Financial Market Review

BMO Global Asset Management

BMO Asset Management U.S.

Fourth Quarter 2012

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Economic Outlook and Review

SLOWEST POST-WAR RECOVERY EVER

2012 GDP growth will likely be measured in the 2.0% to 2.5% range after all the numbers are finalized. This is still the slowest recovery from a recession ever experienced in the post-war era. Employers are barely hiring enough workers to keep up with the growth of the workforce. Thus, unemployment rates are uncomfortably high at this stage of the recovery. This is not unnoticed by the Federal Reserve, as Fed Chairman Bernanke has recently announced monetary policy will remain aggressive until the unemployment rate drops to 6.5% from the high 7% range of today. Unfortunately, the recent declines in the unemployment rate have resulted more from a decline in the workforce participation rate rather than a typical recovery where employers boost overall payroll by adding workers.

DYSFUNCTION IN WASHINGTON, D.C. LEADS TO DROP IN BUSINESS/CONSUMER CONFIDENCE

The small business optimism index recorded the largest one-month drop ever in November 2012. Fiscal uncertainty has remained a hindrance to business confidence that in turn leads to cautious behavior exhibited by lackluster capital investment. Worries among business executives normally include weak demand, inflation and healthcare costs. But now, confusion over fiscal policy here and abroad coupled with politically charged tax policy debates have trumped more traditional business concerns.

The average consumer has also been affected by the ongoing fiscal shenanigans witnessed at year-end. For example, the December Conference Board measure of consumer confidence came in below expectations. Congressional approval ratings are at rock bottom, likely meaning the average American doesn't put much faith in the legislative process anymore.

Any reduction in federal fiscal spending represents an economic restraint. The new year will be a battle between undefined cuts in federal spending versus the slow but steady revival in the private sector. What spending cuts will prevail? Will the statutory debt limit be used as a lever in negotiations over spending? Both are critical questions determining fiscal policy in 2013 and beyond. So far, what we do know is the payroll tax restoration will be a reduction in disposable personal income for all workers. Fortunately, most of the fiscal drag due to state and local spending cuts are behind us.

BALANCE SHEETS ARE STRONG

Since the end of the recession, both businesses and households have deleveraged significantly. For businesses, unit labor costs are virtually unchanged since the end of the recession, allowing the opportunity for expanded profit margins. Financial organizations have steadily repaired weak balance sheets. The U.S. financial system has never been stronger given additional billions of dollars in new capital and tighter loan underwriting standards. Among first mortgages, the number of loans that have been delinquent for one or two months has never been lower.

Higher income households have shed debt and/or refinanced loans at today's low rates whenever possible. Across all households, the debt service burden (after-tax income used to pay interest) is near a record low.

LONG-AWAITED HOUSING UPTURN ARRIVES AS MOMENTUM BUILDS

Housing is one area of the economy where there is good reason to be optimistic. For the last five years, housing starts have not kept pace with household formation. The option to buy or to rent is swinging in favor of buying as rents have increased while the cost of servicing a mortgage has gone the opposite way. For those who qualify for a mortgage loan, home affordability is within reach.

New home sales increased 4.4% between October and November to an annual sales rate of 377,000 units, the highest in more than two years. Importantly, new home inventories are near a record low (only 4.7 months supply), which gives builders enough confidence to hire back workers to ramp up new home construction. Pending home sales have shown recent strength too. They lead existing home sales by about two months which will add to an already healthy existing home sales pace. Existing home inventories currently stand at the lowest level in the last seven years.

Stronger sales support higher prices as evidenced by the October S&P/Case-Shiller 20 City composite gain of 4.3% year over year. As a home normally represents the biggest asset someone owns, an upturn in pricing causes people to reevaluate their personal financial condition. When home prices stabilize and recover, the so-called wealth effect becomes a positive for future consumer confidence and spending.

SOME MANUFACTURING HEADWINDS REMAIN

Larger than ideal inventory levels coupled with sluggish business investment has created an atmosphere of caution for many manufacturers. The overall strength in the auto sector is a clear exception in this environment. Industrial production numbers are much more robust in geographic regions of the country that are involved in automobile parts and assembly. December was an abnormally strong month for vehicle sales, likely influenced by Hurricane Sandy replacement demand.

