Month-End Review and Near-Term Developments

For 2011, the generally below-par economic recovery in 2010 gave way to weakening growth in the developed world, as government policy initiatives worked only to a point. In the U.S., economic growth for the first nine months averaged just 1.2%, below the 3.4% pace of the prior year. The latest revision for third quarter GDP represented a slight decline from the initial estimates, settling at 1.8%. For the Eurozone, third quarter GDP grew only 0.8%. The United States is the only major economy to have grown at an annualized rate of more than 1% in both the second and third quarters of 2011.

The issue now is that the heavy guns have already been fired, and there’s little ammunition left. As a result, the upturn in GDP that started in 2009 now appears to be slowing, leading to the question: Has the post-recession rebound simply paused, or are the world’s largest economies heading for a double-dip? Expectations for economic growth have fallen over the course of 2011. In the beginning of 2011, the IMF issued growth forecasts for various regions of the world. Together, they resulted in average growth of 4.5%. The latest Bloomberg surveys show current expectations for world growth at 3.8% with the U.S. and Europe down significantly. Some of Europe is expected to suffer a recession in 2012, with growth for the region now expected at 0.2%. Reduced growth of 2.1% is expected in the U.S. Meanwhile, continued strength is expected in emerging markets.

The economic recovery has been orchestrated by the two tools of governments worldwide — monetary policy and fiscal policy. The policy shifts did their job. The U.S. Federal Reserve Bank added Operation Twist in 2011 to bring down longer term interest rates; the European Central Bank (ECB) eventually slashed its lending rate from 4% to 1%. U.S. fiscal stimulus for 2011 consisted mainly of the payroll tax cut, as budget negotiations centered on how much to cut federal spending and whether income tax increases would be part of deficit reduction. European governments began enacting budget cuts in attempts to reduce their fiscal deficits to fight the sovereign debt crisis.

What’s the hang-up regarding future fiscal stimulus? In a word, debt. Specifically, accumulated deficits in Portugal, Ireland, Italy, Greece, and Spain (PIIGS) are close to or above 100% of GDP. As debt levels rise, so does the risk of default, which drives the cost of debt (interest rates) higher. This is a dangerous cycle threatening financial stability in these countries. In turn, several European banks that lend to these countries are also under pressure.

For the final month of 2011 the S&P 500 Index posted a 1% total return, bringing the full-year performance to 2%. It was rough ride, however, as a generally rising market in the first half gave way to a sharp sell-off in the third quarter. The index level was essentially unchanged over the course of the year, as dividends provided the positive return. The stand-out asset class for the year was the Treasury bond sector as Barclays Treasury Index posted a total return of 1% in December, bringing the year’s return to nearly 10%. Investment grade corporate bonds posted a 2% return in December, which contributed to a return of 8% for the year. The financial markets weathered several exogenous events, including the threat of a U.S. Government default, rising fears of a double-dip recession, and the European debt crisis. Abrupt reversals buffeted all markets, which reacted to changing headlines.

Against this volatility, corporate fundamentals improved in 2011, with reported EPS for S&P 500 increasing 12% and net debt on the balance sheet declining 9%. For 2012, current earnings estimates show growth of 10%, and strong cash flow would allow further balance sheet improvement.
The Current Environment – At A Glance…

Market Performance Review – pgs 3 & 4
This section includes performance data for various equity, fixed income, and alternatives indices, as well as yield and/or price levels for certain assets.

Spotlight – pg 5
While the primary fundamental driver of the markets, company earnings, appears to be on track to offer some comfort, the outlook for a second fundamental issue, the economy, is not so clear. However, headlines coming out of the political arena have dominated the fundamental factors driving market returns. These political factors lead to one certainty: volatility (and risk) will remain a recurrent theme for the financial markets as 2012 unfolds.

U.S. Economic Growth and Inflation – pgs 6 & 7
The final estimate for third quarter GDP showed growth of 1.8% over the second quarter, which was a downward revision from the prior estimate of 2.0%. The Core Consumer Price Index (CPI), which excludes volatile food and energy prices, increased nominally to 2.2% in November, while headline inflation (CPI including food and energy) eased slightly to 3.4%.

