

THE YEAR IN REVIEW

It is our custom at the start of each new year to review our prior year's *Financial Markets Forecast* and the results of our investment strategy while keeping in mind that the forecast was a point-in-time view and evolved as events unfolded throughout the year.

The overriding theme in our *2011 Financial Markets Forecast* was that both monetary and fiscal policies for developed nations were overly aggressive but essential if economic growth was to be sustained. However, we noted that ultimately they were not sustainable and that at some point exit strategies would have to be implemented. The timing and magnitude of any pullback from these overly expansionary programs would have major implications for the global economy and financial markets. This proved to be the case.

Policy makers at the beginning of 2011 were in no mood for normalizing policy as a number of events disrupted global economic growth including supply chain disruptions emanating from Japan

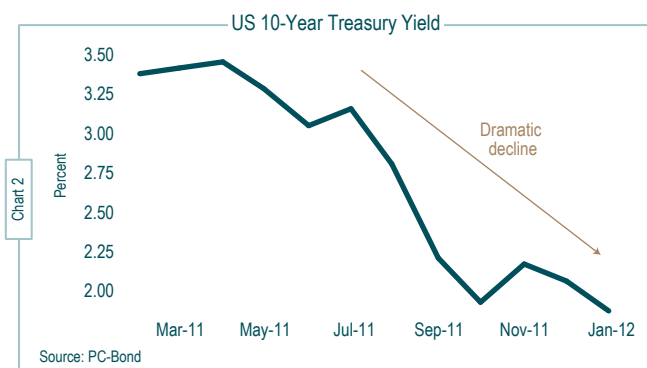
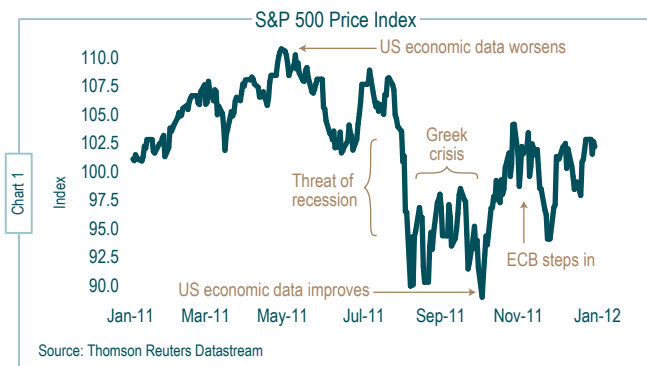
due to a catastrophic earthquake and a spike in oil prices because of the Arab Spring. North American equity markets responded by initially moving up (see Chart 1) as did interest rates (see Chart 2) before trending sideways until the summer when investor attention shifted to the growing debt problems in Europe and the political stalemate in the US. Equity markets in turn sold off and interest rates dropped precipitously (see Charts 1 & 2) as investors fled from riskier assets in search of safety. Again, financial markets were largely driven by macro factors and in particular government action or inaction. Macro factors (monetary policies) were also the driving force as the year came to an end as massive injections by the European Central Bank (ECB) and US Federal Reserve helped calm investors' nerves and stabilize financial markets.

Our *Forecast* for the year was broken down into six component parts as highlighted below (gold italics) along with actual outcomes (green print).

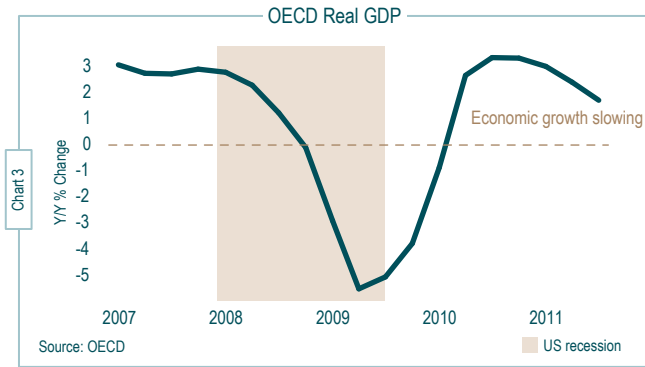
ECONOMY

Global growth was forecast to slow in 2011 to around 4.2% with Europe and Japan weighing down heavily on the outcome. Some slowing in emerging markets was also expected but China and India were forecast to post respectable numbers in the neighbourhood of 9.2% and 8.2% respectively. The outlook for the US economy a year ago looked fairly anemic due to high levels of unemployment, an inventory overhang, a moribund housing market and a need for further deleveraging (debt consolidation). Fiscal largesse and a loose monetary policy were expected to remain in place and would be critical in preventing the US from sliding back into recession. In terms of Canada, we felt that the economy would continue to expand due a better employment picture, a pickup in exports to the US and high commodity prices (oil was forecast to average \$95 a barrel).

