Quarterly Insights

Economic & Investment Outlook

June 28, 2013

Economies

Responding

-

Markets

Adjusting

Policy initiatives by global central banks continue to support economic recovery; however these actions are also increasingly distorting asset prices in financial markets.

The U.S. economy continues to advance at a modest pace. First quarter GDP showed annualized growth of 2.4% supported by increased consumer spending and improvements in housing-related sectors. Home prices have steadily increased over the past year due to pent-up demand, improved affordability and low mortgage rates.

First quarter Canadian GDP increased to 2.5%, due primarily to a surge in exports which made the greatest contribution to the economic growth since mid-2011. In May, 95,000 new jobs were created with nearly all being full-time positions in the private sector. This was the largest monthly gain in eleven years.

In contrast to the North America economies which are in a slow recovery, the Eurozone economy continues to be in recession. The region has experienced six consecutive quarters of declining output and many southern countries are still in an on-going struggle to find the correct balance between the need for fiscal austerity and ways to reduce record high unemployment.

Japan became the latest country to launch a new round of monetary easing initiatives in an attempt to stimulate its economy, which has been trapped in a slow growth deflationary cycle for more than two decades. Through expanded debt purchases, the Bank of Japan has said it will increase the money supply until a 2% inflation target is reached. The goal is to decrease the value of the yen to stimulate exports and also encourage an increase in domestic consumption.

The size of this program is unprecedented. Japan's debt purchasing plan is almost equivalent in size to the quantitative easing program undertaken in the U.S., despite its economy only being one-third the size.

As the size and scope of numerous quantitative easing programs mount, global financial markets are becoming increasingly distorted.

Artificially low yields deprive savers of their ability to generate income, which in turn limits their future consumption and restrains economic growth Companies benefit by being able to take advantage of low interest rates to issue new corporate debt. The majority of these debt refinancing proceeds have been used so far to improve their balance sheets, rather than to increase hiring and capital spending.

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These programs have also significantly altered fixed income markets by purchasing mostly high quality, long-term bonds effectively reducing their supply in the marketplace. As a result, equity and real estate prices have risen in almost all global markets despite only modest economic growth occurring in some developed economies, as some investors accept greater risk in the search for return.

The U.S. Federal Reserve has stated that its preconditions for ending its quantitative easing programs are unemployment declining below 6.5% and inflation rising to 2.5%. Currently unemployment is 1.1% above and inflation is 1.5% below these thresholds. But positive economic momentum in the U.S. has begun to contribute to increased volatility as markets now seem to be anticipating an initial reduction in the size of these easing initiatives by year end.

In May, the yield on 10-year US Treasury bonds increased 0.6% and prices declined by 2%. This was largest monthly price drop in nine years. In fact, the price decline was large enough to offset all the interest that the bond holders will receive in 2013.

Historically, 10-year bond yields have exceeded inflation by a margin of 2%. Therefore, returning to a more normalized monetary policy that is not influenced by quantitative easing, implies that yields have only experienced an initial increase. This adjustment process will likely occur over a number of years rather than weeks, but eventually central banks will have to adjust policy and allow interest rates to rise to a level that is determined without their artificial support.

Financial Markets

Most global financial markets advanced in the second quarter, as investor optimism increased.

Second quarter 2013 returns in local currency terms for world equity markets were:

Country	Index	2013 Q2 Returns
Canada	S&P/TSX	-4.87%
United States	S&P 500	2.36%
United States	NASDAQ	4.15%
United Kingdom	FTSE 100	-3.06%
Japan	Nikkei	10.32%
France	CAC 40	0.20%
Germany	DAX	2.10%
Hong Kong	Hang Seng	-6.71%

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.

Taxation of Investment Income

When investing outside an RRSP, RRIF or TFSA which are tax-sheltered environments, it is important to consider an investment's after- tax rate of return. Your risk tolerance and investment goals are always the most important considerations. But your investment goals only can be met with returns you keep after you have paid the applicable taxes.

Your after-tax investment income will depend on several factors, such as your total income from all sources, your allowable deductions, etc. Canadian federal taxes, as well as those in all provinces and territories except Alberta, are charged at different rates for different levels of taxable income. Higher tax rates are applied at higher taxable income levels.

