Quarterly Insights

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March 28, 2013

Economic & Investment Outlook

Global economic growth continues to be uneven with many countries continuing to struggle to find self-sustaining levels of expansion.

The Canadian economy produced modest GDP growth of 1.8% last year. The first quarter of 2013 has produced gains in employment and improvement in exports. A strengthening U.S. economy will continue to boost Canada's exports and business investment.

Canada's housing sector continues to slow as existing home sales fell in February by 15.8% compared to the previous year. The negative effects of a slowdown in housing will continue to restrain the pace of economic activity.

The U.S. economy produced GDP growth of 2.2% in 2012, as increased job creation is supporting consumer spending and a recovery in the housing sector.

The February U.S. unemployment rate declined to 7.7%, which is the lowest level since December 2008. Almost 20% of the new jobs created so far this year have occurred in the housing and construction sectors.

In March, the U.S. began a sequester that has the potential to slow the future pace of economic growth. This fiscal sequester requires $1.2 trillion of spending cuts to occur over the next decade beginning on March 1, 2013. These automatic spending reductions are the result of legislation that was passed in 2011.

By the end of September, the sequester will reduce total government spending by $85 billion. These cuts are evenly divided between defense and non-defense spending. However, many large entitlement programs such as pensions and healthcare are excluded.

While the sequester will help bring down the deficit over the next few years, it does not address the larger issue of the growing burden of entitlement spending. As a result, it is expected that the deficit should begin growing again in 2016.

The Eurozone is broadly in recession. Policymakers have altered their focus from being solely on austerity, to a more balanced approach between the need to reduce fiscal deficits and also rejuvenate economic growth.

The European Central Bank's pledge to be the lender of last resort for Eurozone sovereign debt has so far prevented a return to the crisis level of volatility experienced last year. But a very weak Eurozone economy, political risks and a lack of progress by governments in strengthening European institutions, risks increasing the duration of the current recession.

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Where Cash is King

Companies produce returns for shareholders in either of two ways:

- They use earnings to buy assets to increase future profitability
- They pay-out earnings as dividends.

Since 2001 Canadian firms have generated $745 billion in after-tax cash flow and about $600 billion of this total still remains on corporate balance sheets.

According to RBC Economics, these cash balances are equivalent to a sizeable 32% of Canada's GDP. This increase in corporate cash is the direct result of a reduction in capital spending combined with a long-term deleveraging trend.

Aggregate corporate borrowing in Canada has been declining since the 1990s. This has contributed to a virtuous cycle where increasing amounts of cash on corporate balance sheets reduces the need for borrowing, which in turn has the effect of supressing interest rates. The borrowing that has occurred has been completed at subsequently lower levels of interest rates. According to the Bank of Canada, corporate Canada's overall debt-to-equity ratio has now decreased from 1.5 in the mid-1990s to a record low of just 0.9.

Companies have also been investing a smaller share of their profits in upgrading and expanding their capital stock. Corporate investment in real assets has decreased from almost 16% of GDP in the 1970s to only 6% by the mid-2000s.

Traditionally 40% to 50% of surplus cash have been distributed to shareholders, but in recent years the proportion returned to shareholders has been closer to 35%.

As the global economy gains stability, corporations will eventually have to increase investment spending or increase their distributions to shareholders. This will result in further support for sustained economic growth or higher dividends for investors.

When Interest Rates Rise...

Investors seeking income continue to purchase fixed income securities in record amounts, even as yields and credit spreads on many types of securities have fallen to historic lows. According to the Investment Funds Institute of Canada, last year mutual fund investors redeemed $5.2 billion from equity funds and added $25 billion to fixed income funds.

Today's absolute low level of yields leaves little potential for further declines. As a result, future double-digit returns in fixed income securities are becoming much less likely and many investors are taking progressively more risks in their fixed income portfolios in exchange for less potential return (yield and price appreciation).

There is a consensus belief among many investors that any future interest rate increases will occur gradually and be modest by historical standards. While this scenario may unfold, the risk of being wrong is increasing as multi-decade low yields produce less current income to offset future price declines in securities due to rising yields.

The price of a fixed income security becomes more sensitive to interest rates changes when yields are low. Any rise in yields causes a relatively larger decline in prices. As always, the longer the maturity of the security, the more sensitive the price is to interest rates changes.

The following table illustrates how interest rate changes will affect the current yield of Government of Canada bonds. The last column shows the yield increase that would generate a zero return over the next twelve months. This is the increase to the break even yield, since the resulting price decline will equal the income received. Any yield increase above these levels would generate a negative return.

Coupon	Maturity	Current Yield	Break Even Δ Yield
2 Year 1.000	2015-Feb-01	1.12%	1.20%
5 Year 1.500	2017-Sep-01	1.47%	.43%
10 Year 2.750	2022-Jun-01	2.00%	.27%
30 Year 4.000	2041-Jun-01	2.61%	.15%

***pricing as of February 15/2013**

The table reveals some bleak details about potential bond market returns.

For example, if an investor purchased the 30-year bond with the current yield of 2.61% and the yield then rose only 0.16% to reach 2.77%, the return over the next year would be negative.

We believe that the eventual outcome of the recent global central bank stimulus measures will be higher inflation and interest rates than have been experienced over the past decade. While no one knows with certainty when interest rates will begin to rise, markets tend to anticipate future events. Therefore, changes in fixed income yields may occur in markets at a more accelerated pace than that of any official changes in interest rates that are administered by central banks.

Not all fixed income securities will be affected in the same way when interest rates eventually rise. As a result, we are continuing to evaluate and reposition the fixed income securities in portfolios in anticipation of a future secular rise in interest rates. Fixed income securities will continue to play an important role in providing stable income, liquidity and diversification in client portfolios.

Financial Markets

Most global financial markets rallied to begin the year, as investor optimism increased.

First quarter 2013 returns in CDN$ terms for world equity markets were:

Country	Index	2013 Q1 Returns
Canada	S&P/TSX	2.54%
United States	S&P 500	12.36%
United States	NASDAQ	10.51%
United Kingdom	FTSE 100	3.74%
Japan	Nikkei	12.10%
France	CAC 40	1.75%
Germany	DAX	1.67%
Hong Kong	Hang Seng	0.36%

Global equity market volatility has reached a five year low and some markets have now returned to pre-2008 price levels.

As the effects of global central banks unconventional monetary policy have now begun to wane, the pace of corporate earnings growth is slowing. Profit margins in many sectors are 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.

Nevertheless, any unexpected increase in global economic growth could substantially increase the return potential for equities.

The Bottom Line

At current levels, most major equity markets are reasonably valued compared with their historic averages. Increasing sovereign debt levels in the U.S. and the Eurozone continue to pose long- term risks. However, real progress on the U.S. fiscal outlook and structural reforms in Europe could add additional support to financial markets.

Fixed income risk spreads continue to compress as investors shift into riskier assets in their search for yield. In anticipation of the impact of rising rates on fixed income securities held in client portfolios, we have reduced duration and increased holdings in corporate securities.

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Managing Uncertainty, Compounding Returns