January 4, 2012

Here's What We're Thinking

The Investment Committee of the Portfolio Advisory Group meets weekly to formally discuss markets, sector allocation and investment recommendations. Below is a brief synopsis of our current market view.

- Major equity benchmarks around the globe ended the year deep in the red, although losses vary widely from region to region. On a relative basis, the U.S. was an outperformer as the Dow Jones Industrial Average generated a total return of 8.4% and 10.8% in Canadian dollar terms. The broader benchmark S&P500 Index advanced a more modest 2.1% including dividends, (4.4% in Canadian dollars). The commodity-heavy TSX Composite finished the year with a loss of 8.7%.
- Canadian bonds were a clear winner in 2011. The DEX Universe Total Return Index gained 9.7%, while the DEX Long Canada Total Return Index posted an impressive 19.8% return! Provincial and municipal bonds outperformed corporates. The long end of the curve benefited from generally weaker growth expectations, and "operation twist", a move by the U.S. Federal Reserve to drive down long-term interest rates and reinvigorate their economy.
- With a rather volatile and challenging 2011 behind us, we look ahead to 2012 with slightly more optimistic lenses as valuations look compelling, corporate balance sheets are strong, and dividend yields are attractive in this low interest rate environment.
- There are certainly a number of risks to consider over the foreseeable future, but at the same time, we observe a reasonable number of catalysts which offset these concerns, thereby allowing us to remain cautiously optimistic.
- Among the risks in the current environment, we caution that volatility could be here to stay as concerns over sovereign debt remain an overhang. As well, in both Europe and the U.S., bringing outsized fiscal deficits under control and restoring balance sheets in the public sector is a difficult and lengthy process.
- Also carrying possibly negative implications for markets are this year's elections in the U.S., France, and Germany, and the risk that political aspirations impede decisive action.
- Cognizant of the aforementioned risks, there are a number of supportive factors for stocks in 2012 that are worth highlighting:
  - We continue to operate in a low interest rate environment which should help to underpin stock markets as alternative asset classes become less attractive.
  - Many corporations currently boast strong balance sheets which can support business investment, M&A activity, and aggressive share buybacks.
  - Particularly over the past several months, U.S. economic data has been stabilizing and in fact suggests the economy is more resilient than originally thought, and barring another global credit crunch, should avoid a recession in 2012.
  - The debt issues facing Europe are undeniably complex. As a mild positive, however, we believe that the recent leadership changes in Europe and at the ECB are encouraging; bringing in world-class financiers as well as fresh views can hopefully help to expedite a swift and effective resolution with regards to the European debt situation.
  - We are committed to the view European politicians and regulators will ultimately put forth a credible solution to deal with these issues
  - From our perspective, fears of a hard-landing in emerging markets appear overdone. Recent economic data in China suggests economic growth has been decelerating (slower growth, not zero or negative growth), and as such, the central bank recently lowered reserve requirement ratios.
  - In our opinion, this is a signal that China will now adopt a more dovish stance and gradually prioritize economic growth over inflationary concerns. This change in policy would be positive for commodities. Longer-term, we believe that continued urbanization and general domestic growth in China and India is a secular theme that should continue to fuel commodity demand.
  - In light of the weakness throughout the second half of 2011, valuations look attractive at the moment. The S&P/TSX Composite currently trading at 11.6x forward earnings versus the long term average of 15.1x while the S&P 500 Index is also valued at 11.6x versus the long term average of 14.6x.
- Over the near term, stocks look cheap but the macro environment is still hampered by concerns over sovereign debt issues in Europe. Persistently low bond yields will continue to lead income-oriented investors into defensive, dividend-paying stocks. While valuations of utility and telecommunication stocks appear stretched by

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historical standards, this new paradigm – higher prices/lower yields – are a reflection of investors' quest for yield.

- Looking ahead, the current low rate environment offers little value in the mid-to-long end of the curve and we recommend investors remain short duration at this time. From a sector weighting perspective, investors should be underweight Canada's and overweight provincials, municipals and corporates. The recent narrowing of high yield spreads leaves us at a point of indifference on these credits. With the Canadian dollar expected to outperform most major currencies over the coming year, we recommend Canadian investors remain in Canadian dollars for their fixed income holdings.
- Austerity measures in Europe and the U.S. will ensure growth in developed economies remains slow in 2012, offset by comparatively stronger growth in emerging markets which argues for the continued need for global diversification. Over the longer term, however, valuation and fundamentals will return to the forefront.
- Equity markets are likely to remain range bound with the occasional cyclical rally within what appears to be a secular bear market for stocks. We believe there are a number of attractive investment opportunities at present but macro risks lead us to advocate a balanced portfolio, a focus on enhancing returns via dividends, and a need to be more tactical in this volatile market.

For more information on how these ideas pertain to your investment portfolio, please contact your ScotiaMcLeod advisor.

Summarized from commentaries by Geoff Ho and Paul Danesi - Portfolio Advisory Group

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