Quarterly Insights

June 30, 2014

Economic & Investment Outlook

Money Flowing

and

Global Growth

Major global economies are continuing to benefit from monetary stimulus as growth continues to gradually accelerate. This economic expansion is expected to strengthen as many of the headwinds that have previously been restraining activity are now dissipating.

The Canadian economy is recovering from the effects of the difficult winter that depressed growth earlier this year. Second quarter GDP, appears to be on a pace to advance 2.5%.

In April, wholesale trade rebounded strongly, while retail sales increased by 1.1%. In May, the housing sector recorded the largest monthly gain in home sales in nearly four years, with prices increasing 7.1% compared to the same period last year.

Despite the improving economy, the job market continues to be restrained. Over the past year, Canadian employment has increased only 0.5%, which is less than a third of the pace produced in the U.S.

Canada's export sector continues to struggle to return to its pre-recession level of activity. Over the past three months the Canadian dollar has appreciated 5.5%, rising to near 93.5 cents from 89 cents. Further gains in our currency will continue to be a headwind for some industries.

However, it is likely that stronger global growth will have an escalating positive impact on exports and business investment, which will make these sectors larger contributors to Canadian economic growth this year than they have been up to this point in the recovery.

Despite a subpar start to the year for the U.S. economy, recent reports on auto sales, business activity and employment suggested growth was rebounding in the second quarter.

Orders for durable goods have been considerably stronger than expected over the past two months. The ISM manufacturing index rose to 55.4 in May, its highest reading this year and its 12th consecutive month of expansion.

Consumer spending continues to increase. Retail sales over the past three months were up 4.3% from a year earlier, with May auto sales reaching their highest level in eight years. Home sales in May reached a six-year high, recording their biggest increase since January 1992.

Nonfarm job creation has totalled over 200,000 positions per month for 13 of the past 21 months. The total number of jobs created has now brought U.S. payrolls back above their 2008 pre-recession highs.

The Eurozone economy grew by only 0.2% in the first quarter. However, increases in industrial output and retail sales, which registered their strongest annual growth in seven years in April, are pointing to an acceleration of economic growth in the second quarter.

Inside this issue:

Economic & Investment Outlook cont'd.

Less than two years after receiving emergency financial support, borrowing costs for bailed-out countries have tumbled back to pre-crisis levels and in some countries, are now near all-time lows. Favorable market conditions have prompted Ireland, Portugal and Greece to take steps to exit their bailout programs and the required austerity programs. This return to private financing marks an important transition toward improving their economies. However, debt reduction will continue to be a priority in the Eurozone for the foreseeable future.

Geopolitical concerns have spread from tensions in the Ukraine to now include a possible sectarian civil war in Iraq. The events in Iraq pose a greater risk for financial markets and the global economy, as the violence in Iraq sent crude prices to 9-month highs.

A prolonged rise in energy prices could put additional pressure on the global economy, as higher gasoline prices are an extra expense for consumers and also increase costs for many industries.

Financial Markets

Global financial markets rallied in the second quarter as investor optimism about the global economy and continued downward pressure on interest rates, continued to act as catalysts for equity prices.

Second quarter 2014 returns in Canadian currency terms for world equity markets were:

Country	Index	2014 Q2 Returns
Canada	S&P/TSX	6.10%
United States	S&P 500	1.05%
United States	NASDAQ	1.33%
United Kingdom	FTSE 100	1.27%
Japan	Nikkei	0.54%
France	CAC 40	-3.39%
Germany	DAX	-1.29%
Hong Kong	Hang Seng	1.12%

Increases in oil prices helped propel the S&P/TSX index to a new 6-year high, while the S&P 500 index also reached a record high on increased earnings estimates.

Accommodative monetary policy continues to play a role in the significant gains seen in world equity markets, which have rallied since bottoming in 2009. Rising valuation multiples (paying a higher price for the same level of earnings) have produced a significant portion of the gains recorded to date.

Therefore, there will be an increasing reliance on profit gains to move share prices higher.

Not all global equity markets appear equally attractive. The continued monetary liquidity provided by the Eurozone Central Bank and the Bank of Japan, will continue to provide support for further equity price gains in these regions. Many emerging markets will likely continue to struggle until global economic growth reaches a higher level.

