# Quarterly Insights

INDEX WEALTH MANAGEMENT
A DIVISION OF BELLWETHER INVESTMENT INC.

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## Economic & Investment Outlook

Sources of global growth are strengthening, both within countries and across regions. The International Monetary Fund has increased its projections for world economic growth to 3.5% this year and 3.7% next year. This increasingly synchronized global economic expansion is resulting in a continuing removal of monetary stimulus by some developed-country central banks.

The Canadian economy expanded by 4.5% in the second quarter, which marked the fourth straight quarter of robust growth. Advancing employment and wage gains have led to strong consumer spending, while the key areas of business investment and exports have also shown improvement.

Canada's economy continues to lead all other G7 nations. Growth has averaged 3.7% over the past four quarters. This is Canada's best twelve consecutive month economic performance since 2006.

Economic activity grew by a solid 0.3% in June, providing a strong handoff for the third quarter. August produced another month of job gains. The Canadian labour market is in its longest run of employment expansion since the 2008 recession, with 387,600 new jobs being created since July 2016. The unemployment rate is now near a decade low of 6.3%

However, it is likely that the pace of Canadian growth will slow into the end of the year as the positive effects of several temporary factors that assisted the economy are now receding.

In September, the Bank of Canada raised its overnight interest rate for the second time in less than two months to 1%. Forecasters now expect the Bank of Canada to increase interest rates at a faster pace than the US Federal Reserve, resulting in Canadian short-term rates equalling those in the US by the end of 2018.

The Canadian dollar reacted positively to economic and interest rate developments in the third quarter by appreciating 4% to a level over 80 cents US. Our currency has now risen nearly 7 cents US from a low near 73 cents US in April. Going forward, the strength of the Canadian dollar may reduce the competitiveness of Canadian exporters and act as a potential restraint on future economic growth.

Trade issues with the US are continuing. In September, the US imposed countervailing duties on certain Canadian aerospace imports. This follows the duties that were leveled earlier in the year on Canadian softwood lumber. Three rounds of the NAFTA renegotiations have been completed and the evolution of the future trade relationship between Canada, Mexico and the US will continue to be a long-term risk to the North American economy.

Second quarter US economic growth was revised upwards to 3.1%, supported by increased consumer spending and business investment. Exports also advanced due to stronger global demand. The US economy's expansion is now in its ninth year, making it the third longest on record.

*Growth Expands*

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*Interest Rates Rise*

**Inside this issue:**

# Economic & Investment Outlook cont'd.

Growth maintained momentum entering the third quarter, as consumer spending rose 0.3% in July, which was the best showing since April. Manufacturing expanded in August at the fastest pace in more than six years, while the Leading Economic Indicator increased to an all-time high.

Month to month US employment gains are decelerating from the pace recorded earlier in the year, however payrolls are still growing faster than the working-age population. Over 2 million jobs have been created in the US over the last twelve months, pushing the unemployment rate below 4.5% for five consecutive months.

In September, the US experienced major hurricanes in the Houston Metropolitan area, Florida and Puerto Rico. Large amounts of property were damaged or destroyed by the storms and economic activity was disrupted as people fled their homes and businesses shut. The impact of the storms will affect expectations for third quarter economic growth and may temporarily boost inflation, through higher gasoline and building materials prices.

The US Federal Reserve confirmed its plans to begin reducing the size of its balance sheet, which consists of Treasury bonds and mortgage backed securities that were purchased during the 2009 – 2014 quantitative easing programs. Starting in October, the Federal Reserve will begin monthly reductions in their Treasury bond holdings of no more than $6 billion, and monthly reductions in their mortgage securities holdings of no more than $4 billion. These amounts will rise each quarter until they reach $30 billion for Treasuries and $20 billion for mortgages each month. This process will remove liquidity from the economy and gradually unwind the prior stimulus provided through quantitative easing. The outcome will be closely monitored, as there is no historical precedent for a major central bank actively reducing its balance sheet.

Growth in the Eurozone economy has been positive for six consecutive quarters, capping off its strongest period of expansion since the initial recovery from the 2009 financial crisis. Accelerating growth in the three largest economies (Germany, France, and Italy) has contributed to the recent strength, however the expansion has also broadened to smaller Eurozone member countries. Growth is expected to continue to accelerate through yearend to an annual rate near 2.5%.

Even Japan, which has been a perennial growth laggard, has produced three consecutive quarters of economic growth at almost double its previous trend pace.

# Financial Markets

The rise in North American equity prices this year has been primarily supported by higher corporate earnings growth. As a result, valuation multiples have been stable. This differs from the previous years where price gains were fueled by valuation multiple expansion. Ongoing growth in earnings will be a positive development for continued equity price gains.

Rising interest rates in Canada took a toll on the bond market. The DEX Universe Bond Index returned -1.84% for the third quarter.

Global equity markets rallied in the third quarter, but the substantial appreciation in the value of the Canadian dollar reduced returns for Canadian investors from foreign investments.

