Nick Mazer , Investment Advisor
BMO Nesbitt Burns

Financial Market Update

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Global Risks

Eurozone Crisis

Europe in Recession

US Fiscal Cliff

China

Iran

Oil Prices

Canadian Household Debt

- **It seems like all we have heard for the last few years is doom and gloom.**

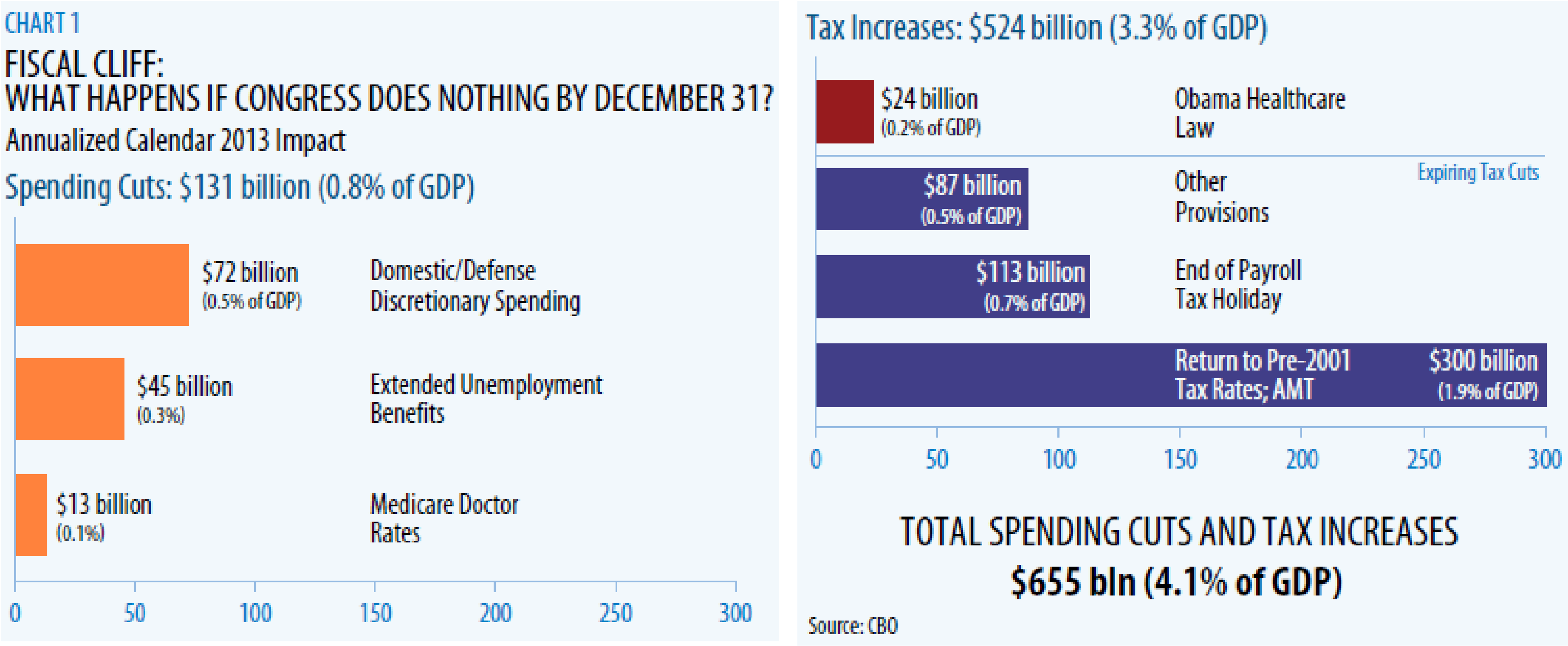
The Cliff

The Fiscal Cliff Explained

“Fiscal cliff” is the popular shorthand term used to describe the conundrum that the U.S. government will face at the end of 2012, when the terms of the Budget Control Act of 2011 are scheduled to go into effect.

