthly publication *Outlook*.

THE SECULAR ENVIRONMENT

In assessing the secular environment, we have examined five broad themes: namely, the post-crisis expansion, the divergence between developed markets and emerging markets, the end of the Great Moderation, financial repression and shifting demographics. Our take on these themes is as follows:

THEME I: DEVELOPED MARKETS' POST-CRISIS EXPANSION

The root cause of the recent global financial crisis, which led to the second major down leg in the current secular bear market that started in 2000, was the formation of a massive amount of debt (see Chart 1). The explosion in debt over the last three decades came about because of a confluence of factors including ample liquidity (easy monetary policies and lenient lending conditions), a secular decline in interest rates (carry costs declined) and the development of mechanisms for creating and distributing debt which became more plentiful and sophisticated. These factors in combination led to a growing dependence on debt to promote growth and consumption beyond the norm.



With the financial crisis of 2008 having past and an economic recovery in place, the question has become, what next? To answer this question we turn to Professors Carmen M. Reinhart and Kenneth S. Rogoff's groundbreaking study of 18 banking crisis.

They found that all the crises had a surprising amount in common, sharing a number of major characteristics:

1. Asset market collapses are deep and prolonged.
2. Real housing price declines average 35% stretched out over 6 years.
3. Equity prices collapse on average 55% over 3.5 years.
4. There is a profound decline in output and employment – the unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average 4 years and output falls (from peak to trough) on average 9% over 2 years.
5. The real value of government debt explodes, rising an average of 86%, then deleveraging sets in, lasting around 7 years, impairing growth in GDP by 1% a year.
6. Extreme debt levels ultimately lead to a sovereign debt crisis (nominal income growth falls short of debt-service costs – i.e. governments have to issue new debt to the service the old).

In this current crisis, the first four of their observations have come to pass and the later two seem to be in the making. There is also a significant body of academic work surrounding the intermediate- and long-term effects of a financial crisis (Reinhart and Rogoff and the McKinsey Global Institute). In reviewing this work, it is worth noting that this is not strictly a US problem. The Eurozone, UK and Japan are experiencing a similar aftermath to the global financial crisis. Specifically, we can make the following observations:

- **GDP:** Growth rates are significantly lower the decade following a crisis with a median decline in GDP of around 1%.
- **Unemployment:** The median unemployment rate averages about 5 points higher in the decade following a financial crisis. In 10 of 15 country-specific episodes, the unemployment rate did not return to the pre-crisis level for 10 years.
- **Leverage:** In the decade prior to the crises, domestic credit/GDP climbs by about 38% and external indebtedness soars. Credit/GDP then declines by a comparable amount after the crisis. In most cases the deleveraging is delayed and then becomes a lengthy process lasting about 7 years. The leverage usually increases at the start of the crisis due to a slowdown in nominal GDP that is not matched by comparable write-downs. Typically,

the greater the unwillingness to write down non-performing debts, the longer the deleveraging process is delayed. What typically happens is the private sector, having gone through the crisis, changes attitudes and activities towards debt. Unable to tolerate the accompanying growth slowdown, the public sector becomes the borrower of last resort to soften the contraction. History suggests that this is simply “kicking the can down the road” (ultimate deleveraging).

- **Inflation:** Tends to fall materially after a crisis (1973 being the only exception to the rule). This is true not only for the developed economies in the study but also for the emerging economies. This is an amazing result considering the heterogeneity of fiscal and monetary policies adopted in response to the crisis, the chronic and high inflation in the group of emerging markets and the massive foreign exchange (FX) devaluations that transpired.

Takeaway: We should expect a decade of slow growth, moderate inflation and structural deleveraging in developed markets. Developed market policy makers will set policy for this environment and this will have an impact on emerging market policy as they will be wary of allowing developed market to export deflation into their regions.

THEME II: DEVELOPED MARKETS VS. EMERGING MARKETS: LIVING WITH DIVERGENCE

The Great Recession of 2008/09 was a response to a build-up of massive global imbalances largely in the form of too much debt and misaligned current accounts. The required global rebalancing is underway, but we may already be hitting some limits that present a challenge to the progress. This is problematic because despite some improvement in addressing the global imbalances, the size of the imbalances is still significant. A key investment theme for the next several years will be the yawning gap between advanced and emerging economies that is, in many ways, the result of the initial conditions leading into the credit crisis and the policy responses during the recovery. The list of divergences and continued imbalances is extensive:

- **Output Gaps:** Large, negative output gaps continue to linger in most developed market countries which creates intense deflationary pressure. Not only are output gaps large, but it is difficult to envision the type of growth required to close them rapidly given the structural nature of the problems. Meanwhile, output gaps have essentially closed in emerging markets and inflationary pressures are mounting.
- **Inflation Trends:** The output gap divergence means varied inflation trends with inflationary pressures building in emerging markets contrasted with either deflation in Japan and the serious risk of deflation in the US, UK and Eurozone.

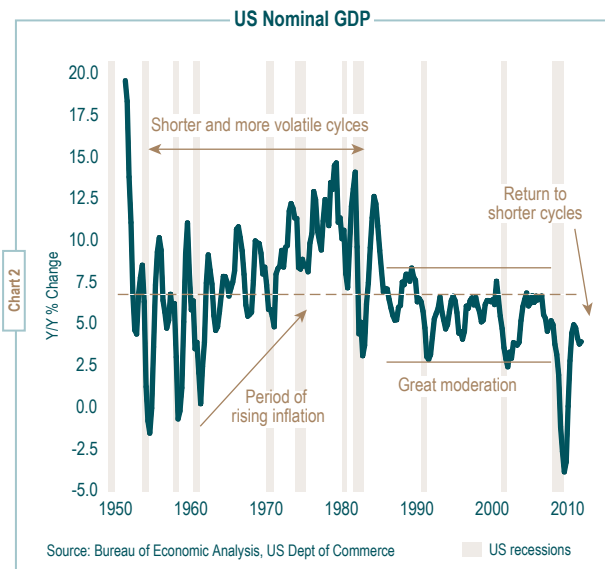
- **Monetary Policy:** Ultra-easy monetary policy is appropriate for the US, UK, Europe and Japan while emerging markets need to limit monetary accommodation to quell inflationary pressures.
- **Fiscal Policy:** developed markets are stretched to the limits with countercyclical policy and some US local governments and European periphery economies deeply distressed. Emerging market fiscal budgets are largely under control but fiscal stimulus is still rather sizeable.
- **Trade Imbalances:** The trade imbalance between the US and emerging markets is still quite large and needs to be improved to rebalance the global economy. This requires continued strong emerging market growth and structural rebalancing within those economies (increased domestic consumption).
- **Capital Flows:** The fundamental divide between developed and emerging market economies and their policy responses implies continued strong capital flows into emerging markets and a risk that bubbles emerge in some of those markets, even as capital flows to some developed market economies remains impaired.

Takeaway: It is imperative that for global rebalancing to continue, emerging market inflation has to be contained and has to become the speed limit for global growth. The combination of non-existent emerging market output gaps, ultra-loose global monetary policy and fiscal policy, above trend emerging market economic growth that attracts hot capital flows and copious amounts of global liquidity translates into an environment with serious inflation risks for emerging economies. Social upheaval and political regime change will be the consequence of emerging markets losing their battle with inflation.

The global rebalancing that is required is pretty simple; strong emerging market internal demand to support developed market export and investment spending. There is a cyclical and secular inflation element in this process. As emerging markets become the dominant driver of global growth, the cyclical improvement eventually comes with a rapid run-up in commodity prices which leads to inflationary pressures within emerging markets. This leads to a slowdown in developed markets (cost model) and a tightening response in emerging markets. As a result, the commodity cycle plays a bigger role in the global business cycle. In addition, a consequence of the shift to a more sustainable model in emerging markets, based on increasing internal consumption and less reliance on exports, is higher inflation due to the disruptive reallocation of resources to less productive non-traded sectors. This leads to a lower path for potential global growth going forward.

THEME III: THE END OF THE GREAT MODERATION

The period from 1982 to 2007 has been commonly referred to as the “Great Moderation”. It was a golden age for developed financial market returns. Over this period, economic growth, in nominal terms, became less volatile (see Chart 2) and business cycles became longer as a result of the better use of fiscal and monetary policy levers and demographic trends.



However, when looked at from a historical perspective, this period appears to be very much the exception rather than the rule (see Chart 2 and Table 3).

Table 3

Period	Median Contraction (months)	Median Expansion (months)	Median Cycle (months)	Median % Time in Contraction (months)
1854-2007	14	30	44	32%
Pre-1982	15	27	42	36%
1982-2007	8	106	114	7%

Note: Data using mean returns looks very similar.

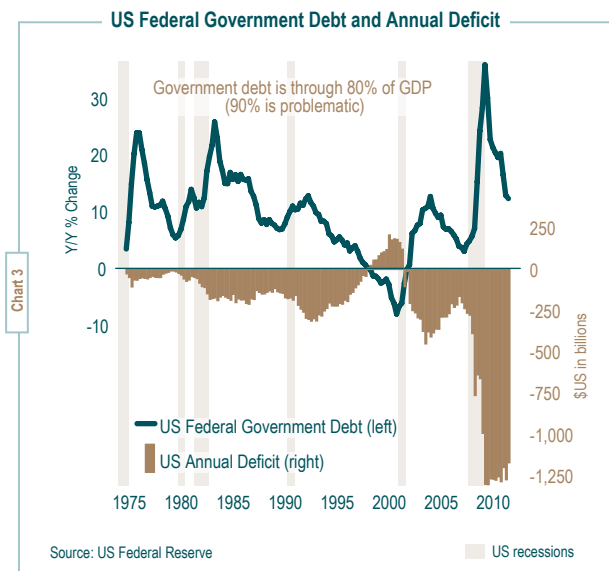
There were a number of secular forces that converged to give us this outcome. These forces now look to be slowing down materially or changing direction entirely. Global demographics are experiencing a significant shift as populations age in the developed world and youth unemployment rises in the emerging world. Also, the pace of globalization is slowing at a time when the developed world’s nominal debt is building and nominal income growth is slowing. As such, if the Great Moderation is giving way to historical norms, there are significant investment implications to note.

Takeaway: We will probably return to a period with more normal business cycles (inventory cycle) which are much shorter and sharper than those experienced during the Great Moderation. Also, we should expect to be in recession about a third of the time. This means slipping into a recession sometime in the next 18 months. In terms of asset valuations, it appears that when the average expansion went from 27 months to 106 months and the time spent in recession went from 35% to 5%, then a secular re-rating of risky assets (lower risk premiums – higher valuations for equities) came about and the sensitivity to macro variables declined. However, if we return to spending 35% of the time in recession, then a re-rating seems likely (lower valuations/higher risk premiums for equities) and macro factors will become more important. Bonds may also have to be re-rated (lower interest rates) as well because inflation expectations embedded in the fixed income markets may have been too high. Also, when comparing the relative valuations of equities versus bonds, some re-thinking is probably in order. History suggests that the two asset classes often trade independent of one another and the correlations have only been strong over the last few years. Dividend yields below corporate interest rates is only a recent phenomenon, and earnings yield analysis spectacularly breaks down if we see deflation or low nominal GDP growth. As long as this outcome even remains a possibility, earnings yields will remain elevated.

THEME IV: FINANCIAL REPRESSION

After the Global Financial Crisis and the Great Recession there remained two primary global challenges. For the advanced economies it was the public and private debt overhang, ongoing deleveraging, lower growth and high unemployment. For emerging markets it was sustained, large capital inflows; inflationary pressures; overheating and bubble risks. These problems are related in that the low growth outcome of advanced economies is causal to the large capital inflows into emerging markets that are building the foundations of a debt problem that must be addressed.

The 2008 financial crisis was resolved by a swap of private sector debt onto the public sector balance sheet. This solved one problem (financial system collapse) but introduced a new one (high and mounting government debt). The empirical evidence surrounding public debt is that when debt/GDP ratios exceed 90%, growth declines by about 1%. Many of the world’s economies are at these levels or they are on a path to breach them in the next 5 years. The US is a perfect example (see Chart 3), although it is worth noting it is not nearly the worst of the lot. The IMF and OECD forecast that in the US alone, an aging population will raise the debt ratio by 50% of GDP over the next 20 years. Even more alarming is that the Congressional Budget Office projects that the US federal debt could reach 300% of GDP by 2050 because of rising health care, social security programs and debt servicing costs.

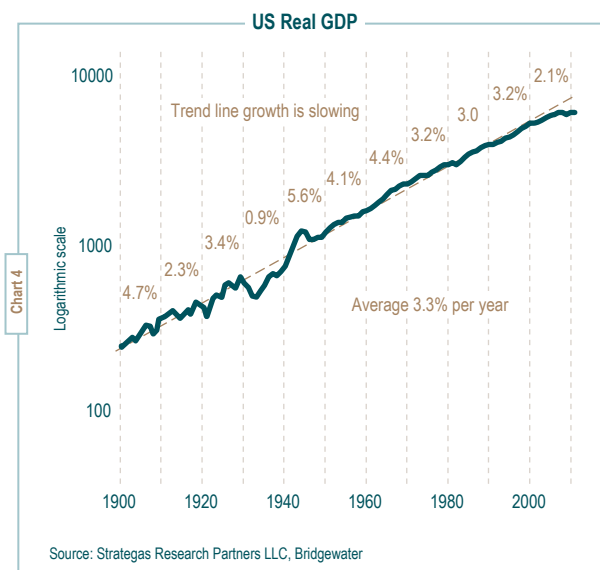


Takeaway: This situation is not sustainable and choices will need to be made. Throughout history debt/GDP ratios have been reduced by some combination of economic growth, fiscal adjustment (austerity), explicit default or restructuring, a sudden burst of inflation (goods produced domestically – not imported) and/or a steady dose of financial repression that is accompanied by an equally steady dose of inflation. Currently the preferred route seems to be financial repression, which can be best thought of as a combination of factors including directed lending to government captive domestic audiences (such as pension funds), explicit or implicit caps on interest rates, regulation of cross-border capital movements and often a tighter connection between government and banks. It is instituted by central banks through interest rate caps or quantitative easing, financial regulation, pension regulation and/or capital controls. The main goal of financial repression is to keep nominal interest rates lower than would otherwise prevail, preferably below the rate of growth in GDP. When financial repression produces negative real interest rates, this also reduces or liquidates existing debts. It is a subtle type of debt restructuring, and there are a number of implications for this type of strategy. First, developed market monetary authorities will continue to run inflationary policies against a deflationary, deleveraging backdrop where low inflation is not tolerated. Second, real interest rates will on average be negative for the next 10 years. And thirdly, to avoid capital inflows and their own debt problems, emerging markets will continue to engage in their own form of financial repression (i.e. financial repression will be global in nature).

