Quarterly Insights

Economic & Investment Outlook

June 30, 2015

The North American economy is rebounding after a slow start to the year.

Canadian economic growth contracted by 0.6% in the first quarter, due primarily to large capital spending cuts in the energy sector and reduced exports. However, growth has rebounded strongly in the past two months as oil prices have stabilized after recouping nearly one third of the decline that occurred earlier this year.

May employment increased by over 58,000 new jobs. This gain was more than five times greater than the forecasted figure and was the largest increase in seven months. Home sales rose 3.1% on a seasonally-adjusted basis in May, the fourth consecutive monthly gain.

Auto sales continue at a record pace, increasing by 1.3% in April which has contributed to a cumulative 2.2% advance in retail sales over the prior two months.

Core inflation rose 0.4% in May to a 2.2% annual rate. The core inflation rate has been above the Bank of Canada's 2% target for ten consecutive months and continues to be one of the highest inflation rates in the developed world.

The U.S. economy fared better than Canada in the first quarter, however GDP growth still declined by 0.2%. The slowdown was attributed to a very cold winter and statistical adjustment factors, which for the past several years have tended to underestimate growth in the initial three months of the year. These one-time factors now appear to have passed and growth has reaccelerated.

Employment rose by 280,000 jobs in May, with revisions to the prior two months adding another 32,000 jobs. Hourly earnings also increased, which continues to support consumers as personal spending jumped 0.9% in May. This was the largest increase since August 2009.

U.S. retail sales rose by 1.2% in May with auto sales having their best month in a decade. Building permits also rose strongly in both April and May, which will result in residential construction contributing to second quarter growth at a much faster pace than earlier this year.

First quarter economic activity in the Eurozone increased at the best pace in four years and it appears that this momentum is continuing to carry forward. The recovery has become more widespread, with growth returning to France, Italy and Spain.

Expanding

Economies

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Tightening

Politics

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Economic & Investment Outlook cont'd.

The improving Eurozone economy is also impacting positively on their labour market. Job creation is running at the highest rate in four years and the unemployment rate has fallen to its lowest level since 2012.

At the end of June, negotiations between Greece, the Eurozone and International Monetary Fund (IMF) appear to have paused. Whether, and to what extent, this is gamesmanship will not be known for some time.

Greece has defaulted on a payment to the IMF, the largest default in the history of the IMF. On July 20, Greece has a payment due to a group of Eurozone institutions led by the European Central Bank. Greece appears unable to make this payment even if willing.

The Greek government has scheduled a referendum for their people next weekend. If the vote is "No", it is a rejection of Europe's latest proposal. If the vote is "Yes", it is a rejection of the Greek government's position, and in this case both the Prime Minister and the Finance Minister have said they will quit.

The consequences now are not entirely clear, partly due to the nature of politics at this level, and partly due to the wide spread of opinions among the parties. Whether this Greek example will set a precedent for other European nations is impossible to predict.

European banks have far less exposure to Greece's debt now than in 2010 (about $40 billion now compared to $100 billion in 2010). This is because most of the money loaned to Greece in the last five years has actually been used to pay off private-sector creditors including German and French banks.

Canadian banks do not have any loan exposure to Greece, while U.S. banks have $13 billion.

Financial Markets

Global financial markets recorded a disappointing performance in the second quarter as concerns about the early year slowdown in North American economic growth and the ongoing negotiations regarding the possibility of Greek debt default restrained optimism. As interest rate volatility increased and liquidity decreased, the current yields in many bond and preferred shares were too low to shield against negative total returns.

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

Country	Index	2015 Q2 Returns
Canada	S&P/TSX	-2.34%
United States	S&P 500	-0.23%
United States	NASDAQ	1.75%
United Kingdom	FTSE 100	-3.72%
Japan	Nikkei	5.36%
France	CAC 40	-4.84%
Germany	DAX	-8.53%
Hong Kong	Hang Seng	5.42%

Approaching Liftoff

The US Federal Reserve's forward guidance has consistently indicated that an improvement in employment is a key requirement to begin the normalization of interest rates. The strong May employment report has increased the three-month moving average of job gains to twice the number that is now necessary to match labour force growth. Therefore, if new job creation continues near the same pace over the summer months, we expect that the Federal Reserve will announce an initial increase in its policy rate by September.