Among the laws set to change at midnight on December 31, 2012, are the end of last year’s temporary payroll tax cuts (resulting in a 2% tax increase for workers), the end of certain tax breaks for businesses, shifts in the alternative minimum tax that would take a larger bite, the end of the tax cuts from 2001-2003, and the beginning of taxes related to President Obama’s health care law. At the same time, the spending cuts agreed upon as part of the debt ceiling deal of 2011 will begin to go into effect. According to *Barron's*, over 1,000 government programs - including the defense budget and Medicare are in line for “deep automatic cuts.”

What Happens If They Do Nothing?



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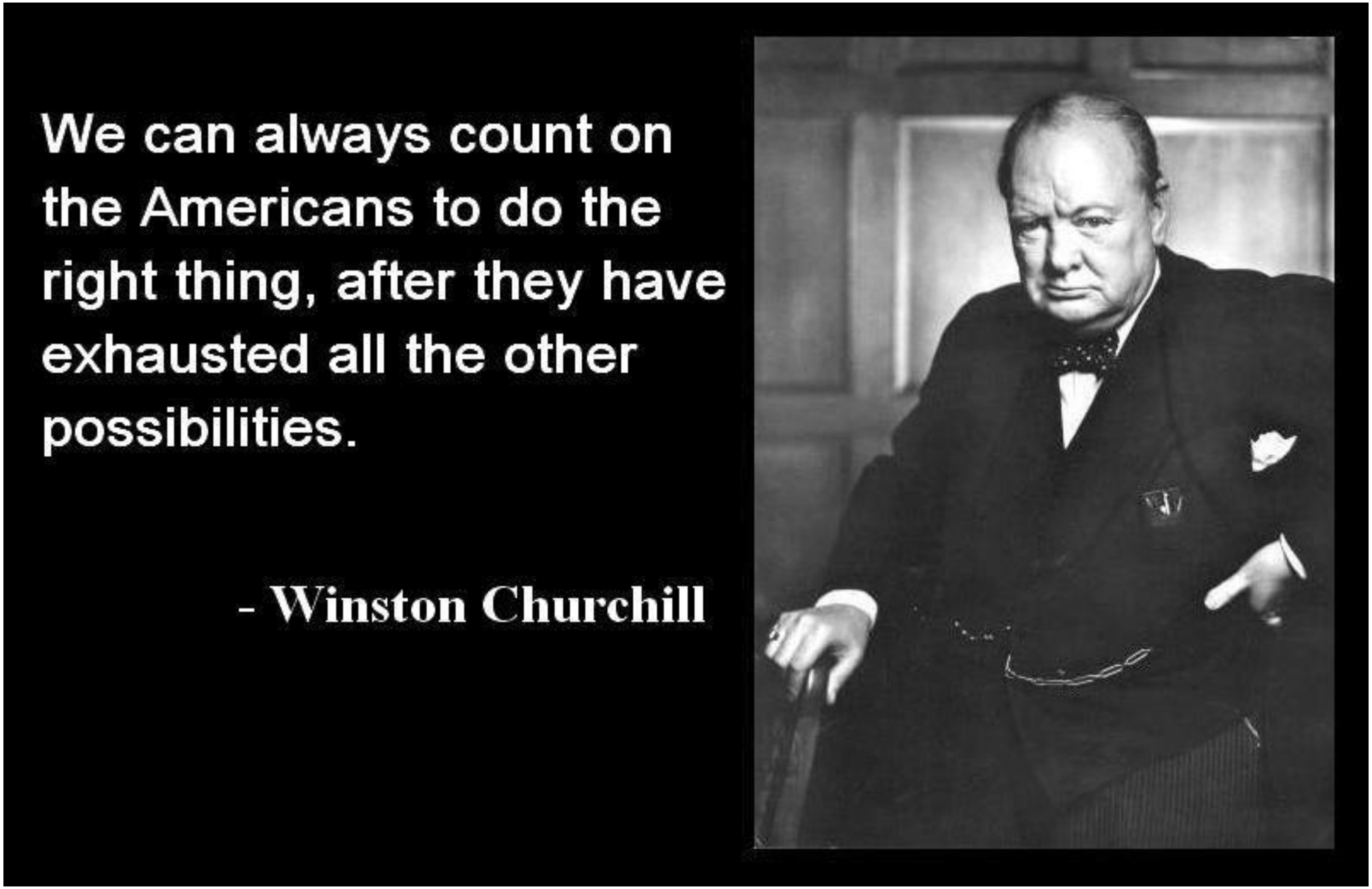
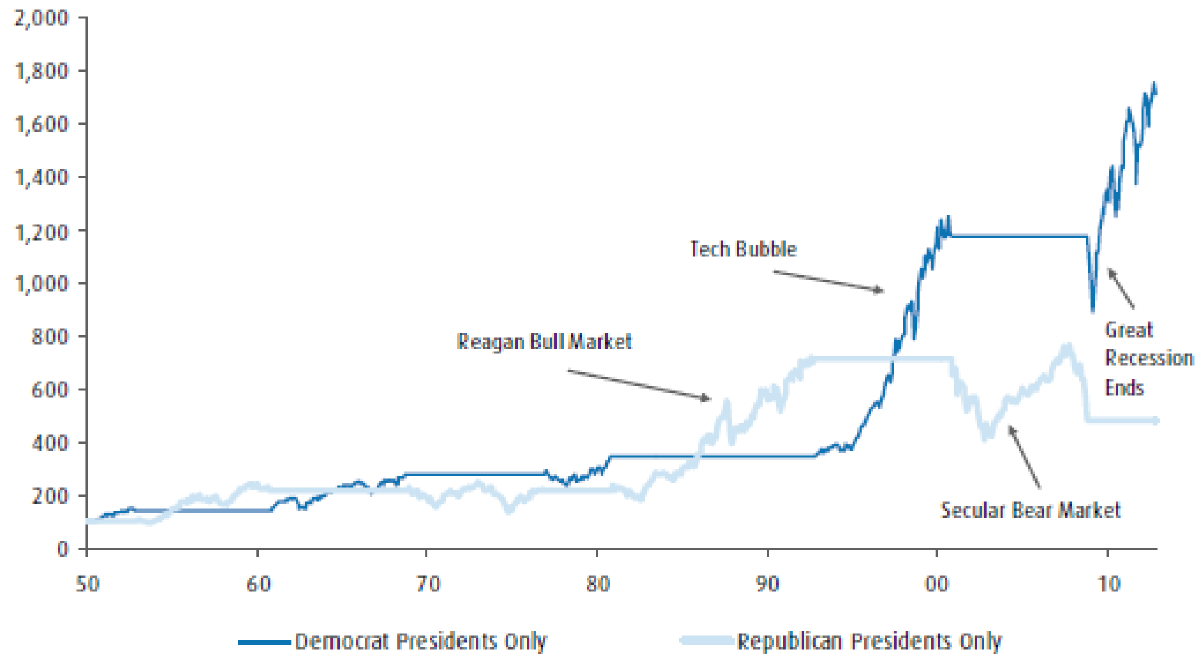
Do The Right Thing?