THEME V: SHIFTING DEMOGRAPHICS

Over the last 60 years US GDP growth in real terms has not varied significantly from one decade to another (see Chart 4); however, the variability that has occurred has been driven by demographics and productivity. In the 1950s and 1960s the US population grew by 1.4% as the baby boom blossomed and productivity expanded by

2.8% leading to real GDP growth of 4.2%. In the 1970s and 1980s population growth started to slow as the baby boom peaked along with productivity growth resulting in real GDP slipping down into the 3% range. Over the last decade the population grew by 0.98% while GDP fell to 2.2%. The downward trend is continuing with the population forecast to grow by 0.75% over the next decade.



Looking at demographics on a global basis, we see that the world's population grew by 142% over the past 50 years and it is now projected to grow by 50% over the next 50 years. While this is still respectable growth, it is a fairly extreme slowdown in the growth rate. Also, these broad measures mask something important in terms of economic growth and asset returns, namely the demographic and geographical shift. The world's population is aging, and all population growth is occurring in the emerging markets; however, demographically several BRIC countries (Brazil/Russia/India/China) are more like developed markets than emerging markets (see Table 4).

Table 4

	Population Growth 1950-2000	Population Growth 2000-2050	Working Age 2000-2050	Population Growth >65 2000-2050
Developed Markets	28%	3%	-11%	69%
Emerging Markets	174%	39%	39%	253%
Brazil	184%	12%	4%	265%
Russia	10%	-17%	-31%	50%
India	178%	33%	41%	271%
China	99%	5%	-11%	197%

Source: Deutsche Bank, UN Population Division

Demographic trends are now in the process of slowly reversing in the developed world. While better in emerging markets, their economic size is not enough to offset the effects of the change in

the developed world. For instance China, despite all the optimism surrounding its economic future, has demographics that are very similar to the developed world. The slowdown will begin in 2015 and looks very much like Japan in 1990s. The prime working group will start to decline, which is in stark contrast to the 170% increase in this group from 1970 - 2000.

Takeaway: There will be a massive increase in old age populations and huge decreases in dependency ratios. Outside of India the numbers are disturbing for the BRIC nations, leaving the Middle East and Africa with the best demographics of any region in the world. As the dependency ratio shifts from the 25 to 64 cohort to the >65 + <25 cohort, productivity will be inhibited and it will reinforce a move towards economic cycles that are more volatile and shorter in nature. In terms of financial asset pricing, we know that stock market price/earnings multiples (P/E) rise when the share of the population that maximizes savings is the largest and vice versa. This suggests that a mean reversion view of P/Es may be incorrect as P/Es may be a function of population distribution. Also, it suggests there will be upward pressure on interest rates as governments issue more debt in a period of declining savings.

The most important concept that often gets missed in the demographics discussion is there simply may not be enough future output to meet demand. A battle over resources will increasingly take the world away from meeting its economic potential and will play out across countries, regions and economic cohorts. Savings are just claims on future output but do not ensure that the output exists.

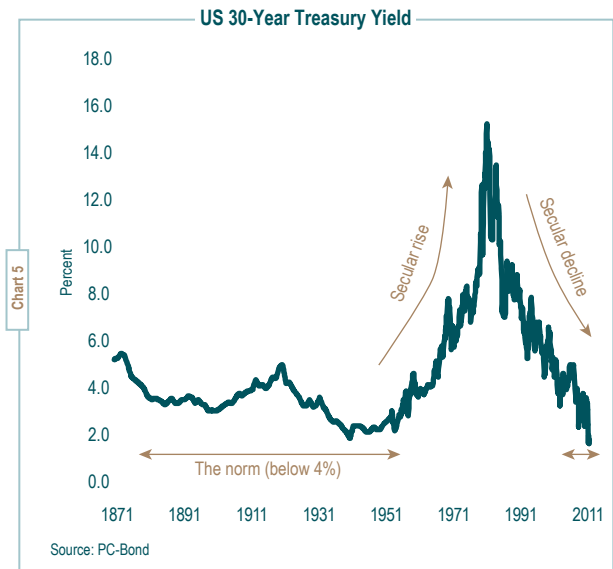
OTHER FACTORS

In addition to the five broad themes discussed above, there are longer-term secular trends around interest rates, profits, discount rates and earnings yields that need to be examined in order to fully understand the secular forces that are driving long-term financial market returns.

INTEREST RATES:

Most market participants are familiar with the two long secular waves of interest rates since the end of the 1930s. The first was the secular rise in interest rates from 1940-1981, where US Treasuries lost 53% in real terms, and the second was a secular decline from 1981 to date where US Treasuries returned close to 600% in real terms. The problem with looking at a time period with only two secular waves is that it is difficult to discern the norm. Interestingly, the consensus seems to have concluded that the low rate environment of the past 40 years has been the result of a confluence of special factors that have driven interest rates below their long-term fundamental values. However, by extending the time frame back further we see that interest rates have in fact spent most of their time below 4% and have been fairly stable (see Chart 5). In fact, it is the 1940-1981 period that looks like the

outlier, and the culprit appears to be the global inflation experienced during that period.



The past 100 years have been highly inflationary relative to history with the bulk of inflation occurring since 1940. As an example, UK prices on the eve of WWI were only slightly above 1650 levels, but since then have doubled six times. In the US, prices rose 61% from 1820-1913, when the Federal Reserve (Fed) was created, and since then are up 2,000%. This late twentieth century inflation experience was global in nature and a function of a number of different factors:

- The most rapid population expansion in world history, particularly 1950-2000 when the world's population increased by 142% (there is a strong anecdotal fit between population data and inflation).
- The movement away from metal-based currency (gold) to currency by fiat (paper).
- The proliferation of central banking as a means of economic management. As an aside, the Fed was not originally created to "fight inflation" but to fight market panics by "creating inflation." They continue to understand the original mandate even if the public has forgotten.

Takeaway: History suggests that low and stable 10-year yields of around 4% are the norm in developed markets unless we experience above average inflation or some other exogenous pressures on interest rates. In the context of our five secular themes, we can make the following observations:

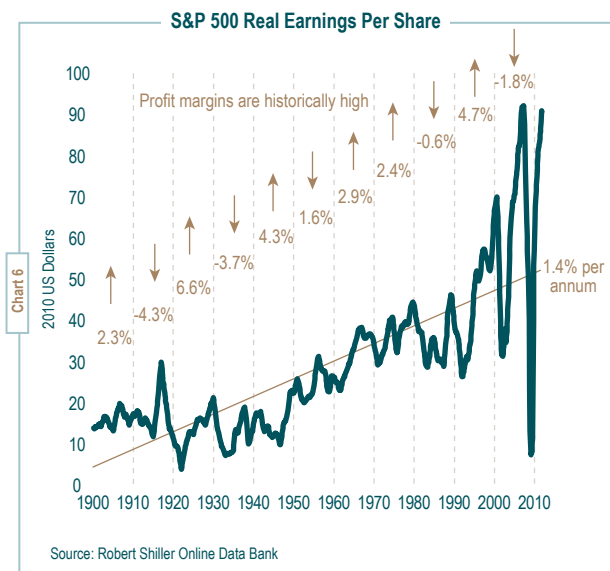
- Population growth is slowing rapidly and looks very similar to the growth rates experienced between 1900 and 1950.
- There is an imminent de-population about to occur across certain parts of the developed world. If population growth and inflation are linked as anecdotal evidence suggests then deflation, not inflation, may be the developed world's concern. Inflation is an emerging market problem.

- We are unlikely to move back to a gold standard, so fiat inflation risks will remain.
- Central banks are likely to continue to be pro-inflationary institutions.
- Private sector deleveraging will make it difficult for central banks to achieve their inflationary objectives.
- Public sector debt levels will bring about financial repression which will work to keep interest rates low and below nominal rates of growth.

In general it seems that secular forces will work to keep interest rates towards the lower end of their historical ranges, and at the very least seems inconsistent with a significant move higher.

PROFITS:

Over the long term, real earnings growth has been much slower than real GDP growth due to the payment of dividends. Also, profits have been much more volatile and somewhat mean reverting – i.e. strong growth in one period has been followed by weak profit growth in the next (see Chart 6).



Dividend payouts have collapsed since 1958, and earnings growth has stayed the same, suggesting an actual slowing of earnings growth has occurred. Currently, corporate profits as a percentage of GDP are at historical highs, as are profit margins which have expanded because of falling tax rates and labour cost containment. However, things may change as the baby boomers move towards retirement producing a smaller labour pool while taxes are going to increase to finance deficits.

Takeaway: (Profits = Revenue * Margins) Top-line revenue growth will be increasingly hard to come by on a global basis because growth in real GDP will most likely slow to under 2% in the developed world due to demographics, deleveraging and a decade

of weak investment spending. However, while real GDP growth in emerging markets will remain strong on an absolute basis, it too appears set to slow because of demographics. However, favourable urbanization trends will help to cushion this, particularly in the BRIC countries. Also, commodities appear to have put a speed limit on emerging market growth due to constrained global supply and demand imbalances.

LABOUR:

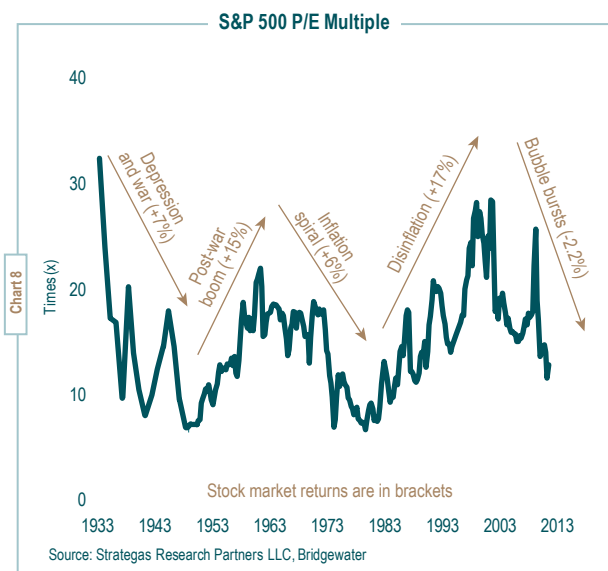
The flip side of high corporate profits as a percentage of GDP is labour's declining share (see Chart 7). In fact, labour's share has been in secular decline for 30 years, falling from 68% to 58% of total GDP. Based on our understanding of demographics during that time frame, this actually makes perfect sense as there has been an excess of labour relative to capital.



Takeaway: The world is about to go through a radical shift in its demographic profile which should tilt the odds in favour of labour going forward. This will result in margin compression. In addition, the period of continuously falling tax rates is likely coming to a close as public sector debts need to be addressed and the need to pay for unfunded entitlements looms. As such, secular forces seem to be lining up in the direction of margin compression and a lower profit environment going forward.

DISCOUNT RATE (RISK ASSET VALUATION):

Profit growth is obviously very important in setting the price of a company's shares. But the level of a company's P/E is equally important. A review of the last 80 years shows that there are definable waves of P/E expansion and contraction. A closer look at the last five cycles illustrates that these trends correspond with periods of above or below average stock market returns (see Chart 8).



P/Es tend to be influenced by real interest rates, expected economic volatility (including regulatory and political uncertainty), expected productivity growth and demographics. In analyzing these variables with respect to our secular themes we find:

- **Real Interest Rates:** Low growth and financial repression should conspire to keep real interest rates on the low side of history. While today's low real interest rates limit the scope for the 10-year US Treasury rates to decline much more, they still represent an impediment to P/E multiple expansion.
- **Expected Economic Volatility:** The imbalances that led to the Great Recession were never really addressed, but rather have been re-characterized via a debt swap from the private sector to the public sector in the developed world. We are now reaching the limits of the public sector's ability to hold and manage this debt load. The periphery countries (PIIGS) in Europe are already stressed while other industrialized nations are preparing for years of economic austerity and sweeping regulatory reform of the financial sector. From an emerging market perspective, it appears that global commodity supply bottlenecks are going to be a source of significant volatility going forward.
- **Expected Productivity Growth:** The US capital stock (investment in plant/equipment/infrastructure) declined for the first time in modern history during the Great Recession and has still not regained its former highs of 2007. In addition, companies are hoarding cash on their balance sheets and the level of investment continues to be weak given where we are in the business cycle. The US experience is close enough to the rest of the developed world that we should ask ourselves where productivity is going to come from without investment. The answer may be from emerging markets, but there exists some serious concerns about the capital allocation process in some of the more centrally planned economies. Evidence suggests that some of the best days of global productivity may be behind us.

- **Demographics:** The high savings age population (35 to 55 year olds) will push up valuations while rising retirees will push them down. The high savings population in the US rose from 24% to 30% from 1989 to 2002 while the retired cohort slowed sharply going negative from 1996 to 2002 (16% to 14%) – more buyers than sellers. The opposite was true in Japan. Their high savings segment of the population peaked in 1990, just as equity markets did, while the US peaked in 2001. This deterioration in the dependency ratio is expected to occur on a global basis.

Takeaway: From the early 1980s to the mid-2000s these factors were all working in the direction of multiple expansion. In fact, over the past 200 years the 25-year period ending in 1999 was the best time for equity returns. That tailwind has turned into a headwind across all factors. A secular expansion in P/E multiples looks unlikely at this stage.

