Wealth Matters – Fall 2014

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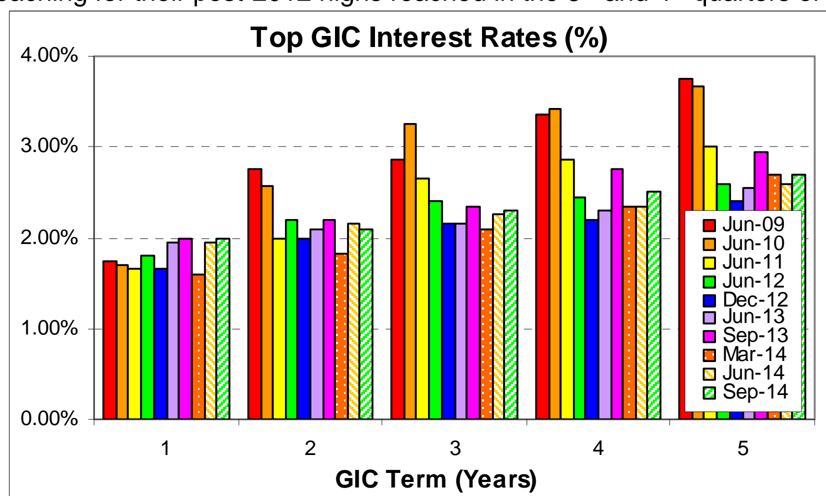
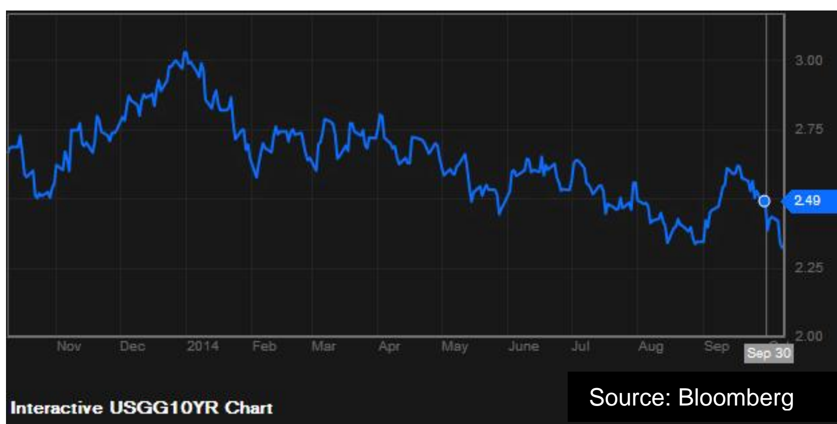
Interest Rate Trends

Here is our usual graph comparing the top GIC rates on offer at the end of the quarter (Source: Cannex Financial Exchanges). Shorter rates are stable to slightly increasing, with 1 and 3-year rates up 0.05% and the 2-year rate down the same amount. Meanwhile, the longer rates are reaching for their post-2012 highs reached in the 3rd and 4th quarters of last year.



The market is generally expecting North American interest rates to rise slowly over the next 2 to 3 years as the US Federal Reserve ends its artificially low overnight rate policy as the US economy nears full employment.

At the beginning of 2014, Bloomberg surveyed 18 economists who all believed bond yields would rise by July 2014. All were wrong. Yields on US government 10-year bonds started the year at 3% and ended the 3rd quarter at 2.49%. Despite the US unemployment rate falling to 5.9% in September, a record post-recession low, the Fed seems more focused on the opportunity to bring 700,000 discouraged workers and 7million involuntary part-timers (who the US Bureau of Labor Statistics says are not counted as unemployed) back into the fulltime workforce without triggering wage inflation. For that reason, it may delay rate hikes until this shift is clearly underway, which may take until mid-2015.



