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What We Think……

2012: Year of the Dragon or the Apocalypse?

2012 promises to be another challenging year for the global economy and capital markets. Although 2011 was also difficult, for most this came as a surprise. In contrast, investors do not seem uniformly positioned this time around. We recall at the beginning of 2011, when most market participants were firmly entrenched in their economic recovery views – ***risk on*** was the trade and government bonds were *a short*. Commentators were uniformly dismissive of Europe as anything but a minor distraction, expecting that Greek debt problems would be resolved by resolute European politicians. Unfortunately, Europe proved to be far more than a distraction, holding risk markets ransom to the constant debates in the halls of Paris, Berlin, Brussels and Frankfurt, not to mention Athens and Rome. For bond investors, all this uncertainty proved a windfall as high grade sovereign bonds (or what's left of it) proved to be the antithesis of risk assets. It is generally accepted that the Euro-crisis has sowed the seeds for a very weak European economy in 2012. However, the impact of the crisis outside of Europe seems to be still open to much debate.

Canada

The outlook for the Canadian economy and capital markets is as murky as we can remember. The combination of domestic dynamics and outside forces will prove challenging for investors in the year ahead. The Canadian economy has clearly been under somewhat of a *halo* since the Credit Crisis, having benefitted from a strong export sector, well regulated banking and an engaged consumer. However, we do not expect the Canadian economy to be able to rely on those same areas in the years ahead, as Canadian fundamentals fall more closely in-line with those of its peers.

The Canadian consumer has by far been the biggest reason for Canada's resiliency in light of slowing growth elsewhere, particularly in the U.S. As the U.S. consumer has been clearly untouched or unimpressed, in any sustainable sense, by monetary policies (QE's 1 & 2 and O*peration Twist*), Canadian consumers have responded to the commitment to low-rate environment employed by the Bank of Canada, and underscored by the Fed. Canadian GDP grew at just over 2.5% – healthy in comparison to other developed nations, largely on the back of the housing sector, but also on the back of deteriorating personal finances. Canadians now have a higher ratio of debt to personal disposable income than our much troubled neighbours to the south – 153% versus 144%. We are concerned that the Canadian consumer will retrench on mass (this advice seems to be coming from all quarters including the Bank of Canada), thus turning the consumer from an engine to a drag on the economy.

We have noted that the recent Canadian payroll data (an average of -3.9 thousand per month over the last three months) are showing signs of a slowdown. The housing sector is also cooling, save for the steroid-driven condo market in Toronto. Although retail sales, a more immediate source of information, have not yet shown signs of slowing, there has been a visible divide between the commodity driven west and the manufacturing and financial service-based east. We deduce that the deterioration in employment has already had an impact on the consumer and overall economic growth, but the strength in commodity prices has thus far been offsetting, particularly in the west.

Europe

The problem facing commodity markets now, however, is the recession in Europe and the likelihood of a general slowdown in the developing world. There have been easier monetary policy actions by the ECB, but these will be more than offset by the move to austerity, already well entrenched in much of the periphery. (In an interesting juxtaposition, the U.S. is undergoing a contentious debate as to how soon and by how much fiscal policy should be tightened, while Europe is proceeding *full throttle* with the German-IMF formula of austerity.) No doubt, the GIPSI debt and deficit problems need immediate mending, but the harsh austerity measures will ensure recession in much of Europe in 2012 and weak growth beyond.

Unfortunately last month's EU summit was singularly focused on embedding the Maastrict Treaty in Eurozone constitutions, while neglecting the very immediate concern of European growth. The current plan for fiscal union seems to be a long one, whereby countries bring their economies in line with Germany's – guaranteed through constitutional reform, before discussing any further pooling of assets, and finally liabilities. During German unification, Germany was able to reform its economy through severe economic measures, but it did so with a back-drop of strong peripheral and global demand. No such demand is available today, and the likelihoods is that as the southern European countries attempt economic reform, they sink further into debt, as the debt dynamics overwhelm sagging GDP. We believe the eventual exit of weak peripheral countries from the Euro lies ahead.