YIELDS:

In looking at the relationship between fixed income and equity yields since 1871, it is not clear that there is a consistent relationship (see Chart 9). There was a strong relationship between 1960 and the late 1990s, but from a secular perspective this looks to be a historical outlier. Earnings yields that were materially higher than bond yields were the norm up until 1965. Based on the evidence, it may be better to cast the 1965-1999 period as a time of chronic equity overvaluation versus fixed income. The current relative relationship is not that much different from historical averages (see Table 5).

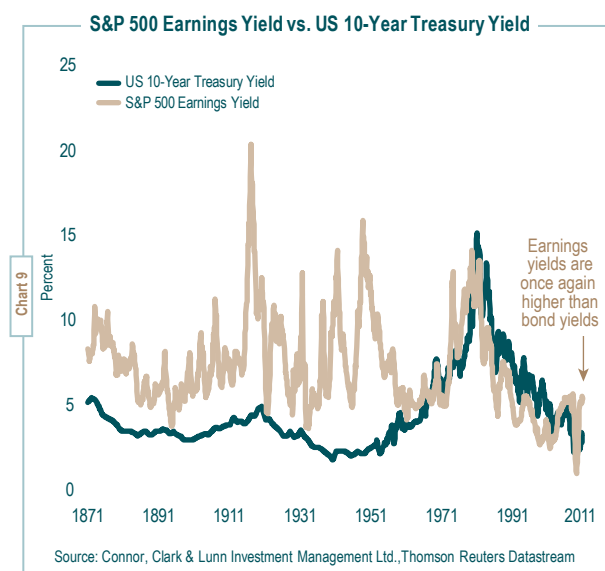


Table 5

	Average	Current
Real Equity Earnings Yields	7.10%	5.3%
Real 10-Year Government Yield	1.86%	0.5%

Source: Thomson Reuters Datastream

Takeaway: The current gap between earnings yields and government yields are the widest they have been in 25 years, but in a historical context they just look average. Intuitively, earnings yield analysis breaks down if we see deflation or very low nominal GDP. So, given the recent crisis that we have just emerged from and our real time experience in Japan, we may need better-than-average valuation metrics from a historical perspective to classify the equity market as “cheap” on this metric.

SECULAR FORECASTS (Next Decade)

UNITED STATES:

GDP grows between 2.0% – 2.5% with CPI around 2.0% – 2.5% and trailing P/Es of 11x.

The US is in the process of restructuring its economy following a financial crisis. History shows that for 7-10 years following a financial crisis an economy tends to grow significantly slower than pre-crisis. The pre-crisis level of US nominal debt makes this low growth environment particularly dangerous and will make the economy significantly more shock-prone and earnings more volatile than the historical norm. The increased volatility of earnings should lead to a de-rating of equities. Potentially offsetting some of this volatility will be diversification that has come about through globalization. The overhang of a large nominal debt burden will result in a decade of financial repression where the objective of policy makers will be to keep interest rates low and inflation slightly elevated.

CANADA:

GDP grows between 2.0% – 2.5% with CPI around 2.0% and trailing P/Es of 12x.

Canada was able to dodge the financial crisis in large part, but because the US is our major trading partner (70% of exports), Canada’s growth rate is linked to that of the US. There is some offset through trading channels with Asia, but they are small in relative terms and have the largest impact not on volumes but on terms of trade. Canada still has a very large debt overhang that will need to be worked off over the next 7-10 years. P/E multiples should be higher than the US given Canada’s greater commodity exposure.

EUROPE:

GDP grows between 1.1% – 1.4% with CPI around 1.8% and trailing P/Es of 9x.

Europe had a financial crisis in 2008 as a consequence of exposure to the US financial system. Europe is now attempting to avoid a second and more serious financial crisis emanating from ballooning government debt levels within the periphery (PIIGS) of the Eurozone. The rules that apply to regions that have gone

through a financial crisis apply to the Eurozone in spades. In addition to the drag on growth from the financial crisis, Europe has shockingly bad demographics. Financial repression will be a tool of European policy makers, but the binding nature of the single currency and an inflation-phobic central bank will keep inflation lower than the developed market average. Greater deflation risk, poor demographics and economic volatility will keep stock market P/Es low.

CHINA:

GDP grows between 7.0% – 7.5% with CPI around 5% and trailing P/Es of 10x.

China’s economic growth rate is set to slow. Potential growth is a function of labour, capital and total factor productivity. All three are slowing as China moves towards a key economic inflection point where overall GDP will decelerate and inflation will accelerate. The inflection point in the economic structure is about to go through a profound transformation with consumption/GDP, service sector/GDP and labour income/GDP rising rapidly. This is a natural evolution but also part of their 5-year plan. There is a fair amount of uncertainty around this forecast because we don’t have any concept of how much capital misallocation has actually taken place in China’s centrally planned economy.

THE CYCLICAL ENVIRONMENT (Next 1-2 Years)

ECONOMY

GLOBAL BASE CASE

We expect trend line growth in the US and emerging markets but a mild recession in Europe and the UK. Growth in the US and emerging markets is effectively being dragged down by events in Europe. Europe, in return, will be pulled higher by a strong growth impulse from the rest of the world. Our forecast calls for Europe to avoid a deep recession as the containment policies put in place by the ECB and other policy makers will prove to be enough.

- In the US, the bulk of the private sector deleveraging is behind them and consumer and corporate balance sheets are in reasonable shape with debt service ratios at historical lows. The employment situation should continue to improve, providing income to consumers and creating a positive feedback loop in the economy. Capital spending should pick up as the capital stock looks low and housing appears to have bottomed and may surprise on the upside. Fiscal drag and export markets will be what holds growth to trend as well as providing the greatest risk to our outlook.
- In emerging markets, the inventory correction is behind them and policy makers have switched from trying to slow growth to trying to stimulate it through both fiscal and monetary policy.

However, Europe will act as a drag through trade and financial channels keeping growth closer to trend.

- Europe is slipping into a mild recession as the private and public sector attempt to deleverage simultaneously. Sovereign debt refinancing and bank deleveraging will keep headline risk and risk aversion high, but in the end the sovereign debt crisis will be contained. There are, however, conditions that must be met for this benign European outcome to be realized:

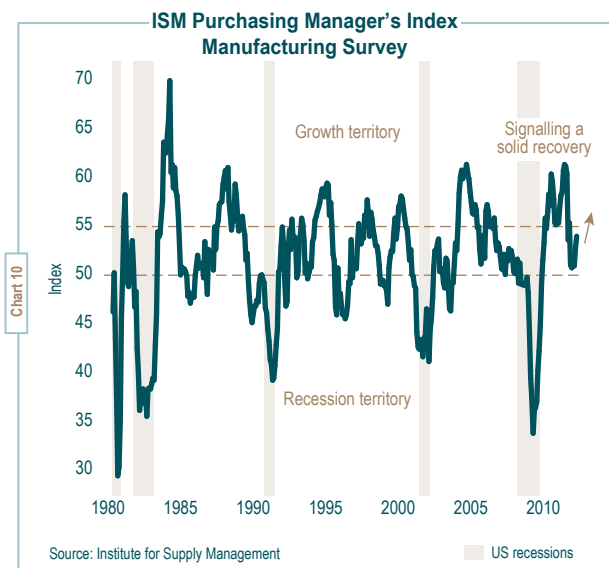
1. Emergence of a balance sheet capable of absorbing sovereign funding, which will likely come from some combination of the European Central Bank (ECB), International Monetary Fund (IMF), European Financial Stability Fund (EFSF), and commercial banks participating in the Long Term Re-financing Operation (LTRO).
2. Germany must signal a willingness to underwrite some form of area-wide debt mutualization (i.e. some form of Euro bond).
3. Disorderly default of sovereign debt (Greece) must be avoided.

BASE CASE COMPONENTS:

UNITED STATES

The US Economy is Improving

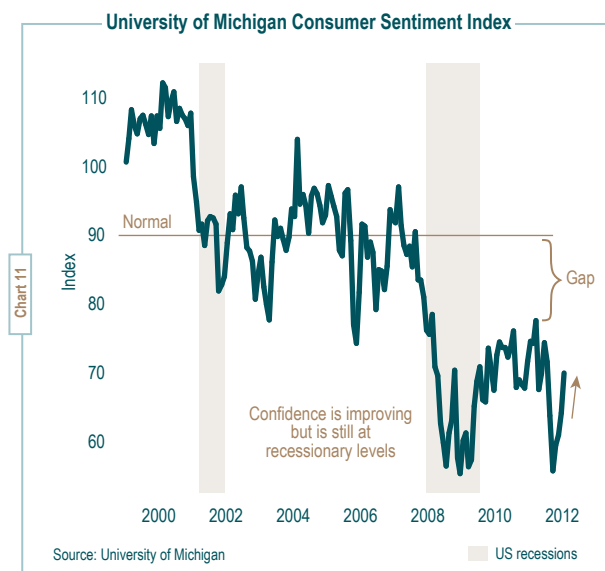
Most components of the ISM Survey (see Chart 10) are pointing to a continuation in the pick up in new orders, ongoing sales and employment prospects. However, there is little pricing flexibility which, while good for inflation, will hurt top-line growth for corporations and nominal economic growth. Business surveys are a mixed bag with CEO surveys down due to worries over Europe but small business owners (largest employers) are finally becoming a little more optimistic as sales have improved along with credit conditions. Finally, the private sector is still receiving a massive amount of fiscal support with the budget deficit running near 9% of



GDP. A large component is structural in nature, which means there will have to be cuts in future program spending and tax increases – this will hurt growth in 2013 and 2014.

The US Consumer is Slowly Making a Comeback

We expect the US consumer to help the economy move along at a moderate rate. Consumer confidence has started to pick up, even though it is still near recessionary lows (see Chart 11). A pickup in employment trends (unemployment claims are well below 400,000) and incomes has helped. This has shown up in retail sales, which are holding up reasonably well (+2.3% annualized), and auto sales, which are hitting new highs for this cycle (13.5 million units). From the consumer perspective some things are normalizing. Financial obligations, such as existing house prices divided by median family income and credit card delinquency rates as a percent of disposal personal income, are all below historical norms. Non-discretionary prices, such as food and energy which had been acting as a huge headwind on real spending in 2011, have improved significantly. However, the recent credit crisis, the bursting of the housing bubble and the depth of the past recession has brought about a secular change in consumer behaviour which means that the recovery in personal consumption will be moderate and restrained. Also, while consumption expenditures, thanks to government transfer payments, are still at 70% of GDP, they are still four points above the more sustainable 66% experienced during the country's golden era (1982 – 2000).

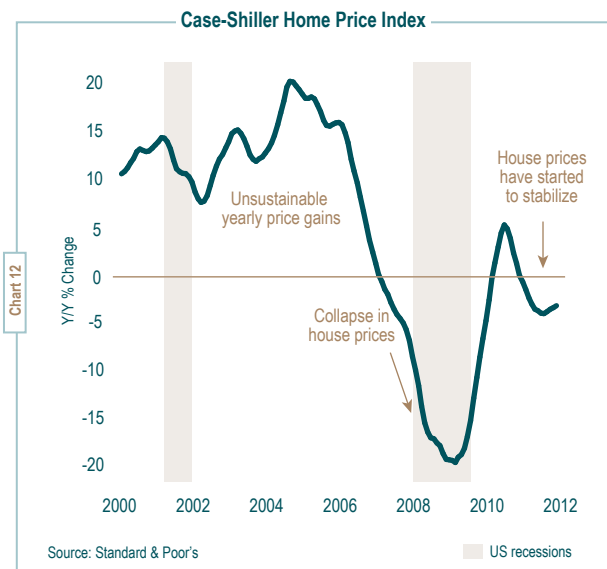


US Housing Market is Bottoming

The US housing market appears to be on the verge of stabilizing. This is of critical importance longer term for the US economy because the housing sector is pivotal to the health of the consumer (wealth effect) and its role as a financial accelerator (housing continues to be the primary collateral of the US financial system). Currently, with 25% of all US homeowners (15 million) having negative equity in their homes, access to credit remains difficult,

not to mention the negative effect this has on consumer confidence. On the brighter side, affordability is the best it has been in 50 years. Mortgage servicing costs currently are very attractive, as is the price-to-rent ratio (cheapest on record), which should encourage a preference for owning a home over renting as long as any rise in mortgage rates remains moderate.

If interest rates remain relatively low then the recent improvement in home sales, building permits and new starts should help stabilize prices (see Chart 12). Importantly, while the level of foreclosures is still problematic, the supply/demand balance appears to have stabilized at a time when the household debt service ratio continues to improve. In addition, it is anticipated that with more than two-thirds of the distressed supply held by government agencies (GSE), a buy-to-rent program whereby investors buy properties from the GSEs may be in the offing. Such a program, combined with current absorption rates, could clean up the excess inventory by the middle of 2013. All things considered, US home prices should be relatively flat on the year with housing starts up by a modest amount.



US Debt is Still a Problem

The US economy is still over leveraged, even though private sector debt levels (consumer and corporate) have been contracting. The contraction in private debt has been largely replaced with public debt as the government has tried to expand credit and increase final demand. This is not sustainable and is increasingly becoming an issue with investors and in turn politicians. The contradiction in public sector debt levels through reduced spending will provide a headwind to growth. Unlike the public sector, US household balance sheets have improved through a small increase in the savings rate, which is now at 3.5%, higher asset prices and a decline in mortgage debt outstanding, a large proportion of which has come about through outright defaults. Overall household debt to disposable income has declined to 115% from a peak of 130% in 2007.

The savings rate, after having reached a high of 8.4%, was also a major factor in restoring household balance sheets, but it has subsequently slipped back into the 3% range. Consumers have drawn down their savings to deal with increased spending because anemic growth in incomes has not been enough. This is not sustainable, and incomes need to start to rise in order for consumers to maintain their current standard of living and to continue to pay down debt (see Chart 13). We expect some progress on this front in 2012 as the employment picture improves because of increased capital spending and hiring plans on the part of corporations, which are in great shape. Unlike the public and household sectors, the corporate sector is very healthy with strong balance sheets (over \$2 trillion in cash) and rising cash flows.