U.S. Election and the "Fiscal Cliff"

- As noted by our colleagues at BMO Capital Markets Economics, U.S. equity markets have outperformed under Democratic presidents rather than under Republican presidents.
- In 1950, investing US$100.00 in the S&P 500 would be worth about US$1,700.00 today (ex-dividends) if held only under Democrat leadership, or just US$482.00 if the same strategy was employed under Republicans.
- While we don't want to trivialize the "Fiscal Cliff, we believe there is a chance it could turn out to be this decade's Y2K for investors.
- We believe the intense focus on this issue implies that at least part of its impact is already discounted in equity valuations. In other words, if BMO CM Economics is correct in its 1.5% tightening base case, then we believe the economy and equity market can withstand this drag.

Figure 7: S&P 500: Republicans vs. Democrats (Value of US$100 invested at the start of 1950)



Source: Bloomberg

[2] The "fiscal cliff" is the accumulation of a long list of specific tax increases and spending reductions pre-programmed for the beginning of 2013. BMO's Economics Team estimates that the net fiscal tightening could be 4-1/2% of GDP in a worst-case scenario but their base case assumption is that ultimately policymakers come to a reasonable agreement, which would entail about 1-1/2% of GDP of net tightening.

Canada

ECONOMIC FORECAST SUMMARY FOR NOVEMBER 9, 2012

BMO Capital Markets Economic Research

	2012				2013				ANNUAL		
CANADA	I	II	III	IV	I	II	III	IV	2011	2012	2013
Real GDP (q/q % chng : a.r.)	1.8	1.9	1.0	1.9	1.8	2.3	2.4	2.5	2.6	2.1	2.0
Consumer Price Index (y/y % chng)	2.3	1.6	1.2	1.3	1.3	1.7	2.1	1.9	2.9	1.6	1.8
Unemployment Rate (%)	7.4	7.2	7.3	7.4	7.4	7.4	7.3	7.2	7.5	7.3	7.3
Housing Starts (000s : a.r.)	206	231	222	200 ↓	195	190	188	187	195	215	190
Current Account Balance ($blns : a.r.)	-59.8	-73.5	-80.0 ↓	-74.8 ↓	-75.3 ↓	-76.1 ↓	-76.5 ↓	-76.2 ↓	-52.3	-72.0 ↓	-76.0 ↓
Interest Rates (average for the quarter : %)											
Overnight Rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.00	1.00	1.06
3-month Treasury Bill	0.88	0.95	0.97	0.99	0.99	0.99	0.99	1.24	0.91	0.95	1.05
10-year Bond	2.04	1.91	1.78	1.79	1.76	1.83	1.96	2.11	2.78	1.88	1.92