Employment – pg 8
After much debate, the payroll tax cuts and unemployment benefits were extended for another two months, now set to expire at the end of February 2012. The unemployment rate dropped unexpectedly to 8.6% in November from 9.0% in October, largely due to departures from the labor force. The average job gain since the peak of job losses recorded in February 2010 was only 110,000 jobs per month, far below past recovery levels.

Housing – pg 9
The housing market is set to enter 2012 with little cheer. As distressed sales begin to dominate transactions in the colder months, home prices are prone to give back earlier gains. While the bottom in housing is likely still ahead, overall conditions seem to have reached a meager, but generally steady, state of bouncing along the bottom.

International Developments – pg 10
On December 9th, leaders at a European summit announced a plan to enforce fiscal discipline among Euro countries. The United Kingdom refused to be part of a European wide agreement. Uncertainty about the extent of the solution continues.

U.S. Equities – pg 11
Equity markets continued to display significant daily volatility during December, but delivered a positive return of 1.0%. The top-performing sectors in December were Telecommunication, up 4.0%, Utilities, 3.4%, and Health Care, 2.9%. The S&P 500 Index returned 2.1% in 2011.

Taxable Fixed Income Market – pg 12
Treasury yields declined slightly in December, as concerns over contagion from the ongoing European saga continued to worry investors. In 2011, yields dropped significantly across the entire curve, with the 10-year and 30-year yields falling by more than 140 bps, driven by poor economic outlook both in the U.S. and abroad. In consequence, U.S. Treasury bonds led both the equity and bond markets, with 9.8% total return in 2011.

Tax-Exempt Fixed Income Market – pg 13
The tax-exempt market finished the year strongly, as yields fell across the curve. The fiscal pressures among municipalities are still present, but less so than in recent years. The optimal maturity range for maximizing return, including both income and roll, for 2012 is currently the 5- to 7-year maturity segment of the yield curve. Preliminary budget deficit projections for FY 2013 are less than one-half those of FY 2012.

Alternative Market – pg 14
With the exception of grain prices, the spot price for most economically sensitive types of commodities (e.g., base metals, oil, platinum) declined during December, continuing November’s overall trend. In part sympathy with gold, the spot price for both silver and platinum have also declined in December. Year-to-date, the DJ UBS Commodity Index has declined by 13.3%, lagging the S&P 500 Index, which increased by 2.1%.
# Market Performance Review

## as of December 31, 2011

### EQUITIES

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<th>3-Mo</th>
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### ALTERNATIVES

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Performance expressed as total return, in percentage points. Total returns for periods of one year or more are annualized. MSCI indices’ performance is net of foreign taxes on dividends. Highlighted items represent either the best- or worst-performing equity sector for the period.

Sources: Bloomberg L.P., BMO Asset Management U.S.
# Market Performance Review

**as of December 31, 2011**

## U.S. FIXED INCOME

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## BOND YIELDS

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Performance expressed as total return, in percentage points. Total returns for periods of one year or more are annualized.

Sources: Barclays Capital, Bloomberg L.P., BMO Asset Management U.S.
Having just completed a volatile year for the financial markets, a natural thought is to wonder what the coming year will have to offer. While the primary fundamental driver of the markets, company earnings, appears to be on track to offer some comfort, the outlook for a second fundamental issue, the economy, is not so clear. Expectations about a double-dip recession in the United States, which arose in mid-2011, have largely abated. However, unsuccessful efforts by European leaders to solve their sovereign debt crisis have led to rising expectations that many European countries are facing a recession.

During the last 12 months, headlines coming out of the political arena dominated the fundamental factors in driving market returns. Headline risk is an important driver of market performance, but it is very difficult to quantify. Events in the political environment ultimately impact earnings and the direction of the economy, and the market implicitly attempts to price in the perceived effects of realized or anticipated policy decisions. Often, market swings appear exaggerated reactions to the headlines.

