Quarterly Insights

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Economic & Investment Outlook

March 31, 2015

Currency

Musical

Chairs

Inside this issue:

The global economy continues to experience divergent rates of growth among the major developed regions. In the past three months, eleven central banks have cut interest rates, while the US Federal Reserve has moved away from cutting, to a neutral stance, in preparation to raise rates later this year.

Canada's economy grew at a 2.4% rate in the fourth quarter of last year, led by increases in consumer spending and exports. Exports have begun to broaden away from energy-related products toward industrial and consumer goods, transportation equipment, and building materials. However, economic data has weakened sharply in early 2015 reflecting the effects from lower energy prices on capital spending in some provinces.

After losing close to a fifth of its value compared to the US dollar in the past two years, the Canadian dollar appears to have stabilized near 80 cents US. Though some import prices will increase, the export sector should remain well supported by our lower currency.

Although the contribution to economic growth from the oil and gas sector will be reduced this year, increased manufacturing activity appears likely to offset this decline. Manufacturing output has increased in four of the past five years. Stable US economic growth will also continue to be a positive influence, as over one half of Canadian manufactured goods are exported to the US.

Despite their ongoing concerns about the risks posed to the economy from rising house prices and elevated consumer debt levels, the Bank of Canada decreased the overnight lending rate to 0.75% from 1% in January. It stated that the move would provide "insurance" for our economy amid declining oil prices. This decision marked a surprising reversal from the bank's previous statements that indicated a rising path for rates. We expect that later this year, increased domestic growth should require a move back toward the tightening of monetary policy.

The US economy expanded at an annual rate of 2.2% in the fourth quarter of 2014, led by non-residential investment and the fastest pace of consumer spending in eight years. However, first quarter growth is expected to be below this pace due to a rising US dollar, declining energy capital spending and severe winter weather experienced in many parts of the country.

The US dollar has increased more than 20% in the past year against a basket of major currencies. This marks one of the fastest yearly gains on record and has pushed the dollar to its highest level since 2003.

The rising dollar will act as a partial drag on US economic growth, as exporters will feel the negative competitive effects of the increased currency value against most major trading partners.

Monthly employment gains in the US

Economic & Investment Outlook cont'd.

have averaged 282,000 during the past six months, which is now almost on a par with past cyclical recoveries. Unemployment has dropped from 6.6% in January 2014 to 5.5% in February of this year. Wages are also rising at the highest monthly level since 2008, which is producing the early stages of pricing pressure as capacity becomes constrained.

The Federal Reserve has indicated that rate increases will begin at some point this year depending on the ongoing changes in employment and inflation data.

The Eurozone economy grew at an annual rate of 0.3% in the final three months of last year. Recent economic data shows that their economy is finally emerging from a long period of stagnation, aided by lower oil prices, a weakening euro, and firming confidence following the European Central Bank's (ECB) launch of a new stimulus program. The ECB has raised its growth forecast for this year from 1% to 1.5%.

The announced ECB quantitative easing program (QE) will purchase by September 2016 more than one trillion euros (averaging about €3.2 bln per day) of primarily government bonds. The amounts purchased will be in proportion to each country's share of the ECB's capital; therefore German bonds will comprise the largest share of the program even though Germany's economy needs little assistance when compared to other smaller European economies.

As the ECB program begins, an expanding number of short to intermediate term securities now have interest rate levels that have fallen below zero. In fact, roughly 25% of all outstanding government bonds in Europe now trade at negative rates. The total market value of AAA-rated government bonds is approximately 15% of Eurozone GDP, which is far less than the equivalent ratio of 50% that was present in the US when the Federal Reserve began its final QE program. This suggests that a scarcity premium will continue to push interest rates further into negative territory as the ECB absorbs these high quality securities.

QE programs have been used extensively by Japan, the United States, Britain and now the Eurozone because the traditional monetary tool of interest rate reductions can no longer be employed with interest rates close to zero or below.

These programs have created financial market conditions that are increasingly being pushed to extremes. The unknown effects that may be created by the now emerging differences in monetary policy between the US and other developed countries are new risks that may influence both the volatility of the global financial markets and the returns that are realized by investors in traditional fixed income securities over the next several years.

Financial Markets

Global financial markets recorded a mixed performance in the first quarter due to concerns about geopolitical issues in the Middle East and diverging economic growth. Asian and European markets advanced, while North American markets paused.

First Quarter 2015 returns in local currency terms for world equity markets were:

Country	Index	2015 Q1 Returns
Canada	S&P/TSX	1.85%
United States	S&P 500	0.44%
United States	NASDAQ	3.48%
United Kingdom	FTSE 100	3.15%
Japan	Nikkei	10.06%
France	CAC 40	17.81%
Germany	DAX	22.03%
Hong Kong	Hang Seng	5.49%

With nearly 45% of the sales of S&P 500 companies being earned in foreign currencies, the rising US dollar is having a negative effect on the profitability of US multinational corporations. For the first quarter of this year, S&P 500 analyst estimates are now projecting year-over-year declines in both revenues and earnings. This would represent the first quarterly decline since 2009.

Equity valuations are currently at levels in the US that make markets vulnerable to any prolonged downgrade in earnings momentum.

Currency Battles

Lower inflation and below average rates of economic growth are causing central banks around the world to continue to ease monetary policy. However, with interest rate levels at historic lows, many monetary policy changes are now occurring as surprise moves in an attempt to increase their effectiveness. A direct consequence of these surprise announcements is a rise in foreign exchange market volatility.

The Eurozone, China, Australia and Canada (representing about a third of the world's economic output) have all experienced significant changes in the relative value of their currencies since the start of the year.

In January, the Swiss National Bank abandoned its policy of capping the Swiss franc against the euro, resulting in a dramatic single day increase of 13%.

What underlies this upswing in volatility is a divergence in monetary policies and central banks attempting to use competitive currency devaluations as another tool to stimulate underperforming economies. The goal is to use a weaker currency to make exports more competitive (boosting the economy) and also increase import prices, which makes deflation less likely.

Currency devaluations also affect global investment flows which influence investment returns. Although many currency transactions are directly related to the supply and demand of a country's import and exports sectors, the majority of currency transactions are related to investments. According to the Economist magazine, the daily value of world goods traded in 2013 was $52 billion; however the daily currency-exchange turnover in the same year was a thousand times larger at $5.3 trillion. Some investment strategies actively switch investments from one currency to another in the hope of enhancing investment returns. The term "carry trade" refers to borrowing money in a currency with a low interest rate and then investing the proceeds in a country with a higher interest rate. These types of investment transactions can further exaggerate currency market volatility.

Nevertheless, there is a "musical chairs" effect to competitive currency devaluations. As one central bank lowers interest rates, others are forced to follow suit to offset the upward pressure on their currencies. The result is that foreign-exchange markets are zero-sum; for one currency to fall, others must rise.

Therein lies the problem. Not all countries can competitively devalue their currencies at the same time. Therefore, it is likely that the current round of foreign exchange devaluations will prove less effective in stimulating economic growth than many central banks had hoped when they began the process.

The Bottom Line

Financial markets are continuing to be buoyed by the unconventional monetary policies of central banks toward record levels. However, the announcement by the US Federal Reserve that it will begin to change its policy direction by increasing interest rates later this year is producing heightened levels of volatility across multiple types of markets.

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 making*

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

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

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

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