Low probability events that were not expected to occur but nevertheless were listed as possibilities included (1) unforeseen geopolitical events, (2) Spain and/or Italy default, (3) break-up of the Eurozone, (4) US dollar collapse and 5) a spike in gold and oil prices.



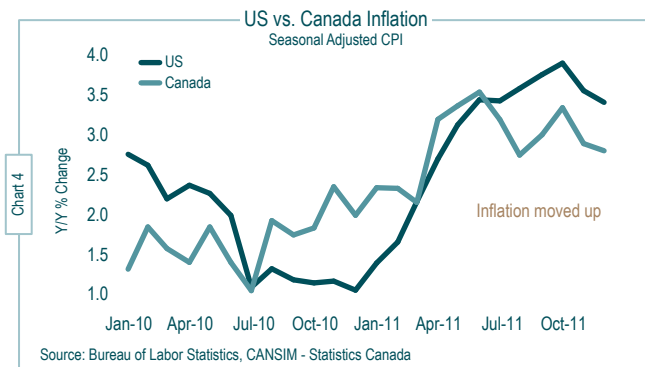
The final numbers for 2011 economic growth rates are not in yet, but it appears that we were pretty close to the mark in terms of our various forecasts (see Chart 3). Most of our low probability events did not transpire except for some “unforeseen political events” in the form of the Arab Spring which sent oil prices dramatically higher hurting first half economic growth and elevating risk premiums in financial markets.



INFLATION

Inflation was forecast to be somewhat problematic in developing economies and would probably be met with a tightening in monetary policy. Rising input costs, rapid economic growth and expansionary monetary and fiscal policies were the culprits. On the other hand we did not foresee inflation being a problem in North America because of the large output gap that still existed. We expected core inflation to drop to 0.5% and CPI to 1.5%.

As forecast, inflation in the developing world was problematic, and central bankers responded by tightening monetary policy. In terms of North America, we missed the boat as CPI in both Canada and the US pushed up to 3% versus our forecast of 1.5% (see Chart 4).

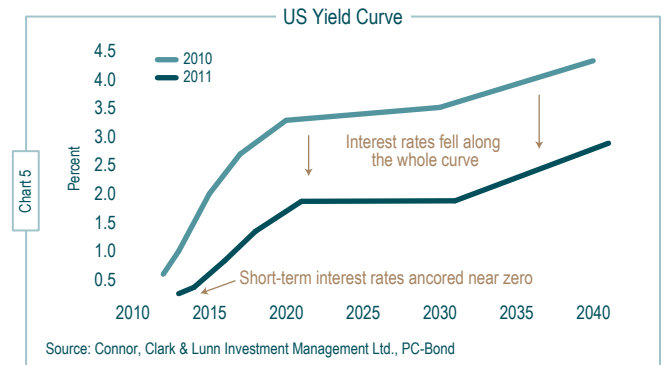


MONETARY POLICY

The outlook for monetary policy in North America was basically more of the same. The US Federal Reserve was expected to keep monetary policy very loose with short-term interest rates unchanged, the yield curve would remain steep and the expansion

of bank credit would be encouraged. No exit strategy on the part of the Fed was anticipated, and in fact we felt that the forward curve, which was pricing in a move up in short rates of 1%, was mis-priced. We also felt that risk premiums for stocks would remain elevated (P/Es unlikely to expand and credit spreads unlikely to narrow).

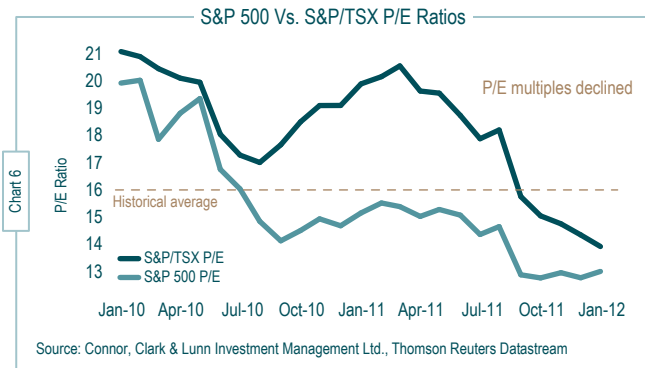
Monetary policy in North America remained very expansionary with the US Federal Reserve anchoring short-term interest rates close to zero and by implementing a second round of quantitative easing. This left the yield curve relatively steep (see Chart 5) and equity risk premiums elevated.



