Quarterly Insights

December 31, 2012

Economic & Investment Outlook

As occurred throughout much of the year, the decisions of governments and central banks continued to dominate the direction of financial markets as the year drew to a close.

U.S. politicians avoided the "fiscal cliff" by agreeing to a new taxation plan just prior to a January 2nd deadline that would have required broad-based tax hikes. There was no agreement on how to make substantial cuts to federal spending, but the sequester deadline was extended to March 1st to allow the debate to continue. Budgetary deficits have now exceeded $1 trillion for four years in a row, thereby making a reduction in spending critically important.

In the Eurozone, Greece received another bailout tranche, allowing the country to avoid default. The European Central bank has agreed to become a single supervisor for the region's banks and use a bailout fund that would provide direct funding to struggling banks.

Global economic growth continues to be uneven, with the Eurozone and Japan falling into recession, while signs of improvement are appearing in the U.S., China and Latin America.

The U.S. economy continued to gain momentum as third quarter GDP growth reached a 2.7% annualized rate. In November: the composite of Leading Economic Indicators reached a new high for the current expansion, industrial production advanced at the fastest rate since December 2010 and personal income growth had the largest month-over-month increase since February.

The housing sector continues to recover as sales, starts, and pricing all have shown consistent improvement over the past few months. The housing sector will make a positive contribution to U.S. GDP growth in the fourth quarter, which will be the first occurrence since 2005.

Canadian economic growth slowed into year-end as third quarter GDP increased by only 0.6%, down from 1.7% in the second quarter. Retail sales, manufacturing and exports have all decreased as high levels of household debt and slowdowns in some parts of the global economy are restraining Canadian economic growth. Overall, we expect domestic economic growth to be soft through the first half of 2013, with any improvement in the pace of global economic conditions providing potential upside to this forecast.

Fiscal Cliff Avoided For Now - Promising Future?

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Pushing On Strings

In December, the Federal Reserve extended its program of monthly $85 billion purchases of mortgage-backed securities and longer-term Treasury securities. It also provided historic transparency in its guidance that future interest rate increases will require a decrease in the unemployment rate below 6.5% and an increase in the inflation rate above 2.5%.

Over the past several years, global central banks have embarked on asset- buying sprees in an attempt to resuscitate economic growth. This unprecedented monetary easing has bloated central bank balance sheets and brought interest rates to historic lows. However, the trillions of dollars in monetary stimulus combined with these record-low interest rates have still failed to spur much economic activity due to the structural imbalances that exist in the global economy.

Many large developed countries (including the U.S., U.K. and Spain) and smaller Eurozone countries (including Portugal and Greece) have been running current account deficits since the mid-1980s. If a country's spending exceeds its income, then it must be sustained by either the sale of foreign assets or loans from other countries.

Therefore, a country with a current account deficit is really just a consumer that is becoming increasingly indebted. Many developed countries, continue to rely on domestic consumption growth driven by ultra loose fiscal and monetary policies, which transfer debt from private balance sheets to public balance sheets. This process endangers future economic growth by attempting to increase economic performance today.

The underlying cause of the recent poor economic performance lies in the structural headwind of increasing debt levels, which have become increasingly difficult to reverse. Many developed countries continue to struggle with finding the right fiscal and monetary policy mix that can close the structural gap between spending and revenue and still allow for some level of self-sustaining economic growth.

After several years of pushing the boundaries of monetary policy, the world's leading central banks may now be approaching the natural limits of their influence.

Debt and Housing

Over the past several years, Canadian housing prices and household debt levels have continued to climb at an almost uninterrupted pace. In September, the ratio of household debt-to-disposable income reached a record high of 166%. As consumers have become more indebted, a reversal in housing prices has the potential to create significant restraints on the future pace of economic growth.

Currently there is $1.65-trillion in household debt in Canada. Nearly 85% of this total is related to housing through mortgages and home equity lines of credit (HELOC). In fact, the total dollar of HELOCs has grown by 700% over the past decade.

Since 2008, the Canadian government has initiated four rounds of policy changes in an attempt to restrict mortgage credit and restrain the pace of further increases in house prices. These policies are to a large degree self-serving, because of how many mortgages are created in Canada.

Canada Mortgage and Housing Corporation (CMHC) is Canada's government-owned national housing agency. CMHC is the dominant provider of mortgage loan insurance and the largest issuer of mortgage-backed securities. For a fee, CMHC insures most mortgages that are initiated with down payments of 20% or less. In the past decade, CMHC has made a total profit of more than $17 billion for the federal government.

