Market Matters - MONTHLY INVESTMENT COMMENTARY

2010 HIGHLIGHTS

- Global equity markets ended on a high note in 2010, boosted by an improving investor confidence and positive global growth outlook.
- In the U.S., the second round of quantitative easing and extended tax cuts helped to improve the outlook and sentiment for the U.S. economy – giving a year-end lift to global equity markets.
- European markets struggled more in 2010 under the weight of persistent sovereign debt worries, particularly in Greece and Ireland.
- Bond markets were stronger through the middle of the year, but ended the year on a down note.
- The Canadian dollar rose close to 6% to end the year at parity with the US dollar.
- Global growth and strong commodity prices all contributed to the strength of the Canadian dollar, including:
    - Gold up 29%
    - Copper up 31%
    - Nickel up 34%
    - Oil up 15%

HERE'S TO GOOD ENDINGS!

Equity markets zigzagged their way along until late summer when markets finally caught some traction and moved upward to the end of 2010 (see table 1). The catalyst seemed to be the discussions about, and eventual announcement of, QE2 (another round of quantitative easing and asset purchases by the U.S. central bank) targeted to boost economic activity and recovery. This was soon reinforced by better than expected third quarter corporate earnings and improved economic news out of the U.S. Once on track, the gains were impressive and equity markets finished off 2010 with a strong rally.

THE ROAD TO SUSTAINABILITY

This past year, investors concerned themselves with issues of sustainability:

- Can the U.S. sustain its economic recovery, or will it fall back into a double dip recession?
- Can China sustain its fast-paced growth, or will asset-bubbles and inflation be its Achilles heel?
- Can the European Union sustain the financial pressure of its struggling members, like Greece and Ireland?

Table 1
Summary of major market developments

Market Returns*	Dec.	Q4 2010	YTD
S&P/TSX Composite	3.8%	8.7%	14.4%
S&P500	6.5%	10.2%	12.8%
- in C$	*3.2%*	*6.5%*	*6.2%*
MSCI EAFE	4.7%	5.2%	2.0%
- in C$	*5.0%*	*3.1%*	*-0.6%*
MSCI Emerging Markets	4.4%	5.5%	11.7%
DEX Bond Universe**	0.2%	-0.7%	6.7%
BBB Corporate Index**	0.3%	-0.6%	9.5%

*local currency (unless specified); price only
**total return, Canadian bonds

Other Price Levels/Change

	Level	Q4 2010	YTD
USD per CAD	$1.01	3.5%	5.8%
Oil (West Texas)*	$91.33	14.4%	15.2%
Gold*	$1,418	8.9%	29.3%
CRB Industrials*	$723.78	30.2%	56.8%

*U.S. dollars

Table 2
Sector level results for the Canadian market

S&P/TSX sector returns*	Dec.	Q4 2010	YTD
S&P/TSX	3.8%	8.7%	14.4%
Energy	7.3%	12.8%	10.0%
Materials	4.4%	14.1%	35.8%
Industrials	3.3%	4.3%	14.4%
Consumer discretionary	2.7%	6.2%	21.8%
Consumer staples	2.6%	4.5%	8.3%
Health care	5.4%	8.8%	50.3%
Financials	2.1%	4.0%	6.3%
Information technology	-4.7%	13.1%	-11.6%
Telecom services	-1.3%	-0.8%	16.2%
Utilities	2.3%	3.6%	12.6%

*price only
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

While none of these worries have completely gone away, the later part of 2010 shone a brighter light on the ability of countries to overcome these economic challenges.

Bond returns surprised many market watchers during the year, as demand for bonds remained high despite the low yields and the significant periods of equity market strength. However, in the last quarter of 2010, the improving economic picture did create a drag on bond prices, and the steady inflow of investors seeking the safety of fixed-income softened. Overall, however, the results for the year were very respectable for fixed-income investors.

North American equity markets managed some of the strongest 2010 returns, thanks to strong earnings results from corporations. This highlights that companies have cleaned up their balance sheets and have more or less fully recovered from the financial crisis – a positive sign towards the eventual pick-up in employment. Likewise, the American consumer gradually showed signs of renewed life as evidenced by improved consumer spending. The good news on the U.S. front was quickly translated to good news for Canada, improving our outlook for exports and for commodity demand in general.

THE DRAGON AND THE PIIGS

European markets on the other hand had a much more difficult time in 2010. Ongoing struggles with sovereign debt continued to surface. As negative headlines about Greece faded, worries over Ireland and the other peripheral countries (Spain, Italy, Portugal) emerged, disrupting investor confidence for much of 2010. However, as the year unfolded and the European Union dealt with each country's crisis, the challenges proved not to be game changers for overall global growth - helping to ease investors' concerns going into 2011.

The focus for emerging market economies continues to be squarely on China. Markets responded with volatility to worries that the Chinese government would be too slow, or worse, too heavy-handed in their efforts to moderate growth and avoid a housing market bubble and/or run-away inflation. Consider that China's emergence as a major economic world player is still in its early stages (relatively speaking), with little precedents on how the Chinese government is likely to proceed in managing their fast growing economy. While the debate will no doubt rage on in 2011, China appears to be pursuing a moderate approach to tightening lending standards – and investor confidence tends to favour the "moderate approach" when it comes to monetary policy.

MATERIAL GAINS

Taking a closer look at the Canadian S&P/TSX in 2010 (see table 2), we see the impressive results of the Materials sector – truly a driving force for the Canadian equity market this past year. As concerns of a double-dip recession in the U.S. faded, the global economic outlook improved and commodity prices rallied. Precious metals, fertilizer products and base metals all had very strong results in 2010, boosting the commodity-heavy S&P/TSX, and adding to the appeal of our Canadian dollar. Stepping back further, we can see that the cyclical sectors (like Energy and Materials) were stronger than the defensive sectors (like Utilities, Financials and Consumer Staples), and smaller companies (measured by capitalization size) outperformed larger companies by a significant margin in 2010. Both results highlight that investors became more and more comfortable with taking on riskier assets in the improving economic environment.

MAKING THE BEST OF A ROCKY ROAD

Looking forward into 2011, we believe the long-term outlook for equity markets is reasonably optimistic, supported by strong corporate earnings, and an improving situation for U.S. consumers and the U.S. economy (still a driving force for global economic health). Having said that, we do expect volatility to remain high, making it important for investors to consider the benefits of taking a long-term and diversified approach to their portfolios. Why? Because investing can be like a bowl of Rocky Road ice cream; rarely do you get a spoon full of just plain vanilla or only pure chocolate. Instead, plan for a mix of both with a few marshmallows to get you excited, and a few nuts thrown in just to keep it interesting!