The Bottom Line

We expect a moderate increase in global economic growth for the remainder of the year.

With central banks continuing to anchor interest rates near zero, it will be difficult for long-term fixed income yields to rise significantly until economic growth normalizes and quantitative easing measures eventually come to an end.

These low interest rate levels combined with a recovering economy should be generally supportive of equities. As a result, we will continue to search for opportunities to gain exposure to equities in client portfolios.

The New Rules of Central Banking

As the global economic recovery continues, major central banks are no longer moving in lockstep. While the U.S. Federal Reserve is reducing its quantitative easing program, other central banks are still maintaining or increasing their monetary stimulus measures.

The Bank of Japan's (BOJ) quantitative easing initiative is now 13 months old and continues to inject 60-70 trillion yen per year ($590-685 billion $US) into their economy. It is estimated that the BOJ has purchased nearly 70% of all government debt issued this year, including almost all of the new issue 10-year bonds.

The Eurozone Central Bank (ECB) reduced the deposit rate it pays on bank reserves to negative 0.10 percent from zero. They are the world's first major central bank to use a negative interest rate. This is a clear sign that the ECB is committed to restoring the European economy to its strength from before the last financial crisis. Several European governments still have too much debt for the size of their economies, and policymakers intend to make banks safer by working off some of the bad debts that are sitting on their balance sheets.

The ECB also enacted additional monetary stimulus measures by:

- Lowering its refinance benchmark interest rate to 0.15 percent from 0.25
- Opening a new 400-billion-euro lending facility for Eurozone banks. These funds can be obtained for up to four years if the institution can demonstrate that the monies will be used for new loans.

The ECB also began preliminary work on a program to purchase asset-backed securities in a similar endeavour to the quantitative easing programs conducted by the U.S. Federal Reserve. Under this program, the ECB would purchase pools of loans made to small and medium-sized businesses that have been made by banks. However, unlike the U.S. program, any ECB asset purchase program will encounter the additional complexity of determining not only which assets to purchase, but also from which issuer country.

Global monetary policy continues to evolve in innovative ways; however the eventual unwinding of these initiatives could present their own set of unique consequences for financial markets.

The Canada-US Entry/Exit Initiative

Beginning on June 30, 2014, Canada and the U.S. will implement the final phase of an Entry/Exit Initiative in which both countries will share information on the individuals entering and leaving each respective country.

Currently, Canadians have been required to self-report their time out of the country and their resident status. Each country only monitored when an individual entered their country, but not when they departed. Therefore, neither country typically knew how long a person had been present within its borders. This new tracking and information sharing process will result in both countries, for the first time, being able to independently determine the number of days an individual spends in each respective country.

Canadian travellers will now need to be much more vigilant about counting and reporting their days spent in each country in order to avoid the negative consequences that can result from being either present or absent from a country for too long a period of time.

These consequences may include:

- Being banned from travel to U.S. due to *unlawful presence rules*. Canadians who remain in the U.S. for more than 180 days in a rolling twelve month period risk being deemed unlawfully present.
- Becoming subject to U.S. income tax and or estate tax on their worldwide income and assets. The determination of a *U.S. resident* for income (the substantial presence test) and estate tax purposes is different and therefore, requires careful planning by Canadian travellers and owners of U.S. vacation property.
- Being subject to Canadian departure tax. Once a Canadian is no longer resident, they are deemed to have disposed all of their assets (subject to some exceptions), which can result in a taxable gain. Whether an individual is no longer a Canadian resident is determined from a facts and circumstances test; with the number of days residing in Canada forming a significant part of the test.
- Losing coverage under a provincial health care program. Once an individual is no longer resident in a particular province, they may no longer be eligible for their health care coverage. The rules for residency for health care differ among the various provinces.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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

We manage our client portfolios utilizing an investment philosophy which maximizes the benefits of Exchange Traded Funds (ETFs) as the core holdings.

Our value to you is focused on the following themes:

- *Accepting a fiduciary standard of care to eliminate conflicts of interest in advising and managing your wealth*
- *Reducing the cost and making your portfolio managements fees visible to maximize your returns*
- *Increasing the tax-efficiency of the investment return you receive*
- *Helping you avoid mental errors in your investment decision*

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