Quarterly Insights

September 28, 2012

Economic & Investment Outlook

New stimulus programs were introduced by a number of central banks in the third quarter, in an effort to counter weakening global demand and ongoing concerns regarding potential Eurozone sovereign debt defaults.

The Canadian economy has weakened amid a slowdown in housing activity and reduced exports. Existing home sales fell 5.8% in August, to 8.9% below year-ago levels, as demand continues to moderate. The combination of stricter lending guidelines for insured mortgages and a deterioration in housing affordability are contributing to a slowdown in the pace of housing activity.

Last year government and consumer spending accounted for a combined 90% of Canadian economic growth. Household debt has now reached a record 152% of personal disposable income, which makes it difficult for consumers to continue to borrow to fuel consumption. This aggregate debt level is not far off the 160% threshold that was reached in the U.S. immediately prior to the beginning of their housing sector contraction.

During the quarter, the Canadian dollar appreciated to several cents above par with the U.S. dollar as Canada's rare AAA credit rating continues to attract global capital.

Although the rise in our currency will benefit cross border shoppers, it also has reduced our export competitiveness and contributed to a record high trade deficit in July.

After posting economic growth of 1.7% in the second quarter, the recent pace of U.S. economic activity appears to have weakened. The leading economic indicator has declined in two of the last three months and employment increased by only 96,000 jobs in August after a 141,000 rise in July.

On a more positive note, the housing sector continues to recover as both new home construction and sales of previously occupied homes increased in August to the highest levels in more than two years. Housing affordability in the U.S. continues to support demand as it has now reached the best level in the last 41 years.

In further contrast to Canada, U.S. consumer spending may soon begin to accelerate. Household mortgage and consumer credit peaked at $13.2 trillion in 2008 and has now contracted for 16 consecutive quarters. The cumulative $910 billion net decline could soon be coming to an end as aggregate consumer debt levels have now returned to their historical averages.

Economies

Weaker

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Equities

Stronger

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Economic & Investment Outlook Continued

The Federal Reserve fulfilled expectations of more quantitative easing stimulus by announcing a plan to buy an additional $40 billion per month of mortgage-backed securities and keep interest rates at "exceptionally low levels" until at least mid-2015. The program is designed to decrease the cost of mortgages and add further stimulus to the housing sector. Unlike the two previous quantitative easing programs that had defined purchase limits, these new purchases will be open-ended. This means that they will continue until the Federal Reserve is satisfied that economic conditions, primarily in employment, have sufficiently improved.

Quantitative easing creates money to buy assets, with the expectation that when this new money reaches the financial system it will be used to increase economic growth. This third quantitative easing initiative will likely increase the Federal Reserve's new money creation to over $3 trillion since it began these programs in 2008. It is noteworthy that the Federal Reserve continues to provide more economic stimulus, despite the fact that inflationary expectations have been starting to move higher. This suggests that it is willing to risk higher inflation in exchange for under pinning economic growth.

The European Central Bank (ECB) also announced quantitative easing measures through a sovereign bond purchase program. As a part of the plan, a country would first formally ask for assistance from the Eurozone bailout fund and approval would require a commitment to deficit reduction targets and structural economic reforms. The ECB could then buy the bonds of this country, up to three years in maturity and in unlimited amounts, on secondary markets. The intention of these bond purchases would be to limit a country's financing costs and build confidence in the euro currency.

The Co-Dependency Euro Zone Banking

In contrast to the U.S. which stabilized its financial system relatively quickly after the collapse of its housing sector, many of the Eurozone's 6,000 banks continue to struggle.

Europe's most troubled countries and their banks continue to suffer from a self-reinforcing cycle of lending co-dependency. Banks are expected to purchase large amounts of government debt, while their government is often a direct or indirect stakeholder in their banks.

This interconnectedness means that a crisis in one can cripple the other. For example, if the risk of sovereign default rises, then the bonds that the bank holds as assets become less valuable. They then face a choice of refusing to roll over their government's debt which would further deepen the crisis, or agree to lend the government the funds needed to repay their bond holders and further expand the co-dependence relationship. Alternatively, if the bank fails first, the government's largest bond purchasers are bankrupt. The result is diminished demand for government bonds, which causes yields on government debt to rise.

Spain exemplifies the negative effects of this co-dependency spreading from banks to a government. Spanish banks have experienced sustained withdrawals of deposits, as concerns about real estate related loan losses have increased. As a result, Spain has experienced a net capital outflow of €220 billion so far this year, which is equal to 41% of annual gross domestic product. To cover this outflow, the Bank of Spain has been forced to borrow. This borrowing now accounts for 24% of Spain's €1.7 trillion gross external debt.

In an effort to break this relationship, the European Commission recently proposed the creation of a "banking union" with a new Eurozone supervisor. Once established, the Eurozone rescue fund could recapitalize failing banks directly, lifting some of the debt burden from governments. This would be an important step in stabilizing the Eurozone financial system by protecting against the downward spiral of weak banks progressively undermining countries that are trying to support them.