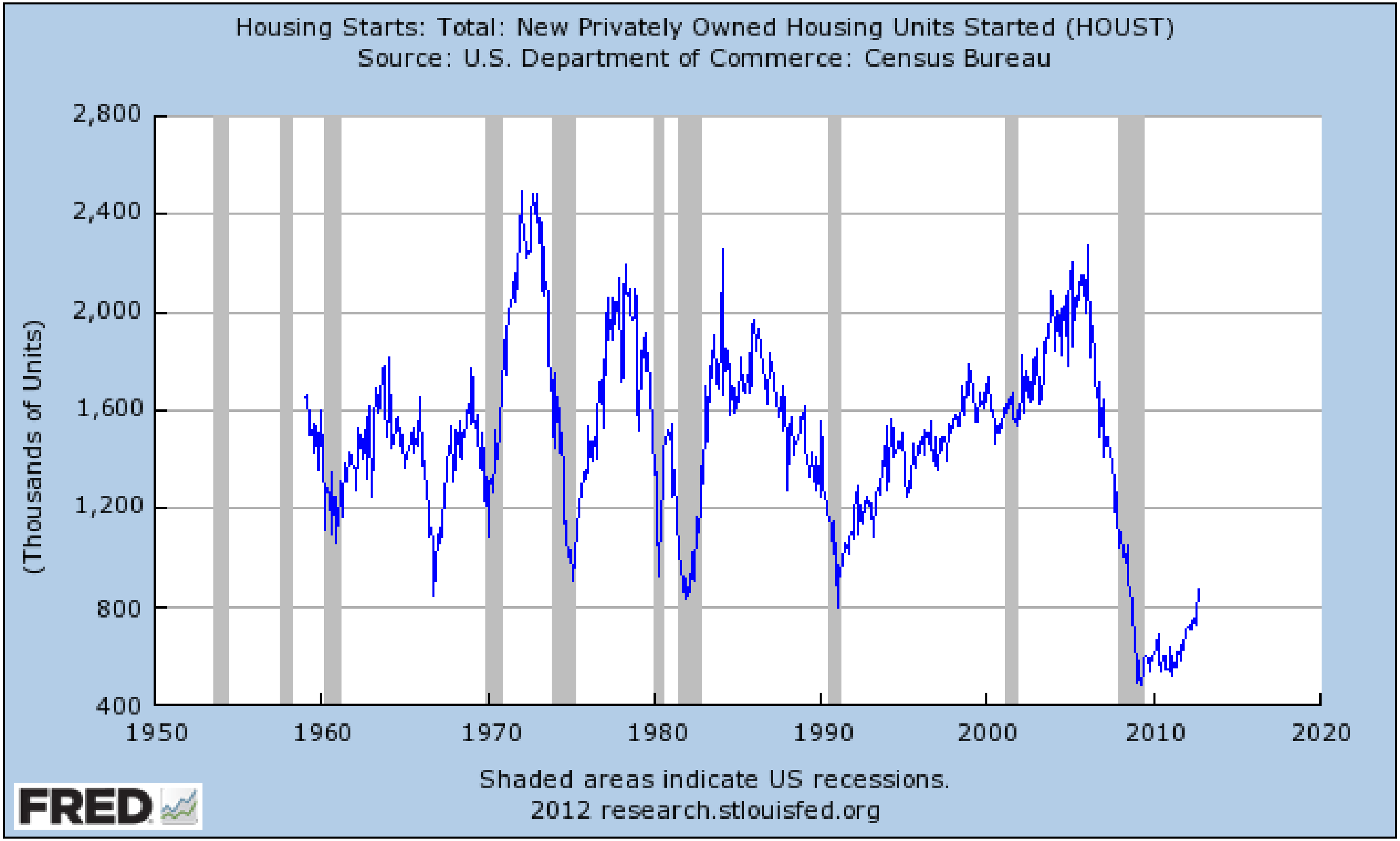
United States

ECONOMIC FORECAST SUMMARY FOR NOVEMBER 9, 2012

BMO Capital Markets Economic Research

	2012				2013				ANNUAL		
UNITED STATES	I	II	III	IV	I	II	III	IV	2011	2012	2013
Real GDP (q/q % chng : a.r.)	2.0	1.3	2.0	2.2	1.7	2.7	3.2	3.3	1.8	2.2	2.3
Consumer Price Index (y/y % chng)	2.8	1.9	1.7	2.3	2.3	2.7	2.6	2.1	3.1	2.2	2.4
Unemployment Rate (%)	8.2	8.2	8.1	7.9	7.8	7.8	7.6	7.5	8.9	8.1	7.7
Housing Starts (mlns : a.r.)	0.71	0.74	0.79	0.85	0.87	0.89	0.91	0.94	0.61	0.77	0.90
Current Account Balance ($blns : a.r.)	-534	-470	-481	-456	-440	-433	-428	-418	-466	-485	-430
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
3-month Treasury Bill	0.07	0.09	0.10	0.09	0.09	0.09	0.09	0.09	0.05	0.09	0.09
10-year Note	2.04	1.82	1.64	1.75	1.68	1.73	1.84	1.96	2.79	1.81	1.80

U.S. Housing Starts



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Why I'm Bullish about the U.S. Economy

Dr. Sherry Cooper

November 16, 2012

Executive Vice-President and Chief Economist,
BMO Financial Group

I have long thought that the next four years would be a gift to the next president, regardless of who won the election, just as the past four years were a nightmare. Underlying U.S. fundamentals are strong going forward, despite what will be an intense period of contentious negotiation over the fiscal cliff. The U.S. economy still has a long way to go to reach full employment, so there are no capacity constraints or prospects of Federal Reserve tightening. Instead, pent-up demand is huge and consumer confidence is rising sharply.

The jobs market has improved and that improvement will accelerate as the uncertainties associated with the federal budget dilemmas are resolved. By the middle of next year, a fiscal plan will have emerged that puts the U.S. budget on a sustainable path. Hopefully, learning from the lessons of Europe, the austerity will be measured.

