



## EQUITY RESEARCH

December 16, 2011

### INVESTMENT STRATEGY

#### 2012 Outlook & Portfolio Strategy

#### Modest market declines expected in 2012 as Europe remains the wildcard

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#### Index Levels

<b>TSX</b>	11504.42
<b>TSX Venture</b>	1404.93
<b>DJIA</b>	11868.81
<b>S&amp;P 500</b>	1215.75
<b>Nasdaq Composite</b>	2541.01
<b>MSCI World Index</b>	289.90
<b>Risk Metrics</b>	
<b>VIX</b>	25.11
<b>TED Spread</b>	0.56%
<b>FAIL<sup>®</sup></b>	2.65

Prices and levels as at close on December 15, 2011

#### Interest Rates & Commodity Prices

<b>Canada T-Bill (90 days)</b>	0.81%
<b>US T-Bill (90 days)</b>	0.00%
<b>Canada 10-year Govt.</b>	1.92%
<b>US 10-year Treasury</b>	1.91%
<b>Canada 30-year Govt.</b>	2.52%
<b>US 30-year Treasury</b>	2.92%
<b>CRB Index</b>	294.45
<b>Spot Gold</b>	US\$1574.90
<b>Crude Oil (Jan.)</b>	US\$93.59
<b>Canadian Dollar</b>	96.77 US cents
<b>USD/Euro</b>	1.3029
<b>USD/JPY</b>	77.84

Source: Bloomberg

#### Summary

- Equity investors will doubtless be glad to see the back of 2011, a roller-coaster year for global stock markets that was characterized by gut-wrenching volatility and spiraling macroeconomic risk. It also turned out to be a year when the “Sell in May and go away” investment premise was validated in spades.
- The European debt situation is the biggest wildcard that could affect the fortunes of the global economy in 2012. Speedy and credible resolution would lead to positive outcomes for the global economy and equity markets, while an uncontrolled crisis could tip Europe into recession and lower global growth by as much as 3 percentage points, according to the IMF.
- Our end-2012 target for the TSX Composite is 11,000, or 4.4% below current levels. Our end-2012 target for the S&P 500 is at 1,200, or 1% below present levels.
- Major risks to our forecast include EU strains, sovereign debt defaults, bank failures, limited policy options for the Fed, and a hard landing in China.
- Our recommended asset allocation is – Stocks 55%, (down 5%), Bonds 20% (up 5%) and Cash 25% (unchanged).

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## MARKET REVIEW

### A roller-coaster year for global equities

Equity investors will doubtless be glad to see the back of 2011, a wretched year for global stock markets that was characterized by gut-wrenching volatility and spiraling macroeconomic risk. As can be seen in Table 1, the venerable Dow Jones Industrial Average (DJIA) is the only one of the major indexes to be in positive territory year-to-date (although another triple-digit daily decline could wipe out that gain as well). The S&P 500 and Nasdaq Composite, with YTD declines in the low single digits, have also fared much better than most other equity indexes.

As of December 14, the S&P 500 had outperformed the TSX Composite by 10.5 percentage points for the year. This margin of outperformance is in line with the 10% differential we had forecast a year ago in our 2011 Outlook report. So while our call was for the TSX to trade little changed and the S&P 500 to gain 10% over the course of this year, at least we got the performance differential right!

While the TSX Composite is on course to finish the year significantly below the 13,175 target specified in our 2011 Outlook report, it hasn't been all downhill this year. 2011 had begun on a promising enough note, as follow-through buying from the last quarter of 2010 – triggered by the Federal Reserve's QE2 program – continued well into the year.

Although financial markets were rocked briefly by the aftermath of the gigantic earthquake and tsunami in Japan on March 11, they recovered rapidly, and North American indexes reached three-year highs on May 2. But investors who expected the upward trend to continue were in for a nasty surprise, as 2011 has turned out to be a year when the "Sell in May and go away" investment premise has been validated in spades.

**Table 1: Major equity indexes – Performance (April 30 and YTD\*)**

Country	Index	Percentage change		
		Jan.1- Apr.30	Apr.30- Dec.14	YTD
Canada	TSX	3.7%	-17.2%	<b>-14.1%</b>
Canada	TSX-Venture	-1.6%	-37.6%	<b>-38.6%</b>
US	DJIA	10.7%	-7.7%	<b>2.1%</b>
US	S&P 500	8.4%	-11.1%	<b>-3.6%</b>
US	Nasdaq Comp.	8.3%	-11.6%	<b>-4.3%</b>
Mexico	IPC	-4.1%	-2.6%	<b>-6.6%</b>
Brazil	Bovespa	-4.6%	-14.3%	<b>-18.3%</b>
UK	FTSE 100	2.9%	-11.6%	<b>-9.0%</b>
Germany	DAX	8.7%	-24.5%	<b>-17.9%</b>
France	CAC 40	7.9%	-27.5%	<b>-21.8%</b>
Russia	RTS Index	14.5%	-32.4%	<b>-23.6%</b>
Japan	Nikkei 225	-3.7%	-13.5%	<b>-16.7%</b>
Australia	ASX 200	1.6%	-13.1%	<b>-11.7%</b>
India	Sensex 30	-6.7%	-17.0%	<b>-22.6%</b>
China	Shanghai Comp.	3.7%	-23.5%	<b>-20.6%</b>

\*as of December 14, 2011

Source: Bloomberg

*US equity indexes have outperformed other major indexes by a considerable margin this year. The Canadian indexes have been dragged down by the decline in commodity prices, with the TSX-Venture index hit especially hard. Europe's sovereign debt woes are reflected in the performance of its bourses, while the BRIC equity indexes are either in or close to bear markets. Overall, investors must be ruling the missed opportunity to trim equity positions in May.*

The difference in global equity performance for the period before and after April 30 (Table 1) is quite remarkable. The 15 indexes in Table 1 had an average gain of 3.3% in the first four months of this year, led by markets in Russia, the US, Germany and France. In contrast, these 15 indexes declined by an average of 17.7% from April 30 to December 14, with particularly steep drops in European and Asian bourses.

