Market Matters

2012 Highlights

- **Sovereign debt levels remained a key issue impacting global markets in 2012.**
- After much drama, American policy makers crafted a last-minute deal to avoid toppling over the fiscal cliff – dealing with the tax issues, but merely delaying the resolution of spending cut issues for a couple of months.
- The European Central Bank offered up enough bandages/bailouts to satisfy immediate sovereign debt problems and provided comfort to investors with strong and aggressive policy action.
- **Despite negative headlines most global equity markets have generated positive returns in 2012.**
- In the fourth quarter the S&P500 held on to its earlier gains for a very strong annual return of 16% total return.
- Many European countries experienced significant market rallies as investors felt emboldened by improving economic conditions and supportive monetary policy action.
- Emerging market results were more mixed, but did better than developed markets overall.
- S&P/TSX Composite index underperformed many developed nations, weighed down by the resource sectors. Gold stocks in particular declined significantly during the fourth quarter.
- **Bond prices traded within a range and ended the year generating a return in-line with an income-only return.**
- Corporate bonds performed best as investors were willing to take on more risk in order to reach for greater yield.

POLICIES, POSTURING AND POLITICS

Global equity markets did not disappoint in 2012 (see Table 1), even amidst of a barrage of disconcerting challenges and threats to investor confidence, including:

- bouts of protests and political brinkmanship over sovereign debt problems in Europe and, most recently, the fiscal cliff in the U.S.
- persistently low interest rates and the need for stimulative/stabilizing central bank programs (e.g. a third round of quantitative easing in the U.S. and Europe's Outright Monetary Transactions program)
- major national elections and leadership changes (e.g. U.S., China, Greece, France, Egypt, Russia).

Beating most expectations for 2012, the S&P500 index advanced a solid 13% (16% total return when including re-invested dividends). The U.S. housing market continued to show signs of improvement, payroll numbers came in higher than expected and consumer confidence hit a multi-year high during the year. On a U.S. sector basis, the Financials sector led the gains, both for the fourth quarter and on an annual basis, as banks continued their restructuring efforts.

Table 1
Summary of major market developments

Market returns*	December	Q4 2012	YTD
S&P/TSX Composite	1.6%	0.9%	4.0%
S&P500	0.7%	-1.0%	13.4%
- in Canadian dollars	*0.9%*	*0.1%*	*11.0%*
MSCI EAFE	3.1%	7.1%	13.5%
- in Canadian dollars	*3.3%*	*7.4%*	*11.1%*
MSCI Emerging Markets	3.8%	5.0%	13.9%
DEX Universe Bond**	-0.1%	0.3%	3.6%
BBB Corporate Index**	0.1%	1.1%	7.7%

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

Table 2
Other price levels/change

	Level	December	YTD
U.S. dollar per Canadian dollar	$1.005	-0.2%	2.1%
Oil (West Texas)*	$91.88	3.4%	-7.2%
Gold*	$1,662	-3.2%	5.6%
Reuters/Jefferies CRB Index*	$295.01	-1.3%	-3.4%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX sector returns*	December	Q4 2012	YTD
S&P/TSX Composite	1.6%	0.9%	4.0%
Energy	0.9%	-1.5%	-3.6%
Materials	-0.2%	-7.0%	-6.9%
Industrials	3.4%	6.5%	12.7%
Consumer discretionary	3.9%	4.9%	18.7%
Consumer staples	5.6%	8.7%	20.4%
Health care	2.8%	3.4%	24.1%
Financials	2.1%	5.2%	12.8%
Information technology	1.2%	7.2%	-3.2%
Telecom services	1.1%	3.1%	6.4%
Utilities	3.1%	0.0%	-0.8%

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

Many European indices, such as Germany, France, and even besieged Greece, managed stellar 2012 returns in the 20%-plus range. European stock markets benefited from a significant rebound from weaker periods of performance, as well as improving economic conditions – allowing investors to see through the fog of policies, posturing and politics and focus more on the outlook for companies.

In comparison, the modest 4% rise (7% total return) of the S&P/TSX Composite index significantly trailed many other developed market indices. Disappointing earnings results, operational cost challenges and weakening demand expectations weighed on Canada's resource companies and their stock prices (see Table 3). Meanwhile, strength in the consumer sectors and financial companies highlighted a popular trend for 2012 – the attraction of dividend-paying and large-cap stocks – whose valuation levels are now becoming relatively expensive when compared to the market as a whole.

THE LOW-DOWN ON LOW YIELDS

Interest rates remained low in December, as they did for all of 2012. Central banks around the world stuck to the low rates and asset buying strategies. The Bank of Canada has held rates steady at 1% since September 2010 (the longest rate pause since the 1950s), but has been talking about the risk of forthcoming rate hikes since April 2012. At December 31, 2012, a 30-year Government of Canada bond offered a mere 2.37% annual yield for the privilege of borrowing your money for three decades!

In 2012 Canadian bond prices traded within a range and ended the year generating a return in-line with an income-only return (i.e. slight capital loss). Corporate bonds fared best as investors stretched for more yield, while short and mid-term federal government bonds experienced negative returns for the year.

Moving into 2013, investors should be mindful of the benefits and challenges of holding fixed income in their portfolio. At current yield levels, bonds prices face a significant headwind and are not without risk of underperforming investor expectations. Valuations (i.e. prices) of equities versus bonds favour equities going forward. But not to be forgotten are the steadfast benefits of fixed income: a portfolio stabilizer during times of market volatility, and an excellent diversification tool when combined with equities in a portfolio.

13TH HOUR DEAL KICKS OFF 2013

December was a politically charged month with ongoing uncertainty over the U.S. fiscal cliff dominating the markets. Ultimately, 2012 ended with the U.S. technically going over the fiscal cliff for a day before a thirteenth-hour compromise saw a partial resolution, with spending issues deferred for a couple of months down the road. In 2013 the effects of austerity measures within the U.S. and in Europe will place a strain on consumers and will bring with it some market volatility. In Canada, softening housing conditions and elevated debt-to-household-income levels will temper our domestic economic momentum, but exports should rebound with commodity demand.

Overall the global economy is entering the new year with positive momentum, mainly in the U.S. and China, which should help corporate earnings and support risk appetite early in 2013. Companies are in good shape, with strong 2012 profits, record cash levels, and very manageable debt levels. The question for 2013 will be whether investors can continue to focus on corporate fundamentals to drive their investment decisions with less distraction from remaining macro and government fiscal challenges.

GLC'S RESOLUTIONS TO A BETTER INVESTMENT-YOU IN 2013

Maintain a healthy weight. We're all made differently. Your ideal equities/bond portfolio weight is unique to you.

No extreme diets. Don't cut out all staples, like large-cap North American equities or core Canadian bond funds. It's often the boring stuff that helps you through volatile times.

Add variety. Some of the greatest foods come from faraway lands - same with companies. Consider adding a little foreign flavour to your investment menu.

Don't binge. 'All in' and 'all out' investment moves (i.e. market timing) is more likely to cause digestive upset than long-term financial benefit.

Moderation & designate a responsible friend. Too much of anything is not good. Set a limit for specialty funds and value personalized, professional advice – you can prevent a lot of damage by having someone to talk you through what seemed like a good idea the evening before.