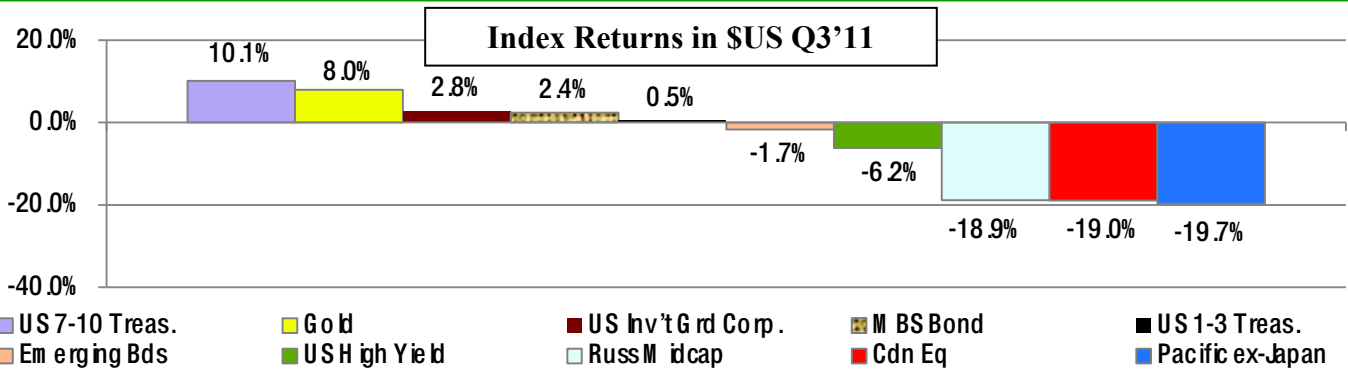


Global Capital Market Review and Outlook

SUS Q3'11



Which Way to Escape the Crisis?

The world economies have continued to slow during the past few months. The results of the global purchasing managers' survey are consistent with world growth of only around 2% in the third quarter. This is less than half the pace in the early stages of the recovery. In recent months, the slowdown has been steepest in the euro-zone, though surveys point to sluggish growth in most advanced economies. With the euro-zone heading for recession, and if their public debt and banking crisis are not contained, the rest of the developed world may follow suit. Emerging economies will also slow, but more gradually because they have lower debt ratios and are less vulnerable to a euro-zone crisis.

It appears that U.S. GDP growth accelerated to 3.2% annualised in the third quarter, more than double the rate in the second. The rebound in spending on motor vehicles, as the Japanese-related supply disruptions faded, explains some of the pick up as well as investments, exports and Federal government spending. The pick-up in GDP growth would appear to contradict the view that the economy may be headed for another recession. Much of the strength however is temporary and growth is likely to slow over the next couple of quarters. The U.S. might avoid another recession in the coming quarters but its recovery looks set to remain lackluster for years to come. Households have made little progress in paying down debt, job creation is slow and private investment growth will be weak, judging by recent business surveys. Also, after Congress rejected President Obama's proposed \$450bn stimulus, the U.S. faces a severe fiscal squeeze next year even if some parts of the jobs bill are eventually passed. Moreover, the U.S. financial sector is also vulnerable to a shock from the euro-zone policy stimulus. U.S. demand is likely to be weak for three reasons. Firstly, fiscal policy, which is already restrictive, will be tightened further. We expect a fraction of President Obama's stimulus package to be passed, while governments elsewhere are even more firmly committed to austerity. Secondly, prospects for private sector demand look gloomy. Households are burdened with high

debt, and unemployment remains well above its pre-crisis level. Falling asset values, including a 25% drop in world equity markets since May, will further dampen household spending. At the same time, business confidence is depressed, pointing to continued slow investment growth. Thirdly, even if the euro survives the current tensions, we expect output in the region to fall in both 2012 and 2013. Governments are preparing to inject more capital into European banks in the coming months. To fully remove the uncertainty they would also need to underwrite the debts of peripheral governments, including Italy and Spain – something they are not yet willing to do.

The market turbulence in the third quarter illustrates how rapidly shocks in developed economies can affect confidence in the emerging world. Stocks buckled again in the third quarter of 2011 as fears mounted of a global recession, with commodity prices and the S&P/TSX hit especially hard. From April highs, the S&P 500 and the S&P/TSX are now down almost 20% as of September 30th. These declines verge on a bear market in size and duration. Once again during the quarter gold shone, returning a decent positive return of 8% in US dollars. US Treasuries have been a superb portfolio shock absorber in the past decade. Meanwhile, the short and medium term U.S. fiscal outlook remains poor as Washington appears to lack the political will to tackle the deficit that is still near 9% of GDP. Given that such a development will lead to an increase in portfolio risk, increased cash holdings at the expense of risky assets becomes one of the only solutions. A new asset class category that we have added to the portfolio is Mortgage Backed Securities. These are agency-backed portfolios of mortgages that exhibit similar return characteristics to short-term treasuries but with less volatility in the current economic environment. As volatility in the markets persists, our focus remains on the state of the near-term global macroeconomic environment and the impact that this has on the asset classes that we model and use in our asset allocation.

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