

# FORGING AHEAD

Our investment experts share their outlook on global markets in 2012



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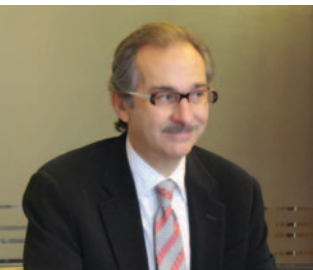
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## WHAT IS YOUR GENERAL OUTLOOK FOR GLOBAL MARKETS IN 2012?

■ **Patricia Perez-Coutts:** My expectation is that throughout 2012 we will probably see more volatility in emerging markets, simply because the European crisis has not yet been resolved. This lack of resolution means that there will potentially be more market upheaval, including in emerging markets as well. There is a bright spot, however, specifically that of earnings in emerging market companies as well as steadiness in U.S. equity markets. In conjunction, these factors may result in more favourable market conditions towards the end of 2012.

■ **Tony Genua:** In my opinion, the markets are going to work their way higher during the course of 2012. While these improvements will be a welcome relief for investors, less welcome will be the continued levels of volatility, albeit at a smaller scale than what we experienced in 2011.



*“Although we will likely not see a complete resolution of the situation in Europe in 2012, we expect to see significant steps taken that should result in some corresponding relief in the markets.” – Tony Genua*

The second half of 2011 exhibited more volatility than we have seen in almost 60 years. There are two reasons behind the dramatic fluctuations experienced by the markets in 2011. One is uncertainty over sovereign debt in Europe. The second reason is the market perception that the movement we have seen towards economic growth in the U.S. is not sustainable. With regards to the sovereign debt crisis, it took a lot of time to form the imbalances in Europe, and similarly it will take some time to correct them, which will require significant action from European policymakers. Although we will likely not see a complete resolution of the situation in Europe in 2012, we expect to see significant steps taken that should result in some corresponding relief in the markets.

Turning to U.S. economic growth, we have seen an acceleration in economic growth in 2011. I expect growth to continue to be solid and maintain an upward (but not above average) trajectory during the course of 2012. I think the U.S. stock market will be supported by higher profits and strong, record-level corporate earnings.

■ **Bob Lyon:** The global economy continues to face strong headwinds as a result of stubbornly high unemployment levels in developed economies and the lack of a co-ordinated restructuring plan in Europe. I think this uncertainty will continue to frustrate investors, and continue to drive volatility in 2012.

While global growth may be slowing, it is likely to remain positive. In the U.S., the Federal Reserve has anchored monetary policy expectations with a pledge to keep short-term rates near zero until 2013, and central banks throughout most emerging economies have relaxed monetary policies. Barring a deep economic downturn, we believe demand growth from emerging economies and slower, albeit still positive, growth from developed economies will bode well for the global markets in 2012 and be supportive of stronger commodity prices.

■ **Steve Way:** The likelihood of a global recession appears to be unwarranted at this juncture; however, we expect a period of muted but positive growth in most parts of the world. Growth challenges for Europe will likely persist for some time. In fact, a recession is anticipated for next year. It is essential that a political consensus be reached to manage the growing sovereign-debt contagion and restore confidence in the region. There needs to be a comprehensive solution which may include further writedowns of debt, a re-capitalization of the European banking sector, more aggressive action from the European Central Bank, and prudent and unified fiscal policies. All of these are required for the survival of the Eurozone and to improve longer-term growth prospects.



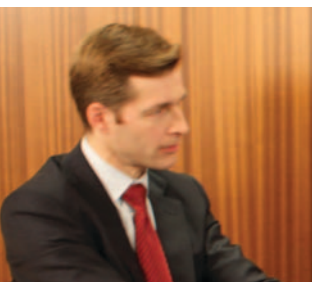
*“It is my view that investors should stay invested, or risk missing some of the significant short-term recoveries that may occur amidst the uncertainty.” – Stephen Way*

So far, the steps announced have failed to exceed market expectations, adding to the uncertainty. The U.S., on the other hand, has provided some positive surprises, and remains on track to achieve positive growth of about 2% as unemployment continues to stabilize. In the broader developed world, monetary policies remain very accommodative; however, obstacles to growth remain from fiscal austerity measures and persistently high levels of consumer debt and unemployment. Fears of a hard landing in China have once again intensified, but there is evidence of only a moderation in growth at this time. Despite this possible slowdown, it is my view that investors should stay invested, or risk missing some of the significant short-term recoveries that may occur amidst the uncertainty.



