GENUS Wealth Management
COMMENTARY
SECOND QUARTER 2014

Volatility Takes a Vacation

The financial markets remained unusually calm through the second quarter as the global economy continues to heal and central banks remain highly accommodative – which benefits stocks. We expect that overall global economic growth will continue strengthening, stocks will finish the year modestly higher, and interest rates will rise slightly in the second half of the year.

Global stock indexes chalked up strong results for the first six months of the year, thanks particularly to a robust second quarter. Markets were powered by a strong tailwind of mostly upbeat economic news in June, continued tame inflation, historically low interest rates, improving corporate fundamentals and positive investor sentiment.

Canadian stocks led the pack with the S&P/TSX up 6.4% for the quarter and 12.9% year-to-date. Stocks in the U.S. posted the next best returns with the S&P 500 up 5.2% for the quarter and 7.1% year-to-date in U.S. dollar terns. Emerging markets posted a half-year gain of 6.6% (CAD) – a remarkable turnaround, since the emerging markets were marginally down for the year as late as April. European stocks were up 3% (CAD) for the quarter. Meanwhile, after posting small losses last year, bonds have gained so far in 2014 despite worries that interest rates could rise. Six-month bond returns ran in the 3%-4% range.

Canada's returns were boosted by oil stocks which are up 23% as a group for the first six months of the year, vastly outpacing the returns of the broader market. Gains were driven by oil price spikes as a result of recent turmoil and escalating violence in Iraq and the Middle East.

Staying Calm

Markets have been less turbulent than usual despite the uncertain geopolitical backdrop. Market volatility (Exhibit 1) has been unusually low since 2012, and the trend has continued. The VIX index, which captures investor expectations for short-term S&P 500 fluctuations, was at 11.6% at midyear, versus a long-term average above 21%. Other stock markets, along with the bond markets, have also been more tranquil than their norms.

Why volatility has remained subdued is a hotly debated topic, but one key contributor to keeping risk low has been central bank policy. The world's major central banks continue to keep short-term interest rates unusually low and in some cases at historically unprecedented levels. The Federal Reserve's overnight interest rate net of inflation has been in negative territory for much of the time since the Credit Crisis – an unusually accommodative stance relative to history. Such low rates throughout the developed world are helping companies and economies to improve steadily (Exhibit 2). Corporate fundamentals are also strong, manifest in cash-rich balance sheets and burgeoning profit potential. Together with tame inflation and moderate global economic growth, signals suggest that we are in the middle, rather than a late, stage of the economic cycle.

While there is never a shortage of geopolitical risks to potentially upset the markets, so long as easy-money policies and economic growth define the landscape, markets should continue to remain calm. But it won't last forever: volatility is merely taking a vacation and it'll be back.

If economic growth strengthens, stocks will likely do well, even if interest rates rise. If growth weakens, but central bank policies remain accommodative, any negative market reaction will likely be subdued. The risk is that slow economic growth could coincide with tighter monetary policies, which would increase uncertainty and market volatility.

One way or the other, if history is a guide, volatility will ultimately return to its normal, higher level. While we can't predict what the catalyst will be or when the change will occur, we do know that central banks can alter their policies, economic growth can sputter, interest rates and inflation may escalate faster than expected, and geopolitical risk can suddenly explode. All these possibilities, and others, could undermine the markets.

Portfolio Positioning

If volatility does reappear in the intermediate term, our portfolios are well positioned. In our balanced portfolios, we continue to favour equities over bonds with an emphasis on market segments that offer good value and potential downside protection. We still favour blue-chip defensive dividend payers and select household-name global growth stocks. Our portfolios are diverse with the top holdings straddling an array of sectors and industries (Exhibit 4).

Within our bond portfolios, we continue to avoid government bonds in favour of shorter-term corporate issues and select commercial mortgages. Our bond portfolios are structured to pare bond (interest rate) risk by remaining anchored in shorter and intermediate durations, where the impact of rising interest rates is limited.