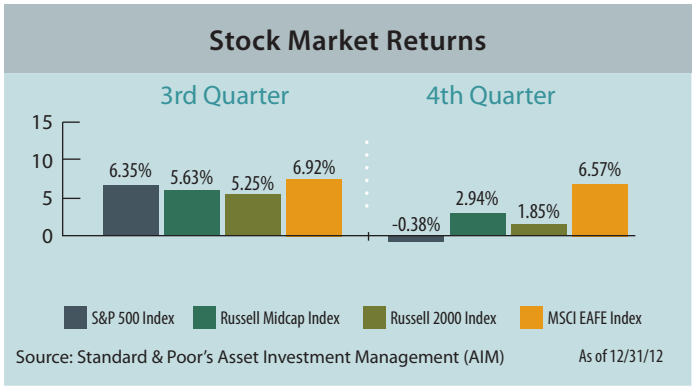
MINIMAL INFLATION PRESSURES

As measured by the Consumer Price Index, 2012 was a tame year for inflation as both the core and overall rate of inflation was approximately 2%. The second half of the year was aided by falling energy prices, but longer-term inflation is much more dependent on labor costs. During a time of inflated unemployment rates, it stands to reason unit labor costs for the year were nearly flat. Now that the Fed is drawing a line in the sand at 2.5% inflation as the upper limit of tolerance, it appears 2013 economic activity will not be strong enough for Bernanke and company to move to a more restrictive monetary policy stance. In a period where some fiscal policy restraint will be seen, this will prove to be an important monetary offset in an otherwise plodding economic recovery.

Stock Market Review

Not even the fear of falling off the financial cliff could derail the stock market as it closed the year with solid double-digit gains across the board. With the exception of the presidential election, investors can expect to continue to deal with many of the same concerns that have caused so much anxiety over the past few years. There is a sense that European struggles have died down at least temporarily, and slow, steady economic growth will likely continue in the U.S. This once again shows that the stock market has the ability to climb a wall of worry when valuations are reasonable and investor sentiment is cautious. Large cap stocks (S&P 500® Index) were down a modest -0.4% for the quarter but up a strong 16.0% for the year. Mid-cap stocks, (Russell Midcap® Index) were up 2.9% for the quarter and 17.3% for the year. Small-cap stocks (Russell 2000® Index) were up 1.9% for the quarter and 16.4% for the year. International stocks were the big winner with the MSCI EAFE Index up 6.6% for the quarter and 17.9% for the year.

Stock investors can thank the Federal Reserve for maintaining an interest rate policy that encourages moving away from short-term bond instruments. The Fed now says that the low interest rate policy will stay in effect until unemployment



goes below 6.5% and/or inflation above 2.5%. Last year's immediate concerns regarding a banking collapse in Europe, and a significant slowdown in China, never materialized. Our own economic recovery has been slow, but appears to be sustainable as we head into 2013. Two significant positives to watch include a recovering housing market and energy independence resulting from new drilling technologies. Both housing and energy could lift economic growth, which would lead to better employment numbers. We are just starting to see manufacturing come back to the U.S. to take advantage of the lower natural gas prices.

Despite a significant upward move, stocks continue to look reasonably priced by most valuation measures. The S&P 500 sells at 14.3 times expected 2012 earnings estimate of $100 per share. This translates into an earnings yield of 7%, which is particularly attractive compared to a 10-year Treasury yield of 1.7%. The unreported story for last year may be the renewed focus on dividends. Many banks reinstated their dividends while others were more aggressive about increasing previous payout level. The pace of earnings growth slowed last year, but we expect another positive, albeit modest, increase again in 2013. International stocks, particularly Europe, are even cheaper but carry their own unique risks.