**WHAT IS YOUR 2012 OUTLOOK FROM A FIXED INCOME PERSPECTIVE, AND WHAT DIRECTION DO YOU SEE INTEREST RATES MOVING IN?**

■ **David Stonehouse:** Fixed income was the place to be in 2011. However, as we have already identified, there are some near-term overhangs spilling over from 2011 into 2012. Chief among these is the European sovereign debt crisis, and while uncertainty reigns in that area, we should continue to see a lid kept on government bond yields with short-term support for bond prices arising from the challenges presented by the global economy. Overall, we do feel that the prospects for the global economy are gradually improving. If we are able to work our way through some of the issues we've been facing such as deceleration in some of the emerging economies, challenges that arose in the North American economies over the summer of 2011 that appear to have abated slightly and of course the situation in Europe, then prospects can improve over the course of 2012. As a result, we are unlikely to see government bonds perform as well as they did in 2011. The current period may be similar to government bond performance three years ago, which had been tremendous for bonds, followed by a period of lacklustre performance. Over the course of the year, we expect that investors may start to favour equities a little more.



*“Overall, we do feel that the prospects for the global economy are gradually improving.” – David Stonehouse*



**THERE CONTINUES TO BE CONCERNS ABOUT SOVEREIGN DEBT LEVELS IN EUROPE AND LACKLUSTRE GROWTH IN KEY GLOBAL MARKETS. HOW DO YOU SEE THIS PLAYING OUT IN THE COMING MONTHS?**

■ **Rory Flynn:** The Eurozone's gross domestic product (GDP) has grown for nine straight quarters. However, growth levels have slowed to just 0.2% over the past two quarters and are teetering dangerously close to negative levels. As such, we can continue to expect lacklustre growth in Europe until there is more clarity around a solution to the region's debt crisis, the timing of which is uncertain at the moment.

We can likely expect muted growth in GDP, which increases the probability that the Eurozone economy tips into a mild recession. The good news is that if there is a recession in the Eurozone, we do not expect it to be deep or prolonged. Expect greater fiscal integration within the region, supported by ongoing monetary efforts to provide those weaker sovereigns with more time to implement greater budgetary discipline.

■ **David Stonehouse:** The imbalances in Europe have been a long time in the making, and as such, are unlikely to be fully resolved in 2012. If you think back to the aftermath of the U.S. financial crisis it can be argued that a full resolution is still not at hand today, and yet that hasn't necessarily held back at least a moderate economic rebound in the past couple of years, along with some improvement in the capital markets. In our view, Europe is likely to unfold the same way. There is no magic bullet or quick fix. It's going to take a long time – it has already been at least 18 months. We think that the political challenges in Europe are even greater than they were in the U.S., where power resides in the hands of a few key officials. There's recognition in Europe now of the severity of the problem and the urgency, but they haven't been able to get their arms completely around the problem, which will weigh on markets in the near term. However, we do think they will continue to push the yardstick forward gradually.



**WE'VE SEEN SLOWER GROWTH IN EMERGING MARKETS LATELY, ESPECIALLY IN CHINA. DO YOU FORECAST THAT EMERGING MARKETS WILL OUTPERFORM DEVELOPED MARKETS IN THE COMING MONTHS? WHAT GROWTH DYNAMICS ARE AT PLAY WITHIN SPECIFIED EMERGING MARKET REGIONS?**

■ **Patricia Perez-Coutts:** There has indeed been an economic slowdown in most of the emerging markets that we currently invest in. In part, this situation has resulted from a slowdown in the developed world; the natural evolutionary course of trading relationships and the subsequent dragging effect that trade with European markets and the U.S. have had on emerging markets. It can also be attributed in part to a retrenchment in consumption in some areas.



*"I commend many of the central banks for being proactive in their policies and management. We cannot rely solely on growth – we also need sound monetary and fiscal policy measures to cement our future economic growth." – Patricia Perez-Coutts*

In addition, there have been moves by various central banks to implement tightening policies and rein in liquidity in order to mop up excess money flows that have resulted from the stimulus packages of 2008. In a bid to reduce inflation, the goals of these monetary policies and of the reserve requirements by countries like China, India and Brazil have taken effect and been responsible in part for the economic slowdown in emerging markets.

