

ECONOMIC AND MARKET COMMENTARY DECEMBER 31, 2011

THE QUARTER IN REVIEW

About the best that one can say about 2011 is that it is now history – and for investors globally it certainly will go down in the history books. Volatility in 2011 was almost unprecedented driven by a series of exogenous shocks – shocks from mother nature (Japan earthquake and subsequent tsunami) and geopolitical / macroeconomic shocks from – unrest in the Middle East, the debt ceiling crisis and subsequent credit downgrade in the US, and

the lingering European sovereign debt crisis. Even the natural disaster shock reverberated economically, especially in the auto industry, as production was impacted by declining inventories due to the tsunami. The equity markets in the last half were caught in a tug of war between hope and fear as investors tried to cope with the various crises, especially in Europe. And yet, surprisingly all major markets finished the fourth quarter on a positive note.

Returns for Major Indices to December 31, 2011						
	Qtr	YTD	1 Yr.	3 Yrs.	5 Yrs.	10 Yrs.
S&P/TSX Composite	3.6	-8.7	-8.7	-1.8	4.3	3.0
S&P/TSX 60	2.8	-9.1	-9.1	11.0	0.9	6.8
S&P 500 \$CAD	9.5	4.4	4.4	7.3	-2.9	-1.6
S&P 500	11.8	2.1	2.1	14.1	-0.3	2.9
MSCI EAFE \$CAD	1.2	-9.8	-9.8	1.7	-6.8	0.5
MSCI World \$CAD	5.5	-2.9	-2.9	5.0	-4.5	-0.4
MSCI Emerging Markets \$CAD	2.3	-16.3	-16.3	13.2	-0.1	9.2
DEX Universe	2.1	9.7	9.7	7.0	6.2	6.4
DEX Short-Term Bond	0.5	4.7	4.7	4.3	5.1	4.8
CitiGroup WGBI \$CAD	-2.2	8.8	8.8	-1.6	4.3	3.0
DEX 91 Day T-Bill	0.2	1.0	1.0	0.7	1.9	2.4
HFRI FOF Diversified Index	-0.4	-4.9	-4.9	3.8	-0.6	--

The biggest surprise for most investors at the end of the fourth quarter was the almost 12% rise in the S&P 500 in US dollars! With politics dominating the headlines and the Republicans in the early stages of election primaries, it was easy to be waylaid by dire headline news – almost running under the radar was the good news emanating from US companies

throughout 2011 with better than expected earnings. The strength in the fourth quarter was enough to move the US into positive territory for the full year at 2.1%. (Interesting factoid – without dividends the S&P 500 was flat for the year – for the first time since 1947.) For Canadian investors the S&P 500 was up 4.4% for the year reflecting the modest

depreciation of the Canadian dollar to the US dollar.

All other equity markets ended the year in negative territory.

The broad Canadian market (S&P/TSX Composite) was up a more modest 3.6% in the fourth quarter although it was not enough to erase the negative returns of the third and fourth quarter. As a result the Canadian market was down almost 9% for the year.

For the last ten years, in local currency terms both the Canadian and US markets have returned a rather anemic 3%. (In Canadian dollar terms the US market is -1.6% over ten years reflecting the appreciation of the Canadian dollar.) As we mentioned in the Second Quarter 2010 commentary we are in a sustained period of market malaise and these anemic returns reflect that malaise. We further noted in the same commentary that the S&P/TSX composite index was having a hard time breaking above 12,000 – a not dissimilar situation to most of the 4th quarter!

International markets also closed the year on a positive note with the MSCI World Index (includes both North American and developed international markets) up 5.5% propelled by the US component. The developed international markets as represented by MSCI EAFE were up a very modest 1.2% in Canadian dollars while the emerging markets (MSCI Emerging Markets) were also up modestly at 2.3%. But notably, over the course of the year, emerging markets fell 16% as their governments (especially China) grappled with overheating economies, rising inflation resulting in monetary tightening.

