

Quarterly Insights



Economic & Investment Outlook

December 31, 2014

As a new year is about to begin, the global economy continues to be characterized by accelerating US growth which contrasts with a lackluster outlook for most other parts of the world.

The Canadian economy had a commendable performance in 2014. Advances in exports and resilient consumer spending consistently added to growth, while business investment was generally weaker than expected.

Strong back-to-back employment increases in Canada for September and October reduced the unemployment rate to 6.5%, which is the lowest level since November 2008.

The decline in oil prices has mixed implications for the Canadian economy. Lower energy prices will reduce capital spending but will benefit manufacturing and consumer spending. For the upcoming year consumer spending will likely grow in line with incomes, as elevated debt burdens will restrain borrowing. Housing demand will be supported by employment and population growth, but will likely be tempered by a gradual rise in mortgage interest rates.

The Bank of Canada has not increased its overnight interest rate from the 1% level since September

2010. In January 2015, the current pause will become the third longest in its 80-year history. Although the exact timing of the next rate change remains up for debate, an increase during 2015 appears likely.

The US economy finished 2014 on a strong note, with employment recording the biggest gain in more than a decade and retail sales climbing in November by the most in eight months. Unemployment south of our border has now fallen to 5.8% from 7% in the past 12 months.

The combination of steady growth in employment, a moderate housing recovery and rising capital expenditures all suggest that the US economy will continue to gain momentum next year. A rise in household wealth and falling oil prices also bode well for consumer spending, which accounts for about 70% of the US economy.

We expect the Federal Reserve to begin raising interest rates in the last half of 2015. The amount and pace of the increases will depend on the strength of the labour market and on how quickly wage growth increases inflation.

Eurozone economic growth finished the year with only a marginal increase in activity as increases in

Stable

Growth

in

North America

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Economic & Investment Outlook cont'd.

both manufacturing and exports were largely offset by declines in consumer spending and business investment. The region continues to struggle to gain self-sustaining economic momentum. The European Central Bank is expected to commence some form of broad-based asset purchases or quantitative easing programs early next year to provide another boost to their economy.

Concerns regarding a financial crisis in Russia have escalated. Western government sanctions due to Russia's action in Ukraine and the decline in oil prices

have caused a rapid decline in their currency value. A ruble is now worth less than two pennies when compared to the US dollar, having lost nearly 50% of its value since the beginning of 2014.

According to the World Bank, Russia began 2014 as the world's eighth-largest economy. However, by the end of the year its GDP had declined to approximately the same as Indonesia, the world's 15th largest economy. There is apprehension that Russia may default on its \$670 billion in foreign debt obligations if their economy does not stabilize.

Financial Markets

Global financial markets were mixed in the last quarter of 2014, as a sharp decline in oil prices and concerns about the rate of economic growth in the Eurozone acted as catalysts for a correction in equity prices.

Fourth quarter 2014 returns in local currency terms for world equity markets were:

Country	Index	2014 Q4 Returns
Canada	S&P/TSX	-2.19%
United States	S&P 500	4.39%
United States	NASDAQ	5.40%
United Kingdom	FTSE 100	-0.85%
Japan	Nikkei	7.90%
France	CAC 40	-3.25%
Germany	DAX	3.50%
Hong Kong	Hang Seng	2.93%

The Bottom Line

A key theme for 2015 will be accelerating growth in Canada and the US, slower growth in Europe and Japan, and the effect this divergence has on interest rate levels and relative currency values.

Historically, the best part of the economic cycle for equity prices has been the period between the end of central bank easing and early in the tightening cycle,

as economic growth gains increasing momentum, but is not overly restrained by monetary policy.

As the process of normalizing monetary policy begins, we will continue to prepare the fixed income allocation in our client portfolios for a rising interest rate environment.

The Economics of Oil

Oil is the backbone of the global economy. It is used as automotive fuel and as a source of heat. It is also required to produce chemicals, plastics, roads, tires, textiles, construction materials and many household products. Although population growth ensures consistent long-term demand, the price has a history of significant volatility due to geopolitical events and changes in supply.

From a price near \$100 in September, oil declined nearly 47% to reach \$53 by year end. Increasing production in the US, uneven global economic growth and a surprising OPEC decision not to reduce production, combined to create an over supplied marketplace.

Although the imbalance between supply and demand is fairly small – between 0.5 million and 2 million barrels per day (bpd) in a global market of 93 million bpd – the steady increase in US supply has reduced OPEC's ability to influence prices. US oil production has been increasing due to improved fracking technology. This has boosted the country's unconventional oil production by a third, to reach a level which is only 1 million bpd less than Saudi Arabia's current output.