I commend many of the central banks for being proactive in their policies and management. We cannot rely solely on growth – we also need sound monetary and fiscal policy measures to cement our future economic growth. As such, I don't see the current slowdown as an obstacle to positive economic expectations for the next three to five years in emerging economies.

Taking a longer-term view, corporate earnings growth has been steady for most emerging market companies. This is a testament to the fact that we can continue to anticipate positive surprises from these regions and we remain vigilant in uncovering all potential sources of economic growth.



## WHAT KEY DRIVERS DO YOU SEE PLAYING OUT IN THE U.S. MARKET IN 2012?

■ **Tony Genua:** There is significant scope for the U.S. market to do well in 2012, supported by two factors. Firstly, from a macroeconomic perspective the U.S. economy is currently in transition, and I would almost argue that it has successfully transitioned, from the first phase of economic growth, which was fuelled by inventory accumulation and government stimulus, to the next phase of self-sustaining growth. When it comes to self-sustaining growth, what is needed is job creation. Job creation results in enhanced consumer spending as well as repairing consumers' balance sheets. What we know about this cycle is that job creation has been below average – but we're still creating jobs. Secondly, companies in the U.S. are in terrific shape; their balance sheets have never been better. In fact, non-financial companies have two trillion dollars<sup>1</sup> of cash on their balance sheets, which supports favourable, shareholder-friendly activities such as buybacks and increased dividends. This cash surplus position also helps the economy as we see companies re-invest in their business. Overall, I believe that record corporate profits and a return of confidence will help the U.S. market do well.



## HOW DO YOU SEE THE CURRENT ECONOMIC AND POLITICAL SITUATION IN THE U.S. IMPACTING CANADA IN 2012?

■ **Peter Frost:** Fortunately for Canadians, our economy has the potential to do relatively better than other developed economies. However, we must remember that growth in the Canadian economy is predicated largely on the strength of the U.S. economy as well as global demand for commodities. Despite high unemployment levels and slowing economic growth in the U.S., corporate profits are robust and corporate balance sheets are supported by record cash levels. In addition, U.S. elections in 2012 may dampen the prospect of any significant policy changes from Washington.

Other risks in the coming year include a hard landing in China, which could weigh on commodities and the Canadian equity markets. China continues to play an increasing role in the demand for many commodities and, as a resource-based economy, commodities represent more than 40% of Canada's equity market.

Finally, the conditions in Europe do not look good, and delays in reaching a co-ordinated solution will only lead to further bouts of volatility. I think this will present opportunities for investors but we will have to be patient. Given the large decline in bond yields in 2011 (the 10-year Canadian yield declined to 2.0% from 3.5%), equities look better placed to protect and build wealth over the next several years, especially those companies that can grow their top and bottom lines in a weaker economic environment.

<sup>1</sup> Source: Federal Reserve Board, 2011

■ **David Stonehouse:** One of the key factors coming up in 2012 in the U.S. is the extension of the Bush tax cuts and whether or not that goes ahead. Seeing those extensions is unambiguously positive for the U.S. economy and will likely spill over into the Canadian economy in a positive way. Earlier in 2011, this might have looked like a dubious proposition, but given that 2012 is an election year the odds of tax cut extensions seem improved. We also anticipate reasonably positive economic performance for the U.S., although it's unlikely to be as strong as Q4, 2011, which bodes well for Canada. Bank lending has improved significantly over the course of 2011, and while housing and construction are still subdued, the rest of the U.S. economy looks like credit is starting to pick up and that should hopefully be supportive of the Canadian economy and the capital markets for 2012.

■ **Tony Genua:** One of the things that I think is hurting the Canadian economy is the U.S. political gridlock. Since the Democrats and the Republicans do not share consensus on many issues, implementation of regulation and legislation is falling behind. The U.S. is Canada's most important and largest trading partner. Yet, despite the history and importance of this trade relationship, statistics indicate that there are some three billion dollars that are lost annually because of inefficiencies in border traffic, thereby hindering trade. Our trade patterns are also contingent on the Canadian dollar, and we need to be cognizant of when our currency goes above par.



