Quarterly Insights

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Economic & Investment Outlook

March 31, 2014

The global economy continues to advance with increased momentum now coming from developed countries, rather than just emerging countries.

First quarter economic data in Canada was distorted due to the severe winter weather that was experienced in many parts of the country. However, strong growth in both January retail sales and manufacturing, which reached the fastest pace in eleven months, are signs that the weather related issues are now being overcome.

Business investment is poised to increase throughout the year, as spending on machinery and equipment is accelerating. This will help offset the ongoing contraction in the housing sector, where sales finished 2013 down 13% compared to 2012 levels.

An accelerating U.S. economy will continue to support Canadian growth throughout this year. However, our economy will not experience the same degree of pent-up consumer demand that currently exists in the U.S.

Poor weather also affected U.S. economic growth to start the year with economist estimates suggesting that weather may have lowered annualized real GDP by 1% in the first quarter. Despite this headwind, February industrial production gained 2.1% to reach a new all-time high. Spending and the incomes of consumers continued to increase in February. Jobless claims fell to the lowest level since last November, as companies continue to expand their payrolls.

U.S. consumers have substantially reduced their debt levels, resulting in their debt-to-income ratio returning to a pre-2008 level. In aggregate, more than $1 trillion in consumer liabilities have been paid off during the last six years.

U.S. home owners have also regained roughly half the equity they lost during the housing decline, resulting in the net worth of U.S. households increasing by 14% last year. This was the largest increase in the last nine years.

As the U.S. economy improves, the Federal Reserve continues to gradually transition from quantitative easing to a normalization of monetary policy. In March, they announced a further reduction in their monthly debt purchase program and indicated that interest rates may begin to increase sooner than was previously expected.

Spending Thaw for Developed Countries

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Chance of Showers

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Economic & Investment Outlook cont'd.

As Eurozone business and consumer confidence has improved, this has resulted in moderate increases in both business investment and household spending. In March, the pace of growth in manufacturing and services reached a 2 1/2-year high.

A number of Eurozone peripheral countries (Spain, Portugal and Greece) have made improvements in their current account positions and wage competitiveness, which will continue to reinforce improving credit conditions. The monetary stimulus that has been initiated by the Eurozone central bank is very similar to the early stages of the U.S. quantitative easing program and this will assist in improving growth.

Geopolitical risks remerged in March as Russia annexed control of the Crimean peninsula. Crimea is a strategic region located on the Black Sea that was gifted to Ukraine by the USSR sixty years ago. Prior to the annexation, Russia leased the Sevastopol port in exchange for a 30% reduction in the price of Russian natural gas that Ukraine depends on for much of its energy needs.

Russia also supplies about a third of Eurozone's natural gas and crude oil which flows across Ukraine's pipeline system. Exports from the Eurozone to Russia are also substantial, so any extended period of economic sanctions against Russia may add a new obstruction to the Eurozone's accelerating growth.

Financial Markets

Global financial markets were mixed in the first quarter, as weather related economic distortions and the events in Crimea affected investor optimism.

First Quarter 2014 returns in local currency terms for world equity markets were:

Country	Index	2014 Q1 Returns
Canada	S&P/TSX	5.24%
United States	S&P 500	1.30%
United States	NASDAQ	0.54%
United Kingdom	FTSE 100	-2.23%
Japan	Nikkei	-8.98%
France	CAC 40	2.22%
Germany	DAX	0.04%
Hong Kong	Hang Seng	-4.95%

Equity prices have recovered at a pace well ahead of the global economy, as liquidity created by central banks continues to fuel asset prices. At the end of last year, U.S. corporate profits reached all-time highs. Canadian corporate profits, measured as a share of GDP, are well above the long-term average. In both countries corporate cash balances are at record highs, with Canadian companies now holding a record $626 billion.

In a rising interest rate environment, the profitability of corporations will be much more dependent on increasing sales. As a result, the pace of global economic growth will now become the primary driver of further gains in equity prices.

The Bottom Line

Despite the hurdles to growth that the world economy has experienced during the first quarter, we continue to look for a broad based acceleration throughout this year. This will provide support for commodity prices and place upward pressure on interest rates.

The medium term outlook for equities is positive in this environment and we will continue to use appropriate exposure to equities in client portfolios, considering their Risk Profile and objectives.

Income Splitting Using Spousal Loans

The objective of income splitting is to shift family income from an individual in a high tax bracket to an individual in a lower tax bracket with the goal of reducing the amount of tax that is paid on this income. However, there are attribution rules contained in the Income Tax Act that allow income splitting only under certain circumstances.

The attribution rules with respect to spouses (and children under 18 years of age) stipulate that if property including cash is transferred directly or indirectly to your spouse, then all income and any capital gain or loss on the disposition of the property, will attribute back to the transferring spouse.

The attribution rules do not apply if money is lent to a spouse using a genuine investment loan charging interest at least equal to the lesser of the Canada Revenue Agency's (CRA) prescribed rate or commercial interest rates.

The current low level of interest rates makes this an attractive time to consider such a spousal loan. For the period from April 1, 2014 to June 30, 2014 the CRA prescribed rate of interest for spousal loans is only 1%. Therefore, where investment assets are expected to produce a return that is well in excess of this rate, it may make sense to loan assets to a spouse and charge the 1% rate of interest.

The lending spouse will be taxed on the 1% interest income received from the loan while the borrowing spouse will be taxed on the amount of investment income and capital gains earned. The borrowing spouse may also deduct for tax purposes the 1% interest paid as a carrying charge.

Spousal investment loans can lock-in the 1% rate for as long as the loan remains outstanding, even if the prescribed interest rises in the future. As a result, the tax savings benefit should grow as interest rates rise.

Proper documentation of the loan is required as well as evidence of actual repayment within a reasonable period of time. The annual interest on the loan must be paid during the year or within 30 days following the year end. Failure to meet these conditions will invoke the attribution rules and all income and capital gains will be attributed back to the lending spouse.

<u>An Example</u>

Bill lends Sally (the lower income spouse) $100,000 by way of a promissory note and charges her interest of 1%. Sally then invests this money and earns a 5% rate of return. Sally reports $5,000 of investment income on her tax return ($100,000 x 5% rate of return) and gets a tax deduction for the $1,000 of interest she pays to Bill ($100,000 x 1% prescribed interest rate). Bill reports $1,000 of interest income on his tax return.

Sally must pay Bill the interest (this is tax deductible to Sally as a carrying expense) by the following January 30th of each year and Bill must report the interest received as income.

As a result of this $100,000 loan, $4,000 of annual income has been shifted from Bill to Sally. The excess return from the assets over the amount of interest charged has now been transferred to the lower income spouse without triggering the attribution rules.

Suite 1204
220 Portage Avenue
Winnipeg, MB
R3C 0A5
T: 204.989.6200

2600 Sun Life Plaza
144-4th Avenue S.W.
Calgary, AB
T2P 3N4
T: 403.269.1375

Suite 300
1055 West Hastings Street
Vancouver, BC
V6E 2E9
T: 604.609.6177

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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