RBC Dominion Securities Inc.

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Views and opinions
for the clients and friends of

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## Spring 2014 - Market Update

The bull market is about to enter into its sixth calendar year. Looking back over the past 110 years, history indicates the cycle could be long in the tooth and suggests we could be due for a slowdown or recession. Therefore, it is crucial to determine how far we actually are within the cycle in order to understand whether the market rally we've experienced over the last few years can continue. Economies go through cycles that are mostly determined by the behavior of investors and corporate management. Peaks in the cycle tend to be marked by consumer and business excesses, and using the chart below as a guideline, it would appear that we are still in the early to mid stages of the current economic cycle.


At this time we see no signs of any excesses as corporate cash balances remain near all time highs and capital expenditure budgets remain low. American households have accumulated $9 trillion in cash and cash-like instruments and there is no evidence of any major rotation from bonds into stocks, which would indicate more risky behaviour. U.S. corporations continue to shrink their balance sheets and are drawing on cheaper debt to refinance at lower rates. In the high yield market, 80% of issuances have been to refinance debt rather than levering up, an indication that we are not seeing excesses in spending. Leading indicators such as the ISM, housing and stock prices rose sharply throughout 2012 and 2013; however, coincidental factors such as employment, industrial production, capital spending, and corporate earnings are only expected to rise in 2014 as confidence continues to improve in the economy. All these factors suggest the cycle still has room to run, before it peaks.

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The strong rally in the U.S. has been driven by a continued improvement in the outlook for U.S. housing and employment, decent earnings, which continue to trudge higher, and a strong U.S. dollar. Many investors felt the market was due for a correction and we appear to be in the midst of one. Some of the risks that have triggered this include China's credit bubble, Argentina's risk of default, and Turkey's debt situation. However, volatility in other markets around the world tend to lead to a stronger U.S. dollar and lower commodity prices, which all boost valuations in the U.S.

***Long-Term Outlook***

With long term bond yields rising while short-term Treasury rates remain near zero, the slope of the yield curve is historically steep, keeping banks incentivised to lend.
Core inflation is also at a very low 1% and this should keep the Federal Reserve at bay for some time. Policy rates and inflation would have to increase significantly to cause concern about excesses in the economy.
A recession caused by a decline in earnings seems unlikely in the intermediate term.

With commodities under pressure and low core inflation, free cash flow is expected to improve as people have more money to spend on non food and energy items. This in turn allows activity and confidence to pick up, which leads to a stronger U.S. dollar and higher market valuations.

Developed markets have outperformed Emerging markets since 2010 and the U.S. is now trading at around 16x forward earnings. Looking forward, we can reasonably expect to see high single digit returns from earnings growth, and only limited room for P/E multiple expansion.

Some investors are concerned that valuations are too high but when dissected, valuations are near long term averages. Investors should have exposure to the U.S. market as we believe the bull market is potentially in the early to mid stages, and far from over.

2014 Handy Financial Planning Facts

***Retirement***

- Maximum CPP benefit at age 65$1,038.33 per month
- Maximum CPP benefit at age 60 if born before 1954CPP $689.45 per month
- Maximum OAS benefit for Q1$551.54 per month
- OAS clawback rate$0.15 for every $1 of net income above $71,592
- RRSP – maximum annual deduction limit$24,270 for 2014

***Education***

- Annual RESP contribution for maximum CESG20% of first $2,500 per beneficiary = CESG up to $500.
- Maximum annual Canada Education Savings Grant= $1,000/year/beneficiary

## Switch to eDocuments

- consider a switch to eDocuments (statements, trade confirmations and prospectuses) for all your RBC Dominion Securities accounts
- Each month we can (or not, just let us know which you prefer) have an electronic email go to you, letting you know the estatements are ready to review
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# How to Make Money and Make A Difference

Socially responsible investing (SRI) is the practice of including environmental, social and corporate governance criteria when making investment decisions. The goal of SRI is to generate attractive long-term returns and to have a positive impact on society.