Exhibit 1 Stock Market Volatility Dips to Pre-Crisis Lows

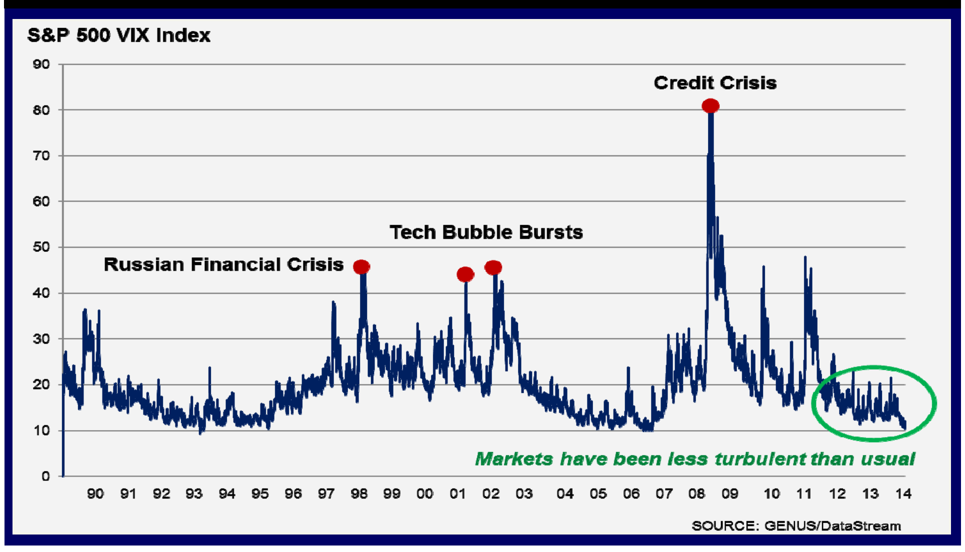


Exhibit 2 Low Rates Supporting Economies & Companies

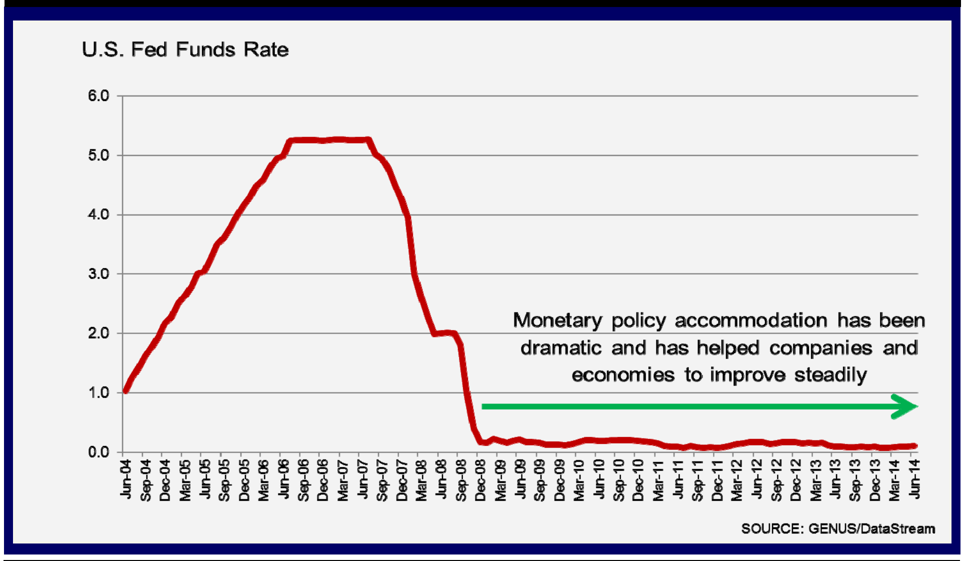
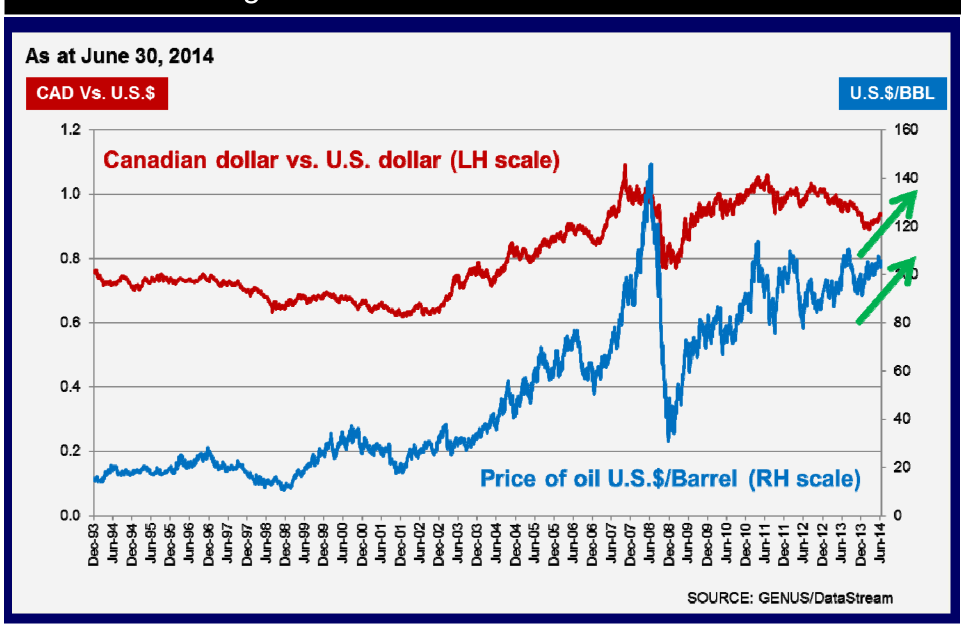


