

## Headwinds and Turbulence— An Outlook for 2007

by Dr. Sherry Cooper



Canada and the United States are facing economic headwinds, creating turbulence for financial markets on both sides of the border. These winds are unlikely to dissipate any time soon.

Housing is the headwind for the U.S. economy. New and existing home sales are now recording double-digit declines compared to levels a year ago, causing the inventory of unsold homes to surge to its highest level in more than a decade. In the meantime, new and existing home prices are deflating. Reflecting these trends, the first gust of the housing headwind reduced residential investment, cutting 0.7 percentage points from Q2 U.S. GDP growth of 2.6% annualized.

The second gust is still a gathering storm. Lower home sales and construction activity should eventually lead to slower sales of home furnishings and appliances, along with job layoffs in the construction and real estate sectors. Meanwhile, mortgage equity withdrawal has reined-in after supporting both home sales and general consumer spending for years.

However, there are offsets to this headwind. Lower energy prices are sparking spending just in time for the holiday shopping season, and business capital spending should remain buoyant as corporations boast the healthiest balance sheets in years. We look for U.S. economic growth to keep to the mid-2% range through to next spring, just in time for a pair of quarter-point Fed rate cuts.

The Fed's current pause is expected to persist for nearly a year despite the housing headwind, as the U.S. central bank keeps an eye on lingering price pressures. The Fed's preferred inflation measure, the core PCE price index, is currently running at an 11-year high of 2.5% year-over-year (over the 2% limit of the Fed's "comfort zone") and critical leading indicators such as unit labour costs are accelerating. The U.S. bond market had been rallying as the Fed stopped hiking rates in late June, but is now partially reversing course as inflation proves stubborn. Meanwhile, U.S. equity markets have been buoyed by the decline in energy prices and the prospect of a soft landing in the U.S. economy. The major U.S. stock indices have recently hit record or multiyear highs. As the full force of the housing headwind is felt early next year, U.S. bond yields should edge downward, but economic growth worries might weigh heavier on U.S. equities. [continued on the back page](#)



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# > ALL HEAVY HITTER MODEL PORTFOLIOS DELIVERED POSITIVE RESULTS IN 2006

by Ranga Chand



In a year where financial markets have been decidedly volatile and have tested the resolve of investors, I am pleased to report that in our annual performance review, the Heavy Hitter®\* Select, Index and Tax Efficient Model Portfolios, available exclusively to BMO InvestorLine clients, have all posted positive real returns over the past 12 months to September 30, 2006. Overall, returns in the Select, Index and Tax Efficient categories have ranged from a high of 10.6% for the all-equity Aggressive Growth Index Portfolio to a low of 2.1% for the all-fixed-income Capital Preservation Select Portfolio.

Markets have been buffeted by a myriad of investor concerns including high energy prices, rising interest rates, slowing economic growth and uncertainty about the outlook for inflation. On the geopolitical front, the ongoing conflict in the Middle East and

its implications for the global economy continues to challenge investors. During 2006, the month of May was especially brutal for equities around the world with emerging markets, in particular, suffering significant losses as the MSCI Emerging Markets Index (in C\$) plunged by 12.0%. In North America, the S&P 500 Composite Index and the S&P/TSX Composite Index also posted negative returns of -4.4% and -3.6%, respectively, during the same month. Moreover, the bond market was not immune and has also suffered considerable fluctuations. For example, monthly returns for the Scotia Capital Universe Bond Index have ranged from a low of -1.0% in October 2005 to a high of +2.1% in July 2006.

It can be difficult to remain calm in times of market volatility but, as the results of the Heavy Hitter Model Portfolios demonstrate, a well-diversified portfolio is better able to withstand whatever blows the economy delivers. Here, we'll look at how the Heavy Hitter Select Model Portfolios performed.

## > HEAVY HITTER SELECT MODEL PORTFOLIOS – ANNUAL PERFORMANCE REVIEW

In our annual review of the Heavy Hitter Select Model Portfolios, returns have ranged from a high of 9.3% for the all-equity Aggressive Growth Portfolio to a low of 2.1% for the all-fixed-income Capital Preservation Portfolio, as shown in Table One. With the exception of the Capital Preservation Portfolio, the portfolios have outperformed the 1-year GIC index and have delivered positive real returns by outpacing inflation, as measured by the Consumer Price Index, over each of the past 1-, 3-, and 5-year periods. The Capital Preservation Portfolio outperformed the above indices over the 3- and 5-year periods and matched the inflation rate of 2.1% over the 1-year period. The investment returns for all the portfolios are shown in Table One. It is interesting to note that during the 12-month period ending September 30, 2006 when 1 in 10 mutual funds delivered negative returns, all of the underlying Heavy Hitter funds in