It is always a surprise when stocks perform so well in the face of so many obstacles. Yet we know that by the time most investors become comfortable with committing new funds to equities, stocks are already up in price and much of the outsized returned is behind us. In our view the credit crisis of 2007 – 2009 did as much damage to investor confidence as it did to our economy. This resulted in money flowing out of equity mutual funds into bond funds for most of the year. Stocks now make up less than 38% of the average household's financial assets, down from 50% in the technology-driven bull market of the late 1990s. Unfortunately, this means many investors have not fully participated in the stock market recovery over the past three years. As more investors regain confidence, we expect money to flow back to equities. This will likely hasten when interest rates move higher and investors become frustrated with lower bond returns. In our opinion targeting an appropriate strategic equity allocation within a diversified portfolio continues to be the best way for investors to participate in long-term benefits of stocks.

Fixed Income Market Review

CORPORATE BOND MARKETS SIGNIFICANTLY OUTPERFORM FOR THE YEAR

Investing for safety proved to be a very expensive strategy in 2012. Generally, riskier credits generated returns that were far superior to anything else in the bond market. Record low central bank rates around the world pushed investors into higher yielding assets. Some consider this yield-chasing behavior a precursor to a painful correction, but until yields of Treasury securities move significantly higher there are few places in the bond market that generate adequate income.

Junk bonds outperformed investment grade bonds by the widest margin since 2010. After a solid fourth quarter return of 3.2%, high yield bonds recorded a 15.2% return for the year (per Bank of America/Merrill Lynch). This compares to returns of 1.2% and 10.4%, respectively, for investment grade corporate bonds over the same time periods. Corporate bonds have now rallied for 13 straight months, eclipsing the past record of consecutive monthly rallies of eight months set in 2003, 2005, and 2009.

Stratification by credit quality breakdown further demonstrates how "risk-on" positioning benefited bond portfolio performance. Per Barclays, corporate bonds graded CCC earned 18.3% for the year. BB and B rated bonds returned "only" 14.5% and 15.5%, respectively. BBB returns for the year were 11.5%. Contrast those returns to that of a 10-year Treasury bond that recorded a return of 4.1%.

Thus far, slow economic growth has failed to dent corporate credit quality. The global default rate of corporate bonds as measured by Moody's has dropped to 2.7%. The long-term annualized average default rate history since 1983 is 4.8%.

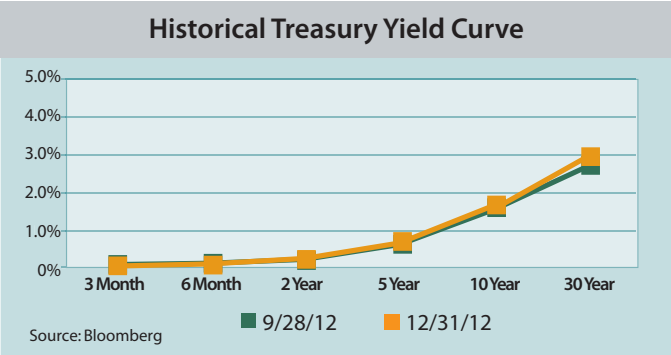
GLUT OF BOND SUPPLY FAILS TO SATISFY DEMAND

Paradoxically, the lower yields go, the more people want to own bonds. In many cases, bond yields are at or near record low levels. At the same time, corporations and governments issued record amounts of debt. Sales of corporate bonds of all quality grades surpassed the record in 2009, reaching $3.95 trillion according to Bloomberg. But flows into bond funds together with Federal Reserve Bank purchases more than offset any supply glut.

Today, many companies are borrowing more than they require, essentially pre-financing their needs in future years at unheard of low borrowing costs. The move to keep interest rates low as engineered by Fed Chairman Ben Bernanke prompted both investment grade and high yield borrowers to sell more bonds than ever before in one year. Some companies sold bonds with interest rates below half a percent for the first time in history, well below the underlying rate of inflation.

MUNICIPAL BONDS PERFORMED WELL IN 2012

As was the case in corporate bonds, longer maturities outperformed shorter bonds, and lower-rated issues outpaced higher-quality bonds. Revenue obligations performed better than general obligation debt as investors preferred the safety of predictable revenue streams as opposed to the tax revenue generated from unsteady property taxes and sales taxes. The slow pace of economic growth still generated an overall increase in tax receipts, and municipal financial health has approached or exceeded pre-recession levels. Well-publicized troubles in select municipalities serve as a reminder that some problems remain, especially in the area of under-funded pension plans. Of course, the ongoing drama in Congress over how to deal with budget deficits creates an environment where every potential revenue source is scrutinized, including the tax-exempt status of municipal interest. An outright abolition of tax-free interest is unlikely, but the idea of capping the deductibility of interest is still being considered.