*Escalating concern about sovereign debt is perhaps the biggest driver of performance divergence in global equities before and after April 30.*

Perhaps the biggest driver of this performance slump was the issue of sovereign debt, the top risk factor identified in our 2011 Outlook. The sovereign debt issue, which had been relegated to the background in the first half of the year, came to the forefront in the second half as concerns about the debt burdens of Greece and the other PIIGS nations escalated rapidly. It gained added traction with Standard & Poor's abrupt downgrade of the US credit rating on August 5, which was precipitated by political brinksmanship on the US debt-ceiling issue.

Negative market sentiment was further reinforced by the Federal Reserve's pledge following its August 9 FOMC meeting to keep interest rates at near-zero until mid-2013, causing considerable angst among investors about the extent of weakness in the US economy. Hopes that the Fed would deliver another blockbuster stimulus package along the lines of QE2 – which boosted the S&P 500 24% between September 2010 and June – were dashed at the subsequent FOMC meeting when “Operation Twist” was unveiled, which proved to be too little, too late.

*Most developed markets were in bear territory by the end of Q3.*

The confluence of these concerns resulted in the market slide picking up momentum in September, making the third quarter of this year the worst one for global equities since the panic-driven fourth quarter of 2008. As many as 20 of 24 developed markets were officially in bear market territory by the end of the quarter (having declined 20% or more from their peaks recorded earlier in the year), with the only exceptions being the US, UK, Singapore and New Zealand.

Expectations that the BRIC nations would be able to hold their own on account of their economic momentum and domestic demand have also been belied, with Russia, India and China mired in bear markets and Brazil close to one. China may already be in the early stages of an engineered slowdown, while the Indian rupee's 17% plunge YTD against the greenback is an indicator of challenges such as rising inflation and a widening budget deficit faced by the third-largest Asian economy.

Equity markets have been trying to stage a tenuous recovery since reaching their 2011 low on October 4, but the gyrations continue as headlines out of Europe roil investor sentiment on a daily basis.

Consider the recent fluctuations in the major US benchmark indexes. In October, on the heels of their worst quarterly performance in almost three years, the DJIA rose 9.5% and the S&P 500 surged 10.8% for their best monthly performance in nine years and 20 years respectively. By October 28, the Dow Jones Transportation Average had soared 20% for the month, and was on track for its best monthly performance since 1939. But with the rebound swamped by negative sentiment last month, the S&P 500 posted seven successive daily declines to register its worst Thanksgiving-week performance since 1932. As optimism for a resolution to the European debt solution resurfaced towards month-end, the DJIA and S&P 500 gained more than 4% on November 30, capping their best three-day performance since March 2009.

Volatility has surged this year as the pendulum of risk appetite has oscillated between “risk on” and “risk off”, as we had foreseen in our Outlook report. While the VIX index is only up 7.6% on average this year, the rise in market volatility since August has been dramatic. The VIX averages 33.40 for the period from August 1 to December 14, 83% higher than its average level for the first seven months of 2011. Figure 1 on page 8 shows the increasing variance of daily returns of the S&P 500 and TSX Composite since August.

*Like the US in 2008, Europe is currently the focus of investor concerns.*

Although the US was the epicenter of the 2008 global financial crisis and credit crunch, Europe is without doubt the focus of investor concerns at this time. Witness the spread in credit-default swaps for European companies relative to US corporations (Figure 2). An index of credit-default swaps for 125 investment grade European corporates is currently trading at a premium of 62 basis points relative to the US index, close to the record 64 bps reached in September. This is an indication that traders and investors are demanding higher premiums to protect against the possibility of European corporate defaults, compared to firms in North America. At the height of the 2008 crisis, as concern about the US economy reached fever-pitch, the European CDS index had traded at a discount of almost 94 basis points to the US index.

*Global market capitalization is still up 75% from the multi-year low of March 2009.*

The carnage since May has wiped out over \$11 trillion or 20% of global market capitalization, which now stands at \$44.8 trillion. Global market capitalization had reached a three-year high of \$56.1 trillion in May, only about 10% away from the record level of \$62.6 trillion reached in October 2007. Even after this year’s declines, global market value is up 75% from the March 2009 multi-year low of \$25.5 trillion.

### **Risk aversion takes toll on TSX and Venture indexes**

The TSX Composite was dragged down this year by its 48% weight in energy and commodities as risk aversion set in and investors gravitated towards safe-havens. The TSX-Venture index, which had rebounded 187% over the previous two years after a 72% plunge in 2008, declined almost 40% this year as junior resource stocks encountered massive profit-taking.

Investors’ preference for defensive sectors in turbulent times is apparent in Table 2. Of the 10 groups on the TSX Composite, only the Healthcare, Telecom Services and Consumer Staples groups have gained YTD. The Healthcare sector outperformed the rest of the index by a huge margin for the second year, driven by its heavyweight constituents Valeant Pharmaceuticals (formerly Biovail, up 64% YTD) and SXC Health Solutions (+33% YTD). The Telecom Services group benefited from its high dividend yield, with all five constituents in the black, led by Telus (+24%) and BCE (+15%). The Utilities group – another quintessential defensive sector because of its above-average dividend yield and stable cash flows – was down marginally for the year but outperformed the broad index by 12 percentage points.

The Materials and Energy groups significantly underperformed the index, reversing last year’s gains. Financials, the other heavyweight group, was down 10.5% YTD, as declines by insurers and banks offset gains by REITs. Information Technology was the worst-performing sector for the second successive year, largely on account of Research in Motion’s 73% plunge YTD.