## Heavy Hitter Select Model Portfolio and Benchmark Returns

**Table One**

### Heavy Hitter Select Model Portfolios Simulated Investment Returns

From September 30, 2001 to September 30, 2006

PORTFOLIO	AVERAGE ANNUAL TOTAL RETURN (%)		
	1 year	3 year	Since Inception 09/01 (5 year)
Capital Preservation	2.1	3.1	4.2
Income	4.2	7.9	7.6
Balanced Income, Limited Growth	5.3	10.7	9.6
Balanced Income & Growth	6.8	12.6	11.0
Growth & Income	7.3	13.4	11.3
Growth	8.5	15.0	13.1
Aggressive Growth	9.3	16.5	14.1
<b>BENCHMARKS</b>			
Inflation (CPI)	2.1	2.2	2.2
1-Year Average GIC Index	2.6	1.7	1.7
SCM Universe Bond Index	4.0	5.9	6.9
S&P/TSX Total Return Index	9.2	18.9	13.6
S&P 500 Composite (\$C)	6.4	5.4	-0.2
MSCI World Index (\$C)	10.3	10.1	3.1

The investment performance of the Heavy Hitter Select Model Portfolios assumes a start date of September 30, 2001. The returns shown are provided for informational purposes only in order to indicate the historical performance of the portfolios. Past performance does not guarantee future results. Source: Chand Carmichael & Company Limited, Globe HySales, Morningstar Canada

## Heavy Hitter Select Model Portfolios Monthly Performance

**Table Two**

### Heavy Hitter Select Model Portfolios Risk/Return Profiles

(September 2005 - September 2006)

PORTFOLIO	Best Monthly Return (%)	Worst Monthly Return (%)	Average Monthly Return (%)
Capital Preservation	1.2	-0.7	0.2
Income	2.3	-2.3	0.4
Balanced Income, Limited Growth	3.2	-3.4	0.5
Balanced Income & Growth	3.8	-3.8	0.6
Growth & Income	3.8	-3.7	0.6
Growth	4.2	-4.0	0.7
Aggressive Growth	4.5	-4.2	0.8

Source: Chand Carmichael & Company Limited, Globe HySales, Morningstar Canada

the Select Model Portfolios delivered positive results. Returns for the Heavy Hitter Funds in the Select Model Portfolios ranged from a low of 1.6% for the TD Mortgage Fund to a high of 15.0%

for the Trimark Fund, a global equity fund.

Given the overall strong performance of equity markets, the portfolios with a higher equity

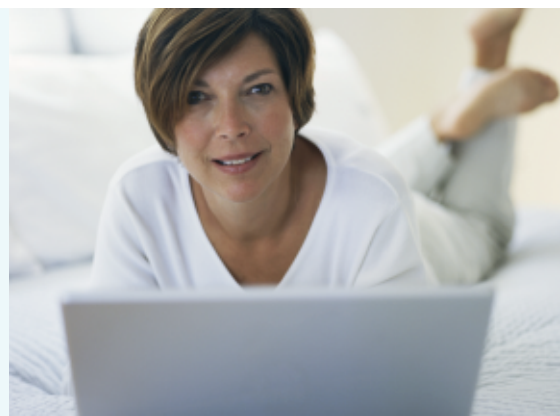
weighting have posted higher returns. As shown in Table Two, the average monthly return for the Select Model Portfolios has ranged from a low of 0.2% for the Capital Preservation Portfolio to a high of 0.8% for the Aggressive Growth Portfolio. However, a comparison of the best monthly return versus the worst monthly return also reveals the increased volatility of the more equity-heavy portfolios. For example, over the past 12 months, the best monthly return for the Aggressive Growth Portfolio was 4.5% and its worst monthly return was -4.2%, for a spread of 8.7%. In contrast, the spread for the Capital Preservation Portfolio was only 1.9%.

For more information on the Heavy Hitter Model Portfolios, sign into your account online and check out *Model Portfolios* under *Research*. Or to purchase one of the Heavy Hitter Model Portfolios, check out *Model Portfolios* under *Trading*.

*Ranga Chand is widely recognized as one of Canada's leading economists and mutual fund analysts. He is also the Founder and President of the research and consulting firm Chand, Carmichael & Company Limited.*

\*Refer to the legal section of InSite for full Mutual Fund disclaimer.