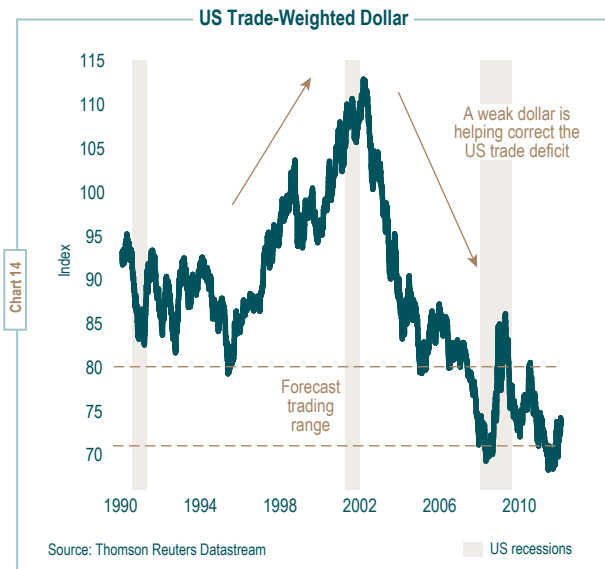


While the total amount of deleveraging in the economy has been minimal (see Chart 13), there has been good progress on the part of households, and governments are starting to get the message that they need to reign in their deficits. A 3% savings rate translates into over \$350 billion in either increased assets and/or decreased debt. This means over time, in combination with rising wages, consumer spending can return to more normal levels.

US Dollar is the Best of a Bad Lot

Massive fiscal deficits, a large current account deficit, low interest rates and a dysfunctional political environment would normally be enough to sink a currency. However, the outlook for the Euro and Yen is no better. The European sovereign debt crisis has still not fully played out, and the region is headed into recession, whereas the US economy is strengthening. The situation in Japan is also deteriorating as capital flows into the Yen are diminishing because of a negative trade balance and because the country can no longer tolerate a strong currency in a deflationary environment.

On a purchasing-power-parity basis (trade weighted), the US dollar is 15% undervalued and is only really overvalued against emerging market currencies such as the Chinese Renminbi (RMB). In addition, from an economic perspective, it is not in the interest of other countries to see the dollar weaken because it only makes the US more competitive. From a financial perspective, foreign governments want to preserve the purchasing power of their dollar reserves. Thus, all things considered, the US dollar will most likely trade between 72 and 80 on the Trade-Weighted Dollar Index (see Chart 14).



Outlook and Forecast: The US economy continues to slowly heal. The housing market is stabilizing, employment conditions are improving, corporations are in great shape, capital spending programs remain strong, small business conditions are improving and fiscal conditions are supportive of future growth. Our forecast calls for growth of 2.75% in GDP with only a 15% chance of a recession.

CANADA

Canadian Economic Prospects are Mixed

Canadian prospects for 2012 are mixed (see Chart 15). The country's fiscal position is sound, as is the banking system, but unemployment remains relatively high by historical standards (7.6%) and our terms of trade are weak. From an external perspective, relatively high commodity prices and an improved outlook for the US economy will help lift Canadian economic growth. Domestically, negative real policy rates, relatively narrow corporate bond spreads and easy bank lending standards will help to promote some credit expansion, borrowing and spending.

Risks to the Canadian economy include too sharp a rise in the Canadian dollar, which is already overvalued on a purchasing-power-parity basis with the US dollar, and/or a further drop in commodity prices. In addition, household debt levels are worrisome because, unlike our American cousins, Canadians have been increasing their debt load with no regard to the possibility of a rise

in interest rates or a slowdown in the economy (household debt to income is at 150% versus 115% in the US).

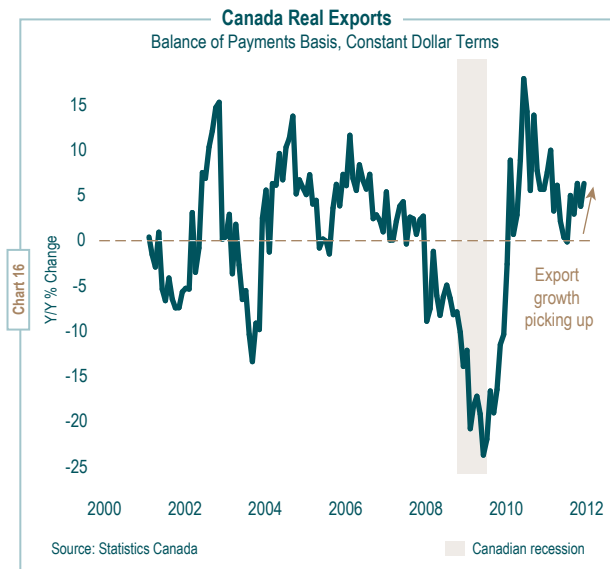


Spending Intentions are Muted

Consumer spending, which on average accounts for 64% of GDP, is forecast to slow in 2012. Employment growth has been weak as of late and wages are growing very slowly. Canada's terms of trade are providing a positive tailwind, but aggregate income growth does not look as if it is accruing to labour. This is impacting retail sales, which are limping along. Also, the household sector continues to run a negative financial balance. This behaviour looks very much like the US in 2006, which suggests there is very little pent-up demand in the consumer sector in Canada. Housing starts are expected to decline, as are sales. High debt loads, tighter mortgage lending standards and eventually rising interest rates will put a lid on the housing market and maybe even lead to a small decline in prices.

Residential fixed investments, which on average account for 6% of GDP, have been red hot but are forecast to slow as an overheated housing market starts to cool. Business spending, which has also been strong throughout 2011 (accounts for 12% of GDP), is weakening as well but is expected to pick up because of the energy sector and productivity enhancements. Government spending (26% of GDP) is also forecast to be relatively weak, growing at only 1% below the rate of inflation, as fiscal restraint kicks in to deal with the country's deficits.

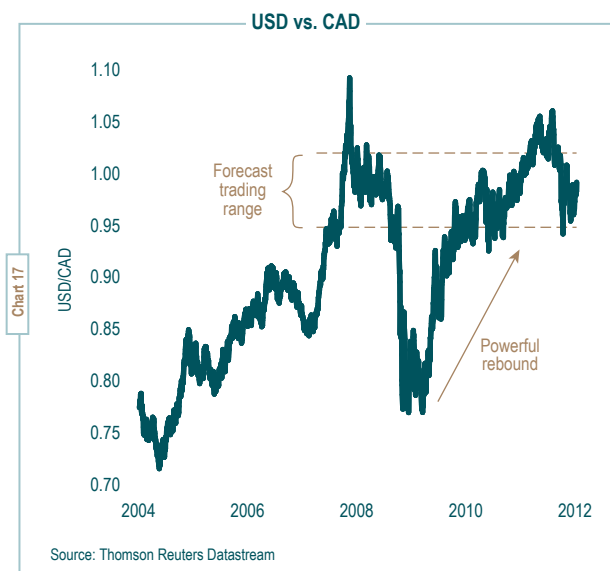
Canada is running a large current account deficit compared to the surplus it ran in 2005. This is due to the strength of the Canadian dollar. And while export growth (see Chart 16) has been strong on an annualized basis, the level of exports compared to imports is still a problem. Also, Canada looks positioned for a mild inventory correction which in combination with the trade picture will weaken growth. However, some weakening in the Canadian dollar, which we are forecasting for 2012, should help improve the trade picture, but with a lag.



The Loonie Will Remain Range Bound

The Canadian dollar, after having experienced a powerful rebound against the US dollar, has settled into a narrow trading range. Shrinkage in the country's budget deficit, firm commodity prices, a recovering auto sector and interest rates above their US counterparts will be a source of strength for the Canadian dollar. While purchasing power parity is around \$0.88 (USD/CAD), it is expected that the loonie will trade above that figure for the year.

As noted above, Canada's current account deficit is not expected to shrink by any meaningful amount because imports (pricing) are increasingly attractive while the country's exports are becoming more expensive because of the strong dollar. Our forecast is for the Canadian dollar to remain strong, trading within a range of US\$0.95 to US\$1.02 (see Chart 17).

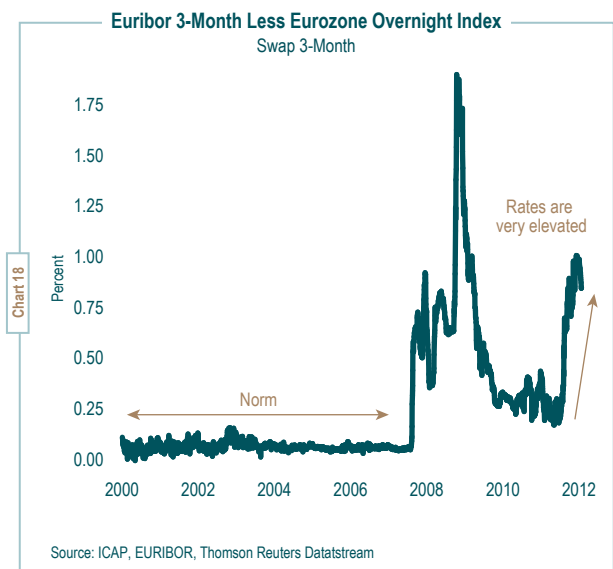


Outlook and Forecast: The data for the private sector is clearly weak, but with improving conditions in the US we can expect a small rebound in spending in the coming year which should lead to 2.25% growth in GDP with only a 15% chance of recession.

EUROPE

Europe is Sliding into Recession

Europe will slide into recession in 2012. Austerity measures currently being implemented in both the core and the periphery of the Eurozone will drag down GDP anywhere from 0.5% to 5%, depending on the country. The net drag on growth will probably be in the order of 1.25% of GDP. Also, the effect of the most recent debt crisis has not been fully felt at a time when the financial sector is very vulnerable. The OIS/Euribor rate is very elevated suggesting funding issues are intensifying (see Chart 18) at a time when European bank deleveraging is set to begin to the tune of 1-2 trillion Euros to meet new European Banking Authority targets. On the positive side of the ledger, corporate cash flows are healthy, the consumer is in relatively good shape, the Eurozone has a balanced international trade position and on a consolidated basis the Eurozone's fiscal metrics are better than that of the US. Global growth will also help mitigate, to some degree, the coming downturn, and the ECB remains very supportive through its massive 2-3 year Long Term Re-financing Operation (LTRO). Thus there should be no bank funding problems, but yields are still elevated across the periphery at a time when there is 328 billion Euros in sovereign debt that needs to be rolled over in the first quarter this year.



Outlook and Forecast: The ECB and policy makers have made significant strides in addressing the debt crisis, but at this time there is still no balance sheet that looks ready to absorb the 700 billion Euros of sovereign debt issuance that are coming down the pike in 2012. Compounding this is the need for European banks

to raise capital and deleverage over a very short time frame (9% capital ratio by June). Both the public and private sectors are deleveraging simultaneously, producing a negative feedback loop. This loop needs to be broken soon or a hard landing becomes more likely. However, at the end of the day we expect the ECB will do whatever it takes to avert a crisis. Currently we are calling for a mild recession, with GDP dropping by 0.75%-1%, but the odds of a hard landing (-3% GDP) are currently around 40%. The reason for setting a high probability on a hard landing is that the Eurozone crisis is as much about politics as it is about economics.

CHINA/EMERGING MARKETS

China Will Avoid a Hard Landing

The slowdown in Europe is having an impact on China and other emerging market countries where both the manufacturing and non-manufacturing PMIs have looked weak. Emerging markets have also been affected by Eurozone bank funding problems, which are their primary source of outside financing. With the latest moves by the ECB, we expect some improvement in this area which will help lift emerging market growth which now accounts for nearly half of global GDP (49%).

China continues to be key to the outlook for global growth in 2012, and the latest PMI numbers and central bank actions argue for a soft landing scenario (see Monetary section below – China). The big driver of Chinese growth remains the unprecedented urbanization of the country which is likely to continue for years to come. Urbanization drives the construction of infrastructure, commercial buildings and residential shelter. In addition, China remains a fairly under leveraged economy with consumer credit only 30% of GDP and a bank loan to deposit ratio of only 70%, which gives Chinese banks plenty of liquidity and the consumer plenty of room to become an increasing factor in the China growth story. The risks to the China growth story largely lie with the outlook

for inflation, which is driven by commodity-related price changes (see Chart 19), and the risk of a trade war with the US (China has been labeled a currency manipulator by the US Senate).

Outlook and Forecast: Growth and inflation have decelerated more quickly than policy makers were expecting. Pro-growth policies have been initiated, and we think the authorities will get aggressive. Given the shift in policy, the risk of a hard landing is only around 15% with growth in GDP forecast to come in around 8% to 8.5%.