**Table 2: TSX Group Performance\***

TSX Group	2010 Performance	YTD 2011 Performance
Health Care	50.3%	44.4%
Telecom Services	16.3%	14.2%
Consumer Staples	8.3%	4.2%
Utilities	12.6%	-2.1%
Industrials	14.4%	-3.2%
Financials	6.3%	-10.5%
Energy	10.0%	-17.0%
Consumer Discretionary	21.8%	-19.2%
Materials	35.8%	-22.1%
Information Technology	-11.6%	-51.8%
<b>TSX</b>	<b>14.5%</b>	<b>-14.1%</b>

\* Ranked by YTD 2011 Performance

Source: Bloomberg

*Investor's current preference for defensive sectors such as Healthcare and Telecom Services is clearly evident.*

## ECONOMIC FUNDAMENTALS

Since August, the global economy seems to have entered a period of renewed uncertainty in terms of the outlook for growth. In its World Economic Outlook (WEO) published in September, the International Monetary Fund (IMF) attributed this to a combination of two adverse developments – a much slower recovery in advanced economies since the beginning of the year, and a large increase in fiscal and financial uncertainty.

The IMF notes that the economic recovery in many countries is being constrained by factors such as tight bank lending, the legacy of the housing boom (& bust), and high household leverage. In addition, markets have also become increasingly skeptical about the ability of many indebted nations to stabilize their public debt. While these concerns were initially limited to a number of small, peripheral European nations, in recent months they have spread to larger nations in Europe and elsewhere – such as Italy and the US – in a contagion effect.

*The IMF estimates that global growth will moderate from just over 5% in 2010 to about 4% in 2011& 2012.*

The IMF estimated in its September report that global growth will moderate to about 4% this year and next, from just over 5% in 2010. It forecasts real GDP in the advanced economies will expand at a sluggish pace of 1.6% in 2011 and 1.9% in 2012, compared with 3.1% in 2010. Growth in the emerging and developing economies is also forecast to slow to 6.4% in 2011 and 6.1% in 2012, from 7.3% in 2010.

The IMF warned that risks to its forecast are clearly to the downside, with two in particular requiring attention from policymakers – first, that the European crisis may escalate beyond the control of policymakers, and second, that softening economic activity in the US may be further affected by factors such as a political impasse or a weak housing market.

*Recent data suggest that the US economy may be heading into 2012 on a strong note.*

While the European crisis seems to have worsened over the past couple of months, the most recent data suggests that the US economy may be heading into next year on a strong note. Although the US housing market continues to be in the doldrums, recent numbers on jobless claims, manufacturing and consumer confidence have been better than expectations. The substantial outperformance of US equity indexes this year may reflect investors' views that the economy may avoid a recession in 2012.

The IMF projected that the US economy would only expand by 1.5% this year, half the 3.0% growth pace of last year, but would grow at a slightly faster 1.8% rate next year. Participants in a recent Bloomberg survey of economists were more optimistic, forecasting that the US economy will probably accelerate to a 2.2% growth pace in 2012, from 1.8% this year.

Canada, on the other hand, is forecast to slow down in 2012 by both the IMF and the Bank of Canada. The Bank forecast in its October Monetary Policy Report that the Canadian economy would expand at a 1.9% pace in 2012, compared with 2.1% this year (the IMF had an identical forecast for Canada).

*The Bank of Canada continues to highlight record Canadian household debt as a major risk factor.*

One risk factor that the Bank continues to highlight is that of Canadian household debt, which rises to new records with every passing quarter. The Bank notes that because of the rising indebtedness of Canadian households in recent years, there is an increased possibility that a significant proportion of households would be unable to service their debt obligations in the event of an adverse economic shock.

Canadian households have increased their borrowing even as Canadian corporations have steadily reduced their outstanding debt. Household debt as a percentage of personal disposable income rose by almost 2.4 percentage points in the third quarter to about 153%. The ratio has increased by almost nine percentage points over the past six quarters, making Canadians more indebted than the Americans or British (Figure 3 on Page 8).

The North American economy may skirt recession in 2012, but Europe may not be so fortunate, especially if the debt crisis drags on and contagion spreads to other nations. While the IMF expects the Euro area to slow down to a 1.1% growth pace in 2012 from 1.6% this year, economists in a recent Bloomberg survey estimated a growth rate for next year that is half the IMF forecast, or 0.5%.

Although China and India are also expected to slow down next year, their forecasted 2012 growth rates of 9.0% (9.5% in 2011) and 7.5% (7.8% in 2011) respectively will still see them maintain their status as the fastest-growing major economies worldwide. But with both nations facing their own unique challenges, downside risks to the growth forecast are prevalent here as well.

Overall, it is very likely that sovereign debt will continue to be the “elephant in the room” well into next year, with actual and threatened credit downgrades by the rating agencies keeping the issue in the limelight. The pernicious effects of mushrooming public debt may be felt for decades to come, with indebted nations having to deal with massive cutbacks and austerity measures. The advanced economies have a heavy load to bear in this regard, since sovereign debt as a percentage of GDP now exceeds 100% (Figure 4 on Page 9). The emerging economies, in contrast, have a substantially lower debt burden.

*Europe’s debt situation is the biggest wildcard that could affect the global economy in 2012.*

The European debt situation appears to be the biggest wildcard that could affect the fortunes of the global economy in 2012. Speedy and credible resolution would lead to positive outcomes for the global economy and equity markets. On the other hand, an uncontrolled crisis could tip Europe into recession and significantly impact global growth, lowering it by as much as 3 percentage points, according to the IMF.

## OUTLOOK

The outlook for the TSX next year admittedly does not look very promising, amid slowing economic growth and heightened macroeconomic risk. Prospects look a little better for the S&P 500, with the US economy expected to hold its own in 2012.

### Earnings Estimates

Index earnings estimates continue to be on the higher side, which should come as no surprise to seasoned investors and market watchers. The only time in recent years that we have found index earnings estimates to be on the lower side was in December 2008, when the global economy seemed to be hurtling towards a deep, widespread Depression. While the global economy escaped with a Great Recession instead, the rebound in corporate earnings from 2009 onwards was faster and higher than even the most optimistic estimates at the end of 2008 (not that there were many of those at the time).

*Index EPS estimates for the TSX are little changed from a year ago, at \$915 for 2011 and \$1,038 for 2012.*

Presently, the 2012 index EPS forecast for the TSX – based on “bottom-up” earnings estimates from the analyst community for all index constituents – is at \$1,038, representing growth of about 13% from this year’s index EPS estimate of \$915. On an interesting note, despite this year’s dramatic developments, these index EPS estimates are virtually unchanged from a year ago.