#### DO YOU THINK THAT INFLATION IS STILL A CONCERN IN EMERGING MARKETS, OR HAS THE ISSUE BEEN COMPLETELY RESOLVED?

■ **Patricia Perez-Coutts:** There have been very important moves by central banks in the last two months to ease monetary policy and reverse some of the tightening that was done in the past, almost as a pre-emptive move against further slowdowns in the global economy. These monetary policy measures have been very well orchestrated, the latest one being the lowering of reserve requirements by the Chinese government by about 25 basis points. I don't believe that they are embarking on a full-fledged loosening stance. That said, there is still plenty of work to be done to improve the capacity and the efficiency of emerging market economies. There is, after all, only so much that monetary policy can do to quell inflation in a sustainable manner. Emerging market economies need to improve their capacity build-outs and productivity through investment in infrastructure. In tandem, these measures may help stave off inflation in the long run.

■ **Tony Genua:** Most inflation pressures come from labour costs. Labour composes almost 70% of the variable cost for corporations. Currently, we are in a period of high unemployment, and it is during these periods of labour surplus that it becomes difficult to ask for increases in wages, and we certainly haven't seen any real wage increases in the last year to year-and-a-half. As such, from a labour perspective I expect that inflation should remain under control. This is important, because the Federal Reserve has significantly expanded its balance sheet, and people are concerned that this eventually will lead to inflation. However, and despite these concerns, I do not foresee any real inflation issues in the U.S. for the next 18 to 24 months.



## COMMODITY PRICES HAVE BEEN EXHIBITING A DOWNWARD TREND IN VALUATIONS. HOW WILL THIS AFFECT THE CANADIAN MARKET IN 2012?

■ **Bob Lyon:** The structural supply and demand fundamentals remain positive for most commodities. I think the fragile global economy has placed monetary authorities in a difficult situation as they are forced to balance the need for additional monetary policy easing despite an over-levered balanced sheet. This situation, combined with depreciating currencies and negative real interest rates, all bode well for hard assets in the medium term. The dislocation between gold equities and the price of bullion in 2011 has created additional opportunities for investors.



*“The dislocation between gold equities and the price of bullion in 2011 has created additional opportunities for investors.” – Bob Lyon*

We continue to believe the fundamentals for oil remain supportive of prices within the US\$80 - \$100 range. It’s been encouraging to note that despite all of the global economic uncertainty experienced during the second half of 2011, oil prices stayed close to the upper end of this band. Longer term, I expect demand growth to be positive and the supply-side challenges that have plagued the sector for the past decade to be supportive of high prices.

■ **David Stonehouse:** Commodities are very important to Canadian capital markets. Just as the U.S. economy has considerable impact on the Canadian economy, commodities also have a significant impact on Canada. We have seen some moderation in prices for certain commodities – for example cocoa has been cut by almost half and we’ve seen the supply for agricultural commodities such as wheat rise to the point that prices have correspondingly hit their lowest levels in years.



*“If energy prices hold up, it will be beneficial for Canada.” – David Stonehouse*

While this decline in commodity prices has been good for some emerging markets and has afforded central banks in these regions some leeway to move in a different direction as they have selectively in countries like China and Brazil, within Canada it can have a bit of a dampening effect on some of our export-led industries. At the same time, we anticipate that energy prices will remain pretty firm, especially if the global economy shows any kind of an upswing, which we might just see from the emerging economies over the course of the second half of 2012. If energy prices hold up, it will be beneficial for Canada. There is also a gradual potential for improvement in base metals over the course of the year.



### WHAT ARE YOUR THOUGHTS ON EMERGING MARKET CURRENCIES?

■ **Patricia Perez-Coutts:** We will probably continue to see more volatility in currencies. Currency markets need to be carefully observed to assess and interpret the potential impact on the companies we invest in. There have been considerable losses in emerging market currencies this year, often because they are labeled 'risky assets'. I believe that these losses will revert back in due course over the next year. The deflationary pressures affecting some of the more developed currencies such as the euro and the U.S. dollar may mean that emerging market currencies may benefit. Turning to the renminbi, I believe it will continue its gradual pace of appreciation, particularly since we've seen movement by the Chinese government to begin opening up the currency, which should eventually lead to upside trading in renminbi and much less volatility in the next two years.



### WHAT DO YOU SEE AS THE KEY OPPORTUNITIES IN 2012 AND HOW DO YOU THINK INVESTORS CAN BEST TAKE ADVANTAGE OF SOME OF THE TRENDS WE'VE HIGHLIGHTED?