MONETARY AND LIQUIDITY CONDITIONS

GLOBAL BASE CASE

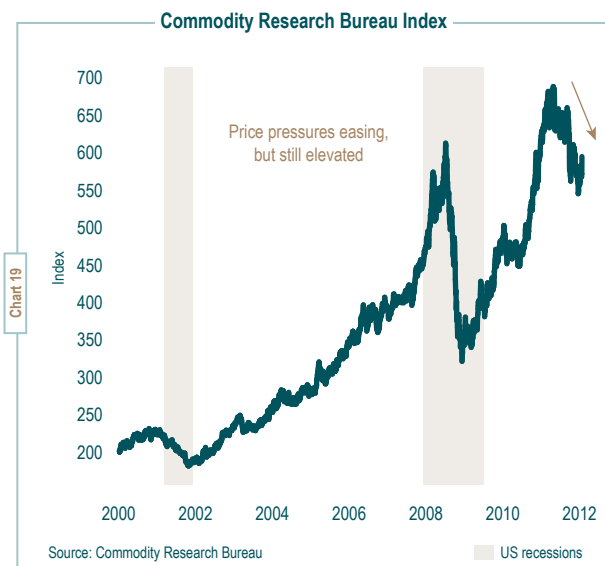
Monetary policy is being eased in almost every region of the globe, and there is a coordinated effort to protect the financial system as witnessed by the Fed, BoE, ECB, BoJ and BoC all agreeing last November to lower the price on US dollar liquidity swap arrangements by 50 basis points. The battle between the deflationary forces of Europe and the reflationary efforts of global central banks is going to keep overall financial conditions erratic but with an easing bias. Europe will be the exception where the terms of existing European treaties and fiscal policies will keep financial conditions tight. Specifically we see the following:

- **US:** The Fed will maintain an ultra-easy stance for 2012 and QE3 (mortgages) is on the table if Europe gets ugly or US growth momentum fades.
- **Emerging Markets:** Most emerging market central bankers are now in an easing mode, and we think the Bank of China (PBoC) will engage in a significant easing cycle.
- **Europe:** The ECB, because of European Common Market (ECM) treaties, is unlikely to enact a Fed-style quantitative easing, even though it would be very beneficial. Europe needs to go to the brink for this to happen. However, the ECB has the tools to fund the banking system and minimize the risk of a Lehman-style crisis.

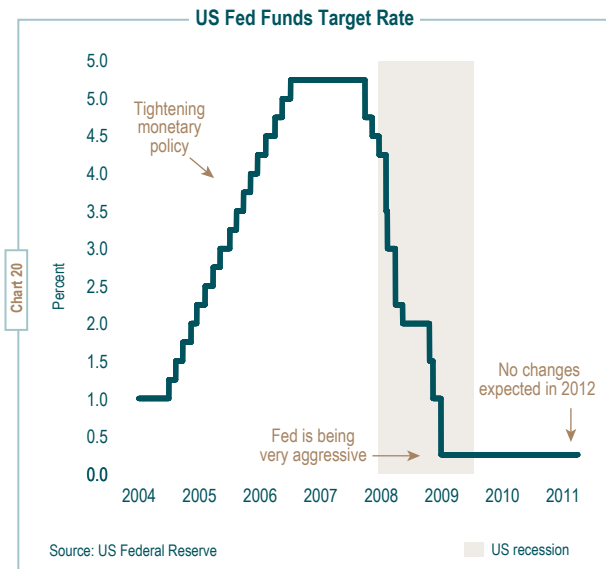
UNITED STATES

Credit Conditions are Easing

The Federal Reserve's mandate is to maintain low and stable inflation, full employment and stable interest rates. It views the biggest risk to achieving these goals to be deflation. The Fed is haunted by the Great Depression which, as an organization, it accepts responsibility for creating. As such, the current stance is to do whatever it takes to avoid deflation, including keeping the possibility of instituting QE3 on the table and providing a conditional commitment to keep interest rates low until the second quarter of 2013. We expect this will be extended into 2014.



The Fed has anchored interest rates close to zero (see Chart 20) so as to promote economic growth and repair the banking system. A healthy banking system is critical to economic growth, and some progress has been made on this front. We are seeing signs that the monetary transmission mechanism, whereby monetary policy feeds directly into the financial system and in turn the economy, is starting to function properly. Money supply growth, as measured by M2, is up 10% year over year, and velocity, the turnover of money (transactions), has moved into the positive column. While banks over the last couple of years have been sitting on cash and not lending to households or small businesses in any meaningful way, this has started to change. Borrowing is picking up which will provide a boost to economic growth.



Outlook and Forecast: The Fed has eased aggressively with operation Twist (buying long-term securities and selling short-term ones). We expect it to keep monetary conditions very loose for the foreseeable future with Fed Funds anchored at 0.25% with a 30% probability of further quantitative easing (QE3). In addition, we foresee an environment in which credit supply and increased credit demand will improve in 2012. This will allow banks to rebuild their loan portfolios, business operations to expand and consumers to refinance their more troublesome debt obligations.

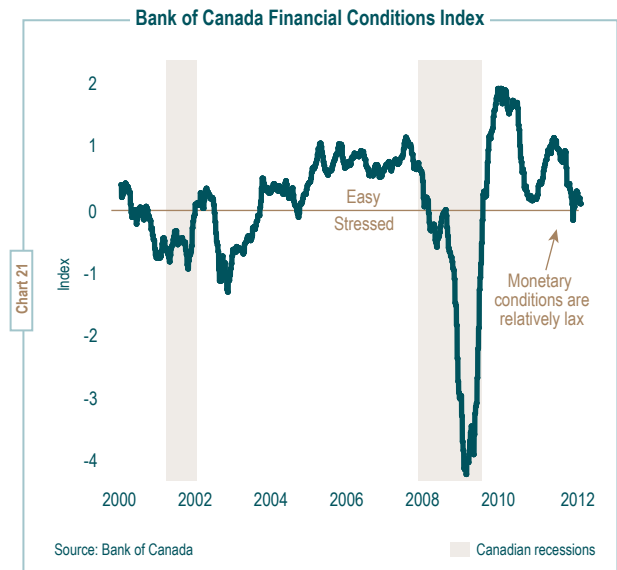
CANADA

Bank of Canada Looks for Symmetry

The Bank of Canada's (BoC) mandate is to promote price stability with a 2% inflation target within a 1%-3% control band. Although it claims symmetry on inflation versus deflation risks, its actions suggest a similar bias as the US Fed. The BoC's current stance is that stimulus is required to close the economy's output gap and return inflation to the 2% target within two years (objective period). It is very focused on global risks and the potential for these to impact

Canada, and this keeps them easier than a traditional output gap analysis model (Taylor Rule) would suggest. This leaves some room for further declines in the bank rate.

Growth in money supply (M3) is around 8%, which is more than adequate to support an expanding economy, but business borrowing is weak and consumer loan growth has decelerated sharply in response to new mortgage rules. This could become problematic for future economic growth. Fortunately, the Financial Conditions Index continues to suggest easy financial conditions, which is a good sign (see Chart 21).



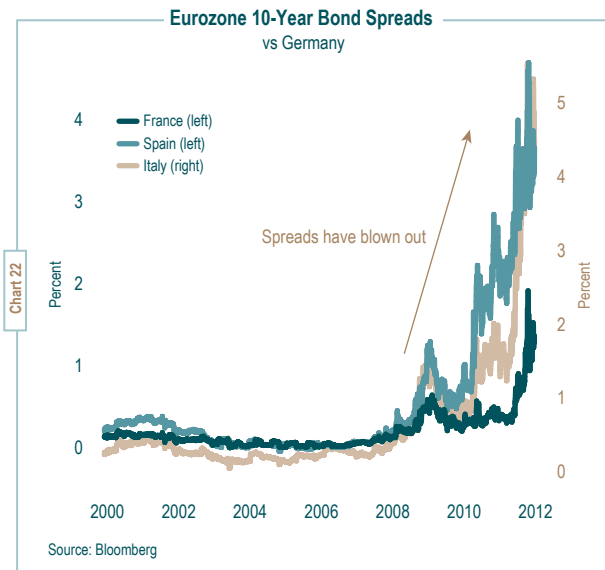
Outlook and Forecast: We see the BoC as being in risk management mode. They see significant downside risk to both growth and inflation from the European situation and therefore will need to see a clear path for some type of resolution before they consider raising interest rates again. In the event of a financial crisis or deep European recession, interest rate cuts will be back on the table. We are forecasting a stable rate regime for the balance of 2012.

EUROPE

European Central Bank Steps Up to the Plate

The ECB mandate is to preserve price stability, which is defined as inflation rates below but close to 2% over the medium term. The ECB views inflation as a worse outcome than deflation as it is guided by memories of German hyperinflation and the global consequences stemming from that period (the ECB was modeled on the German Bundesbank). This overriding concern about hyperinflation has left the ECB scrambling to catch up to events surrounding the European debt crisis. As such, European money supply and credit are barely expanding, and the ECB acknowledges that the monetary transmission mechanism is broken. Despite significant policy intervention, spread metrics continue to flag significant stress in the system. Compared to German bonds,

Italian spreads are back above 4.5%, Spanish spreads are at 4% and French spreads are around 1.5% (see Chart 22). Fortunately, the ECB under President Draghi appears to be more aggressive and willing to break the negative feedback loop between the sovereign debt crisis and financial systemic risk.



The Bank of England (BoE) has two goals, monetary stability (inflation target of 2%) and financial stability. The BoE takes action by committee, which is often divisive, and the Chairman's recommendations are often overruled. The BoE is similar to the Fed in viewing deflation as a far worse outcome than inflation. As such, it recently instituted close to 100 billion pounds of quantitative easing with a distinct possibility of more to come. This should help stabilize debt markets and fend off the deflationary forces that have been unleashed due to extremely tight fiscal policies. The dilemma for the BoE is that the UK economy is a mess, money and credit are contracting but reported inflation is significantly above target.

Outlook and Forecast: The ECB has been very aggressive in lowering interest rates and providing funding to European banks through 2- to 3-year LTROs. We expect this to continue in 2012. The ECB, however, is unlikely to engage in Fed-style quantitative easing, which will keep monetary conditions somewhat tight in the Eurozone. Our forecast calls for the ECB to lower administered rates to match the BoE at 50 basis points.

CHINA

Bank of China Starting to Loosen

The Bank of China (PBoC) has much broader powers than developed market central banks in that it also acts as a fiscal agent. The PBoC runs a floating currency peg, sets interest rates and changes reserve requirements in an attempt to maximize economic

growth while keeping inflation at a moderate level. Inflation above 4% is considered too high by the PBoC. Social stability is the ultimate goal.

The Chinese have moved aggressively on a number of fronts to deal with inflation including administrative measures in the agricultural sector to temper food prices, multiple hikes in required bank reserve ratios to restrain excess bank lending, a modest acceleration in Renminbi (RMB) appreciation and five hikes in benchmark lending rates. Now with food and energy prices having eased in the last six months (see Chart 23), the PBoC has more flexibility which will allow it to ease monetary conditions. The recent slowdown in money and credit growth has been faster than the PBoC wanted, so we should expect further interest rate cuts and administrative easing in the first quarter of the year.



Outlook and Forecast: The PBoC was behind the curve because of Europe and its desire to ensure that inflation was dead before it reverted back easing aggressively. This has all changed as the PBoC has started to ease and stimulate. We expect a lending rate cut next and some further fiscal stimulus. The PBoC has a significant amount of fire power.

INFLATION

GLOBAL BASE CASE

While 2011 was a rough year for inflation, 2012 should be much better. Inflation is forecast to be relatively benign in the coming year which will allow global central banks to support growth through very accommodative monetary policies. The biggest risks going forward are the threat of deflation in Europe, a sharp rise in wholesale prices in China and/or a spike in energy prices due to rising tensions in the Middle East. All three possibilities have the potential of derailing global growth.

INFLATION EXPECTATIONS ARE DECLINING

Diffusion indexes in both Canada and the US are pointing to a drop in core inflation as are inflation-linked bonds. Consensus inflation forecasts are also pointing to lower levels of inflation due to tepid final demand, little pricing power and mediocre wage gains (see Chart 24). The US output gap has come in from -5.5% to around -3%, but there is still plenty of slack in the economy with capacity utilization rates below normal and unemployment hovering above 8%. Even faster economic growth does not have much of an impact on inflation per se until spare capacity is used up, and given the large output gap that still exists, core inflation and CPI should drop (see Table 6).

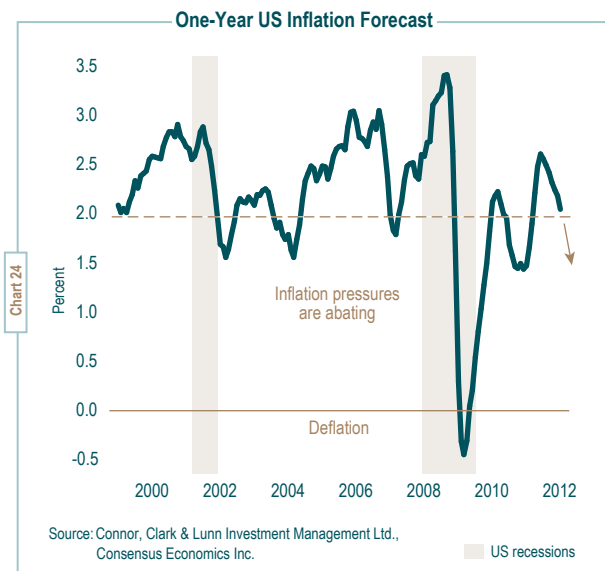


Table 6

	Headline	Core	Forecast (Core)
US	3.2%	2.1%	2.0%
Canada	2.9%	2.1%	2.0%
Eurozone	2.7%	1.6%	1.0%
China	4.1%	2.7%	4.0%

Source: Thomson Reuters Datastream

The only real risk to a lift in inflation is if commodity prices, particularly oil, were to spike up again and/or the US dollar were to weaken substantially (import prices).

There are fears that the Fed's bloated balance sheet will ultimately lead to higher inflation. However, given that the banking system continues to hoard cash and has been stingy about extending credit, these worries are misplaced in the short term. Rapid increases in the velocity of money and money multipliers will be a leading signal that inflation is about to rise. However, this is not expected until the economy gains more traction, at which time the Fed will

attempt an exit strategy from their current unprecedented policy. It is too early to make an assessment as to when this might happen and whether or not they will be successful.

Outlook and Forecast: Headline inflation has turned down and the growth outlook has weakened materially enough that global central banks have put inflation fears on the back burner. Food and energy prices have softened and are no longer squeezing incomes. All the leading indicators we follow point to an easing in inflation in 2012.

