

Market Matters

2011 HIGHLIGHTS

- Traditional and even positive market signals, like strong corporate earnings growth, were trumped by a loss of faith in politicians, fears of nations defaulting, and the cooling of emerging market rapid growth.
- Fixed income markets fared best as investors sought refuge from economic uncertainties.
- Stock market volatility was significant, frequent, and knew no geographic borders in 2011.
- Commodities had sharp price fluctuations. Gold and oil maintained their strong gains for the year, but base metals fell on concerns of slowing global demand.
- If there were to be a theme at all for 2011, it would be the fierce desire of investors to seek safety and comfort over growth potential:
 - Bonds outperformed stocks;
 - Developed country stock markets outperformed those of developing economies;
 - Defensive sectors outperformed cyclical sectors; and
 - The U.S. (the world's most established and largest economy), saw its S&P500 equity market outperform other major markets.

IN A NUTSHELL

No sense mincing words. 2011 was a tough year for stock markets; another banner year for debt (bond) markets; and an unsettling year for the economies of countries from every corner of the world. That might be the story of 2011 in a nutshell, but like most things the devil is in the details.

FINANCIAL GLOBALIZATION

With few exceptions (though a notable one from the U.S.), world stock market results ended the year significantly lower than where they started, but that hardly tells a full story (see table 1). Investors' confidence was shaken in 2011 by the realities and uncertainties that come with financial globalization. Consider that a natural disaster in Japan disrupted supply chains and hurt industrial productivity in Germany; geopolitical concerns in Arab nations hurt U.S. consumers at the fuel pumps; and a deadlock in Washington over fiscal policy threatened export demand prospects in Canada. Debt problems in Greece dampened the economic growth outlook for developing countries like China. China's tightened

Table 1
Summary of major market developments

Market Returns*	Dec.	Q4 2011	YTD
S&P/TSX Composite	-2.0%	2.8%	-11.1%
S&P500	0.9%	11.2%	0.0%
- in Canadian dollars	0.6%	8.7%	2.2%
MSCI EAFE	0.4%	3.6%	-14.8%
- in Canadian dollars	-1.2%	0.6%	-12.9%
MSCI Emerging Markets	-0.1%	4.5%	-14.9%
DEX Bond Universe**	1.7%	2.1%	9.7%
BBB Corporate Index**	1.6%	2.2%	8.7%

*local currency (unless specified); price only
**total return, Canadian bonds

Other price levels/change

	Level	Dec.	YTD
U.S. dollar per Canadian dollar	\$0.9839	0.2%	-2.2%
Oil (West Texas)*	\$99.03	-1.4%	8.4%
Gold*	\$1,575	-9.8%	11.1%
Reuters/Jefferies CRB Index*	\$305.30	-2.7%	-8.3%

*U.S. dollars

Table 2
Sector level results for the Canadian market

S&P/TSX Composite sector returns*	Dec.	Q4 2011	YTD
S&P/TSX Composite	-2.0%	2.8%	-11.1%
Energy	-0.7%	10.6%	-12.3%
Materials	-11.6%	-4.5%	-21.8%
Industrials	3.0%	14.5%	2.0%
Consumer discretionary	-1.8%	-0.2%	-17.9%
Consumer staples	1.6%	2.4%	4.8%
Health care	-0.8%	14.8%	49.6%
Financials	2.3%	0.1%	-6.6%
Information technology	-10.2%	-15.5%	-52.6%
Telecom services	4.8%	8.6%	19.0%
Utilities	0.3%	-0.3%	1.6%

*price only
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond

lending strategies hurt resource-based countries like Canada and Russia. The list goes on with each one making headlines and bringing about global economic consequences and significant market volatility, unsettling even the most steeled among us.

BONDS - THE BELLE OF THE BALL

Sharp risk-on, risk-off trading characterized the bond market performance in 2011, with emphasis on the risk-off moves driving investors to the bond market

and pushing bond returns higher. Economic uncertainty and a general unease with policy makers' efforts to find fiscal resolutions to debt problems trounced investors' confidence during the year. Investors moved into the perceived safety of bonds (including United States Treasury bonds even after the nation's credit rating suffered its first-ever downgrade), and shunned stocks (even as American companies set records for profits). No matter that the Government of Canada will pay you less than two per cent for the privilege of lending them money for ten years – the stability of bonds amidst equity market volatility made them the belle of the ball in 2011 (see table 1).

NORTH AMERICA – AMERICA'S LEAD

The Canadian S&P/TSX Composite reversed its two year trend of outperforming its American counterpart, the S&P500. Despite a stable economic backdrop, the cyclical (i.e. resource-based) nature of the Canadian stock market fell victim to slowing economic growth out of the U.S., China and Europe.