Exhibit 3 Rising Crude Oil Prices Lift Loonie and Oil Stocks



Key Takeaways

- The environment for equities remains favourable – central banks remain accommodative, inflation is not an issue, the global economy is healing.
- The U.S. economy continues to strengthen, China is stabilizing, Japan is picking up, and the Eurozone recovery has become entrenched.
- Geopolitical risk centres on Iraq and the Middle East and energy shocks.
- Developed economy central banks are likely to keep short-term interest rates anchored at zero, keeping long-term rates from sharply increasing.
- Global growth stocks and high-quality global dividend payers, corporate bonds and commercial mortgages are favoured in the current environment.

Global decoupling continues

The main themes of diverse and uncoupled global economies are intact as we enter the second half of the year: a firm U.S., a fragile but growing Eurozone, an uncertain Japan, China still slowing but stabilizing, and continuing troubles for Russia and Brazil. The unrest in the Middle East and ongoing Ukraine turmoil are keeping the markets on their toes.

U.S. Strengthening

Recent strong reports have confirmed that the U.S. economy has recovered from its early 2014 weather-induced slowdown, and is expected to grow at around 2.5% this year. Evidence points to manufacturing being strong and getting stronger while industrial production is being supported by the manufacturing and energy renaissances. Consumer spending, however, is being hampered by a reliance on income for purchases a reluctance to use credit. This is a good thing longer-term, but it's tough now for retailers.

The recovering economy has helped push U.S. stocks to new records and should help support earnings growth in the second half of the year, especially for large-cap household brand names and cyclical stocks in the Energy, Materials, Technology and Industrials sectors.

Eurozone Still Fragile

Despite the ongoing Ukraine turmoil and Middle East bloodshed, Eurozone business and consumer confidence have ticked down just slightly, remaining at decent levels. But deflation risks, high unemployment, and a still-struggling banking system indicate the recovery remains fragile. There is, however, upside to Eurozone stocks in light of the ECB's recent monetary policy easing effort. Included in its action was a move to push short-term deposit rates into negative territory, the first time a major central bank has attempted this. The combination of rate cuts and other measures should help ease credit conditions and support a steady economic recovery in the region. With ECB and Fed policies moving in opposite directions, the euro should remain weak, which will help corporate earnings in the second half of the year.

Japan Picking Up

So far the Japanese economy remains on track to achieve 2% inflation within 12 to 18 months as it continues its emergence from the 15-year-long grip of deflation in the aftermath of the 1990s banking crisis. Economic growth and wage developments are also satisfactory to the Bank of Japan (BOJ). As long as the economy continues to evolve according to its forecast, the BOJ will not increase its quantitative easing program this year. However, it remains ready to do so should the economy go off track. Overall, the BOJ is and will remain very supportive of Japanese equities.

China Stabilizing

In China, the risk of a hard landing for the slowing economy has abated. Recent economic data has increasingly shown signs of stabilization, reflecting the government's continued stimulus efforts to boost construction and selectively ease credit. While concerns about shadow banking and the housing market slump remain, the risks appear quite manageable considering the country's low total debt as well as the central government's strong balance sheet and its unique influence on the lending sector. Despite recent growth jitters and declining business confidence, the government is pushing ahead with its capital market reforms and remains focussed on curbing excesses (credit, investment, pollution, and corruption among officials).

Canada Trudging Along

Leading indicators for Canada project 2.5% year-over-year growth net of inflation for 2014. The shift down from 3% was due to projections for slightly softer growth in the U.S. and expected headwinds from downward commodity price pressure as a result of declining demand from China.

The lagged effects of the decline in the Canadian dollar and an acceleration in U.S. economic growth should both help Canadian exports, which accounts for about 30% of GDP. Although inflation has picked up recently, it's still in the lower half of the Bank of Canada's target range. Given that economic growth is likely to be just moderate, the BoC is likely to maintain its overnight interest rate at 1% and remain on hold for now. ▪