Other factors supporting the delay include the fact that 11 central banks in other parts of the world have cut rates in the past 4 years, strengthening the US dollar, while inflation remains well below the 3% long term average. In fact, labour force trends and demographics suggest that inflation may remain well below the long term average for many years. It should be noted that the average US long term bond yield from 1880 to 1960 was only 3.6%, while the 6.6% average of the last 60 years was influenced by a much higher-than-average inflation background of the post-gold-standard era. If central banks can limit money supply growth to the economic growth rate to contain inflation, bond yields may not need to rise much more than 1% to get back to equilibrium.

Financial Planning Update

Several budget-driven changes will influence our financial planning work in the next few years, and may impact your existing plans. Here are a few of the important proposed changes:

- **Testamentary Trusts** will no longer enjoy lower graduated tax rates 36 months after the taxpayer's death, unless the trust beneficiary qualifies for the Disability Tax Credit. The changes as drafted may also limit the ability of the estate to claim certain credits if more than one trust is created by the Will. Comments to the draft legislation have been submitted by various groups to question whether these effects were intended and to seek clarity in the wording, but there may not be time for revision if the current majority government wants to push this legislation through before the next election.
- **Tax-exempt life insurance** policies will generally have lower maximum tax-deferral room for policies issued after 2016. Draft legislation confirms that policies issued before 2017 are expected to retain the current higher limits.
- **Prescribed life annuities** will offer reduced tax deferral in 2017 when new actuarial tables are to be used, which reflect longer life expectancies. Annuities issued before the change will retain the current higher deferral.
- **The Minimum Annual RRIF** withdrawal schedule is too high given longer life expectancies and lower recent investment returns. The high minimum withdrawals force RRIF assets to be significantly depleted long before age 90, while more and more retirees are living well past this age. A submission has been made to the Finance department by the Conference for Advanced Life Underwriting (CALU), asking for the withdrawal schedule to be adjusted when the new mortality tables for annuities are to be adopted. https://calu.com/CALU-2015-Pre-budget-Submission . The submission was recent and no response has yet been received.

If we're already working on your retirement or estate planning, we'll take these impacts into account. If you're not already working with us on your financial plan, please give us a call so we can review your situation and objectives and see how we might best help you achieve your goals.