There is a growing belief (supported by demographics) that the world is in the midst of a structural shift between the developed world and the developing world. As the tag line for a current HSBC newspaper advertisement (Globe and Mail, January 12, 2011) asserts: ***“In the future, there will be no markets left waiting to***

emerge”. The advertisement further notes that: “Even as soon as 2050, 19 of the top 30 economies by GDP are forecast to be countries that we currently describe as emerging.” It is notable therefore that over the past 10 years, unlike the developed world, emerging markets rose a healthy 9.2%.

Bonds for the first time in many quarters lagged the equity markets in the fourth quarter with longer-dated bonds outperforming shorter-dated bonds – this dispersion is reflected in the return for the Dex Universe index (duration of 6.9 years) which increased 2.1% versus the Dex Short-term Bond index (duration of 2.7 years) which barely registered a positive increase at 0.5%. Essentially what this total return means is that the price of short-term bonds declined but the coupons (average 3.55%) allowed the index to register a small gain. Global bonds were down on the quarter at -2.2% in Canadian dollars and 0.12% in US dollars.

PLUS ÇA CHANGE, PLUS ÇA RESTE LA MÊME.....

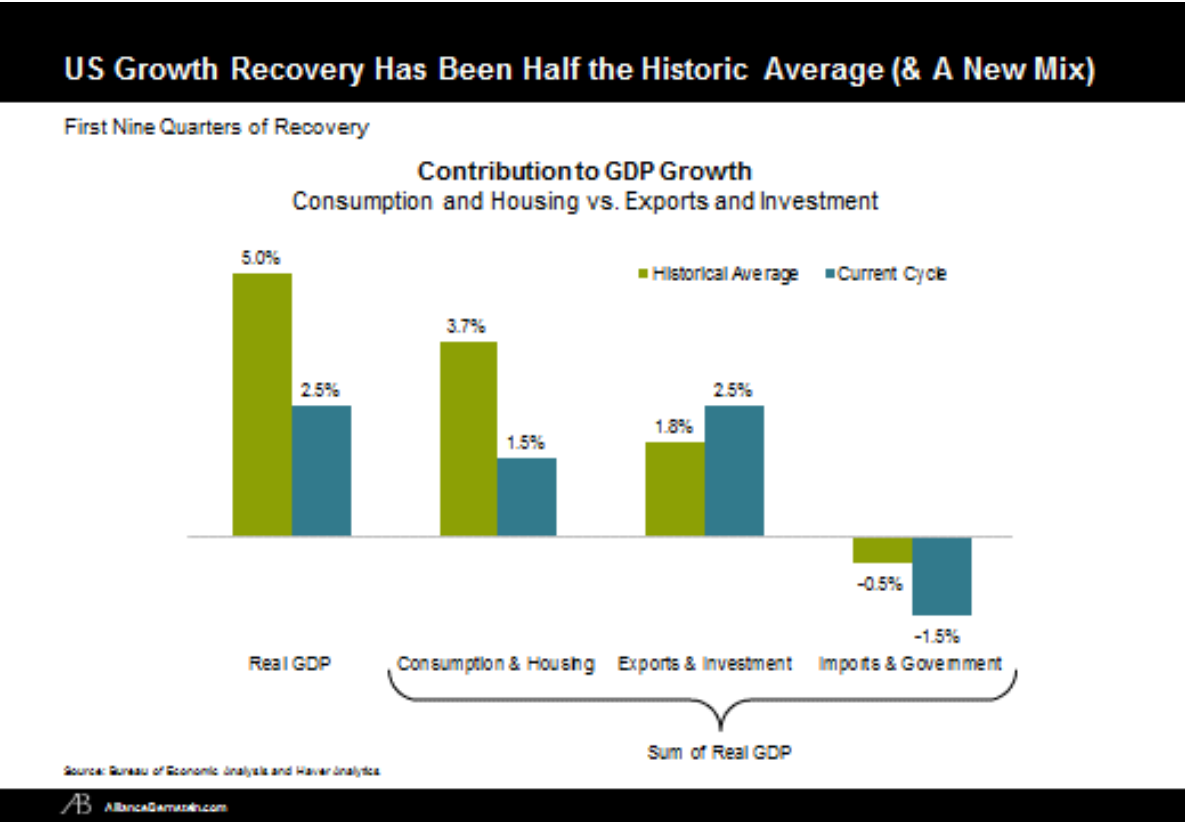
The headwinds in the fourth quarter at times felt gale force as the European sovereign debt crisis and looming banking crisis continued unabated. Markets fought to establish traction in the face of an unrelenting sea of negative headlines - Greece and the prospect of default, the Middle East and the prospect of continued social unrest as well as Iran and its nuclear ambitions, Italy’s success in having Berlusconi depart government and then challenged by 10 year bond yields breaching 7%, the increase in yields in Spain and France, the introduction of severe fiscal austerity measures, especially in the peripheral European countries with the very real possibility of pronounced social discontent, amongst others.