The political environments in the United States and in Europe do not offer much comfort that 2012 will be much different. With primary election season getting into full swing culminating in election day in November, the prospects for an improved political environment in the United States are not encouraging. Political posturing over the extension of the payroll tax rate resulted in only a temporary extension at the 11th hour, as Congress was unable to forge a compromise to agree on the rate for the entire year. This inability to reach a decision continued the pattern established earlier in the year, when the extension of the debt ceiling was passed which left decisions on deficit reduction to a super-committee. In spectacular fashion, the super-committee also was unable to arrive at an agreement on deficit reduction, leaving in place automatic, across the board cuts in government spending. As political campaigning accelerates toward election day, an improvement in the ability of the Congress and the President to govern would not seem to be likely. Perhaps, the voters will resolve this problem on election day.

Additional meetings between the German Chancellor and the French President are planned in advance of another European summit at the end of January in the continued search for a solution to the sovereign debt crisis. The goal is to establish the details on an agreement reached in December to enforce fiscal discipline on Euro members. The attempt to address the underlying fiscal cause of the sovereign debt crisis represents an important step toward an ultimate solution. But securing an actual agreement remains to be accomplished. Once an agreement is reached, it will take time for it to become effective and for reduced borrowing by European governments to ease the crisis. In the interim, maturing debt will need to be refinanced. So the crisis will continue.

In addition to the political issues in the United States and Europe, a third wild card in the political arena continues to be present: Iran. The latest issue which can disrupt markets is Iran’s threat to close the important Strait of Hormuz. The threat emerged in the wake of efforts by the U.K. and France to ban imports of Iranian oil into the European Union.

The net effect of these political factors on financial markets leads to one certainty: volatility (and risk) will remain a recurrent theme for the financial markets as 2012 unfolds.
The final estimate for third quarter GDP showed growth of 1.8% over the second quarter, which was a downward revision from the prior estimate of 2.0% (Exhibit 1). GDP was up 1.5% compared to the last year’s third quarter. The results were in line with economists’ estimates, who looked for no change from the previous estimate. Economic growth for the nine months of 2011 averaged 1.2%, still significantly below the nine-month average of 3.4% for 2010.

Among the components of GDP, investment in non-residential construction contributed the strongest growth with 16%. Consumer spending was 2% higher than the second quarter, with purchases of durable goods leading the way. The growth in consumption resulted in a dip in the savings rate (Exhibit 2).

A survey of economists taken in early December by Bloomberg News put expectations at 2.8% growth for the fourth quarter of 2011. The odds of a recession in the next 12 months continued to decline, with a probability of 23%, a slight decline from November’s 25%.

The Chicago Fed’s National Activity Index indicated a slight weakening in growth in November with a decline to -0.37. The index averaged -0.24 over the last three months, a level which indicates that growth remains below its long-term trend.
**Inflation**

- The Core Consumer Price Index (CPI), which excludes volatile food and energy prices, increased nominally to 2.2% in November, while headline inflation (CPI including food and energy) eased slightly to 3.4% (Exhibit 3). Both measures have remained higher than the second half of 2010. Market inflation expectations have been rising since September 2011.

- Fed actions through QE2, Operation Twist (purchasing longer maturity bonds), and its commitment to low rates stem from the conviction that inflation remains under control. In its press release following the December 13th FOMC meeting, the Fed noted that its preferred inflation measure (the personal consumption expenditures price index excluding food and energy, or PCE) had shown that inflation has decelerated on a month-to-month basis in the last couple of months.

- Money supply growth is one measure of the monetary stimulus which the Fed has provided throughout the financial crisis. On an annual basis, the M2 measure exhibited dramatic growth from the end of July to August 2011 period. The increase corresponded to the time when Operation Twist began. Since the end of August, the growth rate has been declining, a trend that should continue over the near term (Exhibit 4).
After much debate, the payroll tax cuts and unemployment benefits were extended for another two months, now set to expire at the end of February 2012.

The unemployment rate dropped unexpectedly to 8.6% in November from 9.0% in October, largely due to departures from the labor force (Exhibit 5).

The duration of unemployment remains at a stubbornly high rate. At an average 39.4 weeks in November, the duration is only slightly below its all-time high of 40.5 weeks reached in October 2011 (Exhibit 5).