Emerging Economies

Despite the generally precarious footing of the world economy last year, global growth still did manage to average about 4%, on the back of strong growth in emerging economies of about 6.4%. Chinese growth was strong, although falling back to the pace experienced during the debt crisis of around 9%. In terms of commodities, global demand was not sufficient to prevent prices from falling in the second half of the year. The Arab Spring which is now an Arab Winter (Syria and Egypt, to name a few, are still far from settled) did contribute to more resilient oil prices, but will likely not repeat in 2012.

What makes the developing world situation more problematic than in 08-09 is the unreliability surrounding policy stimulus? During the last recession, developing countries were unquestionably at the table, with lower rates and in some countries government spending – their own interest and economic circumstances were in alignment with those of the developed world. However, recent inflation has been higher in many developing countries, notably the BRIC countries, which makes easier monetary policy more problematic. We have already seen rate reductions from several central banks including Brazil, Israel and Indonesia which suggest that monetary policy will be supportive, but unlikely to generate the collective firing-power seen during the 08-09 recession.

Importantly, China appears to be in a delicate spot having come off inflation levels above 6%. While high domestic growth rates are still needed to continue the absorption of excess labour, Chinese officials appear more sensitive to spiralling inflation. We note that some analysts believe that excess labour from the countryside has begun to run out, although recent worker unrest in response to factory closures would seem to undermine this assertion. Nevertheless, China will have to rely on domestic demand to fill the void from weaker global exports – particularly those to Europe.

Further monetary stimulus is likely through a combination of increased bank lending and cuts to bank's required reserve ratios. Any additional fiscal stimulus will likely be tempered by concerns over excessive household debt which now stands at 200% of GDP.

The U.S.

With Europe out of the game, and emerging economies seriously hobbled, Canada will once again turn to its neighbour to the south to absorb its exports of both commodities and manufactured goods – the U.S. still accounts for 77% of Canada's manufactured good exports. There may be some truth to the *Fortress America* argument (the U.S. is far less sensitive to the rest of the world than vise-versa), however we believe that the U.S. has enough of its own economic problems to make this a moot point.

On the surface, the U.S. housing market has begun to show some glimmers of hope, as starts and permits have both turned up. However, digging below the surface reveals a mixed bag, as most of the recent growth has come from multi-unit residential construction, more likely to be rentals rather than dweller-owned. There is no question that any building activity is good for the labour markets, and given the scarce inventory of rental units this construction should continue for some time. But apartment and townhouse construction will not deplete the significant backlog of unsold single family homes, with soon to be foreclosed homes adding to that backlog. What's more, in a *slap in the face* to those *pro-home-ownership-at-all-costs* policies of the Fannie-Mae and Freddie-Mac era, these new units going for rising rents will only further damage the asset base of renters. Ironically, America is moving backwards towards *rentership* with land-ownership concentrated amongst the wealthy (further fuel for the fledgling *Occupy Movement*). Finally, from a broader economic perspective: the large supply of single family homes, the waning demand for owner occupancy and the difficulty associated with turning inventory into rentals will ensure that house prices (S&P/CaseShiller Home Price Index is down 3.4% over the last year) remain weak and the wealth effect derived from those prices remains negative.

We acknowledge that recent employment data is looking better. Both employment surveys in the U.S. have shown some improvement since June. In November the widely followed establishment survey (non-farm payrolls) showed growth of 120K jobs – still not enough to absorb the growth in the work force and well below what is necessary to make a noticeable dent in the ranks of the unemployed. We would also caution those who have gotten optimistic about the drop in the unemployment rate from 9.0% to 8.6%, as the numbers of discouraged workers leaving the labour force has swelled – the U-6 *underemployment rate* is still hovering around 16%. As long as the employment situation remains tenuous, it is hard for us to see anything but slow growth ahead.