And yet through it all, almost overshadowed by the political rhetoric of a pre-election year, and certainly overshadowed by Europe, the US economy added jobs, US corporate profits

grew, corporate balance sheets were healthy, the American consumer maintained a reasonable spending pattern and the US equity market rebounded soundly. Who would have thought that likely as we progressed through the quarter? And the consensus forecast for 2012 is GDP growth at 3% - not stellar but certainly on the right track with many economists suggesting that the surprise could be to the upside.

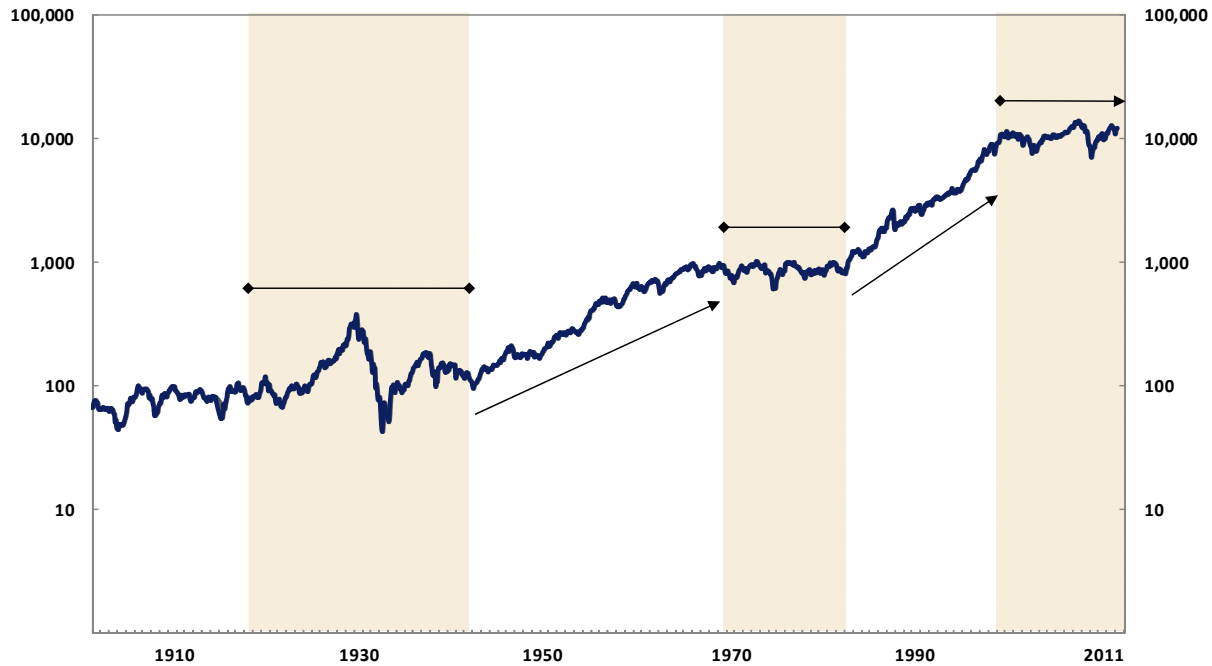
We noted last quarter that growth can only come from three areas – companies, consumers or governments. The chart below courtesy of

Alliance Bernstein shows that not only has US GDP growth in the nine quarters post the bottom of the Great Recession been half the historic rate but that the sources of growth have been remarkably different. Historically, the typical recovery is led by the consumer (consumption and housing); this time as consumers worked to repair their personal balance sheets and the housing crisis continued to unfold, corporations stepped up to the plate as exports and investments largely accounted for the growth in Real GDP – something which Alliance Bernstein noted has been unprecedented since World War II.