MARKET VALUATIONS

We felt that the outlook for corporate profits was excellent going into 2011 due to rising sales and high margins. We forecast S&P 500 profits to be \$92 a share and that Canadian profits would touch \$940 thanks to high commodity prices. Stock valuations were attractive due to our bullish outlook for corporate earnings and elevated equity risk premiums. However, our enthusiasm for stocks was somewhat tempered because risk premiums were not expected to materially improve because of structural imbalances around the world and the perception of large tail risks. Forward P/Es were felt to be compelling with the S&P/TSX trading at 14.3x and the S&P 500 at 15x. We noted that on an inflation-adjusted basis P/Es would normally be around 17.5x, but in an environment where the rate of change in corporate earnings was declining, it would be difficult for them to expand.

Earnings in the US exceeded our expectations (S&P 500: \$98 per share) while in Canada they fell short of expectations (S&P/TSX: \$840 per share). The shortfall in Canadian corporate profits in combination with a decline in P/E multiples (see Chart 6) pushed the S&P/TSX into negative territory for the year (down 9% on a total return basis) while the S&P 500 was basically flat thanks to very strong earnings growth even though multiples declined.



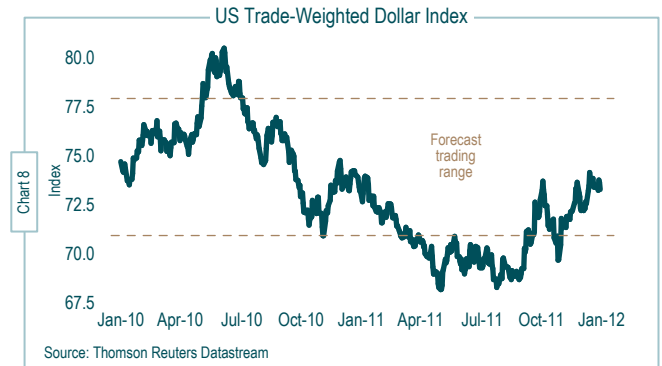
Bond yields were forecast to rise due to rising inflation expectations, an expansion in real yields, increased supply and the end of QE2. Government bond yields were also trading below nominal GDP growth, which is not the norm, suggesting interest rates would move higher. Corporate spreads were forecast to narrow slightly because of lower default rates, rising liquidity, search for yields, and spreads that were well above the historical norm.

We missed the mark on yields. Not only did yields not rise, they totally collapsed (see Chart 2) as investors fled risk assets (equities) in favour of government bonds, particularly US Treasuries, due to mounting concerns over the European debt crisis. This also precipitated a widening in credit spreads (see Chart 7).



In terms of currencies, our forecast was for the US dollar to be stronger (up from 72 on the Trade-Weighted Dollar Index) because of the problems facing Europe and Japan. In addition, the US dollar was 20% undervalued on a purchasing-power-parity basis. The loonie was also expected to be relatively strong as well because of the country's strong fiscal position, higher rate structure and firm commodity prices – (a trading range of \$0.98US to \$1.04US).

Our call on the US dollar on a trade-weighted basis was directionally right (see Chart 8), while our forecast for the Canadian dollar fell short of the mark as the loonie spent the better part of the year below our forecast trading range because of soft commodity prices.

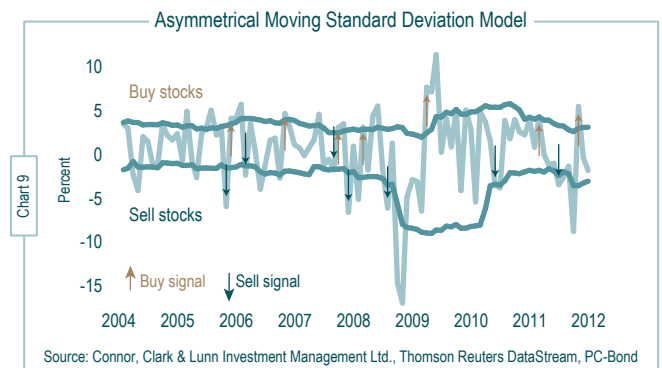


TECHNICAL CONDITIONS

Equity markets in North America from a trend perspective looked attractive given that they were trading one standard deviation below their historical trend line. However, 3 of our 5 longer-term technical models were bearish which to us signalled limited upside and that markets would be prone to a series of corrections. Investor sentiment was also too bullish for our liking.