■ **David Stonehouse:** If the global economy weathers the storm and gradually shows signs of improvement, that should dissuade investors slightly from government bonds and we should start to see them favouring corporate bonds instead. Corporate spreads are at fairly wide levels right now, even in the healthier areas of the world, so when you take a look at North America, for instance, which has been one of the best places to be, U.S. investors are looking at 2.35% spreads over U.S. treasuries for investment-grade corporates and a 1.75% spread for Canadian corporate bonds. This means investors are getting on average at least double from corporates what they are earning on government bonds. Default rates are always negligible on investment-grade securities; hovering around a fraction of 1%. Even during the worst year of the Great Depression, the investment-grade default rate was barely over 1%.<sup>2</sup>

In the near term, the ongoing credit crisis in Europe could spill over into our credit markets, but over the course of the year if we do see some abatement there, I think return prospects look pretty intriguing. The last few years have been very good for high yield overall. It's been a pretty competitive asset class against equities, and we think it has the possibility of continuing to perform well over the next few years.

<sup>2</sup> Source: Moody's, 2011

■ **Patricia Perez-Coutts:** In emerging markets, one big area of opportunity is exposure to Chinese equities. I feel that the landing in China will be soft, which will probably be the most positive surprise in the market as many are anticipating a hard landing. In general, prospects indicate positive economic growth as well as low inflationary pressures for 2012 and continuing on to 2013. Countries such as Indonesia, Thailand and Brazil also appear to be good areas of opportunity. Brazil has a large-scale plan for infrastructure build-up and the marketplace has gone through a transformation over the past few years in which it is now increasingly dependent on domestic consumption.



*“I feel that the landing in China will be soft, which will probably be the most positive surprise in the market...” – Patricia Perez-Coutts*

■ **Tony Genua:** It has been a lost decade for U.S. equities. Ten years ago, everybody loved American equities.<sup>3</sup> In fact, US\$654 billion went into U.S. equities by Americans in the last three years of the 1990s. In stark contrast, 2011 marks five straight years of redemptions. What’s interesting is that the money has gone into fixed income. We have seen two bubbles burst in the past decade – the technology bubble bursting at the beginning of the decade, and then closing out the decade with the global financial crisis, which caused significant weakness in the economy. Since that time, though, we’ve had record corporate profits bolstered by expanding margins, while the economy continues to limp along. One of the trends that seems to be benefitting the U.S. and also Mexico is that we have gone from outsourcing to near-shoring to on-shoring as some manufacturing companies move closer to North America.

We’re always on the lookout for companies with strong leadership that espouse the spirit of innovation. Although some continued trepidation regarding the U.S. may persist, we nevertheless foresee investors reconnecting with their appetite for risk in 2012, which should herald a resurgence in interest for equities, and U.S. equities in particular. Since the U.S. has never had a 20-year negative rate of return, the next 10 years look promising.

<sup>3</sup> Source: ICI, U.S. equity flows from 1998 to 2000.

■ **Rory Flynn:** In stark contrast to the general economy, corporate Europe’s reasonably strong position presents tentative upside potential. Net debt-to-equity is around 55%, cash positions are at record levels of around 700 billion euro and most companies reported better-than-expected revenues and earnings in the third quarter. Return on equity for European companies is approaching peak levels at around 14% and net income margins are also approximating record levels at around 7%.



*“For Canadian investors in particular, this is a great time to be using the strong domestic currency to add global exposure in their portfolios as earnings margins and valuations for most Canadian companies are at peak levels.” – Stephen Way*

■ **Steve Way:** In contrast to the global macroeconomic environment, the corporate picture remains more optimistic, with record-high levels of cash on balance sheets and historically low financing costs. Our base-case scenario is that corporate profit margins and earnings will ease, but will not contract significantly from current levels. Present equity valuations already reflect pessimism, so any positive developments could trigger substantial recovery on the upside.

For Canadian investors in particular, this is a great time to be using the strong domestic currency to add global exposure in their portfolios as earnings margins and valuations for most Canadian companies are at peak levels. Global growth uncertainty will only contribute to further weakness in commodity prices, which may be a headwind for commodity-related sectors.

Recent volatility in global markets has created a valuable opportunity for investors to gain exposure to solid long-term investment opportunities. In an environment of divergent economic policies and growth rates, however, investors will need to be particularly selective in terms of country exposure. A fundamental approach will also be key in finding individual companies that can still grow and thrive in a slower growth environment.

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