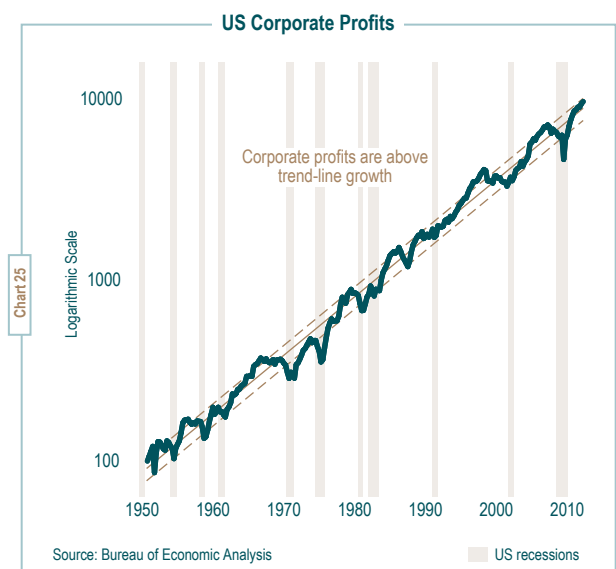
VALUATION

EQUITY

The average bear market in the US retraces 73% of the prior bull market gain. The worst case was a 114% retracement in the 1973-1974 bear market, followed by the 107% retracement from 1929 to 1932 when stocks fell 89%. The 2007-2009 bear retraced 113% of the prior bull market, falling over 50% (an outlier in terms of the distribution of returns). The previous two secular bear markets took between 7 to 15 years to recover their former highs. This would suggest that it will be some time before investors have recouped all of their lost capital.

THE PICTURE FOR US CORPORATE PROFITS IS WEAKENING

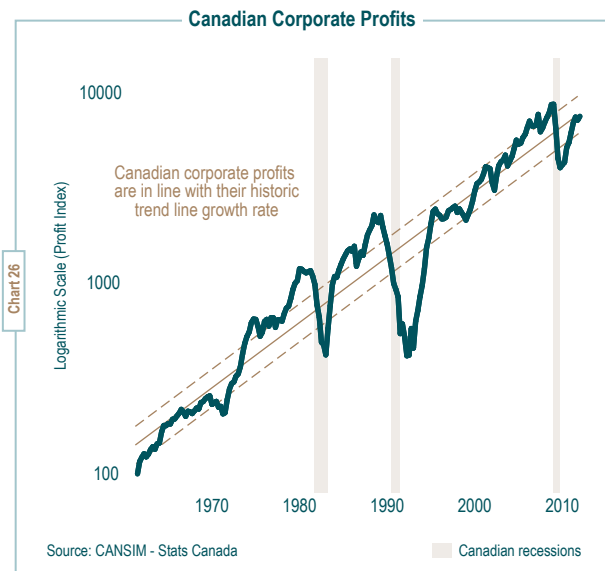
US corporate profits have moved above their long-term trend after having been almost 2 standard deviations below trend during the Great Recession. Historically, profits peak once they are one standard deviation above their long-term trend, which they are now approaching, suggesting there is less and less room for profits to move higher (see Chart 25). Coincident with a peak in corporate earnings is a peak in profit margins which are currently well above their long-run average. However, margins will probably stay elevated because they peak only after the economy's output gap has



closed (currently -3.5%) and wage growth exceeds 3.5% compared to today's growth of 2%. Thus, with a pickup in economic activity and sustainable profit margins, earnings should advance for another year. The consensus forecast for corporate profits is coming in at \$107 a share (a growth rate of 9%). We think this is a bit too high and our forecast is calling for \$103/share. However, there is upside risk to our forecast if cash-rich corporations increase the buy-back of their shares at low multiples (lifts profits).

CANADIAN CORPORATE PROFITS HAVE FURTHER ROOM TO EXPAND

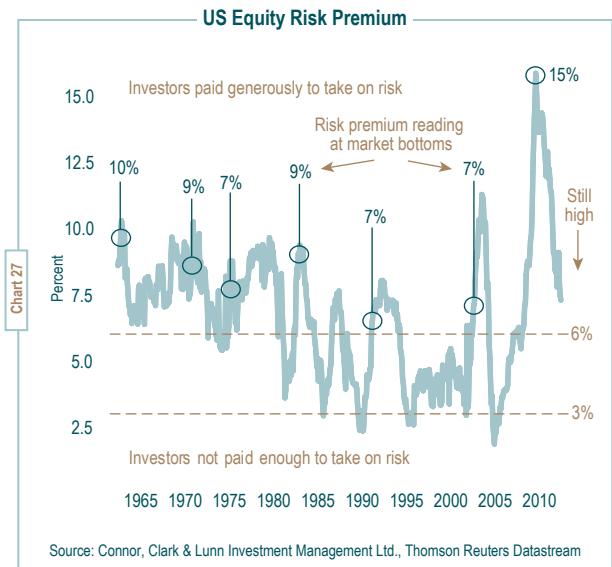
Canadian corporate profits have moved up close to trend line growth (see Chart 26) and should break through if the 2012 consensus forecast of \$992 for S&P/TSX earnings is met, which is a gain of 21%. This compares to our forecast of \$940. A modest pickup in US economic growth (rising auto and lumber sales) will help the profit picture while stable energy and commodity prices will help the earnings picture for the resource sector. Only limited growth can be expected from the consumer and banking sectors due to a stagnant employment picture and low loan growth respectively. Also, the country's ongoing poor productivity record and strong currency will limit future earnings gains.



EQUITY RISK PREMIUMS ARE ATTRACTIVE

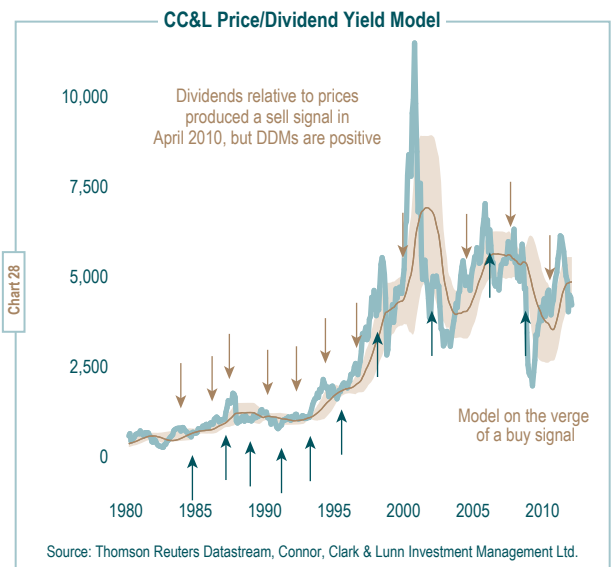
From a historical perspective, current equity risk premiums (ERPs) are signalling that equity markets are very undervalued (see Chart 27). However, because today's environment is materially different from previous cyclical recoveries in terms of tail risks (greater than a 3 standard deviation move) and financial repression, ERPs will probably stay elevated and act only as a reminder of the potential for further market gains rather than what we'll actually experience in the medium term. We can expect ERPs to stay elevated until the structural imbalances facing the developed world

are rectified. Both monetary and fiscal policy have to normalize back to a level where government spending, taxes and the level of interest rates is conducive to the proper balance between savings, credit formation, investment and growth.



DIVIDENDS OFFER MILD SUPPORT

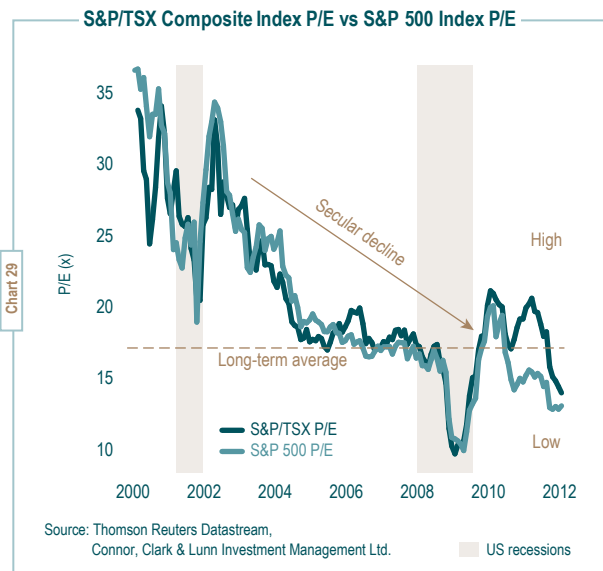
The price-to-dividend yields on the S&P/TSX Composite and S&P 500 are not as attractive as they have been over the last few years. Increases in dividends have not kept up with the rise in corporate earnings, making stocks less compelling from a yield perspective. While the CC&L Price/Dividend Model is still registering a sell signal (see Chart 28), it is close to signalling a buy, which will come about by a small increase in dividend payouts or a retracement in stock prices. However, our Long Bond Yield/Dividend Model has a buy signal in place. The S&P/TSX dividend yield of 2.85% is double the 2-year Canada bond yield of 0.95% and exceeds the yield on the 10-year Canada bond by nearly 1%. In



the US the S&P 500 dividend yield of 2.22% is substantially above 2-year Treasuries and their meager yield of 0.27% and nicely above 10-year Treasuries which are yielding 1.88%. Finally, a survey of financial industry dividend discount models (DDM) shows that on average markets are trading below fair value. A typical DDM, assuming the cost of equity at 7.5% and long-term core inflation of 2%, puts the fair value of the S&P 500 at 1350.

FORWARD P/E MULTIPLES ARE ATTRACTIVE

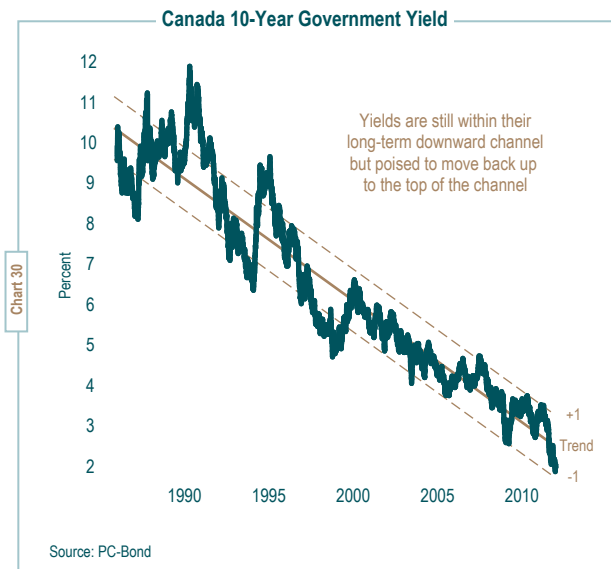
Price-earnings (P/E) ratios in North America, based on trailing and forward earnings, look attractive (see Chart 29). The consensus forecast of \$992 per share puts the S&P/TSX Composite at 12x future earnings while our forecast of \$940 a share puts the market at 12.5x – both are below the long-term average of 14.5x future earnings. Using a 14.5x multiple and earnings of \$940 would put the S&P/TSX at 13,630 for a 14% gain on the year. The S&P 500 P/E also looks attractive based on consensus earnings of \$107 per share. If this is achieved and the current trailing P/E of 13.5x is applied, the Index will move up to 1440 for a 12% gain. Using CC&L’s forecast of \$103 per share, a 13.5x P/E multiple would lift the S&P 500 up to 1390 for a gain of 9% on the year – both very respectable returns.



It is often pointed out that on an inflation-adjusted basis P/Es should be around 17.5x, which would put markets through their former highs. However, we do not foresee P/E multiples expanding even though the economy is growing and earnings are rising. This is because of the fragile nature of the economic recovery due to the long-term structural problems facing the developed world and the tail risks emanating out of Europe, which means investors will continue to demand high risk premiums (i.e. lower multiples). In addition, multiples usually do not expand when profit margins are at record highs and the rate of earnings growth is decelerating, as they are now.

BOND YIELDS ARE CONTAINED WITHIN A CHANNEL

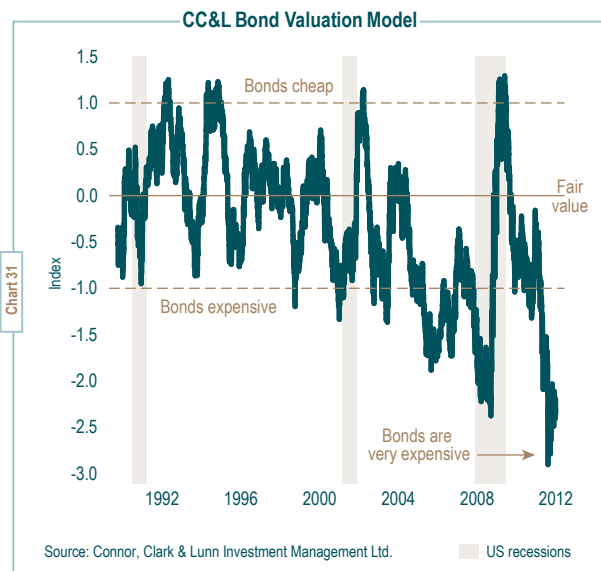
Interest rates on government bonds remain in their long-term downtrend channel (see Chart 30) thanks to a flight-to-safety mentality and falling inflation rates. However, if inflation expectations rise, real yields expand or investors take on more risk by selling bonds to buy stocks, then a backup in interest rates is in the cards. Also, if demand should diminish at a time when supply is rising as governments continue to come to the market to fund their large deficits and corporations look to finance takeovers and increased capital spending, then yields will be under upward pressure. The Fed estimates that on a structural basis for every 1% increase in the Federal Debt/GDP ratio, yields on 10-year Treasuries tend to rise 3 to 4 basis points. This ratio is forecast to increase nearly 30% over the next 4 years, which would translate into a 1.0% increase in yields. Rising yields in the US will push up Canadian yields.



It is worth noting that thanks to a flight to safety and financial repression, Government bond yields have been below nominal GDP growth for the past few years, which is not the norm. With Canadian and US nominal GDP growth forecast to be somewhere between 4.0% and 4.5% (2.0% to 2.5% real growth plus 2.0% inflation), government bonds from this perspective appear expensive – yields should be north of 3%. Other technical factors that could come into play in terms of pushing up yields include the expansion of the real component of bond yields, which is very low by historical standards, and investors wanting an increase in the term premium when they move further out along the yield curve. The bottom line is there appears to be more factors pointing to a rise in yields than to further declines in yields. At the very least we should expect yields to move up towards the top end of their long-term downtrend channel.