Why I'm Bullish about the U.S. Economy, cont'd

Housing is finally recovering and construction jobs will follow the recent pickup in homebuilding activity—a powerful stimulant with many ripple effects throughout the economy. House prices are rising and inventories of unsold homes are down, while sales are up as housing affordability has hit its most favourable level in over forty years. Mortgage rates are at extreme lows and mortgage money is more readily available. Household formation is rising and first-time homebuyers will be the big winners, and foreign demand for U.S. residential real estate is strong, especially from Canada.

The U.S. trade picture has improved considerably despite a slowdown in Europe, Asia and Canada. The U.S. dollar is down, American labour costs are very competitive and technological advance has added to productivity. Importantly, as well, U.S. energy costs are low.

The shale gas and oil revolution has fired up an American industrial revival, breathing new life into businesses such as petrochemicals and glass, steel and plastics. Many environmental issues have yet to be resolved, but natural gas prices in the U.S. market have fallen to a fraction of what they are in Europe and Asia. This has translated into significantly lower costs of electricity generation to power industrial plants, reducing the

Why I'm Bullish about the U.S. Economy, cont'd

costs of producing solvents, plastics, paints, packaging, dyes, inks, lubricants and many other products.

Manufacturing is now expanding in the U.S. and this, along with a housing revival, bodes well for stepped up job creation. Employment in the chemical industry, for example, is in the early stages of a major revival. Companies such as Dow Chemical, CF Industries (ammonia and urea units) and Methanex are building new U.S. operations, 'reshoring' production. And with more plastic produced in the U.S., domestically produced toys, household goods, and even computers could replace imports, avoiding the costs of transportation and the risk of intellectual property infringements. Foreign manufacturers are also setting up shop in the U.S. and many more are eying the U.S. market as municipalities compete, offering financial incentives to attract large employers.

Consumers have already stepped up spending after years of belt-tightening and deleveraging. Auto sales and production are strong, retail sales have increased and business confidence will improve with the resolution of the fiscal drama. Today, the boomers are beginning to leave the workforce and the participation rate of women has

Why I'm Bullish about the U.S. Economy, cont'd

stabilized, so potential growth is probably no more than 3% or somewhat less, but that level of growth will go a long way towards making the President's second term a lot more buoyant than his first.

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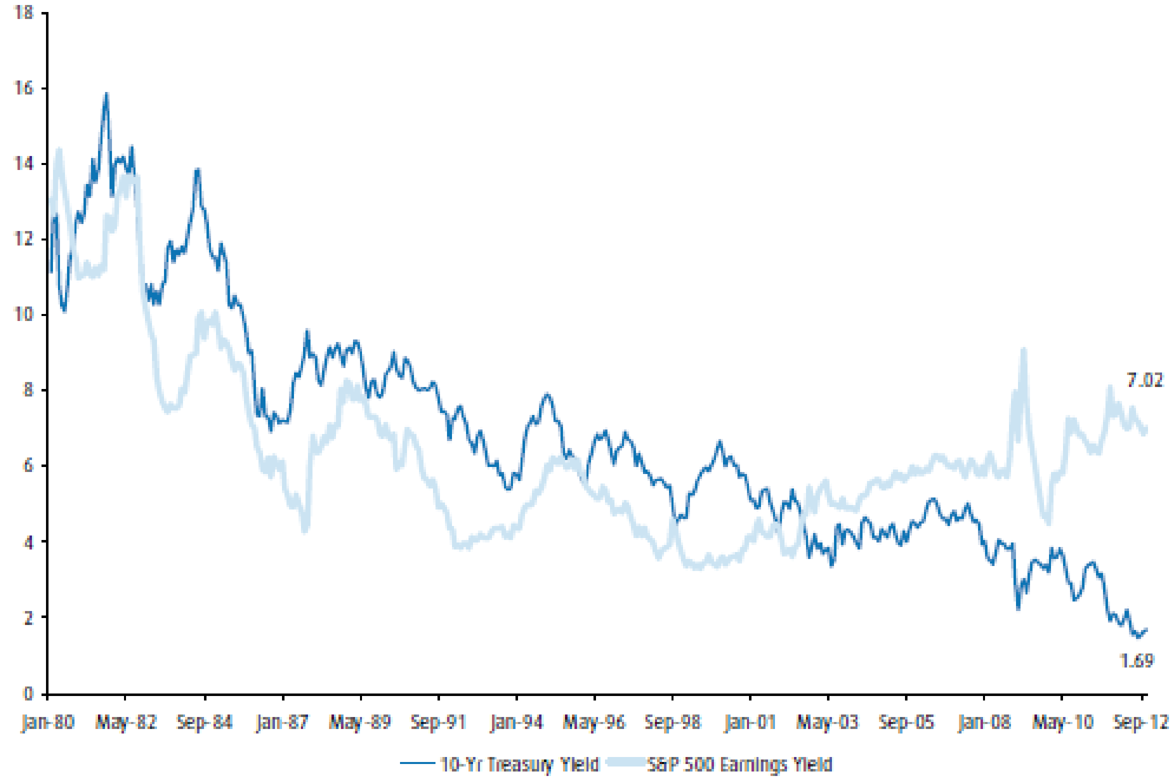
Equity Market Valuations: Still Advantage Equities