Genus Pooled Fund Performance

Returns are shown Gross of Fees

As at June 30, 2014	Compound Annual Returns 3 months	1 year	3 years	5 years	10 years
Balanced Fund	2.7	17.9	9.4	9.3	5.3
Equities					
Canadian Equity	6.2	28.9	6.4	8.8	7.9
Dividend Equity	3.8	24.2	12.6	12.4	
Global Equity[1]	1.5	28.4	19.6	16.3	5.0
CanGlobe Equity	3.2	28.3	11.7	11.7	
Emerging Markets	2.2	12.5			
Fixed Income					
Short-Term Corporate Bond	0.9	4.2	3.4	3.9	4.3
Strategic Bond	2.3	7.9	7.0	7.3	
Commercial Mortgage	1.3	5.3	4.4		
Biosphere SRI					
Biosphere Dividend Equity[2]	0.5	17.8			
Biosphere CanGlobe Equity[3]	1.5	29.3			
Biosphere Corporate Bond	2.2				
Index Returns					
S&P/TSX Composite	6.4	28.7	7.6	11.0	8.8
S&P 500 Index (C$)	1.6	25.8	20.5	16.8	5.3
MSCI Emerging Mkt (C$)	3.0	15.8	3.3	7.7	9.7
MSCI World Index (C$)	1.4	25.9	16.2	13.6	5.4
DEX Universe Bond Index	2.0	5.3	4.8	5.2	5.5

Past performance is no guarantee of future results.

1 **Mandate change:** Genus U.S. Equity mandate changed to Global Equity mandate as of September 14, 2012.
2 **Mandate change:** Biosphere Canadian Equity (100%TSX) changed to Biosphere Dividend Equity (40% TSX, 30% S&P 500, 30% MSCI EAFE) as at April 1, 2013.
3 **Mandate change:** Biosphere Global Equity (50% S&P 500 / 50% MSCI EAFE) changed to Biosphere CanGlobe Equity (40% TSX, 30% S&P 500, 30% MSCI EAFE).

Stocks enjoy solid second quarter

Global stocks enjoyed relatively good gains in the second quarter, supported by accelerating merger and acquisition activity and fresh evidence that the U.S. economy was rebounding from a harsh winter and the global economy overall was continuing to heal. Energy stocks rallied on fears of a potential oil and gas shortage amid continuing turmoil in Iraq and Ukraine. Bonds also benefited from flight-to-quality as interest rates tumbled in developed markets. Emerging markets stocks rebounded as political uncertainty subsided in some nations.

U.S. stocks touched multiple new highs, with the Standard & Poor's 500 Composite Index notching its sixth consecutive quarterly rise – its longest streak of quarterly gains since 1998. The index climbed 5.2%, taking its year-to-date return to 7.1%. Mergers-and-acquisitions activity was robust, with U.S. deals in the first half nearly doubling from the previous period to $750 billion. Canada's Valeant Pharmaceuticals took its proposal to purchase ophthalmic products maker Allergan directly to shareholders in June after Allergan's board rejected Valeant's $53 billion offer; Allergan's shares rose 36% over the quarter.

European stocks advanced amid rising mergers-and-acquisitions activity and another round of stimulus measures by the ECB. M&A activity soared, particularly in the Health Care sector, where several large cross-border deals dominated the market. Overall, the MSCI Europe Index rose 3% and the euro fell 1% versus the U.S. dollar.

Canada's S&P/TSX composite index rose 6.4% for the quarter, helped by gains in the Energy, Materials and Financials sectors. Shares of Air Canada rose more than 70%, buoying Industrials. Health Care was the only sector to lose ground, pulled down by Valeant's 7% decline as it met resistance to its plan to acquire Allergan. ▪

Exhibit 4 Featured Genus Defensive Dividend Equity Holdings

Country	Sector	Stock Name	Yield
Canada 	Energy	Canadian Oil Sands	5.8%
	Financials	Power Financial	4.2%
	Financials	TD Bank	3.1%
	Telecom Services	Telus Corporation	3.6%
United States 	Consumer Staples	Procter & Gamble	3.1%
	Industrials	Lockheed Martin	3.2%
	Health Care	Pfizer	3.4%
	Information Technology	Microsoft	2.6%
EAFE  (Europe, Australia, Far East)	Industrials	Siemens AG	3.1%
	Telecom Services	Swisscom AG	4.3%
	Health Care	GlaxoSmithKline	5.1%
	Financials	Bank of Queensland	5.1%

Genus Balanced Fund Asset Allocation
(As at June 30, 2014)

Asset Class	Percent of Market Value
Government Bond	1.8
Short-term Corporate Bond	3.3
Strategic Bond	21.2
Commercial Mortgage	9.8
Total Fixed Income	**36.1**
Canadian Equity	**3.1**
Dividend Equity	**22.5**
Canadian Equity	*8.7*
U.S. Equity	*6.6*
International Equity	*7.2*
CanGlobe Equity	**30.7**
Canadian Equity	*12.4*
U.S. Equity	*9.4*
International Equity	*8.9*
Global Equity	**5.4**
Canadian Equity	*0.4*
U.S. Equity	*3.0*
International Equity	*2.0*
Emerging Markets	**2.2**
Total Equity	**63.9**
Total Portfolio	**100%**

Portfolio Equity Exposure	
Total Canadian Equity	38.4
Total U.S. Equity	29.7
Total International Equity	28.5
Total Emerging Markets	3.4
Total Equity	**100%**