As activity in the housing sector has fast-tracked, CMHC has rapidly expanded the amount of mortgages it guarantees. This total now exceeds over $1 trillion.

This flow of this credit has provided an enormous boost to economic activity. Since 2007 real GDP growth from sectors related to residential construction has increased over 10%, while growth from all other sectors is essentially unchanged.

Signs are now appearing that the current pace of housing activity has become unsustainable, as existing home sales have fallen in seven of the past eleven months. Although it's unlikely that the Canadian financial system will completely escape any negative consequences from a prolonged slowdown in the housing sector, we believe the severity of any losses experienced by the sector will be less than those that occurred in the U.S. several years ago.

Since the majority of low-down payment mortgages are insured against default by CMHC, Canadian taxpayers, rather than the banks, are the ultimate owners of these $1 trillion in guaranteed mortgages. Therefore, our financial sector is insulated to some degree because our government has already committed resources to shield the mortgage credit market in the event of a housing sector contraction. The U.S. financial sector was crippled by a decline in housing prices and an accompanying wave of mortgage defaults, which is less likely to occur in Canada because of the structural differences in how mortgage credit is created.

Although the direct implications of a Canadian housing sector slowdown to our financial sector are restrained, the effects on the economy as a whole will be more pronounced. This sector has been the primary driver of economic growth and job creation over the past several years, so it stands to reason that the end of the boom will have a negative effect on both the pace of economic growth and the federal government's debt burden.

Financial Markets

Most global financial markets experienced a year-end rally, as signs of increasing economic growth in China and a partial resolution of the U.S. fiscal cliff issue, fueled investor optimism. Fourth quarter 2012 returns in local currency terms for world equity markets were:

Country	Index	2012 Q4 Returns
Canada	S&P/TSX	0.94%
United States	S&P 500	-1.01%
United States	NASDAQ	-3.10%
United Kingdom	FTSE 100	2.71%
Japan	Nikkei	17.19%
France	CAC 40	8.53%
Germany	DAX	5.49%
Hong Kong	Hang Seng	8.72%

At current levels, most major equity investment asset classes look reasonably valued compared with their historic averages. However, we view government bonds as expensive and vulnerable to substantial price decreases when interest rates eventually increase.

After a significant rebound following the global financial crisis, the pace of corporate earnings growth will likely begin to slow. Profit margins in many sectors are now near historic highs that leave little room for further expansion. Therefore future earnings growth should be limited to only the pace of broad based economic growth.

Nonetheless, any unexpected increase in global economic growth or inflation expectations could substantially increase the return potential for equities.

The Bottom Line

2013 is likely to continue to be a year when the fate of financial markets will continue to be influenced by the decisions of politicians and central bankers.

Increasing reliance on unconventional monetary policy and continued growth in sovereign debt levels continue to pose long- term risks.

Real progress on the U.S. fiscal outlook and structural reforms in Europe could stimulate corporate spending and risk taking by investors. We continue to maintain a strategic allocation to commodities, with the expectation that prices will eventually benefit from any increases in the pace of global economic growth or inflation.

Deferring Old Age Security

Changes to the Old Age Security (OAS) program now allow for an election to defer the pension in a similar way that Canada Pension Plan payments can be accelerated or deferred
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Beginning July 1, 2013, individuals do not have to begin receiving their OAS pensions when they reach age 65. The option now exists to defer payments beyond 65 for up to five years.

In Q4 2012, the full annual OAS pension is $6,540 (indexed quarterly). Under the new rules, for each month of deferral a premium of 0.6% will be added to the pension. This equals 7.2% for one year or as much as 36% if the deferral is for the full five years.

Therefore, for a 65-year-old who expects to live past age 82 they will receive more OAS pension by deferring receipt to age 70. Obviously if an individual has known health issues that can affect life expectancy, it is best to begin the OAS pension as soon as they are eligible.

OAS payments are subject to an income-based clawback. In 2012, the clawback begins at $69,562 and payments are reduced by 0.15 for each dollar of additional income above this threshold. Therefore OAS payments are completely clawed back when taxable income exceeds approximately $110,000.

The new deferral option allows for tax planning as it relates to the timing and amount of the potential clawback. It may be an attractive alternative for some individuals to defer receiving OAS in favour of earlier or larger RRIF withdrawals. This would be attractive in a scenario where their projected future taxable income maybe low enough to reduce the OAS clawback from that which would apply if they began to receiving the OAS pension at age 65.

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Managing Uncertainty, Compounding Returns