*Earnings growth in 2012 for the TSX is expected to be led by Materials and Healthcare.*

Earnings growth in 2012 is expected to be led by the Materials and Healthcare groups, followed by the Industrial and Consumer Discretionary groups (Table 3). The Financials group is expected to record very modest EPS growth, while Energy earnings are forecast to increase appreciably.

**Table 3: TSX Groups – Forecast EPS change in 2012 & Valuations**

TSX Group	Forecast EPS change (%)*	Forward Index P/E**	Indicated Dividend Yield
Consumer Discretionary	11.5%	10.2	3.4%
Consumer Staples	8.1%	12.9	2.7%
Energy	11.4%	13.9	2.9%
Financials	4.5%	9.7	4.3%
Health Care	34.3%	12.7	2.3%
Industrial	22.6%	13.1	2.2%
Info Tech	-4.2%	6.1	0.3%
Materials	34.4%	10.1	0.9%
Telecom Services	3.9%	12.6	4.6%
Utilities	6.3%	17.7	4.7%
<b>TSX</b>	<b>13.3%</b>	<b>11.1</b>	<b>2.9%</b>

\*Forecast EPS change in 2012

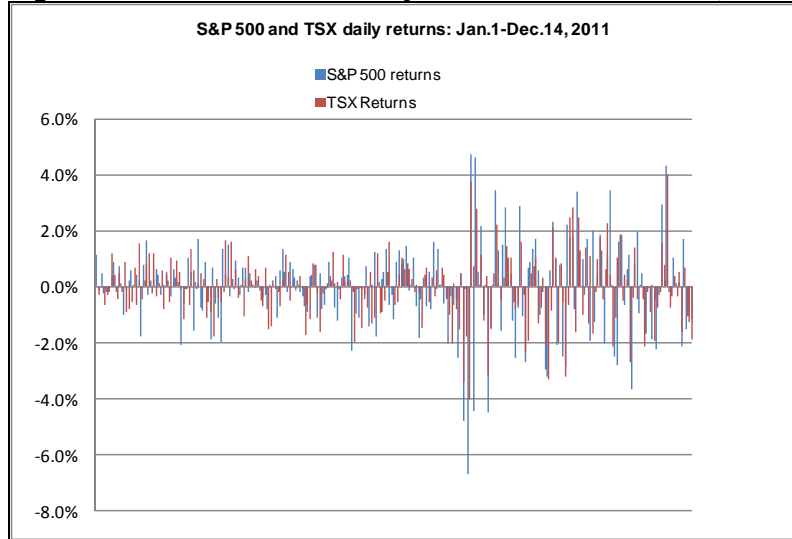
\*\* Forward P/E based on 2012 EPS estimate

Source: Global Securities Research, Bloomberg

In our opinion, the TSX may be hard-pressed to break the \$1,000 EPS barrier, especially as analysts may ratchet down earnings estimates for the Materials and Energy groups in the months ahead if the global economy worsens and commodity prices continue to tumble. In the current unsettled environment, earnings growth of 13.3% (while only about one-third of the 36% EPS growth rate expected for this year) over the next year seems quite ambitious.

**(Continued on Page 10)**

**Figure 1: S&P 500 and TSX daily returns – Jan. 1-Dec.14, 2011**



Source: Global Securities Research, Bloomberg

*Foreshocks or aftershocks? The variance of daily returns for the TSX and S&P 500 has increased significantly since April. Hopefully, this spike in volatility is just the financial markets' way of dealing with heightened macro risk, and not a precursor to a major financial earthquake.*

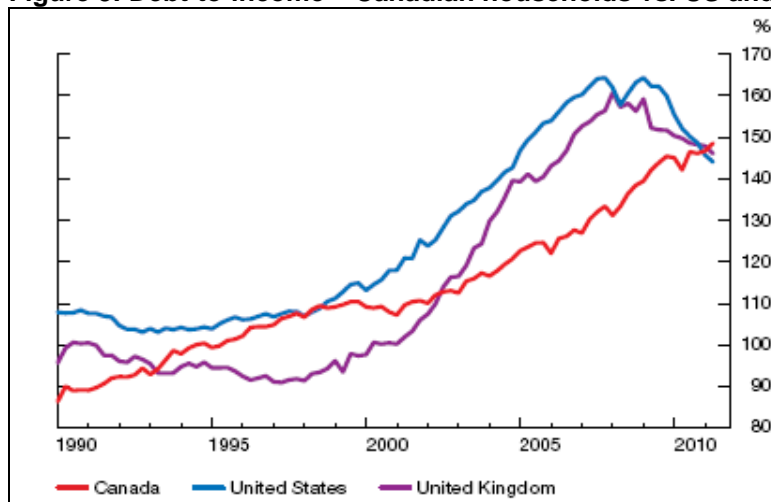
**Figure 2: Credit-default swaps for European vs. N. American firms**



\*Markit iTraxx Europe index vs. Markit CDX North America Investment Grade index  
Source: Bloomberg

*The cost of protecting European corporate debt against the possibility of default is near a record high vis-à-vis US corporate debt, a complete turnaround from 2008. As the chart shows, the CDS spread has been widening since mid-2010, when concerns about European sovereign debt first began building up.*

**Figure 3: Debt-to-income – Canadian households vs. US and UK**

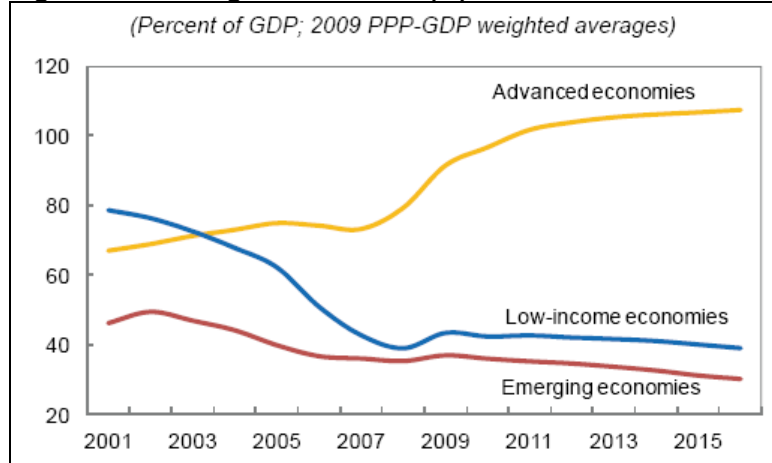


Source: Bank of Canada Financial System Review, December 2011

*Canadian household debt as a percentage of disposable income rose to a record 153% in Q3. With this metric now higher in Canada than in the US or UK, Canadians are increasingly vulnerable to economic shocks.*