GOVERNMENT BONDS ARE OVERVALUED

Bonds have dropped from fair value at the beginning of 2011 to being overvalued as per CC&L's Bond Valuation Model (see Chart 31), and from a technical perspective they are at the bottom of their long-term down trend channel (see Chart 30). Also, bond yields tend to rise when the ISM Purchasing Manager's Index troughs, which it did recently (see Chart 10), and if the economy gains momentum and things settle down in Europe, then investors will be prepared to take on more risk by shedding fixed income investments in favour of equities. Other factors that could cause interest rates to rise include a severe shortfall in net savings, concerns over government deficits (rise in risk premiums), large bond sales by banks as lending activity picks up and/or real yields moving up closer to their long-term average of 3%. However, rising yields will be constrained by Fed buying, lack of inflation pressures and investors being forced out along the yield curve because of the meager returns available in short-term bonds.

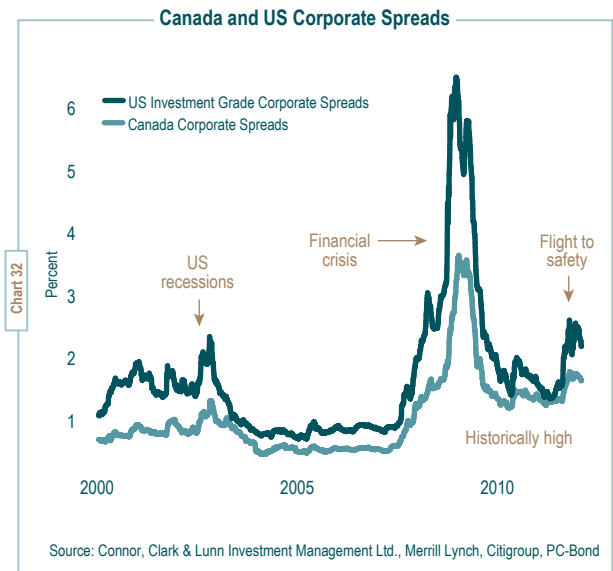


The bottom line is that North American bond markets look to be moderately expensive relative to the fundamentals, but given the high number of known tail risks, this is not that surprising. Therefore, a quick return of yields based on fundamentals seems unlikely in the near term; however, we do see bonds trading in a range of 2.0% to 3.0% for 10-year Canadas with a slight upward bias and fair value on 10-year Treasuries at 2.5%

CREDIT SPREADS SHOULD NARROW

Corporate credit spreads over government of Canada bonds have widened over the last year after recovering from the blowout during the credit crisis (see Chart 32). From a historical perspective, corporate spreads are still likely to remain above their historical norm, but they are pricing in implied default rates above the worst 5-year period on record. On a risk-adjusted basis, this makes credit very cheap. Also, strong corporate balance sheets with high cash positions and elevated profit margins accompanied by continued

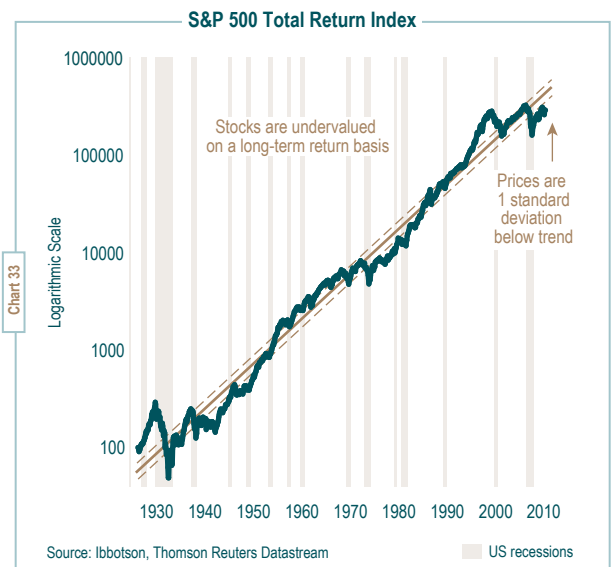
earnings gains support the view that credit is cheap. We expect a move away from risk aversion, lower default expectations and the search for yield by investors will support some narrowing of corporate spreads over the coming year. However, as bullish as we are on credit, there are risks to our forecast. Risks include poor liquidity and high volatility (dampens investors' appetite for credit), a slump in economic activity (implications on future prospects for the corporate sector), a rash of corporate takeovers and share repurchases financed by debt and/or a further flight to safety. These are all factors that could upset our 2012 forecast.



TECHNICAL CONDITIONS

STOCK MARKET RETURNS STILL BELOW TREND

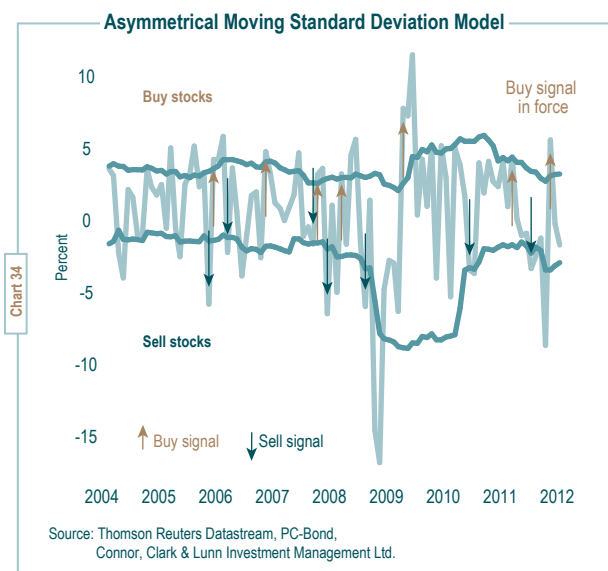
Canadian and US equities look attractive from a long-term perspective (see Charts 29 & 33). Historically, when stocks have been below trend by one standard deviation, returns over the next ten years have been strong. However, there have been periods of



longer-term underperformance such as the 1930s and 1970s. Given global structural imbalances and associated tail risks, it will likely be sometime before markets achieve above trend line returns.

LONG-TERM MODELS ARE BULLISH

Three out of our five longer-term technical models, such as our AMSD model (see Chart 34), are positive, which suggests from a technical perspective that equity markets have further upside. From a short-term perspective, our momentum and breadth indicators for the majority of global equity markets are registering in neutral territory. However, investor sentiment is overly bullish, which is not a particularly good thing in the short term because it is a contrarian indicator.

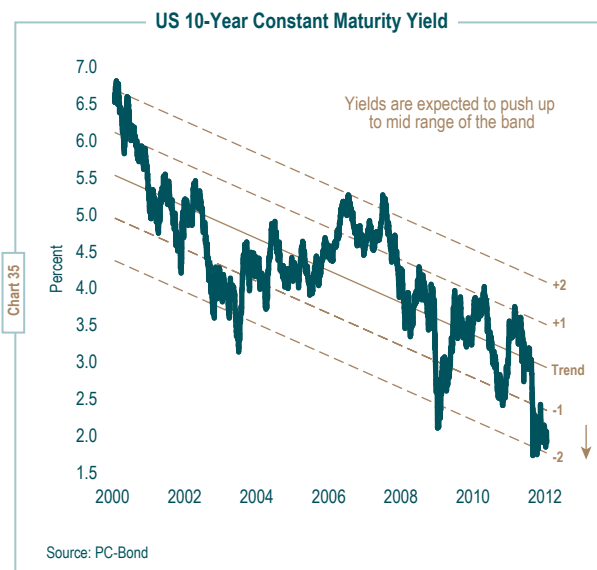


From a flow-of-funds perspective, we expect institutional investors to take on more risk in 2012 by switching out of bonds in the face of very meager yields to move into equities in response to some improvement in the underlying fundamentals. Retail investors, on the other hand, will by and large continue to seek out yield through high dividend-paying stocks and higher yielding debt instruments. From a supply/demand perspective, corporate share purchases will remain strong while mutual fund sales will remain anemic. However, cash holdings are still near record levels (\$3.5 trillion in the US alone) and earning next to nothing, which is a future source of buying.

THE TREND IS YOUR FRIEND

Bonds yields have been in a long-term secular decline. Ten-year US Treasury yields are below 2%, putting them at the bottom of their long-term down channel (see Chart 35). From a technical perspective, there is no compelling case for yields to break out of their long-term trading pattern. Momentum indicators have moved into overbought territory, which signals a reversal in prices and rising yields, while sentiment towards interest rates is bearish (this is a positive from a contrarian perspective) due the absolute low

yields available and a feeling that interest rates cannot continue to fall. The state of our short-term momentum indicators and our longer-term technical models points to fixed income markets selling off (rising yields) this year. However, yields will be range bound with 10-year Government of Canada bonds trading between 2% to 3% for the coming year.



FINANCIAL MARKETS THESIS

OUTLOOK SUMMARY

- **Economy** – growth in the US is improving, it is positive but slowing in emerging markets and Europe is sliding into recession. On a global basis this will be a push.
- **Monetary/Liquidity** – a global synchronized easing cycle has begun and monetary policy is moving to being very accommodative.
- **Inflation** – the rate of inflation is forecast to drop in most industrialized economies and in emerging markets including China. Food and energy prices are a mild tailwind for headline inflation while core inflation is a bit sticky.
- **Valuation** – equities look increasingly attractive on a historical basis but less so when factoring in secular issues. Bonds look expensive in our base case but less so under a recession scenario.
- **Technicals** – improved picture for equities but not so for bonds.

BASE CASE CAPITAL MARKETS SCENARIO

(60% Probability)

In reviewing the secular and cyclical forces at play, we have determined that the most likely outcome for 2012 is for slightly below trend global growth, extremely accommodative monetary policies and benign inflation pressures but with an elevated level

of macro tail risk. Given this scenario and the current pricing of financial assets, a constructive stance towards risk assets is warranted. However, the amount of risk should be kept low pending a reduction in the potential for an outright global recession due to ongoing structural imbalances in the global economy and/or market valuations become extreme and pricing in a much higher probability of a recession than we think is warranted. The current “risk on/risk off” trading environment will continue and warrants a more tactical approach.

Base case metrics (12-month Forecasts):

Table 7

	Global	US	Canada	Eurozone	China
GDP	3.5-4.0%	2.75%	2.2%	-0.7%	8.0%
Bank Rate		0.25%	1.00%	0.75%	
10-Year Rate	1.75-2.75%	2.00-3.00%	1.75-2.75% ¹	6.00%+ ²	
Earnings Growth		5%	12%	-20%	
P/E Multiples		13.5x	14.5x	11.0x	
Credit Spreads			1.25%		

¹ Germany, ² Italy

MAJOR DOWNSIDE RISKS

- **European Hard Landing:** even without a financial crisis there is a risk that austerity (public sector deleveraging) and bank balance sheet contraction (private sector deleveraging) could push the Eurozone into a deep recession.
- **European Banking Crisis:** the ECB has signalled it will do whatever it takes (within treaty limits) to prevent a bank funding crisis. There is little the ECB can do with respect to solvency issues that could arise if Spain or Italy is unable to make principal repayments (roll over debt), etc.
- **China Hard Landing:** should inflation risks not recede enough to allow policy makers to ease fast enough, a hard landing scenario becomes more likely, particularly as money supply growth is suggesting that policy makers are already behind the curve.
- **A Surge in Energy:** a spike in oil (+\$130 WTI a barrel) due to increasing geopolitical risks would hurt global demand.
- **Liquidity Trap:** developed economies slide into a liquidity trap and central banks are unable to respond (out of bullets).

MAJOR UPSIDE RISKS

- **Significant Pickup in Lagging Indicators:** such as a sustained turn around in employment and the housing sector.
- **Chinese (emerging markets) Economy Gains Momentum:** demonstrates that emerging markets are not being dragged down by Europe.

- **Significant Policy Shift in Europe:** a surprise move towards fiscal union/debt mutualization (Eurobond) and/or a substantial shift away from austerity to more pro-growth policies.

ALTERNATE SCENARIOS – BEAR CASE

(25% Probability)

The developed world’s economies are very fragile and they have inherently weak growth characteristics (over leveraged and lacking final demand). Because lower growth economies are more unstable than higher growth economies, any slowdown in growth has a greater potential of dipping the global economy back into recession. This may be the case going forward where recessions appear every 4 years like they did in the 1950s and early 1960s versus the 10-year intervals experienced over the last three decades (see Chart 2).

SCENARIO 1: MAJOR SLOWDOWN GGDP > 2.5%

(15% Probability)

There are two independent, yet very interrelated, macro events that could push the global economy into this type of scenario.

1. Europe

Europe turns out to be worse than the consensus view and enters a deeper recession (GDP: -2% to -3%), but it does not turn into a broader financial crisis. The trade linkages to the rest of the world are not particularly strong absent a financial crisis, and the global slowdown would be on the mild side. Emerging market policy makers have significant room to ease under this scenario which prevents global financial conditions from getting too tight. Global growth would come in at 3%+ with developed markets at -0.5%, earnings would drop 20% and interest rates would move back to their recent lows.

2. China Hard Landing

A hard landing in China could certainly be a sub-set of a broader European crisis, but more likely it is an event that is more home-grown. A hard landing (significant slowdown) could unfold in China (emerging markets) driven primarily by higher food and energy prices and the corresponding monetary response. In the process, excesses in Chinese property markets are exposed and a meaningful housing correction ensues. Our base case is that Chinese policy makers can ease financial conditions to offset this weakness and stimulate growth. Under this scenario the risk is that they are already too far behind the curve (real estate bubbles are tricky) or get hemmed in by inflation. The fact that there are two looming forces of significant downside risk and that they could potentially compound is one of the reasons why investors are so focused on this scenario.

