Quarterly Insights

Economic & Investment Outlook

September 30, 2013

Growth in the global economy continues to be uneven. Countries are exiting recessions at different times and the pace of their subsequent growth varies.

Geopolitical risks re-emerged in the third quarter as conditions in Syria and Egypt deteriorated. However recent reports regarding the U.S. and European economies have shown an improvement.

The estimate of U.S. second-quarter GDP was 2.5%, with growth being fueled by improvements in the trade deficit, retail sales and rising manufacturing production. The housing recovery is building momentum and consumer debt is contracting to manageable levels. Fiscal policy is likely to be less of a drag on growth in the year ahead, although debate about raising the U.S. debt ceiling and the potential continuation of the sequester, will add a level of uncertainty that may affect growth over the next few months.

After posting six consecutive quarterly declines, Eurozone GDP rose at an annualized rate of 1.1% in the second quarter, ending the recession that began in late 2011. The Eurozone is still the weakest major global economy and it may be some time before Europe establishes a sustainable, broad-based economic recovery. It continues to face the headwinds of fiscal austerity, broad structural reforms and high levels of unemployment in the southern countries.

Unlike the U.S., the Eurozone still has failed to recapitalize its banks or write off non-performing debts. Indecision over establishing a banking union has also helped create a dysfunctional credit market, with northern economies having access to credit while the southern economies continue to be burdened by austerity measures. It is unlikely that economic momentum will accelerate significantly without a co-ordinated strategy to deal with lingering debt and structural issues.

The Canadian economy faced a number of significant hurdles in June with severe flooding in Alberta and a construction strike in Quebec. However it rebounded in July as manufacturing sales jumped 1.1%, wholesale trade increased 1.4% and retail sales gained 0.6%.

Canada's growth in household debt appears to be slowing, which will likely dampen consumer spending and act to restrain growth in the housing related sectors. However, as the global economy continues to improve, the export sectors will make a larger positive contribution to Canadian economic growth.

Nations,

Correlations

&

Durations

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Interest Rates, Fixed Income Securities and Duration

For more than thirty years, North American interest rates have followed a steady downward trajectory, reaching the lowest levels in a generation earlier this year. For example, 5-year U.S. Treasury yields have declined from 14% in 1982 to only 0.76% during the spring of this year. Over this timeframe virtually all fixed income securities have enjoyed steady returns with low volatility. In fact, Canadian investors have not experienced a year with negative bond total returns since 1997.

When the Federal Reserve began to indicate in May that it could begin to partially reverse some of its quantitative easing measures, fixed income markets reacted by pushing bond yields substantially higher. 10-year U.S. Treasury yields jumped from 1.63% on May 2nd to 2.98% on September 3rd, which represents the largest 5-month increase in yields in the past decade.

Bond prices have an inverse relationship with interest rates; when interest rates rise, bond prices fall, and vice-versa. Duration measures a bond's interest rate sensitivity which is the most important determinant of bond price volatility. All things being equal, the longer a bond's maturity the higher the duration and price volatility. This occurs because the bond's value is the sum of the total cash flows received (interest payments and principal payments), discounted at the current interest rate until the bond's eventual maturity.

For example, a 10-year bond with a duration of 8.7 will rise or fall about 8.7% for each 1% shift in interest rates; a 30-year bond with a duration of 18 will move approximately 18% for a 1% change in rates.

The investment return of an individual fixed income security includes the coupon payments, the return received when the coupon payments are reinvested, and the full principal of the security if it is held to maturity. The return of principal at a specified future date counters any negative short-term price changes that may occur prior to maturity.

We are currently at a cyclical turn in the interest rate cycle that will continue to produce increased price volatility in fixed income markets. Short-term price reductions provide the opportunity to invest new capital and the interest received from existing fixed income holdings, at much higher yields than were available just six months ago. Not all fixed income securities are affected in the same way when interest rates rise. By managing the duration of fixed income investments, price volatility can be reduced.