**Figure 4: Sovereign debt to GDP (%)**

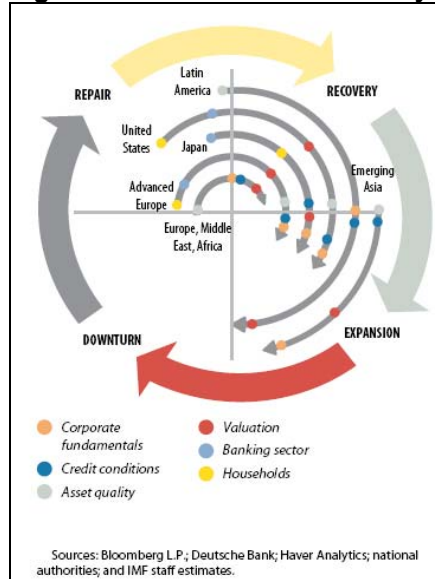
Advanced economies will be weighed down for the foreseeable future by their foreseeable future by their massive debt loads, now exceeding 100% of GDP. For the G-7 nations as a group, total sovereign debt as a percentage of GDP is back to levels that last prevailed in the 1950s. Emerging economies do not have these debt concerns.



Source: IMF Fiscal Monitor, April 2011

**Figure 5: Phases of the Credit Cycle**

The global financial crisis has left advanced economies at an earlier phase in the credit cycle and allowed emerging markets to move further along it, according to the IMF. It estimates that the US is straddling the recovery and expansion phases of the credit cycle, while the Euro area is at an earlier stage because of lags in the economic cycle and bank balance sheet repair, as well as high household leverage.



Sources: Bloomberg L.P.; Deutsche Bank; Haver Analytics; national authorities; and IMF staff estimates.

Source: Global Financial Stability Report, IMF, Sept. 2011

**Figure 6: TSX Technical Picture – Nov. 2008 to Present**

The technical picture for the TSX Composite is a somber one, with the uptrend dating back to March 2009 decisively broken earlier this year. The critical support level of 10,900 represents the line-in-the-sand for the index, and will almost certainly be tested in 2012.



Source: Global Securities Research, Bloomberg

**(Continued from Page 7)**

The S&P 500, which is well on course to post record EPS of \$97.27 this year (Figure 7), is forecast to post earnings growth of 10.3% in 2012. Index earnings are forecast to grow about 16% this year, which is also only about one-third of the 47% growth rate recorded in 2010, when earnings surged from their depressed levels of the preceding year.

**Table 4: S&P 500 Quarterly Operating EPS Estimates**

Period	2010-A	% Change	2011-E	% Change	2012-E	% Change
Q1	\$19.38	91.7%	\$22.56	16.4%	\$24.83	10.1%
Q2	\$20.90	51.3%	\$24.86	18.9%	\$26.55	6.8%
Q3	\$21.56	36.6%	\$25.30	17.3%	\$27.44	8.5%
Q4	\$21.93	27.8%	\$24.55	11.9%	\$28.50	16.1%
<b>Total</b>	<b>\$83.77</b>	<b>47.3%</b>	<b>\$97.27</b>	<b>16.1%</b>	<b>\$107.32</b>	<b>10.3%</b>

Source: Standard & Poor's

**Technical Picture**

*The technical picture for the TSX Composite has been worsening since May.*

The technical picture for the TSX Composite has been worsening since we first commented on this aspect in our weekly Market Bulletin of May 6. We had noted then that the index seemed to have broken through on the downside of the upward channel dating back to July 2010, and was poised for a test of the long-term trend line extending back to the March 2009 lows. We had also noted that the double-top around the 14,320 level, which had occurred over the span of a month, could turn into a significant resistance level.

Since then, the index has crashed through one support level after the other, and is fast approaching the "line in the sand" or key support level that has to hold if the rally that commenced in March 2009 is to continue. As noted in our November 25 Market Bulletin, this support level for the TSX is at 10,900 (Figure 6 on Page 9). It marks the 50% retracement of the run that commenced after the index bottomed out just below 7,480 in March 2009, and took it up 90% to a 33-month high of 14,329 on March 7, 2011. The corresponding line in the sand for the S&P 500 is 1,020. A test of these support levels is almost certainly on the cards in 2012.

*The index seems entrenched in a well-defined downtrend.*

The TSX now appears entrenched in a well-defined downtrend, and only a definitive break above the 12,000 level would negate the risk of a further decline.

Will the TSX and S&P 500 bounce off these critical support levels, as they did so convincingly nearly three years ago? There is a possibility that they could, although there are some factors that argue against a huge rebound –

- Although volatility has escalated, equity indexes are well away from their 2008/09 lows; as a result, while valuations are attractive, most stocks are not the absolute bargains that they were three years ago.
- Investors are likely to be increasingly wary of equities after the unprecedented market swings seen in recent months.
- The upsurge in macroeconomic risk and the financially stretched consumer will constrain appetite for "risk on" trades.
- Despite easy monetary policy, tight lending practices amid sluggish economic growth may hinder access to investment capital for retail investors.

**Valuations**

The TSX Composite currently trades at forward multiples of 12.6x 2011 estimated index EPS of \$915, and at 11.1x forecast 2012 index EPS of \$1,038. The S&P 500 trades at almost identical valuations, a forward multiple of 12.5x 2011 estimated index EPS of \$97.27, and at 11.3x 2012 forecast earnings of \$107.32.