Third quarter 2017 returns in local and Canadian dollar terms were:

| Country | Index | 2017 Q3 Local | 2017 Q3 In CAD$ |
|---|---|---|---|
| Canada | S&P/TSX | 2.98% | 2.98% |
| United States | S&P 500 | 3.96% | -0.02% |
| United Kingdom | FTSE 100 | 0.82% | -3.04% |
| Japan | Nikkei | 0.67% | -3.18% |
| France | CAC 40 | 4.08% | 0.10% |
| Germany | DAX | 4.09% | 0.10% |
| Hong Kong | Hang Seng | 6.12% | 2.06% |

# The Bottom Line

With improving global economic growth, some central banks are now beginning the process of normalizing interest rates and removing extraordinary measures of monetary accommodation. Rising bond yields will be the result of these policy changes.

Bond prices have an inverse relationship with interest rates; when interest rates rise, bond prices fall, and vice-versa. All things being equal, the longer a bond's maturity the higher the price volatility. We have positioned client portfolios to mitigate the impact of rising bond yields by holding short term bonds and preferred shares which will be less affected by rising interest rates.

Although equity valuations are expensive by historical measures, equities continue to remain attractive relative to bonds in this rising interest rate environment.

We will continue to monitor relative valuations across all asset classes and rebalance client portfolios as required.

# The Economic Impact of Natural Disasters

Hurricanes Harvey and Irma caused widespread destruction throughout Texas and Florida. Houston is the fourth largest metropolitan area in the US and it experienced historic levels of flooding. It is estimated that every building in the Florida Keys was either destroyed or damaged. The impact of these storms will make the reporting of economic activity more volatile during the current quarter and through the end of the year.

The economic impact of natural disasters can be divided into two phases. The initial phase is a downturn related to the closing of businesses and the dislocation of residents as the disaster strikes. When a disaster occurs in a specific geographic region that is located in a large diversified economy such as the US, the impact of this first phase is generally small when compared to the entire country's output.

A second phase will then follow, which focusses on rebuilding the destruction caused by the disaster. The transport system and the electrical grid are restored. Homes and businesses are repaired, and automobiles and other equipment that were destroyed are replaced. Recovery spending usually produces higher output that is reflected in increased employment and broad economic growth statistics and for a limited period of time.

However, this positive effect on the measurement of economic activity is somewhat of an illusion, as post-disaster replacement expenditures do not increase economic growth in aggregate. In fact, the process of rebuilding is simply redirecting resources and labour from other productive uses.

Economic statistical measures also do not account for the loss of capital that was caused by the disaster. Not all damage and loss that occurred is covered by insurance and government relief programs. Therefore, uninsured losses must then be replaced by saved capital which can subsequently no longer be used for future consumption.

As a result, natural disasters have the effect of only distorting economic growth rather than acting as a catalyst to meaningfully increasing it.

# Potential Changes to the Taxation of Canadian Privately Controlled Corporations

On July 18th, the Department of Finance released a consultation policy paper that proposes a series of significant changes to the tax regime for Canadian privately controlled corporations. The paper calls for input on the proposed measures up to October 2nd.

The paper outlines changes to taxation in four main areas:

<u>Income Sprinkling</u>

"Income sprinkling" refers to splitting income with adult family members who are subject to lower personal tax rates. This strategy is accomplished by distributing private company dividends directly to family members who are shareholders or indirectly through a family trust.

# Potential Changes to the Taxation of Canadian Privately Controlled Corporations cont'd

There are currently rules in place to prevent income splitting with minors by taxing all income received by children at the top marginal rate.

The proposed policy change would extend the income splitting rules to adult family members, subject to a new "reasonableness" test that evaluates a family members' involvement in the business based on contributions of labour and/or capital. It would also utilize more stringent reasonableness requirements for family members aged 18-24.

Restricting Access to the Lifetime Capital Gains Exemption

Canadian residents have a lifetime capital gains exemption available (currently $835,716) for the disposition of "qualified small business corporation" shares. There is also a capital gains exemption available of up to $1,000,000 for the disposition of qualified farm and fisheries properties.

The proposed policy change would prevent combining these lifetime capital gains exemptions among family members for a single transaction.

Increasing Taxes on Passive Investment Income

The proposed policy changes include:

- Eliminating refundable taxes on passive investment income

And where the source capital of an investment is income taxed at the corporate income tax rates:

- Denying access to the lower "eligible dividend" tax rates on distribution of corporate earnings; and
- Denying the addition of the non-taxable portion of capital gains (currently 50%) on passive investments to the capital dividend account.

Eliminating the Conversion of Income into Capital Gains

In some circumstances, shareholders of a private company can remove retained earnings as capital gains rather than dividends.

The proposed policy changes would introduce some technical measures to eliminate these types of transactions.

Summary

If these proposed changes are implemented in their current form, this would significantly impact owners of Canadian private corporations and their families.

If you own a private corporation, we would recommend that you consult a tax advisor as soon as possible to assess how these proposals may impact your existing tax and estate planning.

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