Investment Market Returns to September 30, 2014

Total Return to Sep. 30, 2014	**1M**	**3M**	**6M**	**9M**	**12M**	**2Y**	**3Y**	**5Y**	**10Y**	**15Y**
Canadian Dollar ($US/$CA)	*-3.13%*	*-4.75%*	*-1.38%*	*-5.11%*	*-8.24%*	*-6.32%*	*-2.50%*	*-0.88%*	*1.21%*	*1.82%*
Canadian Fixed Income										
FTSE TMX Canadian Bond Universe	-0.63%	1.06%	3.08%	5.93%	6.34%	2.46%	3.45%	4.85%	5.37%	-
91-day Treasury Bill	0.09%	0.24%	0.46%	0.68%	0.93%	0.99%	0.97%	0.86%	1.97%	-
Short Term Bond	-0.03%	0.37%	1.06%	2.12%	2.90%	2.11%	2.13%	2.90%	3.94%	-
Long Term Bond	-1.44%	2.28%	6.18%	11.61%	11.34%	2.42%	4.96%	7.63%	7.39%	-
Corporates AAA/AA	-0.10%	0.50%	1.41%	3.02%	3.98%	2.71%	3.35%	4.20%	4.84%	-
High Yield	0.44%	0.62%	3.25%	7.23%	9.44%	8.16%	9.95%	8.69%	7.60%	-
Canadian Equity										
S&P/TSX Composite	-3.99%	-0.59%	5.79%	12.20%	20.38%	13.56%	12.07%	8.67%	8.50%	7.73%
S&P/TSX 60	-3.52%	0.43%	6.78%	12.67%	21.34%	14.28%	12.34%	7.92%	8.75%	7.57%
S&P/TSX SmallCap	-9.25%	-9.36%	-0.88%	6.99%	14.36%	6.22%	6.02%	7.49%	4.13%	-
S&P/TSX Equity Income	-3.34%	-0.95%	5.14%	11.05%	18.17%	14.65%	13.81%	13.49%	-	-
S&P/TSX Preferred Share	-0.62%	0.38%	3.05%	5.83%	5.48%	2.21%	3.62%	5.00%	3.13%	-
Canadian Sectors										
Cdn. Energy	-9.74%	-11.74%	-0.10%	9.53%	14.12%	9.40%	9.79%	3.10%	7.46%	-
Cdn. Materials	-11.39%	-10.11%	-4.40%	4.83%	2.75%	-16.71%	-12.45%	-4.35%	4.90%	5.68%
Cdn. Industrials	1.16%	8.05%	17.66%	20.15%	39.70%	33.63%	30.16%	19.43%	13.27%	9.29%
Cdn. Consumer Discretionary	-3.95%	3.92%	8.65%	13.34%	22.37%	30.86%	25.74%	17.35%	8.50%	6.53%
Cdn. Consumer Staples	3.33%	12.25%	15.38%	23.84%	28.90%	29.28%	24.50%	19.25%	9.43%	12.35%
Cdn. Health Care	0.90%	7.86%	6.83%	13.51%	24.05%	25.43%	24.98%	25.94%	8.65%	5.08%
Cdn. Financials	-2.21%	2.71%	8.60%	11.26%	23.15%	22.73%	18.58%	11.29%	9.72%	-
Cdn. Information Technology	0.47%	3.96%	10.23%	18.27%	28.65%	33.80%	16.84%	9.33%	3.73%	-
Cdn. Telecommunication Services	-2.56%	-0.03%	0.70%	4.21%	10.44%	10.12%	12.10%	15.00%	12.00%	8.43%
Cdn. Utilities	-0.56%	0.40%	1.67%	10.51%	13.89%	3.41%	3.47%	9.42%	9.11%	9.95%
Cdn. Diversified Metals & Mining	-9.39%	-5.73%	0.59%	1.42%	1.51%	-4.40%	-0.37%	-1.08%	13.79%	14.61%
Cdn. Real Estate	-2.67%	1.80%	6.49%	13.33%	18.83%	10.06%	13.69%	15.85%	10.47%	11.44%
Global Gold	-17.51%	-15.04%	-7.45%	7.36%	-4.20%	-29.91%	-23.92%	-12.04%	-1.65%	-
Global Mining	-10.88%	-8.80%	-5.91%	0.39%	5.34%	-8.41%	-6.54%	-2.98%	-	-
S&P/TSX Cdn. REIT	-3.00%	-0.94%	2.95%	8.90%	12.35%	1.89%	8.57%	14.01%	10.60%	12.64%
U.S. Equity										
S&P 500 (LargeCap)	1.78%	6.17%	7.91%	14.17%	30.48%	27.60%	26.15%	16.73%	6.82%	2.99%
S&P 600 (SmallCap)	-2.31%	-2.07%	-3.46%	1.46%	15.24%	25.88%	26.01%	17.28%	6.05%	6.54%
Russell 1000	1.42%	5.67%	7.29%	13.78%	29.69%	28.04%	26.39%	16.93%	7.16%	3.44%
Russell 2000	-3.02%	-2.74%	-4.14%	0.74%	13.26%	24.10%	24.37%	15.30%	6.90%	5.99%
Global Equity										
London FTSE 100 (UK)	-1.64%	-1.13%	1.09%	4.37%	16.20%	19.27%	17.40%	10.35%	5.19%	2.14%
Frankfurt DAX 30 (Germany)	-0.37%	-6.26%	-7.43%	-3.77%	12.60%	21.50%	20.56%	8.64%	8.23%	3.49%
S&P/ASX 50 (Australia)	-8.35%	-3.15%	-3.88%	5.67%	8.27%	13.29%	14.76%	8.35%	9.73%	9.16%
MSCI World (Net)	0.43%	2.72%	4.03%	9.48%	22.27%	23.97%	20.95%	11.85%	5.84%	2.27%
MSCI Europe	-0.63%	-2.34%	-2.22%	3.86%	15.91%	23.06%	19.20%	8.50%	5.96%	3.13%
MSCI Japan	2.61%	2.69%	5.82%	3.95%	9.99%	23.05%	12.19%	6.54%	2.72%	-1.24%
MSCI Pacific ex-Japan	-6.59%	-1.19%	-0.40%	6.60%	10.59%	13.65%	15.10%	8.42%	9.39%	7.54%
MSCI EAFE (Europe, Asia, Far East)	-0.70%	-1.13%	-0.37%	4.34%	14.10%	21.77%	17.09%	8.00%	5.53%	2.44%
MSCI EAFE (Net)	-0.74%	-1.18%	-0.66%	3.93%	13.61%	21.26%	16.56%	7.51%	5.05%	2.01%
MSCI Emerging Markets	-4.40%	1.46%	4.57%	8.27%	14.06%	9.92%	10.31%	5.69%	9.71%	7.38%
MSCI EM Latin America	-10.53%	-0.72%	2.58%	7.03%	8.17%	2.41%	4.08%	0.97%	11.97%	10.68%
MSCI EMU (Euro. Monetary Union)	-0.17%	-4.07%	-4.91%	1.63%	15.28%	25.22%	19.27%	5.39%	5.16%	2.50%