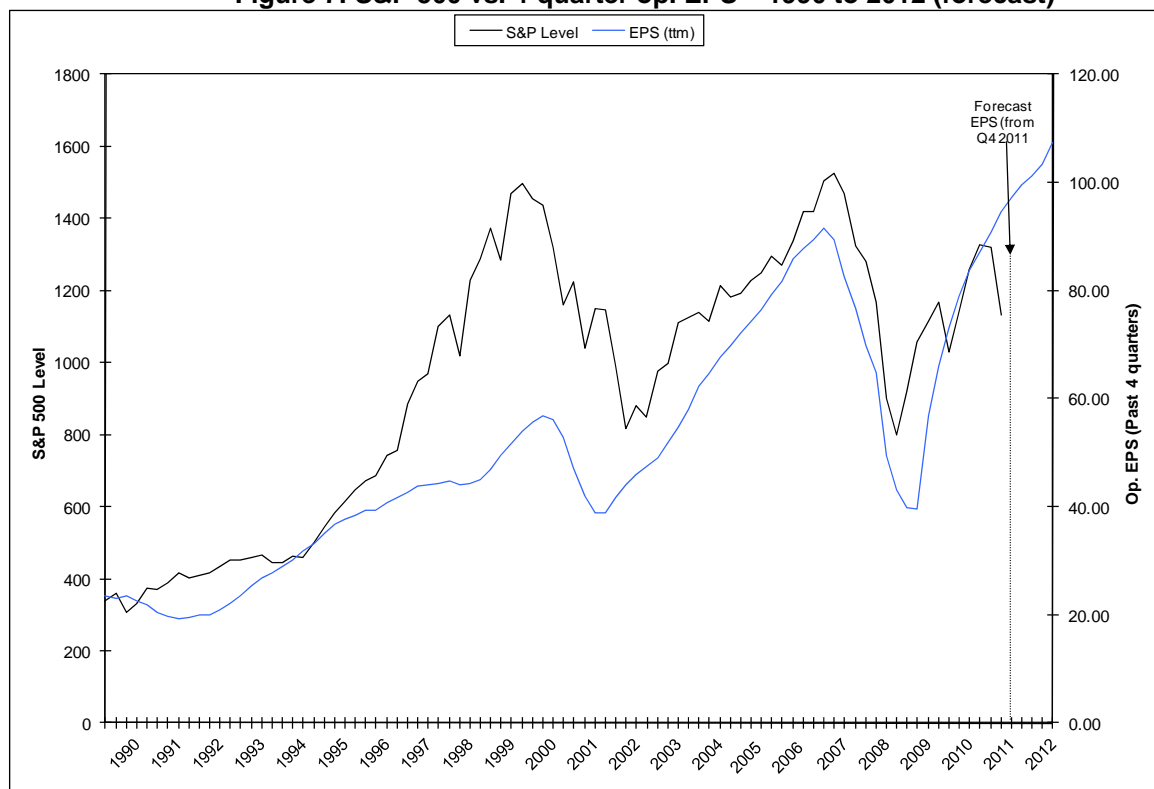
While those valuations are substantially lower than a year ago, they should be viewed against the backdrop of lower earnings growth next year. Index valuations may not look as attractive if EPS estimates for 2012 are lowered in the months ahead.

Current valuations also appear in line with earnings growth forecasts for next year. However, equity markets are quite adept at sniffing out earnings trends for the next couple of years; the possibility that current lower valuations may signal earnings growth that is significantly below current expectations cannot be ignored.

*Our end-2012 targets are 11,000 for the TSX and 1,200 for the S&P 500.*

Our end-2012 target for the TSX Composite, computed on the basis of a 11.2x multiple applied to our index EPS estimate of \$975, is 11,000, or about 4.4% below current levels. For the S&P 500, our end-2012 target is 1,200 (based on 12x our index EPS estimate of \$100), or 1% below current levels. We have assigned a lower earnings multiple to the TSX because of its higher earnings volatility (due to its 48% weighting in commodities) arising from disproportionate exposure to macro risk.

**Figure 7: S&P 500 vs. 4-quarter op. EPS – 1990 to 2012 (forecast)**



Source: Global Securities Research, Standard & Poor's

## Risks

Key risks that could have a negative impact on our forecasts are summarized below.

- **Strains in the European Union:** With policy makers running out of viable options to mitigate sovereign debt risk in the PIIGS nations, it is becoming increasingly harder to see how the European Union can survive in its present shape and form. Market-watchers are placing increasing odds on some members of the EU being pushed out of the monetary system in the years ahead, a proposition that was seemingly unthinkable a few months ago but is now seen as a possible option. The consequences of such an event are impossible to predict.
- **Sovereign debt defaults:** The possibility exists of a debt default by Greece or another of the PIIGS. The contagion effect in such a case may lead to sharply higher funding costs for other indebted nations, causing a domino effect of sorts.
- **Bank failures could trigger Credit Crunch Part II:** As the IMF notes, concerns about sovereign debt have translated into worries about the banks holding these sovereign bonds, especially in Europe. These worries have led to a partial freeze of financial flows, with banks keeping high levels of liquidity. Some indicators are pointing to elevated concern about global systemic risk, although they remain well below the peak levels reached in Q4 of 2008. If the European debt issue results in the failure of a large bank or institution, another credit crunch like the one that followed the collapse of Lehman Brothers could be a possibility.
- **Limited policy options for the Federal Reserve:** The Fed has used up most of the weapons in its arsenal to counter the consequences of the financial crisis and Great Recession. As such, it now has very limited policy options to combat another financial shock, should that occur.
- **Hard landing in China:** China took measures this year to curb rampant speculation in its real estate market and rein in capital investment. On November 30, the country's central bank cut reserve requirements for lenders for the first time in three years. While current expectations are that China will be successful in engineering a soft landing, a steep decline in growth would have negative ramifications for the global economy.
- **Currency volatility:** The euro managed to stay firm for most of the year, but is coming under pressure heading into 2012. Recent risk aversion has led to safe-haven demand for US Treasuries, which in turn has caused the greenback to appreciate. If the global environment worsens, the US dollar may strengthen as it did in 2008-09, exacerbating declines in commodity prices because of its negative correlation with commodities.