- Stocks continue to be inexpensive in absolute terms given robust corporate earnings and cash flow trends.
- Stocks also appear compelling relative to government bonds both in Canada and the U.S.
- In the last decade, the spread between the S&P 500 earnings yield (7.0%) and 10-year U.S. government bonds (1.7%) was only this wide[3] during the recession of 2008/2009, which turned out to be a great entry point for investors.

Figure 16: S&P Earnings Yield versus 10-year Treasury Bond Yield



Source: Bloomberg

[3] A wider spread indicates stocks are cheap versus bonds.

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Equity Market Valuations: Still Advantage Equities

- The TSX dividend yield is considerably higher than 10-year government bond yields, which is again something we only saw during 2008 and in the mid-50s. In other words, the relative value of stocks versus bonds is as good as it's ever been in the last 60 years!
- Looking at multiples, valuations are inexpensive with both the TSX and S&P trading at around 12x forward expected earnings. This is low by historical standards and is particularly attractive considering the current very-low rate environment.

Figure 17: TSX Earnings Yield versus 10-year Canada Yield

Source: Bloomberg

Comparing the Indexes

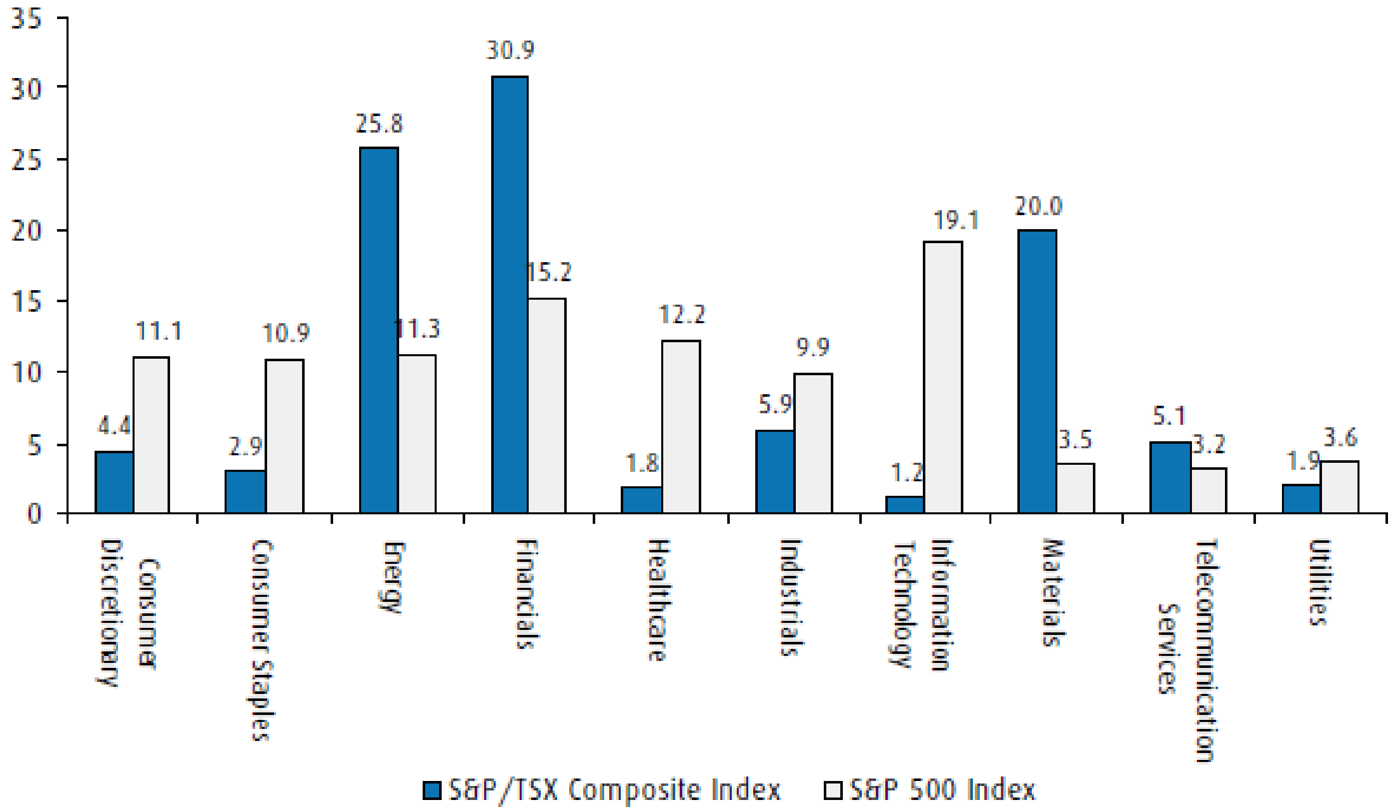
Sept. 15, 2008 to Nov. 15, 2012

- **S&P 500 (Black)**
- **S&P/TSX (Blue)**
- **S&P/TSX Energy Index (Gold)**

Sector Weights: Canada vs. United States

Sector Weights (as of October 31, 2012)

Figure 15: S&P/TSX Composite Index and S&P 500 Index Sector Weights



Source: Bloomberg