Even in a rising interest rate environment, fixed income securities will continue to play an important role in portfolio asset allocation by providing: capital preservation, consistent income, and diversification through negative correlation with other investment types. We will be using this emerging transitional interest rate environment to maximize investment opportunities in client portfolios.

Financial Markets

Global financial markets experienced increased volatility in the third quarter, but managed to post gains.

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

Country	Index	2013 Q3 Returns
Canada	S&P/TSX	5.43%
United States	S&P 500	2.37%
United States	NASDAQ	8.37%
United Kingdom	FTSE 100	8.40%
Japan	Nikkei	4.40%
France	CAC 40	12.81%
Germany	DAX	9.92%
Hong Kong	Hang Seng	7.64%

Five Years After the U.S. Housing Crisis

Beginning in 2006, declines in both home prices and the value of securities supported by real estate collateral began to negatively impact the U.S. housing sector. Initially the companies affected were those directly involved in home construction and mortgage lending as they could no longer obtain financing through credit markets. Over 100 mortgage lenders went bankrupt during 2007 and 2008.

The housing crisis eventually spread to the financial sector and reached its peak on September 15, 2008, when Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy. This was the largest bankruptcy in U.S. history with a negative worth of $129 billion. The failure of Lehman Brothers was the catalyst that subsequently led to several major financial institutions either failing, being acquired under duress or needing capital injections from the government. These companies included: Bear Stearns, Merrill Lynch, Fannie Mae, Freddie Mac, Washington Mutual, Wachovia, Citigroup, and AIG.

The collapse of the U.S. housing and financial sectors had global economic implications and resulted in the first ever recorded instance of negative global GDP growth. As economies worldwide slowed, credit availability and international trade declined, and the U.S. economy slid into its deepest recession of the post-war era. The Canadian economy also experienced a recession. However, the contraction was less pronounced than in most other G7 countries and the subsequent recovery was quicker.

These events had a significant impact on global stock markets. Price levels suffered large losses and volatility was record breaking. In the week that followed the Lehman Brothers bankruptcy filing, the S&P/TSX Composite Index had daily point changes of: -516, -27, -349, +187, and +848. Over the next seventeen months the Dow Jones Industrial Average Index declined more than 50%.

Governments and global central banks responded to these events by initiating unprecedented fiscal stimulus combined with quantitative easing measures that eventually reduced interest rates to record lows.

Five years have now passed since this crisis began and the prices of most major investment asset classes have either fully recovered or recorded gains. Over the past five months the yields on most fixed income investments have moved substantially above their record lows and the U.S. Federal Reserve is now expected to begin to slowly unwinding its quantitative easing initiatives. Although the North American economies are in a recovery, the effects of the crisis are still significant in the labour market. Unemployment rates in both the U.S. and Canada are 1% (or more) above the pre-Lehman Brothers bankruptcy levels. The U.S. labour-market participation rate sank to a 35-year low in August as individuals continue to be discouraged about the prospects for obtaining employment.

The U.S. banking sector has recovered, the Canadian banking sector is enjoying record profitability, but many European banks are still burdened with non-performing loans and a fragmented regulatory environment that is preventing effective new lending.

There is a saying that “time heals all wounds” and to a large degree this also applies to economies and financial markets. Clearly the healing process has begun, but more time is required to bring the global economy back to a healthy pace of growth.

	Sep 12 2008	**Sep 12 2013**	**Change %**
S&P/TSX Composite Index	12770	12701	-0.5%
Dow Jones Industrial	11422	15301	34%
CDN $(US$/CDN$)	94.3	96.9	2.8%
WTI Crude Oil	$101.18	$108.60	7.3%
Gold (US$/oz)	$750.00	$1,328.00	77%

The Bottom Line

At current levels, most major equity markets are reasonably valued compared with their historic averages.

The pace of global corporate profit growth has declined this year as economic growth has struggled to accelerate.

Particularly hard hit were cyclical sectors linked to global trade and commodities. The transition of economic expansion from central bank assisted growth to more self-sustaining growth, supported by private sector demand, appears to be in the early stages. This will provide a constructive background for equities.

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Managing Uncertainty, Compounding Returns