Scenario 1 metrics (12-month Forecasts):

Table 8

	Global	US	Canada	Eurozone	China
GDP	2.5-3.0%	1.75%	1.2%	-2.5%	<7.0%
Bank Rate		0.25%	0.75%	0.50%	
10-Year Rate	1.25-1.75%	1.60-2.10%	1.25-1.75% ¹		
Earnings Growth		-18%	-25%	-30%	
P/E Multiples		12x	13x	10x	
Credit Spreads			1.95%		

¹ Germany

SCENARIO 2: GLOBAL RECESSION GGDP <2.5%

(10% Probability)

Europe enters a deep recession and European policy makers are unable to contain the problem and a full-blown global financial crisis begins. There is 328 billion Euros of European debt refunding that needs to be addressed in the first quarter of 2012, and it is unclear as to how that is going to happen as the EFSF looks unable to attract capital. It became apparent that while Europe has the financial resources to solve this issue, the problem is one of political economy and a crisis develops that moves faster than policy makers can act. Because global financial linkages are very powerful, global trade freezes up and the downturn spreads quickly. Under this scenario emerging markets can ease but developed markets have few bullets left.

Scenario 2 metrics (12-month Forecasts):

Table 9

	Global	US	Canada	Eurozone	China
GDP	0.0%	-2.0%	-2.5%	-3.5%	<5.0%
Bank Rate		0.25%	0.25%	0.25%	
10-Year Rate	1.00-1.65%	1.25-1.75%	0.90-1.50% ¹		
Earnings Growth		-35%	-35%	-35%	
P/E Multiples		12x	12x	10x	
Credit Spreads			2.85%		

¹ Germany

ALTERNATE SCENARIO – BULL CASE (15% Probability)

SCENARIO 3: GLOBAL ACCELERATION GGDP >4%

The US private sector begins to demonstrate that the bulk of the heavy lifting of deleveraging is behind them driven by the non-financial corporate sector. The emerging market slowdown turns out to be a classic inventory correction that ended in the fourth quarter

of 2011, and the region responds quickly to monetary reflation. The many individual moves by European policy makers end up cumulating in something significant, and the European economy surprises to the upside. Interest rates remain low, central banks continue easing and the tremendous amount of pent-up demand is released with a return of confidence that comes about through a decline in the risk of a European debt crisis.

Scenario 3 metrics (12-month Forecast):

Table 10

	Global	US	Canada	Eurozone	China
GDP	4.5-5.0%	3.5%	4.0%	1.0%	10.0%
Bank Rate		0.50%	1.75%	1.00%	
10-Year Rate	2.75-3.75%	2.75-3.75%	2.25-3.25% ¹		
Earnings Growth		15%	20%	10%	
P/E Multiples		14.5x	15.5x	13.0x	
Credit Spreads			1.00%		

¹ Germany

PORTFOLIO STRATEGY AND STRUCTURE

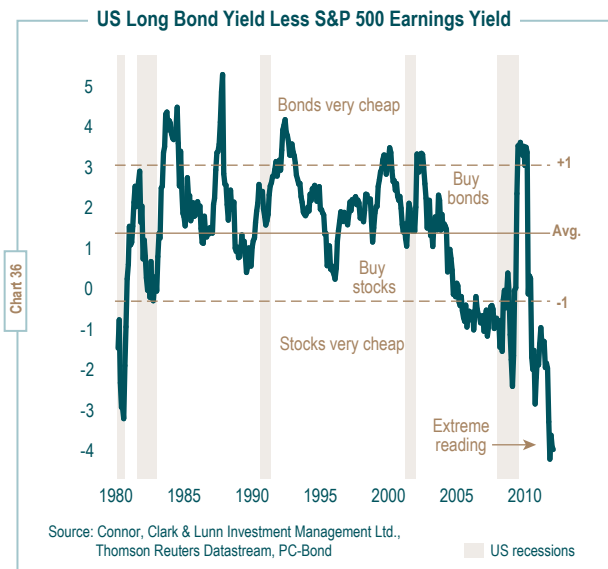
ASSET MIX

RISK ASSETS LOOK ATTRACTIVE

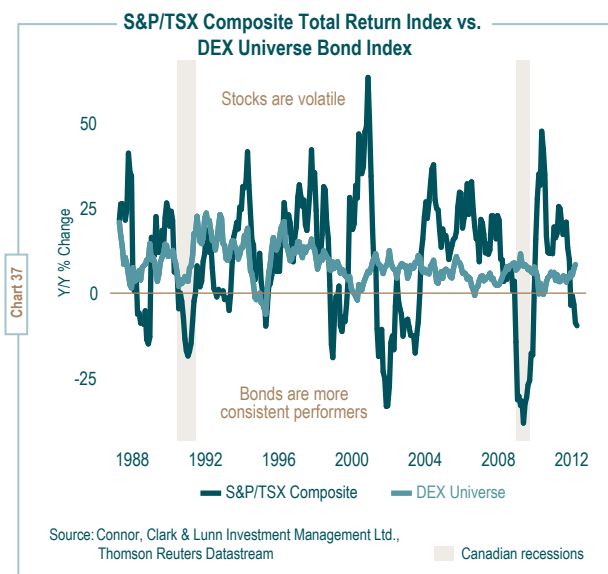
In 2012, financial markets will continue to be driven by global macro factors, although country, sector and stock specific events will be increasingly important. As such, relative value will be an important theme, and managing idiosyncratic (stock specific) risk will lead to success in picking stocks and credit. Four out of five of our stock/bond valuation models are registering an expected advantage for stocks over bonds. The exception being our Earnings Less Long Bond Yield/Price to Cash Flow Model which shows that bonds are favoured over stocks because earnings momentum is declining. However, our US Long Bond Yield Less S&P 500 Earnings Yield is registering a clear advantage for stocks over bonds (see Chart 36) as are our US Long Bond Yield/Dividend Yield and Government of Canada 1-3 Year Bond Yield Momentum models.

Equity risks premiums are very high which, when compared to the negative real rates of return coming from fixed income, make stocks look very attractive over the longer term. This is especially true when one considers that corporate balance sheets look better than sovereign ones and profit margins are high.

In addition to their better relative valuation metrics, stocks should outperform bonds because of supportive monetary conditions and, in the case of the US, because the improved outlook for economic growth and continued earnings growth should encourage investors to take on more risk.



Equity markets are forecast to remain volatile (see Chart 37) because of ongoing macro uncertainty, low investor conviction and shortened time horizons. This will only change when the environment starts to normalize and tail risks shrink. We also expect equity and bond yields to remain positively correlated because returns will largely be driven off of growth expectations, which suggest that a modest backup in interest rates should not necessarily derail the stock market.



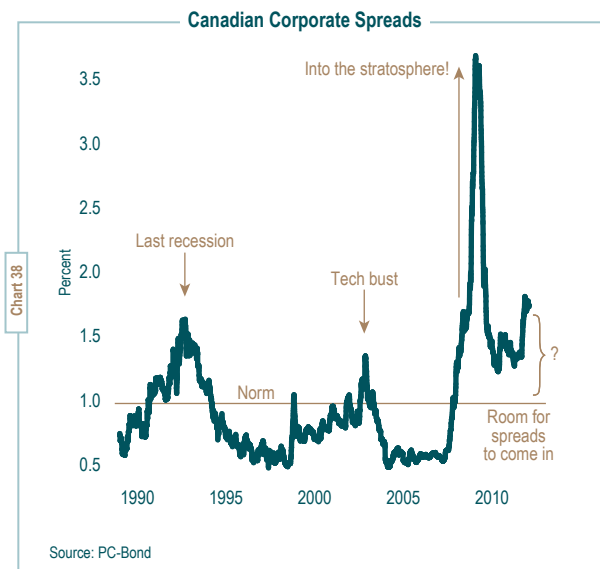
Our base case calls for 10-year Government of Canada bond yields to trade in a range of 2.0% – 3.0% with a bias to the upside as the year progresses. As such we expect total returns for Canada bonds (DEX Universe Index) to be anywhere from 1% to 4% for the year. In contrast, we expect North American equities to provide a return of between 9% and 14%. Both the S&P/TSX and S&P 500 are forecast to be range bound (11,800 to 14,000 and 1200 to 1400 respectively) for most of the year or until there is significant

progress on the major macro risk factors facing investors. If meaningful progress is made in resolving a number of the major risks we have identified, then stocks should have a sustained move to the upside.

From a North American perspective, the Canadian market should marginally outperform the US, while from a global perspective we expect the US to be in line with EAFE markets. In terms of EAFE, Europe outside of Germany is struggling with anemic growth and the sovereign debt crisis. The financial sector is particularly vulnerable. Valuation levels are good, but future earnings prospects are not inspiring. Japan is still in the throes of deflation and Australia is facing rising inflationary pressures and an overvalued currency.

CORPORATE CREDIT IS ATTRACTIVE

The pickup in running yield of 1.75% above government bonds remains very compelling. Strong balance sheets, rising earnings and interest rate spreads that are still above historical norms make corporate credit investments attractive (see Chart 38). Credit positions are concentrated in higher quality corporate issuers and provincial issuers. In addition, exposure to companies that will benefit from global growth, particularly growth outside of Europe and Japan, are preferred.

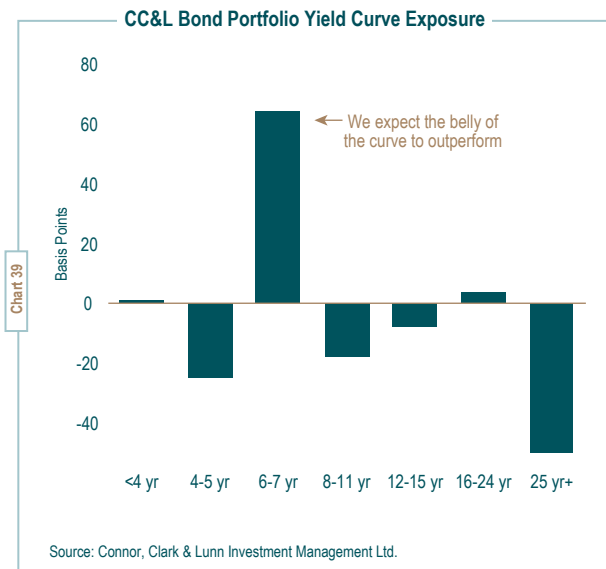


In terms of specifics, portfolios are overweight high quality financial issuers including Canadian banks and insurance companies which are preferred over US financials because of their superior risk/return characteristics, US regulatory changes requiring higher capital ratios and ongoing deleveraging. Portfolios are underweight telecom issuers because of intense competition and infrastructure because of unattractive valuation metrics while foreign sovereign credits continue to play a role in portfolio construction, on a fully hedged basis, because of their higher yields.

CANADIAN YIELD CURVE WILL STEEPEN SLIGHTLY

In the US, the front end of the yield curve will remain anchored because the Fed wants to ensure that economic growth is self-sustaining and it is not worried about inflation because of the nation's large output gap. Long-term interest rates will have some upside bias as economic growth takes hold and the threat of deflation subsides. Thus, there should be some mild steepening in the yield curve.

In Canada, the yield curve is also expected to steepen as the Bank of Canada holds short-term interest rates down because of the risks to growth coming out of Europe and the recent slowing in inflation and the Canadian economy. Portfolios are underweight shorter-dated securities because this area is expensive relative to the pickup in yield in the mid-term area. With some steepening in the curve expected, portfolios are also underweight the 25-year area (see Chart 39).



STOCK AND SECTOR SELECTION WILL BE IMPORTANT

The rate of change in earnings growth is slowing, but profit generation is still high enough to help lift stock prices in general. Higher quality stocks will outperform lower quality stocks because of their better valuation metrics and higher certainty of earnings growth. We also expect small cap stocks to outperform large cap stocks in first half of the year as investors take on more risk due to an improved economic climate. Quality of earnings and exposure to the US and China will be themes that play out at this point in the cycle. Value stocks are expected to outperform growth stocks because of better forward price-to-earnings multiples, similar volatility and an improved earnings picture. Also, companies with the ability to raise dividends will outperform as investors continue to seek out yield. And finally, we are focused on companies with some combination of low fixed or high variable costs, relatively high barriers to entry, high inventory turnover and pricing power.

Specifically, with oil forecast to trade around \$95 a barrel in 2012, we expect solid price gains for selected oil producers and equipment suppliers. Producers of base metal commodities and fertilizers are also expected to outperform the broad market with firm commodity prices due to a soft landing in China. The Canadian banking sector also looks attractive as P/E multiples have come in closer to global levels and, given their superior balance sheets, Canadian banks should outperform. The same goes for technology and industrials because they are the prime beneficiaries of corporate spending. We are less enamored with utilities and telecom stocks which are trading at historical high valuation levels relative to where they should be in the cycle.

SUMMING UP

Our base case forecast for 2012 is reasonably encouraging when it comes to the outlook for global economic growth and equity markets. In North America, there are early signs that the private sector is starting to do some of the heavy lifting and there will be less reliance on governments to sustain economic activity. Inflation is well-behaved and monetary policy is very supportive of growth in financial markets. While Europe is limping along, collectively the Eurozone has been addressing the sovereign debt crisis through a combination of fiscal and monetary support, but additional movement towards some form of fiscal union or mutualization of Eurozone debt is needed. Developing economies are experiencing a slowdown in their economies, but with early signs that inflation is abating further, stimulative monetary policies should support economic growth. Under this base case scenario, risk assets such as equities and fixed income credit should perform reasonably well which lends itself to being overweight these asset classes in balanced portfolios. However, we are mindful that there are tail risks to our base case scenario and until they subside an overly aggressive tilt to risk assets is not warranted.

The coming year will have its share of surprises as is always the case. And while we are committed to our base case for the economic outlook, financial markets and portfolio positioning, we are cognizant of the fact that we cannot expect to capture the multiple facets of reality as it may unfold. However, we have looked at a number of alternative scenarios and have ranked them as to their probability of coming to fruition, and as such we stand prepared to adjust our thinking and portfolio positioning as circumstances change.

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