Nonetheless, it is challenging to see how the US can enter a sustained period of economic recovery with its debt overhang and its looming fiscal crisis. As we noted last quarter, secular bear markets generally last 17 years and reflect major structural shifts in economies; they last until the structural changes have been effected. We noted this historical pattern of growth followed by trending markets in the 2nd Quarter 2010 Commentary. In the chart on the following page the shaded areas represent the periods of adjustment.

Dow Jones Industrial Average (1901 to 2011)



Source: Bloomberg

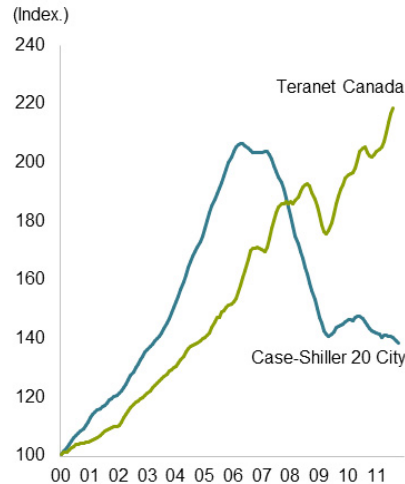
A year and a half later and little has changed – the developed markets continue to trend as their governments cope with rising and increasingly unsustainable debt and worsening fiscal positions. While it might appear, with the relatively constructive news from the US that the worst is over, they are not out of the woods. The US faces a fractured political system, politicians that seem more concerned with rhetoric and with slaying the enemy (inside or outside their respective political parties) than with constructively working together to repair a growing fiscal and monetary crisis. They can certainly push the ball down the road (highly likely in an election year!) with short-term fixes but the ball will not disappear – at some point in the not-to-distant future, the US must address their major revenue and expenditure dislocation and the accompanying debt crisis. And when they do so, the resulting indigestion

will have the potential to cause extreme market dislocation – both equity and debt. Canada will not be immune given our close proximity to the US. While exports from our rich commodity base to the developing world has helped to shelter us these past few years, we are not immune to events south of our border – nor is the rest of the world.

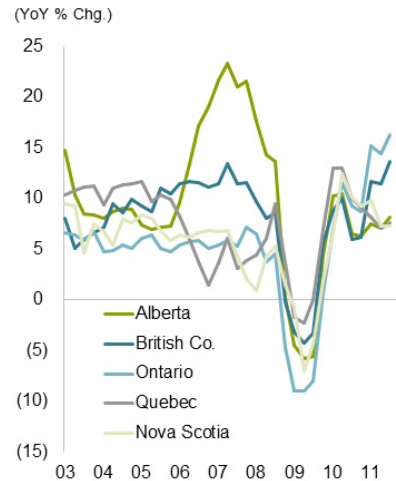
Canada escaped the Great Recession relatively unscathed particularly the meltdown in housing that roiled the US economy. However Mark Carney, the Governor of the Bank of Canada has begun making regular pronouncements that Canada is vulnerable to its own housing bubble. The chart on the following page also courtesy of Alliance Bernstein highlights the discrepancy between US and Canadian house prices lending support to Mr. Carney's view.

Canada: Home Prices Keep Rising


Canadian Existing Home Prices



Canadian Credit Leverage



Source: Bank of Canada, Bloomberg and Haver Analytics

 AllianceBernstein.com

Not that anyone expects to see a collapse in housing in this country to the extent faced by the US with its ultimately profound impact on their economy but rather that the trajectory in Canadian house prices is unsustainable. And, moreover, that Canadians are vulnerable when interest rates rise given our degree of leverage. Europe? What is there to say about Europe that is not already covered daily?