Finally, U.S. consumer spending has also been on a reversal of late, showing more fortitude than foresight on the part of the consumer. It is not surprising that the U.S. economy would experience some bounce following the massive decline in rates experienced during 2011 (5-year Treasuries fell about 1% and long-term mortgage rates hit historical lows falling from around 5% to just under 4%), and the fall in commodity prices. But more unexpectedly, the U.S. consumer, in perhaps a display of frustration and fatigue with poor economic prospects, threw caution to the wind in September and October and dipped into their savings to boost spending. Consumer credit is now back to levels seen two years ago, a situation we see as not sustainable.

As difficult as the consumer is finding it to wean itself of deficit spending, so too is the U.S. government – *the apple does not fall far from the tree!* We do not expect the fiscal drag that we had been anticipating in late 2011–early 2012 to materialise until after the U.S. presidential election, and even then if it all this year. Fiscal policy will largely be dependent upon the balance of powers between the President, Senate and Congress. As we have stated before, the freedom that the unchallenged reserve currency status of the U.S. dollar offers, will continue to allow the U.S. government to increase the size of its debt – now 100% of GDP, and run alarmingly large deficits – now 9% of GDP.

Central Banking

In this era of experimental central banking it has become a challenge to guess what comes next from the likes of the Fed, the ECB and the Bank of England. With the ineffectualness of most governments, central bankers have taken it upon themselves to implement countercyclical policies. After two-rounds of quantitative easing and an Operation Twist, there is still high expectation that the Fed will go at it again in 2012. As with previous non-conventional policies, we expect that another round of quantitative easing if implemented (some are suggesting the purchase of mortgage market securities to help the housing market), will have only short-term benefits.

The ECB presents the most interesting challenge for analysts given its relatively short history, complicated structure and lack of transparency. We are choosing to take Governor Draghi at face value, and accept that the ECB will not be engaged in outright quantitative easing through the market purchase of sovereign debt, beyond what is necessary to smooth markets and financed by the EFSF and ESM. We premise our analysis on the assumption that the ECB is essentially very political, and that Germany is not interested in assuming European peripheral debt, either directly through the issuance of Eurobonds or indirectly through the balance sheet of the ECB.

The recent activities of the ECB, in particular the Long Term Refinancing Operation (LTRO), present a most interesting policy development. While the ECB has cut interest rates and eased reserve requirements, it has doggedly maintained a conservative position on monetization. With the introduction of the three- year LTRO, the ECB has enabled the troubled European bank sector to recapitalize and in some cases take on more domestic sovereign debt. While such bank activity may help the immediate sovereign debt crisis, it will only further impair banks and their sponsoring governments down the line. (In an interesting twist, some European banks have been recent sellers of mortgage debt – the very same debt the Fed is rumoured to be considering for the next round of QE.)

As far as the Bank of Canada goes, we do not expect the Bank to lower rates in 2012. Governor Carney has proven to be resourceful and creative (the Bank was the first to use the conditional commitment) and we would expect him to prefer leaving the overnight rate where it is, and rely on other means for promoting growth in the economy – a task that will likely fall upon the Bank in 2012.

Although the Fed and the ECB will generally be active in 2012, we don't expect their actions to dominate the path of the dollar and the Euro. The Fed has been printing money and may continue to do so (political opposition notwithstanding), but the U.S. and the U.S. dollar as the loan truly safe havens will ensure that the greenback remains a strong currency in 2012. The Euro on the other hand will likely depreciate regardless of which path European politicians or the ECB take, as weak economies and devaluing debt ensure continued capital flight. Perhaps, the greatest impact of a central bank will be felt from the Bank of China, who will aim to preserve as much of its trade surplus as possible by promoting a weak Yuan. Other central banks may also take action to devalue their currencies such as the BoJ and the Swiss National Bank who have been aggressive in the past.

We don't expect that central bankers will be forced to respond to inflation concerns. Outside of some emerging markets, where unemployment levels *appear* to be too low and a cause for wage inflation, the outlook for inflation is generally benign. Should global demand drop too dramatically, we would be more concerned that falling commodity prices could result in a rise of deflationary expectations. An appreciating U.S. dollar could add to the effect of falling commodity prices and precipitate deflation concerns in the U.S. – we anticipate that the Fed would respond aggressively. With the decline of the Euro likely, we doubt that even disinflation will be a problem in the Eurozone, and should that not be the case, we have we expect the ECB to react decisively.