For annual performance reviews on the Heavy Hitter Index and Tax Efficient Model Portfolios, visit [bmoinvestorline.com/EducationCentre/SpecialReports.html](http://bmoinvestorline.com/EducationCentre/SpecialReports.html)



# The Upside of Downside Risk Management

**Market-linked GICs offer the potential for higher returns not normally associated with capital preservation.**

Although market-linked GICs have been around since the early 1990s, their popularity grew significantly following the high-tech correction in the early 2000s. Investors, weary of exposing their portfolios to volatile equity markets, turned to investments that offered the potential for equity-like returns without equity-like risk.

## UPSIDE POTENTIAL OF MARKET-LINKED GICs

Market-linked GICs provide you with the opportunity to earn potentially higher returns than those offered on traditional GICs, while maintaining the security offered through a guarantee on your principal investment.

Market-linked GICs appeal to security conscious investors who want upside potential without the downside risk. The upside potential of a market-linked GIC is usually tied to the performance of one or more stocks, mutual funds or stock indices. The unique risk-return profile offered by these investments is not easily attainable by retail investors.

## RISK MANAGEMENT WHEN YOU NEED IT

If you are inching closer to retirement, you are probably learning about the increasing importance of managing risk in your portfolio. As you may be drawing your primary source of income from your investments, and since you will likely live longer than past generations, it is critical you have enough money to enjoy those years.



With interest rates near all-time lows, you will need to diversify with investments that offer the potential for higher returns. However, if you have a short time frame to retirement, you may not want to take the risks normally associated with investments that traditionally offer higher returns. Negative returns can have detrimental effects on your portfolio and its ability to keep the income flowing at a rate needed to sustain your lifestyle.

Market-linked GICs, with their potential for high returns and their principal guarantee, may be a great option for your unique needs.

## DIVERSIFICATION OPPORTUNITIES

As market-linked GICs are ideal for investors approaching or in retirement, they can also be quite appropriate for other investors. Their unique risk-reward profile makes market-linked GICs a great tool for increasing the level of diversification in any investor's portfolio.

Spreading a portfolio among many asset classes can reduce the impact that a negative return in any one of them has on the whole portfolio. This concept works well when asset classes move independently of each other. If returns on asset classes move in lock-step with one another – as they have started to do in recent years – the benefits of traditional diversification are lost when markets decline. Market-linked GICs can

provide a cushion against these declines when it is needed most. At the same time, they can contribute to the upside when markets are doing well.

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*more information on BMO Progressive GICs, visit your local BMO Bank of Montreal branch. To learn more about BMO Term Investments, visit [bmo.com](http://bmo.com).*

*“Market-linked GICs provide you with the opportunity to earn potentially higher returns than those offered on traditional GICs...”*

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*continued from front page*

The headwind in the Canadian economy is the decline in real net exports (exports minus imports), reflecting the strong Canadian dollar and the slowing U.S. economy. The goods and services trade balance, after adjusting for price changes, has moved from a record surplus in Q1 2002 (before the loonie soared) to a record deficit in Q2 2006. As a share of GDP, this represents a shift of nearly 9 percentage points, which is a hefty prolonged headwind. In Q2 2006 alone, the deterioration in net exports carved a whopping 3.4 percentage points from Q2's Canadian GDP growth, leaving it at just a 2% annual rate.

Although some commodity prices are declining, which is setting up a period of underperformance (versus the U.S.) for the Canadian dollar and the TSX, the lingering impacts of past appreciation in the

loonie and the unfolding U.S. economic slowdown will keep Canada's economic headwind blowing. Again, there is an offset—decent domestic demand growth. Compared to south of the border, the combination of lower interest rates and stronger employment trends have kept consumer spending and housing more buoyant, while the commodity boom has been a boon for related-industry profits. Meanwhile, Canada's superior fiscal position

*"...the lingering impacts of past appreciation in the loonie and the unfolding U.S. economic slowdown will keep Canada's economic headwind blowing."*

is providing more leeway for tax cuts and spending hikes.

The Bank of Canada has been more cautious than the Fed since both central banks started tightening back in 2004; the Bank is cognizant of the effects of the decline in net exports and has kept an eye on the

stark regional and industrial skew to Canada's economic and inflation performance. Canadian interest rates are well below those in the U.S. and are likely to remain so due to lower inflation and the surplus position in our budget and current account. We look for the Bank to follow the Fed's rate-cutting lead, particularly as Canadian GDP growth languishes in the 2% range.

We expect the Canadian and U.S. economies to land softly during

2007, as their respective headwinds subside.

Late in the year, improving economic prospects should prove positive for equity markets on both sides of the border, but the absence of a more severe economic downturn and more aggressive central bank easing will make

for a more challenging environment for bonds. Nevertheless, yields will likely remain tucked under their recent cyclical highs.

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