Returns

Financial markets have rallied since July on the anticipation that the global economic growth will respond positively to central bank stimulus programs. Third quarter returns to September 30, 2012 in Canadian currency terms for world equity markets are:

Country	Index	2012 Q3 Return
Canada	S&P/TSX	6.33%
United States	S&P 500	2.14%
United States	NASDAQ	2.53%
United Kingdom	FTSE 100	2.60%
Japan	Nikkei	-2.52%
France	CAC 40	2.90%
Germany	DAX	10.28%
Hong Kong	Hang Seng	3.57%

Sizeable third quarter gains in equity markets must have caught many investors by surprise, judging from the fact that demand for fixed income mutual funds in Canada continues to grow at the expense of equity funds. $1.16 billion flowed out of equity funds in August, while $1.68 billion flowed into fixed income funds.

Year-to-date, there have been net redemptions of $8.85 billion from equity funds and net purchases of $13.7 billion of fixed income funds. We believe the investment rational of this trend is flawed.

This asset allocation shift is occurring in an investment environment where current bond market conditions reflect the mirror image of when long-term interest rates peaked nearly three decades ago. Since 1982, the fixed income market has been characterized by benign inflation combined with periods of falling or stable interest rates. A large portion of the historic returns from fixed income investments can be attributed to the capital gains produced from falling yields. With central bank stimulus measures becoming more forceful at the same time that inflationary pressures are rising, the long-term bond yields that investors are now accepting ensures that the real purchasing power of their capital is being eroded.

With today’s current low yields as a starting point, investors who are hoping that future returns will equal past returns, are bound to be disappointed. Our fixed income strategies in client portfolios will continue to be based on the projection that future returns will be lower than the past returns. Our focus will be on yield consistency and the preservation of capital value, rather than the unrealistic expectation of over-sized future capital gains.

The Bottom Line

Quantitative easing programs by central banks have previously resulted in temporary increases in equity and commodity prices. However, each subsequent market reaction has been shorter in length and a sustainable advance in the pace of economic growth has yet to be achieved by these actions.

The ECB's plan to buy unlimited amounts of sovereign bonds and the potential creation of a banking union will assist in stabilizing the Eurozone financial sector.

However, the global economy will soon need to begin to show signs of a faster pace of growth, in order for equity prices to continue to advance.

We will continue to implement investment strategies in client portfolios that are intended to mitigate financial market volatility by purchasing dividend paying equities and preferred shares of companies with strong balance sheets and selectively using call option strategies to enhance portfolio income.

Estate Planning with Testamentary Trusts

A testamentary trust is a legal entity created in a person's will that comes into effect upon their death. A will may contain more than one testamentary trust and may address all or any portion of the estate assets. There are three parties involved in a testamentary trust:

- the person who specifies that the trust be created, called the settlor
- the trustee, whose duty it is to carry out the terms of the trust that are specified in the will
- the beneficiary(s), who will receive the benefits of the trust

The trust structure allows the settlor to specify an amount of money or property that will be held for a beneficiary(s) for a specified period. The settlor also specifies the terms of the trust that the trustee will carry out.

There are several uses of testamentary trusts, including:

- Trusts for Minors: that allow for the protection and management of their assets until they reach the age of majority.
- Protective Trusts: for special needs dependents or beneficiaries who the testator considers unable to effectively manage their own wealth.
- Spousal Trusts: to provide for a surviving spouse during their lifetime. They may also be used to deal with a second marriage and for the benefit of the settlor's children.

Testamentary trusts can offer tax savings opportunities that may not be available to a beneficiary who receives an outright inheritance:

- Taxable income earned in a testamentary trust can be subject to the same graduated tax rates as an individual taxpayer. Since the income earned within a trust can be taxed on a separate tax return at these graduated tax rates (although the basic exemption is not allowed), an income-splitting opportunity may arise for each beneficiary.
- Testamentary trusts do not have a calendar tax year-end of December 31st. The trustee is able to select a fiscal year-end within a 12-month period to allow for maximizing tax deferral.
- Testamentary trusts are also exempt from instalment payments, with the caveat that all taxes owing must be paid within 90 days of the trust's elected year-end.
- Testamentary trusts are not subject to attribution rules that affect asset transfer to minors.

For families concerned about intergenerational wealth transfers, a properly structured testamentary trust can be a valuable planning tool.

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Dispute Mediation Services

Index Wealth Management strives to maintain the highest level of service to our clients; therefore it is important to let us know if you have any concerns regarding the services we provide. Any concern can be discussed by contacting our office directly at 1-855-989-6200 or in writing to the attention of the Chief Compliance Officer. We will make every attempt to resolve any concern in a timely manner.

However, should we not be able to come to a satisfactory resolution, securities regulations now require that we must ensure that an independent dispute mediation services is made available to clients to resolve any complaint regarding trading or advising activity of the firm or one of its representatives. This service will be made available to clients at the expense of Index Wealth Management Inc.