While the economic, political, cultural problems seem almost intractable and while there are many who have questioned the rather lacklustre role of the ECB, progress (albeit of a snail-like pace) appears to be being made. Nonetheless, the threats to the Euro and the EU are real. The challenge for Europe is that the EU and the Euro were political constructs with economic ramifications. In hindsight it is hard to imagine how the Maastricht Treaty could have been developed without a binding fiscal contract amongst the treaty nations. Certainly the fiscal deficiencies of the union have become horribly visible in the past year. But it is perhaps challenging for us in North America to

understand the magnitude of the cultural differences amongst the 17 nations and the profound political will that was required to overcome those differences to create the economic union and the common currency. It is hard to believe that the same political will does not exist today to keep the union and the currency in place in some form or another with the important addition of a fiscal contract. This quarter we have included comments from our Credit Opportunity Manager for whom the banking crisis in Europe presents investment opportunity.

CREDIT OPPORTUNITY MANAGER

"The European Markets are clearly and unambiguously the focal point of Global Markets concern. Of paramount importance is the ability of the European Banking system to endure the stress that mounting losses will entail. To provide some perspective here, let's take a look at the collective exposure of BNP

Paribas, Dexia and Societe General (the 3 banks with the largest exposures) to Greece.

These 3 banks have collective exposures of \$16 Billion. To date they have written down half of this debt. It is worth noting that this \$8 Billion in writedowns is roughly half the collective earnings of these three banks in 2010. While additional writedowns to Greece and or other European sovereigns will further deplete the earnings of these banks, we are comforted by the fact that the prognosis for the three most vulnerable banks does not appear catastrophic. Disabled banks can be rescued through M&A (Japan being an obvious case in point). Security can be taken when the issues are with individual banks rather than a banking system. While the French banks are the most heavily exposed in the stress testing conducted by the European Banking Authority, all the French banks passed. This testing explored the ongoing viability of European banks given prevailing capital bases under significant shock scenarios (4% decline in GDP, 15% decline in European equity markets, losses equating to those of 2009 occurring for consecutive years etc). Passing constituted not having the banks' Tier 1 capital ratios fall below 5%.

The central banks and bank regulatory authorities have taken a number of steps to shore up the respective European Banking Systems though one can fairly question what took them so long. Some of the measures they have taken include:

- Requiring European Banks to have Tier 1 capital ratios of at least 9% by the end of 2012. Under Basle II, the standard which applied in 2008 and much of 2009, this ratio was 2%.*
- The ECB cut the rate at which it will lend to European Banks to 1%. In the last week of 2011 alone they lent in excess of Eur 1/2 Trillion to European Banks for three years. While it is hoped that this will keep banks lending throughout the system, even if the*

borrowing banks with these funds buy longer dated government bonds issued by, for instance, the German & French Governments - the earnings from the traditional "carry trade" will help to further enhance their respective capital bases.

- The Fed and ECB announced a joint program to provide \$750 Billion of short term funding to European Banks. What is most relevant here is not the size of the program but the currency in which it is denominated. Given the exposures that American banks have to the European Banking system, programs of this nature are both predictable and comforting. Similar support from other central banks can certainly be expected.*
- Serious discussion is under way regarding the guaranteeing of senior debt issued by European banks before 2013. Whether a sovereign is guaranteeing this debt or purchasing this debt, this explicit support helps to restore private sector confidence. This action is philosophically not dissimilar from the quantitative easing undertaken by the Fed. While this stimulus may be inflationary it nevertheless is very compelling as a means by which to combat market concerns relating to Europe.*

The prolific capital needs of banks globally greatly enhances the attractiveness of the opportunities to invest in the structures which Orchard originates that release Tier 1 capital being held in reserve by banks against core earnings-driving asset pools. It enables Orchard to be very selective on the bank counterparties we work with and the specific asset pools we take exposure to. It also provides us with great leverage as we negotiate structural risk mitigants and pricing. The commitment which countries have to ensure that their banking systems continue to function seamlessly is clear and profound as can be inferred from the measures cited above."

It is apparent that Europe continues to offer significant downside tail risk to global markets, both in the short-term and the long-term. The EU and Euro crisis will not be fixed overnight. Politicians are driving the bus called Reform and politicians don't always act rationally or constructively. Caution and prudence continue to be our watchwords.

As always, we welcome your comments.



Audrey Robinson,
Chief Investment Officer
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CONTACT US

If you are interested in learning more about WaterStreet and our unique approach to architecting investment portfolios, please contact us at the numbers below.

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