The economy added 120,000 new jobs in the month of November, bringing the total job gains in 2011 to 1.4 million, far exceeding the 940,000 job gains recorded in 2010. Despite encouraging job gains in 2011, cumulative job losses since the end of 2007 stand at a breathtaking 6.2 million (Exhibit 6), but below the peak of 8.7 million job losses recorded in February 2010. The average job gain since the peak of job losses recorded in February 2010 was only 110,000 jobs per month, far below past recovery levels. At this pace, it would take another 4.7 years to regain all jobs lost since the onset of the last recession.

Continuing jobless claims have been steadily declining since July 2009, to 3.7 million as of the end of November. However, initial jobless claims are above their lowest 2011 level recorded in March, reaching 395,800 in November.
The housing market is set to enter 2012 with little cheer. As distressed sales begin to dominate transactions in the colder months, home prices are prone to give back earlier gains. While the bottom in housing is likely still ahead, overall conditions seem to have reached a meager, but generally steady, state of bouncing along the bottom. The S&P/Case-Shiller Index posted declines in September and October, settling just 2% above cycle lows (Exhibit 7).

The U.S. government completes another year painted in a corner, as it attempts to address two irreconcilable issues – reduce its presence in the housing market, while simultaneously help mitigate the impact of foreclosures on the consumer. As the economy teeters above the floating mark and external shocks abound, the latter concern is likely to win in the near term, but a sweeping housing solution remains politically untenable. Tweaks to existing programs and a systematic effort to keep rates low (Exhibit 8) will make up the bulk of the tool set.

Despite the significant human toll, investors can take some solace knowing that housing has a far less significant economic impact today at just half its peak GDP weight. And some encouraging developments, such as strong demand for rentals, slowly declining inventories, chipping away at unemployment, and continued government support will likely prevent prices from reentering freefall. Looking forward to the new year, in an environment of jumping from crisis to crisis globally, avoiding freefall in U.S. housing may just be good enough.
The European sovereign debt crisis continues to create turbulence for financial markets. The crisis did spread beyond the PIIGS group (Portugal, Italy, Ireland, Greece and Spain) when an auction of German government bonds last month attracted bids for just 60% of the planned amount. Pressure on Greece and Italy credit yields continues, but Spain and Portugal have seen some relief (Exhibit 9).

On December 9th, leaders at a European summit announced a plan to enforce fiscal discipline among Euro countries. The markets initially responded positively to the news. However, skepticism surrounding the agreement quickly began to emerge, and major rating agencies weighed in with warnings about sovereign credit ratings. The United Kingdom refused to be part of a European wide agreement. Uncertainty about the extent of the solution continues.

With new funding sources under pressure, European banks have extensively tapped a new three-year loan program from the European Central Bank. Concerns over bank exposure to sovereign debt of southern European nations have made investors wary.

European equities, measured by the MSCI European Monetary Union (EMU) Index, posted a 0.2% drop in December following its decline in November, and it was down 15.1% during 2011 (Exhibit 10). The emerging markets equities also reacted to the European debt problems, with the MSCI Emerging Market Index dropping 1.2% in December and ending the year down 18.4%.
Equity markets continued to display significant daily volatility during December, but delivered a positive return of 1.0%. The top-performing sectors in December were Telecommunication, up 4.0%, Utilities, 3.4%, and Health Care, 2.9%. The S&P 500 Index returned 2.1% in (Exhibit 11).

Although up 1.8% in December, financial institutions posted the largest drop among all large-cap firms in the S&P 500 Index during 2011, falling 17.0%. This highlighted the risk that is perceived amongst the largest global financial companies, as Europe continues to muddle through its debt crisis.

While December is generally a light month for earnings reports, there were several notable reports which were representative of the poor performance of cyclical sectors and the outperformance of defensive sectors. The story of 2011 was that of high quality, low risk stocks providing strong returns for investors. In 2011, the 100 lowest risk stocks in the S&P 500 Index returned almost 18%, while the 100 most risky stocks fell more than 19%.