*The failure of a large bank or institution could possibly result in another credit crunch, like the one that followed the collapse of Lehman.*

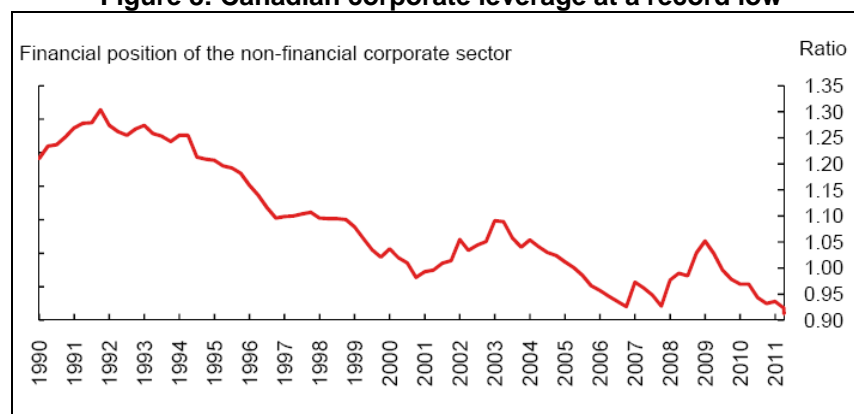
## PORTFOLIO STRATEGY

Although headwinds abound and risk factors are predominant at the present time, there are a number of positive drivers that could spur upside performance in 2012. These include –

- **Extremely stimulative monetary policy:** The Federal Reserve this week reiterated its intention to leave the federal funds rate at exceptionally low levels at least through mid-2013. In Canada, the central bank is also perceived to be on hold until mid-2012 at least. While cheap money can encourage speculative excess, it is also the vital fuel that can prime the economic pump and foster a strong recovery.
- **Solid earnings growth:** Notwithstanding recent economic challenges, analysts continue to forecast double-digit EPS growth for the TSX and S&P 500 over the next two years. As Figure 7 demonstrates, there is a close positive correlation between earnings growth and equity index performance. If earnings expectations are met, equity indexes could rebound strongly next year.
- **Oversold conditions:** Stocks in certain sectors appear deeply oversold, making a rebound quite possible once sentiment turns around.
- **Valuation support:** The TSX and S&P 500 are trading at attractive forward valuations that are below their long-term average. Many stocks are also trading at single-digit earnings multiples, which could mitigate the risk of additional declines.
- **Solid balance sheets:** Government balance sheets may have deteriorated over the course of the past three years, but corporate balance sheets are in great shape, thanks to diligent efforts to shore them up in the wake of the 2008 credit crunch. Leverage in the non-financial corporate sector in Canada is currently at a record low (Figure 8), making it easier for such companies to withstand periods of financial stress and turmoil.

*While government balance sheets have deteriorated over the past three years, corporate balance sheets are in great shape.*

**Figure 8: Canadian corporate leverage at a record low**

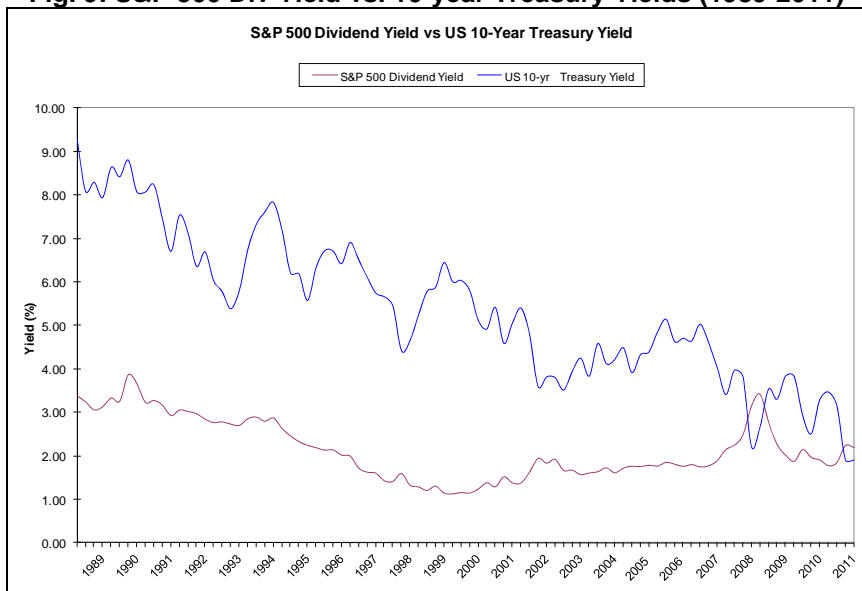


Based on these views, we present the following portfolio strategy recommendations and investment themes for 2012.

*The barbell strategy is especially effective during volatile periods, and will enable investors to take advantage of short-lived rebounds.*