If you add another dollar to your total taxable income, it is taxed at the top of the rate scale as it applies to you. This is called your marginal tax rate, the rate of tax applied to an additional dollar of income you receive.

In calculating your taxable income, your investment income is generally considered to be added to your income from all other sources. So generally each additional dollar of investment income is considered to be taxed at the highest rate on the scale as it applies to you.

There are generally three sources of investment income from a securities portfolio.

- Interest income earned from investments is generally taxed at your marginal tax rate.
- Taxable dividends from a corporation resident in Canada are generally taxed at a lower rate than interest income.
- A capital gain results when you sell or transfer an asset at a price that exceeds its initial purchase price.

Generally, the effective tax rate on dividends is lower because it recognizes that the corporation has already paid tax on its income before dividends are paid to its shareholders. The mechanism involves some accounting and a dividend tax credit. Dividends received from foreign corporations are not eligible for this tax credit.

The recipient of a taxable dividend paid by a corporation resident in Canada includes in income both the amount received, and an additional 1/4 of that amount. This addition is referred to as the "gross-up". Then the recipient also may deduct a tax credit amount equal to 2/3 of this “gross-up”. A further tax credit is effectively allowed by the provinces. The combined federal and provincial tax credit is approximately 25% of the actual dividends received that are required to be "grossed up", varying from province to province.

These comments apply to taxable dividends whether they are received in cash, in kind or as stock dividends.

The tax rate on capital gains also involves some accounting. Capital gains deductions may be available. If a capital loss occurred in the year, it can be used to reduce any capital gains in that year, to a balance of zero. If capital losses are more than capital gains, that is called a net capital loss for the year. Generally, net capital losses in one year can be applied to reduce taxable capital gains of the three preceding years and to taxable capital gains of any future years.

In addition to structuring an investment portfolio to minimize your annual tax liability, after-tax income can also be managed by implementing appropriate tax deferral strategies that allow for taxes to be paid at a future time when a lower marginal tax rate may apply.

The following three tables indicate the variety of Federal and Provincial marginal tax rates that can apply to different sources of investment income in Canada.

Alberta Taxable Income	Interest Income	Eligible Dividend Income	Capital Gains
First $43,561	25.0%	-0.03%	12.5%
Over $43,561 to $87,123	32.0%	9.63%	16.0%
Over $87,123 to $135,054	36.0%	15.15%	18.0%
Over $135,054	39.0%	19.29%	19.5%

British Columbia Taxable Income	Interest Income	Eligible Dividend Income	Capital Gains
First $37,568	20.06%	-6.84%	10.03%
Over $37,568 to $43,561	22.70%	-3.20%	11.35%
Over $43,561 to $75,138	29.70%	6.46%	14.85%
Over $75,138 to $86,268	32.50%	10.32%	16.25%
Over $86,268 to $87,123	34.29%	12.79%	17.15%
Over $87,123 to $104,754	38.29%	18.31%	19.15%
Over $104,754 to $135,054	40.70%	21.64%	20.35%
Over $135,054	43.70%	25.78%	21.85%

Manitoba Taxable Income	Interest Income	Eligible Dividend Income	Capital Gains
First $31,000	25.80%	3.84%	12.90%
Over $31,000 to $43,561	27.75%	6.53%	13.88%
Over $43,561 to $67,000	34.75%	16.19%	17.38%
Over $67,000 to $87,123	39.40%	22.60%	19.70%
Over $87,123 to $135,054	43.40%	28.12%	21.70%
Over $135,054	46.40%	32.26%	23.20%

The Good News

There will always be uncertainty and volatility in economies and markets. The good news that keeps getting verified is that these do not prevent success.

Having a realistic plan which meets your needs, as expressed in your Investment Policy Statement, and allowing that plan to keep you on track, is a reliable way to receive satisfaction.

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Index Wealth Management Inc., is an independent portfolio manager with offices in Vancouver, Calgary and Winnipeg. Our firm provides discretionary investment management services and structures equity protection and monetization strategies for individuals, foundations and non-profit corporations.

We construct portfolios for our clients utilizing Exchange Traded Funds (ETFs) as the core holdings. Depending on a clients investment goals, objectives and "risk comfort zone" these ETFs can then be combined with equity option strategies to enhance income or reduce the volatility of the annual return of a portfolio.

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WEALTH MANAGEMENT

Managing Uncertainty, Compounding Returns