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Canada or the U.S.

Sector	Canada or US	Comment
Consumer Discretionary	US	Broader selection of high and low end themes
Consumer Staples	US	Much more stable earnings with expansive global footprint
Energy	US	US integrated oil companies offer higher yields and cash flow; Canada E&P has higher growth
Financials	Canada	Superior management and business models in Canada; higher dividend yields and much more consistent ROE
Health Care	US	Industry diversification and yield
Industrials	US	Higher cash flow and broader industry diversification
Info Tech	US	Defined structural tone of US markets with stable earnings and expansive cash flow
Materials	Canada	Better longer-term growth and product offering in Canada, although near-term earnings weakness is likely
Telecom	Canada	Slightly better yields and diversification in Canada
Utilities	US	Mildly better yields in US; Canadian valuations are quite high
TSX vs. SPX	**US**	**We believe the US provides broader diversification, much more stable earnings and steady cash flow with ability to increase dividend payouts. While Canadian payout ratios will likely increase as well, it is way out front of US in terms of dividends, which we view as a major positive.**

What I Do For My Clients

- **Help people retire**
- **Guide them through good and bad markets**
- **Construct portfolios that meet client's needs whether that is capital preservation, income or growth**
- **17 years of experience**
- **I haven't seen it all but: 2000 Tech Meltdown, 9-11 Attacks, $0.65U Loonie, 2008 Financial Crisis**

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