Overall earnings expectations for 2012 continued their downward trajectory, as the S&P 500 Index is now expected to earn just under $107 next year. While the current forecast is down about 1.6% from the beginning of the year, $107 would represent earnings growth of over 10% versus 2011 earnings (Exhibit 12).
Taxable Fixed Income Market

- Treasury yields declined slightly in December, as concerns over contagion from the ongoing European saga continued to worry investors. In 2011, yields dropped significantly across the entire curve, with the 10-year and 30-year yields falling by more than 140 bps, driven by poor economic outlook both in the U.S. and abroad (Exhibit 13). In consequence, U.S. Treasury bonds led both the equity and bond markets, with 9.8% total return in 2011, as dropping yields pushed the bond prices higher.

- Despite an increase in credit spreads during 2011, corporate bonds performed very well on an absolute basis, posting an 8.1% total return, driven primarily by Industrial bonds, which posted a return of 10.5% in 2011. However, relative to U.S. Treasuries with like duration, corporate bonds lagged by 3.7% in 2011.

- High-yield bonds, whose performance is highly correlated to the equity market performance, had a solid performance in December, but lagged most bond sectors in 2011, posting 5.0% total return (Exhibit 14).

- Structured product securities, including residential and commercial mortgage-backed and asset-backed securities, were positive for the month and year-to-date on an absolute return basis (Exhibit 14). ABS and CMBS bonds posted positive excess returns relative to duration-like Treasury bonds, while MBS bonds delivered negative excess returns in 2011.
The tax-exempt market finished the year strongly, as yields fell across the curve. Yields in the 8- to 12-year maturity range fell approximately 35 bps in December; this same maturity range was also the best performing segment for the year. In 2011, 10-year yields fell 130 bps and the 30-year segment fell more than 110 bps (Exhibit 15). Although yields fell in 2011, the tax-exempt curve remains quite steep. (Exhibit 16). The expected optimal maturity range for maximizing return, including both income and roll, for 2012 is currently the 5- to 7-year maturity segment of the yield curve.

The fiscal pressures among municipalities are still present, but less so than in recent years. Preliminary budget deficit projections for FY 2013 are less than one-half those of FY 2012. Importantly, however, general fund revenues for the current year are still below FY 2008 levels, evidenced by the higher unemployment rate. A few states, like MN and IN, are expecting surpluses in next year’s budget, while CA announced automatic spending cuts of $1B because revenues continue to trail expectations.

The lone surviving and active monoline insurer, Assured Guaranty, was downgraded to AA- from AA+ by Standard & Poor’s. The move was largely expected and the fact that it now carries a "stable" outlook has been viewed favorably.

One year ago, Meredith Whitney, a prominent financial analyst, predicted “hundreds of billions” of municipal defaults in 2011. Through November, the total volume of actual payment defaults was $2.1B, down from $2.8B in 2010.
With the exception of grain prices, the spot price for most economically sensitive types of commodities (e.g., base metals, oil, platinum) declined during December, continuing November’s overall trend (Exhibit 17). Angst centering on the European debt crisis continues to weigh on most commodity prices although these headlines had temporarily abated towards the end of the year. Despite macroeconomic concerns, underlying physical demand remains solid. Since mid-December, a flight to cash, a U.S. dollar rally, and year-end portfolio adjustments triggered a wave of gold selling. In part sympathy with gold, the spot price for both silver and platinum have also declined in December. Year-to-date, the DJ UBS Commodity Index has declined by 13.3%, lagging the S&P 500 Index, which increased by 2.1%.

Breaking through its 200-day moving average support, the price of gold came under renewed pressure (Exhibit 18). For much of the year, gold was viewed as a currency hedge, more so than an inflation hedge. But as gold weakened, flows went to the U.S. dollar, which ended below the start of the year levels, at $1.296 per Euro. Like equity traders, currency traders have faced periods of high volatility and trend reversals with no net gains.

Publicly traded REITs rebounded to modestly positive year-end performance, as investors continue to search for dividend income. The asset class is especially attractive for those who believe the Fed’s low interest rate policy is here to stay.
Disclosure

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