Investment Markets Commentary

The graph below compares price index levels for three major stock market indices over the past 12 months in their local currencies: the Canadian TSX index in blue, the US S&P 500 in red, and the global MSCI EAFE in green (Source: yahoo finance). The table of index returns shows the total return in Canadian dollars for a variety of equity and bond market indices (Source: Guardian Capital Advisors).

The third quarter of 2014 was disappointing for equity investors, with all major indices declining sharply in September, but with mixed results over the quarter.

The Canadian benchmark ended down less than 1% for the quarter, and remains up over 12% for 2014 and over 20% above its year-earlier level. Gold and other metals, materials, oil and other commodity prices continued to decline in response to flat European and slower-growth Asian economies, which hurt sectors that are over-represented in the Canadian market. Consumer staples and industrials held the market up so far, though consumer debt levels remain high and job growth has been weak. Canadian unit labour rates are 30% - 50% higher than in Mexico or the US, and our trade surplus has not recovered since being erased in 2008. The recent depreciation of the Canadian dollar to under 90 cents US should help with Canada's global competitiveness, but a further devaluation to at least 80 cents US would be required to restore purchasing power parity (Source: OECD and Fidelity).

The US index was about flat for the quarter, but the Canadian dollar declined almost 5% against the US dollar, giving currency-exposed investors a 6% gain. Job growth has been strong and relatively steady in the US, and unemployment levels dropped to a 6 year low of 5.9% by the end of the quarter. While this may signal the economy is strong enough to absorb an increase in interest rates, it seems the Fed is focused more on the labour participation rate, and would like to see jobs for many of the workers who have given up looking for work, and are therefore not holding the unemployment rate up to where it would otherwise be. One view is that there can be significant additional employment in the US without causing inflation, because these discouraged workers (predominantly younger people) earn less than the older more experienced ones and don't have the same bargaining power. Corporate profitability and balance sheets are still very strong, which should support equity valuations.

The global index started its downward trend in late June and continued through the quarter, giving back almost all of its gains from the past year, though the weakness was masked by a 3% dividend yield plus exchange rate impacts which kept the total return in Canadian dollars at over 14%. Several geopolitical developments (Ukraine, Iraq, Israel) continue to destabilize an already-weak European economic recovery which is creating neither jobs nor growth. European central banks are pushing the country banks to boost consumer lending to stimulate a self-sustaining recovery, but this has been slow to work. Chinese GDP growth, while slower than forecast a year ago, is still expected to lead the world's growth at a 7% rate. Emerging markets suffered in September along with the rest of the world's equity markets, especially with conflict in Russia and a technical debt default in Argentina which unsettled bond investors.

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Equity Market Correction or Collapse?

Equity markets are by nature volatile. While their value should be based on fundamental factors such as the value of corporate assets, and estimated future profits discounted back to present value, the reality is that market values reflect the aggregate of the personal opinions and moods of all market participants. And because we're talking about humans, they can be moody sometimes, either bidding up assets beyond their 'fair' value, and other times selling assets a below their fair value.