Further short-term price declines and volatility are possible as much of the daily price changes that now occur in commodity markets are influenced primarily by leveraged financial traders rather than actual producers. It is not unusual for short-term trading to diverge from long-term fundamentals in these markets. However, we believe the current price of oil is unsustainably low relative to production costs as the price is now well below what 10 of OPEC's 12 members need for their annual budgets simply to break even, according to data compiled by Bloomberg.

The expectation that OPEC producers would reduce output when required has previously been an important stabilizing factor for the previous market price of oil. It is now likely that OPEC has shifted tactics to begin using negative pricing as a

means for regulating the growth of the industry's capital investments.

The current surplus of oil was brought about primarily by the success of unconventional oil production. However, many of these new projects have development costs that are now greater than current market prices. As a result, some of these future projects will be cancelled or delayed until the return on investment becomes more attractive.

During the previous major oil price correction of 2008-2009, it took a year and a half for the price of oil to complete a full cycle, where it declined from a peak to a "shut-in" level and then subsequently recovered to the point where it again became profitable for new development. If the current cycle follows a similar path, then a substantial recovery in the price of oil may occur by the end of next year.

While these reductions in supply are occurring over the next 18 months or so, the global economy will benefit from lower oil prices. The International Monetary Fund estimates that for every 10% drop in crude oil prices, global real GDP increases approximately 0.3% over two years.

Declining oil prices shift funds from producers to consumers. Large importing countries such as the Eurozone and Japan will benefit the most, while producers in regions such as Norway and Middle Eastern countries will experience a decline in the value of their exports. For the US and the Canadian economies, the impact is mixed as consumers benefit from lower gasoline prices while both corporate profits for producers and taxes for governments will decline. Overall, oil production is four times more important to the Canadian economy than the US economy.

The net result is that the global economy will receive a boost next year that should primarily benefit those regions that have been struggling with below trend rates of growth.

Registered Education Savings Plans (RESP)

A Registered Education Savings Plan (RESP) is a tax deferred savings vehicle which allows a subscriber to save money for a beneficiary's post-secondary education.

An RESP can be established by a subscriber on behalf of one or more beneficiaries. Each beneficiary must be under 21 years of age at the time of designation and must be related to the subscriber by blood or adoption. Children, grandchildren, brothers and sisters are considered blood relations, while nieces and nephews are not.

There is no annual limit for contributions to an RESP, however the maximum amount that can be contributed for each beneficiary is \$50,000.

Canada Education Savings Grant (CESG)

The Canada Education Savings Grant (CESG) is added to an RESP by the Federal Government. This grant increases the annual contribution by 20%, up to a maximum of \$500 (\$2,500 contributions x 20%) per beneficiary. The lifetime maximum CESG for each beneficiary is \$7,200.00.

Payments to Beneficiaries

The value of an RESP must be used by beneficiaries for the purpose of their education. Withdrawals can be used to cover a beneficiary's expenses for tuition, housing, transportation, books, supplies and other incidentals relating to education. The timing, amount and frequency of payments to each beneficiary are directed by the subscriber and payments do not have to be equal among all beneficiaries of the plan.

Withdrawals from an RESP have differing tax consequences that depend on the original source of the capital. The CESG and any accumulated investment return are taxed as income to the beneficiary in the

year in which they are received. However, the capital contributions made by the subscriber can be removed tax-free.

What happens if a beneficiary does not pursue a post-secondary education?

A subscriber is always able to withdraw the capital contributions made to an RESP.

The following options are available if none of the original beneficiaries attend a post-secondary educational institution:

1. Change the beneficiary. The replacement beneficiary must also be related to the subscriber by blood or adoption. The CESGs paid into the plan can be used by the replacement beneficiary or any of the other beneficiaries as long as they are under the age of 21.
2. Transfer the accumulated investment return to an RRSP. The subscriber may transfer up to \$50,000 of the investment income to their own RRSP or that of their spouse, provided that unused RRSP contribution room is available.
3. Pay tax and penalty. Any accumulated investment income that is not transferred to an RRSP will be taxed as income to the subscriber. The subscriber must also pay a 20% penalty on the withdrawn income. This penalty represents a return of the accumulated CESGs that were paid into the plan.

An RESP combines payment flexibility, tax-deferred investment growth, income splitting and direct government contributions to assist a subscriber to fund their education savings goals for their children or grandchildren.

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