Debt Markets

A European recession is clearly in the cards for 2012, and if anything it will be deeper than the consensus forecast. We are also holding to our earlier forecast that the U.S. economy will not get off *scot free*, but will also experience a shallow recession sometime in the year. With that as a back drop, we expect risky investments to again be a challenge with the markets offering volatility and little clear direction. Most importantly for us, as bond investors, government bond yields will remain low amidst persistent volatility; though we note that the market is clearly delineating between so-called risk-free debt and those masking as such (yield spreads of even AAA-France (for now) have widened significantly). **2012 will not be the year that risk-free bond yields begin their trend upwards.**

Government of Canada's, though not benefitting from the breadth, depth and reserve currency of Treasuries or the internal funding of JGB's, nonetheless offer relatively good fiscal fundamentals and more importantly a level of diversification for global investors. Demand for longer dated Canada's will keep the overall Government of Canada yield curve low and may even result in flattening later on – some form of Bank of Canada commitment may act as a catalyst.

While corporate yield spreads are driven by the same macro fundamentals as the equity markets, they are often impacted with different timing. What's more, credit market dynamics tend to be specific to the corporate bond market. To date, we do not believe that Canadian corporate yield spreads have kept pace with the underlying economic and credit fundamentals. We believe some of the resiliency in corporate spreads can be attributed to the poor liquidity that has engulfed the credit markets, as capital commitment on behalf of intermediaries has diminished and investors remain unwilling to realise losses on over-weighted corporate positions. We expect corporate bonds to come under some further pressure in 2012, but will eventually present a good investment opportunity in advance of the equity markets.

The troubles befalling Europe and the banking sector in particular will likely leak into bank spreads outside of Europe, albeit to a lesser degree in Canada. The financial sector will continue to be a challenging place for investors with debt higher up on the capital structure being the preferred investment in the short term. We have believed that defensive sectors would be the place to reside in 2011 and that will continue to be the case for the beginning of 2012 - infrastructure, utilities and even telco's have all performed well. The opportunity further out will be to capture the higher running yields, once yield spreads have widened. We recognize that corporate bonds will not underperform year-after-year, but nor does their performance follow a calendar.

Risks

Of course to any forecast there are risks… With respect to Europe, there is a risk of the *Crisis* deteriorating more quickly and more substantially – all bets are off under this scenario. The ECB may surprise with support, but we see that risk as negligible. Emerging market economies may surprise to the upside, which may provide some support for commodity prices and give a boost to commodity exporters like Canada. However, the EM's on their own will not take care of the debt deleveraging challenge facing developed countries and the slow growth that this imparts.

The biggest risk to **our forecasts** is an underestimation of the vigour of the recent U.S. upturn. If the U.S. recovery were to broaden out, we do not fear a dramatic rise in bond yields – too much leverage in the economy means consumers and governments are sensitive to any increase in yields; but we do have concerns for our view on risk assets including corporate bonds. There is still sufficient capital sitting on the sidelines (not having abandoned risk assets altogether) that would jump head-first into the corporate bond market and move yield spreads tighter. The biggest risk to the **markets** is an underestimation of the economic decline facing developed countries. In the event of a deeper recession in the U.S., a decline in Treasury and Canada yields to JGB levels and more dramatic decline in risk asset prices are likely.

We are confident that Canadian bond returns will be reasonable in 2012 – somewhere around current yields. The substantial capital gains realised in 2011 will not be on offer, but the credit markets will provide more of an opportunity for adding value, albeit later in the year. Finally, we will look to take advantage of the market volatility to generate incremental returns through active management.

According to the Chinese calendar, 2012 is the year of the dragon – a symbol of power, strength and good luck. According to some interpretations of the Mayan Long Count Calendar, 2012 marks the end of the world. Looking forward to the challenges facing the world economy, we prefer not to think of the apocalypse, but as far as dragons go we will settle for good luck in 2012!

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