1. **Use the barbell strategy for investment portfolios:** The market environment always looks bleakest just before things turn around for the better, as they did in March 2009. So while stocks could have still significant downside risk from these levels, upside potential triggered by a massive turnaround in sentiment is certainly a possibility. We therefore strongly advocate a barbell strategy for investment portfolios, which would involve balancing longer-term core positions in high-dividend yield, defensive sectors, with tactical trading positions in cyclical stocks. This approach is particularly effective during periods of volatility, and will enable investors to take advantage of temporary market rebounds like the one in October.
2. **Opt for short-term corporate bonds over sovereigns:** In our opinion, balance sheets of many corporates whose bonds are rated below investment grade are arguably in better shape than many highly indebted sovereign nations. Spreads are widening as investors continue to gravitate towards the dubious safe-haven of US Treasuries even while growing concern about global growth prospects pushes corporate bond yields higher. With little risk of inflation at present, and major central banks either on hold or in easing mode (EU and China), we would suggest investing in short-term corporate bonds rather than government bonds of comparable maturity.
3. **Keep your risk tolerance uppermost in mind when deciding between blue-chips with above-average dividend yields or their bonds:** Assuming that an investor is only interested in yield and is indifferent to asset class, choosing between a blue-chip with a higher dividend yield than its five-year bond, and the bond itself was easy – the stock was preferable in most cases. But it's a different story now, which is why we suggest keeping your risk tolerance uppermost in mind when deciding between the stock and the bond. With US and Canadian government bond yields plunging to record lows this year, the yield on 10-year US Treasuries of 1.91% is well below the dividend yield on the S&P 500 of 2.19% (Figure 9). This anomalous situation is similar to that seen in 2008, and while it may suggest a great buying opportunity for stocks, it may also be a harbinger of tough economic times ahead. Investors for whom capital preservation is of the utmost importance should therefore opt for the safer bond – despite its lower yield – in this uncertain environment.
4. **Avoid dividend debacles:** The allure of double-digit dividend yields may be hard to resist, but investors with low to moderate risk tolerance would do well to stay clear of such stocks. Although dividend cuts did not occur to the extent that we had expected in 2011, we believe there is a growing risk of a significant number of companies slashing dividends in 2012, as economic conditions become more challenging and dividend payouts become harder to sustain at current levels. Stocks of companies that have either slashed / eliminated dividends (Yellow Media, Armtec) or are perceived as being at significant risk of doing so have posted substantial declines this year.

*The yield on 10-year US Treasuries is well below the dividend yield of the S&P 500, an anomalous situation similar to that seen in 2008.*

**Fig. 9: S&P 500 Div Yield vs. 10-year Treasury Yields (1989-2011)**

Source: Global Securities Research, Standard & Poor's

*Consider covered calls and preferred shares for investment portfolios.*

5. **Follow these three principles for dividend payers:** (i) Stick with quality (a large-cap utility or telecom is eminently preferable to a small or mid-cap stock in a cyclical sector). (ii) Check payout ratios and financial stability (ask yourself – Is the dividend sustainable? Does the company have too much leverage? Why is the stock sliding despite its attractive dividend?) (iii) Pay attention to long-term fundamentals.
6. **Consider covered calls for additional yield:** Based on our forecast for volatility to ease in 2012, we recommend covered calls as a way of generating additional yield within a portfolio without incurring too much incremental risk. Covered calls are the preferred option strategy when upside moves are capped and markets are expected to move sideways to lower with declining volatility, a scenario we think is likely next year.
7. **A good time to prefer preferreds:** We like preferred shares at the present time for a number of reasons – the dearth of high-yield alternatives, the preferential tax treatment on preferred dividends, and their lower volatility. We especially prefer preferred shares to common shares of an issuer in a sector such as banking, which has to contend with a heightened degree of uncertainty.
8. **Exercise caution on bank shares:** Shares of European and US banks are sliding, and many of them are trading at substantial discounts to their book values. However, Canadian banks are trading at premium valuations, with the Big 5 presently trading at an average 1.7x book value. By way of comparison, the US banks in the KBW index are trading at about 0.65x book value. While Canadian banks deserve a premium valuation because of their stronger financial position and prudent risk management practices, they may not be totally immune to pressures in the global banking sector if they intensify. We suggest refraining from adding to positions in bank shares at the present time.

*We are cautious on bank shares and suggest refraining from adding to positions at present.*

**9. Canadian REITs may encounter profit-taking:** REITs have been one of the best-performing asset classes this year, dominating the ranks of the top performers on the TSX Financials index. But the risk of a slowdown in the Canadian economy, coupled with the fact that the TSX REIT index traded at a four-year high in July, leads us to believe that the sector's stellar performance may make it vulnerable to profit-taking in 2012.

**10. Opportunistic M&A may continue:** Recent acquisitions (Grand Cache Coal, Quadra FNX Mining) by buyers with deep pockets are undoubtedly opportunistic, although investors in these stocks have scant reason to complain. We forecast more such opportunistic M&A activity in 2012, although we expect this to be largely restricted to mid-cap, non-marquee names in the mining and energy sectors, whose acquisitions are unlikely to attract political opposition.

*The disproportionate selloff in gold producers is an opportunity to accumulate senior producers trading at compelling valuations.*

**11. Accumulate senior gold producers:** Gold producers, which seem to perpetually lag the price of gold, have sold off disproportionately in the wake of gold's recent plunge. We believe this represents an opportunity to accumulate shares of senior gold producers, many of which are trading at compelling valuations.

Based on the foregoing analysis, we are reducing the equity allocation in our recommended asset mix by five percentage points to 55%, and are boosting the bond component by a similar amount to 20%. Our cash weighting remains at 25%, as we believe it may be prudent to keep our powder dry to capitalize on future investment opportunities in the event of a steep market decline. **Our recommended asset allocation is therefore – Stocks 55%, Bonds 20% and Cash 25%.**

**Table 5: Recommended Asset Allocation – Changes over past three years**

Asset Class	Weighting								
	Dec.'08	Apr.'09	July '09	Nov.'09	Dec.'09	Apr.'10	Dec.'10	Apr.'11	Dec.'11
<b>Stocks</b>	45%	50%	50%	55%	60%	60%	60%	60%	<b>55%</b>
Change in weight		5%	0%	5%	5%	0%	0%	0%	-5%
<b>Bonds</b>	30%	30%	30%	25%	20%	15%	15%	15%	<b>20%</b>
Change in weight		0%	0%	-5%	-5%	-5%	0%	0%	5%
<b>Cash</b>	25%	20%	20%	20%	20%	25%	25%	25%	<b>25%</b>
Change in weight		-5%	0%	0%	0%	5%	0%	0%	0%
TSX level	8564.93	9073.14	9773.92	10878.35	11463.40	12186.35	13166.94	14270.53	11504.42
TSX change (%)		5.9%	7.7%	11.3%	5.4%	6.3%	8.0%	8.4%	-19.4%
S&P 500 level	896.47	834.38	882.68	1042.88	1102.47	1187.44	1233.00	1332.63	1215.75
S&P 500 chg.(%)		-6.9%	5.8%	18.1%	5.7%	7.7%	3.8%	8.1%	-8.8%

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