Commodity prices fluctuated strongly throughout the year. The year's gains in oil and gold bullion prices belied their volatile price swings during the course of 2011. Gold bullion's sharp rise (hitting highs of \$1,900/oz in early September) gave way to a bear market decline of 21%, to end the year at \$1,576/oz. Oil prices advanced to \$114/barrel (WTI) in late April only to drop as low as \$75 in early October. And while both saw healthy returns for the year, the realities of companies levered to commodities price (and more importantly to the future outlook of those prices) highlights why price volatility, even to the upside, can be more foe than friend. Gold stocks on the S&P/TSX Composite declined 17.3%, while oil & gas exploration and production stocks dropped 20.3%, both contributing to the significant decline of the Materials and Energy sectors (see table 2).

Meanwhile equities in the U.S. came in like a roller coaster returning to its platform, ending 2011 just about where it started the year. Zero return was enough to give it top performing status among the G7 countries. If only investors could have ignored the stomach churning twists and turns it took along the way. In spite of a fragile economic recovery, a disappointing display of political gamesmanship and a debt downgrade, encouraging economic improvements in the second half of the year, healthy corporate earnings and a lack of better global equity

alternatives drew investors back to the U.S., albeit modestly.

EMERGING MARKETS – VERY HOT

China's multibillion-dollar stimulus faded in 2011 and policy makers tightened lending and investment practices to cool their red-hot economic growth. While emerging market economies are still experiencing strong relative growth, their ties to the weaker economic prospects in Europe and the U.S. meant that the 'super fast' growth that their stock markets had priced in, needed to be adjusted down a notch...to just 'fast' growth. The stock price adjustment was significant with the MSCI Emerging Markets index down 14.9% (local currency, price only) in 2011.

JAPAN – A DIFFICULT YEAR

A devastating natural disaster, supply disruptions and a weakened outlook for world economies conspired to leave the exporting country and once-economic powerhouse significantly weakened. The Japanese Nikkei 225 index closed at its lowest year-end level since 1982.

EUROPE – A REPETITIVE STRAIN

Stock markets in Europe told a particularly grim story of neighbouring economies at odds with each other. The peripheral nations such as Greece, Portugal, Spain and Italy, all came under intense fire for their sovereign debt issues. Political and financial ills intensified from headache to migraine status quickly and with troubling frequency. The remedies (with still more to be prescribed) will be complex and a bitter pill to swallow for all those involved. European stock markets were down significantly in 2011.

GLC'S 2012 INVESTMENT OUTLOOK

We believe the Eurozone is near (and most likely in) a recession. We expect continued sub-par global economic growth, boosted by emerging markets' strength and a modest improvement in U.S. economic growth. As for the effect on stock markets, as bad as things are for Europe, by now the region has garnered a likeness to a slow moving train wreck and markets have already priced in a dire outlook. Barring a natural disaster, geopolitical crisis, or a dramatic political misstep, we feel the odds are for a positive surprise, which would boost global stock markets should 'better-than-feared' news come out of Europe.

If the current political environment, particularly in Europe and the U.S., stabilizes, we think investors will begin to place greater focus on market fundamentals, like earnings growth, and stock price valuations. Those companies who've spent the last few years showing financial restraint, becoming leaner and more efficient businesses, are poised to make the most of low borrowing costs and high cash reserves and we expect they will be rewarded for their good stewardship. Suffice it to say we are optimistically leaning forward on our toes rather than our heels as far as our outlook for stock markets in 2012. And what about volatility in capital markets? We continue to think that it will be the norm, with years like 2004-2006 having been low-volatility outliers for capital markets. Until the European fiscal challenges get sorted out, expect a bumpy ride.

Bond markets are more complex to anticipate. Part volatility protector, part economic health barometer, part inflation predictor, and part supplier for the demands of an aging demographic, bond prices fluctuate at the will of multiple masters. Considering the current environment, we expect bond market returns to lag in 2012 as the safety trade slowly unwinds and investors adjust to a slow-growth economic environment. However, while long-term bond returns may be muted, bonds will continue to benefit from the strong demand of a growing aging population seeking income and looking to stabilize the volatility in their portfolios.

In our view, no market outlook is complete (nor appropriate) without due consideration for the inherent risks of any such outlook. It's the premise behind one of GLC's core values – to provide timely, upfront and clear insight into the current investing environment. As mentioned earlier, financial globalization is a reality for today's investors, and political leaders in all parts of the world have much work to do in stabilizing their domestic economic conditions. How successful they are will have a significant effect on investors' sentiment (as demonstrated by the market volatility in 2011). We would be naïve to think all of the world's economic and fiscal woes will be resolved over the course of 12

short months. We would be naïve to think that there will be no surprises and unforeseen events that shift investor sentiment one way or another...but those predictions are left to the crystal ball readers. Instead we will focus on managing money in the current environment, being opportunistic to incorporate changes to market conditions, and managing investment portfolios with patience, prudence and perseverance.

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