When interest rates begin to rise, they tend to trend higher for extended periods. Over the previous four decades, there have been eight periods when the Federal Reserve increased policy interest rates. The shortest duration lasted nine months and the longest was thirty nine months.

The Federal Reserve recently published targets that show 2015 year-end policy rates at 0.50%-0.75%, followed by consecutive increases of 1.25% in each of 2016 and 2017. This path would bring rates to 3% in 2018 from the current rate of 0.25%.

Each rising interest rate cycle has its own attributes. However the near-zero interest rate policy that has been in effect in the U.S. since 2009 combined with the artificial suppression of longer-term bond yields due to multiple quantitative easing programs, will make the progression of this cycle extremely unique.

Volatility in many types of fixed income securities has increased substantially over the past several weeks as a combination of unsustainably low yields and anticipation about the timing and trajectory of U.S. interest rate increases has begun to shape global fixed income markets. For example, German 10-year government bond yields traded at 0.95% in early June, after reaching a low of 0.07% as recently as mid-April. Price changes of this magnitude over such a short time horizon have not previously been experienced in sovereign debt markets.

As the Federal Reserve begins the process of normalizing interest rates, the equilibrium level for yields should continue to move higher. We would expect that Canadian interest rates will continue to follow a similar path as our economic growth continues to improve. Real rates of return (returns after inflation) have been negative in most global sovereign debt markets since the introduction of quantitative easing initiatives by central banks. The normalization of interest rates and the reappearance of positive real returns in fixed income securities will be a positive development for income oriented investment portfolios.

The Bottom Line

We expect the economies of major developed countries to continue to expand, however the rates of growth will vary.

Global equity markets have benefited by a solid recovery in corporate profitability and higher valuations that have been supported by historically low interest rates.

We continue to expect volatility to increase across many types of financial markets as the normalization of monetary policy begins by global central banks.

TFSA & RRIF changes

The recent Federal budget introduced beneficial changes to both tax-free savings accounts (TFSAs) and registered retirement income funds (RRIFs).

New TFSA contribution limits

A TFSA account allows contributed capital and any investment return that is earned to accumulate tax-free.

The annual contribution limit for TFSAs has been increased from $5,500 to $10,000 for 2015 and future years. Contribution limits are no longer indexed to inflation, so any further increases will have to be legislated.

An individual who has not previously contributed to a TFSA account can now utilize $41,000 of contribution room.

New RRIF minimum annual withdrawals

A RRIF account allows for payments to be received from the capital that has accumulated in an RRSP. At the end of the year in which the owner of a RRIF turns age 71, a minimum withdrawal must be made from the account. The withdrawal percentage increases each year and the amount is taxable in the year in which it is received.

The previous RRIF rules required someone who turned 71 to withdraw 7.38% of the market value of their assets. By age 94, the withdrawal percentage peaked at 20%.

Under the new rules effective for 2015, that same person would have to make an initial withdrawal of 5.28%. By age 94, they would withdraw 18.70% and not reach the maximum cap of 20% until age 95.

The reduced minimum withdrawal requirements allow more capital to be retained in a tax-deferred environment for a longer period of time.

For example, consider a RRIF which had a market value of $300,000 at the end of the year in which the owner turned age 71 and earned a 5% annual rate of return. Under the old rules the year-end market value in which the owner turns 90 would be $132,633 if only the minimum annual withdrawals were made. Using the new minimum withdrawal requirement, the remaining market value would be $193,434. The difference is $60,801 or 46% more than in the previous example.

Both TFSA and RRIF accounts should be part of the framework for structuring a tax-efficient retirement income strategy for most individuals.

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Managing Uncertainty, Compounding Returns