A large number of asset management firms and pension plans incorporate SRI into their investment selection process. According to the Social Investment Organization, more than $600 billion of investments in Canada follow some form of SRI discipline. This includes mutual funds as well as pension plans such as the Canada Pension Plan and Ontario Teachers' Pension Plan.

SRI strategies can incorporate screens and research to identify firms that score well for their social impact and avoid firms that score poorly. In this framework, each investment is typically evaluated based on these three factors: environmental, social, and corporate governance. This process usually leads SRI portfolios to exclude firms with significant revenues from the production of tobacco, alcohol, nuclear energy, gambling, weapons and pornography. Some proponents of SRI go a step further and push for change by engaging companies through discussions with discussions with management, filing shareholder resolutions and using their shareholder votes.

1. ***Environmental***

The companies considered do not need to be producers of renewable energy products such as solar, water and wind. Investment ideas are "best-in-sector" where even a company in the oil and gas sector can qualify as acceptable if it follows environmental best practices for that industry or responds to environmental challenges better than its peers.

2 . ***Social***

Considers factors with the workplace environment including issues related to human rights, diversity, health and safety, and labour-management relations. A company's products are also reviewed with respect to safety and quality. Social aspects like community involvement and philanthropic activities are also considered.

3. ***Corporate Governance***

Governance reviews seek to determine whether the interests and goals of company management are aligned with shareholders. This is accomplished by evaluating executive and board compensation schemes, management accountability and shareholder rights.

There are a few ways to include socially responsible investments: (1) "Ethical" Mutual fund (2) Specialty ETF (3) Individually screened stocks. To learn more about Ethical Investing, Please contact Catherine Johnston who will then mail or email you the information.

## If Interest rates begin to rise in 2015, where are bond yields headed?

In February, leadership of the US Federal Reserve transitioned from Ben Bernanke to new Chair Janet Yellen. We expect the US Fed to continue with its tapering plans with bond-buying likely wrapping up in the fall of this year. It is conceivable that asset purchases could be extended for a few months longer if deflation fears or the recent spell of disappointing data persist, but the end of quantitative easing is nonetheless in sight. The combination of improving economic prospects, higher risk appetite and declining Fed bond-buying led to a significant increase in bond yields in 2013. And now, for the first time in several years, yields in most major bond markets are approaching equilibrium (fair value).Yields should continue nudging higher in the second half of 2014 and into 2015.

Bond and Interest rate now and March 2015 targets

| | March 2014 | March 2015 |
|---|---|---|
| Canada Overnight rate | 1.0% | 1.0% |
| US Overnight rate | 0.25% | 0.25% |
| Canada 10-year bond | 2.41% | 3.25% |
| US 10-year bond | 2.65% | 3.50% |

## Save Tax by Owning "Corporate Class" Mutual Funds

The majority of mutual funds in Canada are set up as mutual fund trusts. In recent years, there has been a steady increase in the Corporate Class mutual funds which are set up as corporations. The Corporate structure provides benefits to investors including ways to defer tax. There are two ways to defer tax with Corporate Class funds

(1) Tax-free switching between funds – investors are allowed to switch between funds with no tax cost. As long as an investor stays with the fund family i.e. Fidelity. Switching from an equity fund to a money market fund will not trigger a capital gain. The gain is not realized until the investment is redeemed out of the corporation.

(2) Reduced taxable distributions – Compared to standard mutual funds, corporate class funds give investors an opportunity to pay less tax on income earned inside a fund. Corporate class funds can manage the taxable income and deductions generated by all the funds under its corporate umbrella. This way, losses or expenses in one fund can be used to shield taxable income in another.

Corporate class funds are suitable for
- investors with taxable accounts (i.e. non-registered, cash accounts)
- investors or any income level or tax rate
- investors of any risk profile.

RBC Wealth Management Dominion Securities

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