In terms of bonds, we noted that yields were still bound by their long-term down channel and there was no compelling case that yields would break out from their long-term trading pattern. 10-year Government of Canada bonds were forecast to trade between 2.9% and 3.5%.

In hindsight, we should have paid more attention to our technical indicators which were better at capturing the changing psychology of investors (flight to safety) versus our other more traditional fundamental financial market models (see Chart 9).



PORTFOLIO STRATEGY AND STRUCTURE

Our base case for equity markets was that they would grind higher throughout the year because of expansionary fiscal policies, accommodative central bank action, low inflation and attractive valuation metrics.

Our base case in terms of forecasting economic fundamentals proved to be accurate, but they provided little in forecasting equity markets which were overwhelmed by the rise in equity risk premiums (P/E multiples fell) due to geopolitical events and the European debt crisis (see Chart 6).

In terms of sector performance, our forecast was for large cap stocks to outperform small cap stocks due to better valuation metrics and their potential for growth due to foreign sales. Growth stocks were expected to outperform value stocks because of better valuation metrics and stronger earnings prospects.

We got this right as growth outperformed value and large cap stocks outperformed small cap stocks (S&P/TSX 60 Index down 11.4% versus S&P/TSX Small Cap Index down 18.4%).

We felt bonds were priced at fair value but expected the general trend for interest rates would be higher because the QE2 program would be ending, there was a severe shortfall in net savings, concerns over government deficits was rising, bank debt issuance was expected to rise due to a pickup in lending activity and real yields were expected to move up towards their longer-term average.

Again, most of the fundamentals that we were looking at played out as forecast, but we did not anticipate the extremely negative investor sentiment (fear factor) and flight to safety that transpired due to policy makers' inability to contain the European debt crisis.

An overweight in corporate credit was justified in our minds because of the pickup in running yield of 1.25% above government bonds. In addition, strong balance sheets, rising earning and interest rate spreads above historical norms further supported this stance.

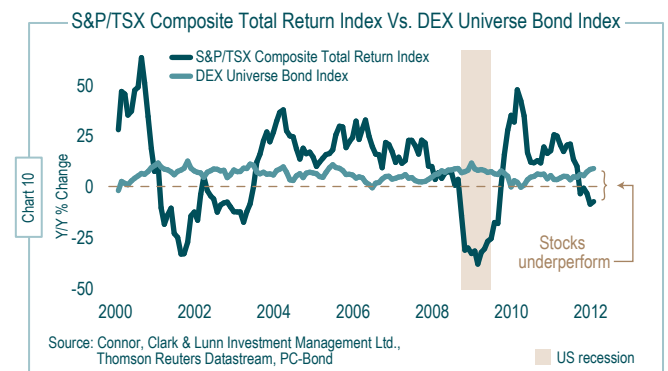
Our call on the corporate sector suffered from the same misreading as the flight to safety trade (see Chart 7).

The Canadian yield curve was expected to flatten as the Bank of Canada was forecast to raise short-term interest rates at least two to three times while the US curve was expected to steepen as the Fed held short-term rates near zero and long-term interest rates drifted up.

Yield curves in both Canada and the US flattened. The curve flattened by more than expected in Canada as short-term interest rates rose during the first half of the year while longer-term interest rates dropped due to the flight to safety (see Chart 5). In the US, short-term rates were maintained near zero, but long-term rates moved dramatically lower. On an inflation-adjusted basis the yield on most maturities out along the yield curve provided a negative real return.

From an asset mix perspective, we forecast North American stocks to outperform fixed income because financial conditions were improving, the economy would continue to expand and valuations were attractive. However, we did throw in a couple of caveats by stating that equity markets would be derailed if there was a hard landing in China and/or if the European debt crisis worsens. In terms of specifics, we felt that the Canadian stock market would do as well as its US counterpart thanks to firm commodity prices and an expanding global economy, even though the US market was more attractively priced. The US was forecast to outperform Europe because of better growth prospects and the country's limited exposure to Europe's debt problems.

Our forecast for stocks to outperform bonds missed the mark by a wide margin (see Chart 10), but we did adapt to the changing environment throughout 2011 and as such asset mix was only a very small detractor in terms of its contribution to total balanced portfolio returns.



Finally, we noted that 2011 would have its fair share of surprises, and while we made a single-point forecast for the economic outlook and financial markets, we were cognizant of the fact that Forecast cannot capture the multiple facts of reality that may unfold and thus we were prepared to adjust our thinking and portfolio positioning as circumstance change.

We followed our own advice on this last point, but in hindsight, not to the full extent that we should have.