Market Matters - MONTHLY INVESTMENT COMMENTARY

JANUARY 2011 HIGHLIGHTS

- And the good news kept on coming…
  - Healthy U.S. GDP growth (3.2% annualized GDP growth during the fourth quarter of 2010)
  - Solid corporate earnings
  - Improving consumer spending
  - Supportive monetary policy

  …and equity markets soaked it up, continuing the rally that began late last year.
- Investors gained comfort with more cyclical (riskier) assets levered to economic growth and moved away from traditional 'safe haven' assets.
- The Bank of Canada held the bank rate steady, but did announce tighter household lending policies aimed at keeping a lid on economic growth, particularly within the housing sector.
- Emerging market countries continued to show strong economic growth. China, in particular, reported 9.8% GDP growth in the fourth quarter (yr/yr), and continues to show double-digit increases in petroleum consumption.
- The improving global economic growth picture drove commodity prices higher:
  - Copper reached all-time highs
  - Oil was up 1% (geopolitical concerns also contributed)
- The rising price of agricultural commodities caused food prices and inflation concerns, particularly in emerging markets.

Table 1
Summary of major market developments

Market Returns*	January	2010
S&P/TSX Composite	0.8%	14.4%
S&P500	2.3%	12.8%
- in C$	*3.1%*	*6.2%*
MSCI EAFE	1.5%	2.0%
- in C$	*2.6%*	*-0.6%*
MSCI Emerging Markets	-2.2%	11.7%
DEX Bond Universe**	-0.4%	6.7%
BBB Corporate Index**	0.0%	9.5%

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

Other Price Levels/Change

	Level	YTD
USD per CAD	$0.998	-0.8%
Oil (West Texas)*	$92.16	0.9%
Gold*	$1,332	-6.0%
CRB Industrials*	$777.54	7.4%

*U.S. dollars

Table 2
Sector level results for the Canadian market

S&P/TSX sector returns*	January	2010
S&P/TSX	0.8%	14.4%
Energy	4.6%	10.0%
Materials	-5.4%	35.8%
Industrials	3.4%	14.4%
Consumer discretionary	2.4%	21.8%
Consumer staples	-0.5%	8.3%
Health care	22.2%	50.3%
Financials	0.6%	6.3%
Information technology	2.9%	-11.6%
Telecom services	4.1%	16.2%
Utilities	0.7%	12.6%

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

A GOOD START

The first month of 2011 is in the books, and for most major equity markets it was a good start to the year. Investor confidence improved (a continuation of the trend we saw late in 2010) and there was a noticeable shift out of bonds and into risk assets like equities and commodities.

RISK AVERSION TAKES A BACK SEAT

Overall global economic data, particularly from the U.S. and emerging markets boosted commodity prices, investor confidence, and stock markets alike.

Risk aversion is taking a back seat of late as demonstrated by the lack lustre results in the bond markets late in 2010 and continuing into early 2011(see Table 1). Investor demand for bonds has waned over the past few months as low-interest rates and a better economic outlook have drawn investors back into equity markets, albeit slowly.

Within the U.S. S&P500 and the Canadian S&P/TSX the Energy companies got off to a blazing start, leading the way to positive results on both sides of the border. European markets also found encouragement in positive economic news. Of particular note, Germany's economy seems on the right track with unemployment rates dropping to an 18-year low. It also helped that Europe's sovereign debt problems seem to be contained, at least for the moment.

A FLIP SIDE TO EVERYTHING

Like most things in life, there is a flip side even to strong economic growth. Inflation pressures have been growing in countries like China and India over the last several months. These concerns seemed to weigh on investors during January which contributed to weaker MSCI Emerging Market Index results. Geopolitical concerns (most notably in Egypt) also contributed to volatility at the end of the month.

Taking a closer look at the Canadian market (Table 2), you will note that while the Canadian equity market remained positive for the month, a significant headwind came from the Materials sector. This might come as a surprise given that many commodity prices (such as base metals, fertilizers and other agricultural commodities) were up significantly during the month. However, the Materials sector in Canada (unlike in the Materials sector within the U.S. S&P500), has a heavy weighting in gold companies and these companies were negatively affected by a drop in gold prices during the month (-6%). Gold prices fell victim to a more confident investor who gravitated away from traditional 'safe haven' assets toward risk assets (like equities and cyclical commodities) that are more levered to economic growth.

CONFIDENCE AND COMFORT

After almost two full years of being wary of equity markets, investors appear to be regaining confidence and comfort with stock markets. In January, we saw equity fund inflows outpace bond fund inflows in the U.S. for the first time since mid-2008. We expect the trend would be similar for Canadian investors.

While headwinds exist, such as the unwinding of policy stimulus, soft exports and higher household debt (an emerging issue in Canada), the positives of stock market advances, the accelerating U.S. economy, improving employment data, positive corporate earnings results and low interest rates are tipping the balance towards a 'glass half-full' view of the world for investors. Simply put, the positives are outweighing the negatives and investors are taking notice.

But when it comes to capital markets, too much optimism comes with its share of risks, and the need for investors to diversify their investment portfolios only gains in importance.

Consider that the S&P/TSX is up 20% in the seven months since the end of the second quarter. A healthy pause or pull-back in stock prices would not be completely unexpected. Within the psychology of investing, one of the greatest ironies is the fragility of confidence. Market surprises can arise with little to no notice (e.g. geopolitical risks) and can quickly shake an investor's confidence in capital markets. Maintaining a balance of fixed-income and equity holdings that is in-line with your personal risk tolerance is one of the few consistent ways to prepare for both the known and unknown risks to investing. And besides that, a diversified investment plan can boost an investor's confidence and comfort…for whatever the next market move might be.