A bear market is considered a 20% drop over at least 2 months over more than one major index. This happens on average once every 4 years or so, and ends when investors generally agree the price is below fair value.

A 'correction' is generally considered a 5-10% or larger decline in a market index. These tend to happen 1 or 2 times a year early in a bull market (growth phase), and 2-3 times a year once the growth phase has lasted over 3 years without a bear market. Corrections can sometimes trigger the broad pessimism that leads to a bear market, but are usually short-lived. The table at right is from Provisus Wealth Management, showing "Paired Days" shows that most often within a short time of a large losing day, we have an unusually strong gaining day that makes up for the decline.

We are hearing several arguments that we are currently experiencing a correction, but likely not entering an extended bear market. These include:

- US economic growth is strong: Q2 clocked in at 4.6% annual rates - the strongest it has been in 2 ½ years, and close to the highest in the past 10 years. http://www.tradingeconomics.com/united-states/gdp-growth . Q3 is estimated to come in at about 2.5%, a bit higher than the average of the past 3 years.
- US real estate prices, housing starts, and employment growth are solid, debt defaults relatively low.
- Car sales and Canadian lumber exports are growing.
- Fundamentals such as Price/Earnings ratios for major stock indices were about 10% above their 10-year averages at the start of the quarter. Given the losing quarter on most markets, any overvaluation has already been cut back.
- Given a lower-inflation environment with lower than average bond yields, coupled with relatively high dividend yields, a higher-than-average P/E multiple may be appropriate.

Professional portfolio managers generally hold back some cash when valuations rise above their estimates of fair value. We have seen a lot of this among many of the equity managers we typically use in our portfolios, leaving them poised to pick up a few bargains in this correction.

We expect that there will be other corrections within the next year, yet it is nearly impossible to time purchases and profit-taking to avoid the drawdowns and buy on the dips. Maintaining a balanced asset allocation across various equity and fixed-income mandates - and re-balancing back to your long-term target every year or so - is the surest way to profit from the higher long-term return potential of equities while not feeling overly anxious when the media plays up the latest correction. Please call us if you're feeling concerned about your own portfolio so we can reconfirm your investment policy and make adjustments if they are warranted.

Paired Days			
Gains		Losses	
28-Mar-80	5.1%	27-Mar-80	-5.3%
		19-Oct-87	-11.1%
21-Oct-87	9.0%	20-Oct-87	-6.9%
30-Oct-87	5.1%	26-Oct-87	-7.6%
08-Sep-98	4.1%		
15-Oct-98	4.8%	27-Aug-98	-6.0%
31-Oct-00	4.2%		
08-Dec-00	4.2%	25-Oct-00	-8.1%
19-Sep-08	7.0%	29-Sep-08	-6.9%
30-Sep-08	4.2%	02-Oct-08	-7.0%
14-Oct-08	9.8%	06-Oct-08	-5.3%
20-Oct-08	7.2%	10-Oct-08	-5.6%
28-Oct-08	7.2%	15-Oct-08	-6.4%
13-Nov-08	4.8%	22-Oct-08	-5.7%
21-Nov-08	5.6%	27-Oct-08	-8.1%
28-Nov-08	5.9%	12-Nov-08	-5.3%
08-Dec-08	5.6%	20-Nov-08	-9.0%
		01-Dec-08	-9.3%
10-Mar-09	4.1%		
23-Mar-09	5.3%	02-Mar-09	-5.4%
Isolated Days			
12-Oct-82	4.3%		
		27-Oct-97	-6.2%
		14-Apr-00	-5.5%
		16-Feb-01	-6.4%
22-Jan-08	4.2%		

Feedback

We hope you've enjoyed this newsletter. Your comments are important, and they are very valuable to us. Please let us know any ideas you may have for improving the newsletter, or topics you'd like to see in future issues. Email us at contact@askpage.com. You can receive this newsletter by email – just ask!!

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Other products and services offered through Page and Associates Ltd.
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