State governments are starting 2013 in the best financial shape since the end of the recession. Home values have stabilized and are rising in many places. Local municipal revenue had been threatened by property tax delinquencies and lowered appraisals, but the worst appears to be over.

WHERE DO WE GO FROM HERE?

During the past three years, investors around the world have shifted nearly $700 billion into bond funds, while pulling nearly $300 billion out of stock funds. In those years, often more than half of the total return generated by bond funds came from capital appreciation as yields fell and corporate yield spreads contracted as compared to Treasury securities. Sooner or later the law of diminishing returns will apply. Part of the risk facing investors is that the math on bond prices and yields means just a small move higher in interest rates will significantly impact returns. Durations have lengthened significantly due to lower rates. A 10-year Treasury yielding about 1.7% would lose 9.2% in value if interest rates rose by 1.0%. A comparable maturity investment grade corporate bond would drop by more than 6% in value given the same move higher in rates. This doesn't translate into a recommendation to sell all your bonds, but recognition that there is little room for additional capital appreciation. Future return expectations should be tempered by this reality.

Alternative Investments Review

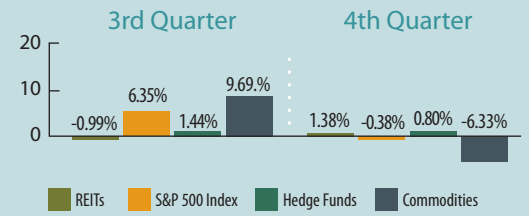
As the fiscal cliff loomed, prospectively higher taxes on capital gains, dividends, and incentive fees (carried interest) earned by private equity managers seemed inevitable. The fourth quarter of 2012 provided a window for sellers to realize gains from long-held positions, and for buyers to identify attractive values from a broad inventory of new opportunities.

In the private equity area, sellers were spurred by tax considerations as well as improved valuations in concert with the upward track of publicly traded equity markets. Buyers benefited from low cost deal financing and from motivated business owners worried that further expansion would be hurt by increasing government regulatory costs.

Uninspiring recent hedge fund performance (3.5% for 2012) has curbed the enthusiasm of the ultra-high net worth investor class. However, institutional investors such as pension funds and endowments have expanded their commitments in order to harness lower volatility and pursue improved risk management. This transition has favored the larger hedge funds and caused the closure of smaller funds. "Fund of fund" multi-manager strategies have also been negatively impacted as many institutions have the wherewithal to diversify across fund strategies independently. Finally, hedge fund managers have been under pressure from Federal government prosecutions for alleged insider trading violations by setting new standards for what was once defined as proprietary research.

Real estate investment continues to attract capital from investors seeking yield from real assets, especially tangible properties that generate rental income. Likewise, infrastructure investment in pipelines and conveyance providers has provided steady cash flow and the opportunity for appreciation.

Selected Alternative Indexes vs. S&P 500 Index



Source: REIT returns represented by the Wilshire U.S. REIT Index, Hedge Funds represented by the HFRX Global Hedge Fund Index and Commodities represented by the Dow Jones UBS Commodity Index. As of 12/31/12

Commodity indexing strategies have broadly disappointed this year. For example, the DJ UBS Commodity Index had a negative return of 1.1% for the year. Demand has moderated and inflation has been subdued. Grains rose in price during the summer drought (+18.1% in 2012), while precious metals fell (-14.5%) along with energy (-9.4%).

As 2013 emerges, risk-management discipline is coveted by investors across the spectrum of alternatives. Lesser risk appetite may limit performance in up markets in the short-term, but loss avoidance or minimization may improve long-run return profiles.

Monthly Updates:
Readers are reminded that our detailed Monthly Economy and Markets publication is available from our websites at **bmogamus.com** and **bmofundsus.com**.

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