The Great Decoupling

Good deflation boosts U.S. consumer incomes, bad deflation weakens Eurozone banking system

The main themes of diverse and uncoupled global economies are intact as we enter the final three months of the year. From a global perspective, the recovery remains weak, monetary policy support is extraordinary, equities are still well supported despite the early October correction, inflation and "safe" bond yields are at historically low levels — and deflation means different things for the U.S. and the Eurozone.

Exhibit 1 Volatility Picks Up After a Quiet Summer

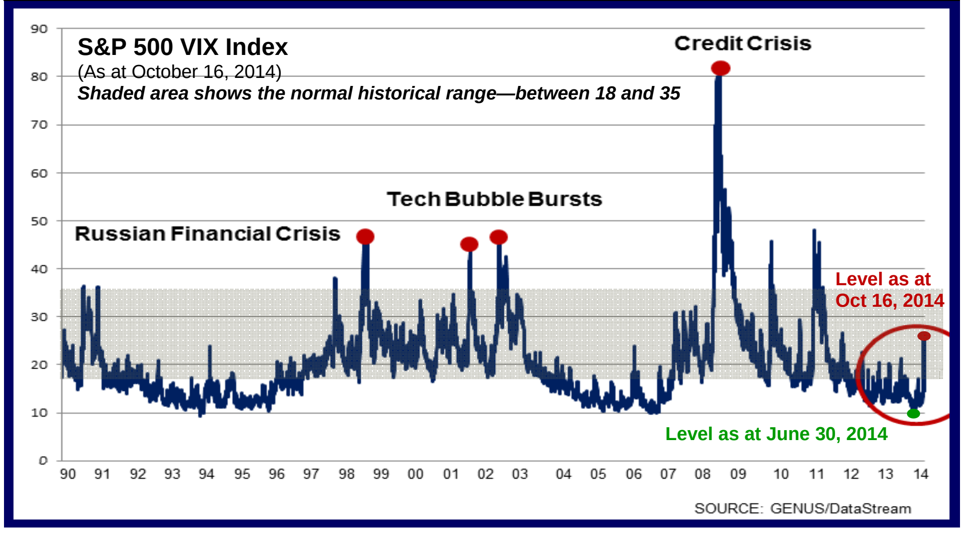


Exhibit 2 U.S. Energy Renaissance Boosts Economic Growth

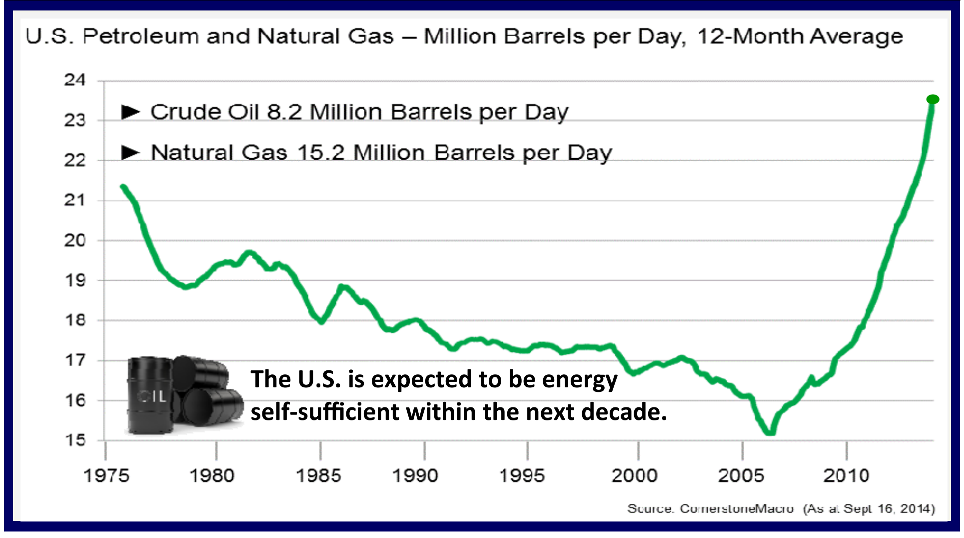
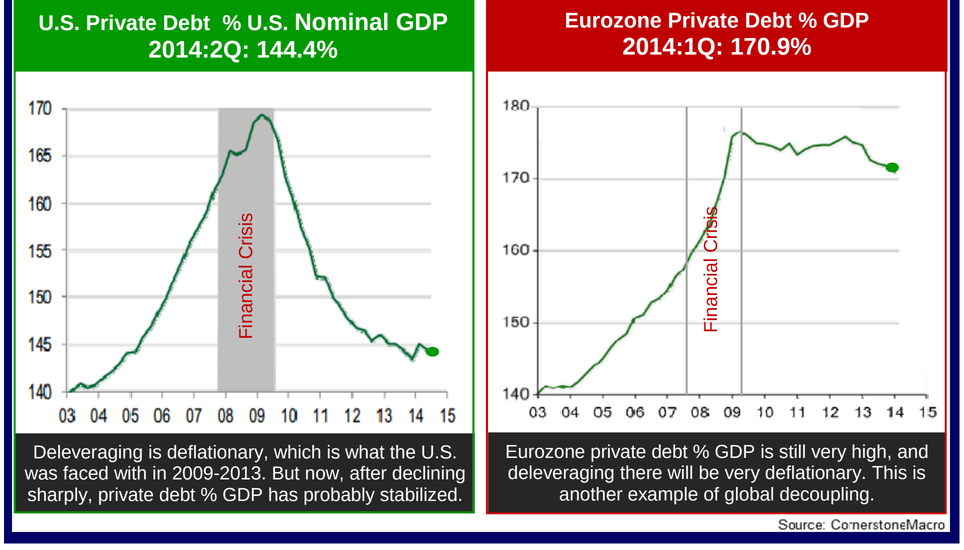


Exhibit 3 Global Decoupling: U.S. Deleveraging vs. Eurozone



Volatility Returns

Volatility returned to the markets after the summer break as global stocks declined in U.S. dollar terms on a quarterly basis for the first time since 2012. Volatility spiked sharply in early October as stock markets were roiled by investor apprehension over negative economic data out of Europe, the end of the Federal Reserve's bond buying program, and the spread of the deadly Ebola virus to the U.S. and Europe.

All of these concerns come as investors are struggling to assess the diverging growth and performance trends that have taken hold this year. These have seen the United States regaining its economic footing and decouple from Europe and China; both Canada and the United Kingdom in decent economic shape; Japan muddling along; China trending lower toward a "new normal" growth; and the Eurozone stalling amid weak growth, mounting deflationary pressures and a fast-depreciating euro.

VIDEO COMMENTARY
A video version of our commentary is available on our website. Visit the Newsroom at www.genuscap.com and click on the video menu option to view.

Hopes that the U.S. would drag the rest of the world up have been replaced by fears that unless the European Central Bank follows the Fed's playbook and takes drastic stimulus measures to stoke the fires of economic growth, Europe will drag the U.S. and the rest of world down. Adding to concerns is the fact that China is also at risk of deflation given their need to unwind excess credit and investment.

Headwinds Vs. Tailwinds

To be clear, deflation, often referred to as inflation's evil twin, comes in different forms—the good, the bad and the ugly. The market, however, doesn't seem able to separate them. First, there is *good deflation*, which is boosting growth in the U.S. Then there's *bad deflation*, which Europe is now facing as a result of extremely low inflation, very low wage gains, a weakening banking system, and deteriorating economic activity. Finally, there is ugly deflation, which we last saw during the Great Depression of 1929-1933 when bad deflation was so devastating it turned downright ugly.

Our lead economic advisor, Nancy Lazar of Cornerstone Macro, sent us a note this week outlining the bad deflationary pressures the Eurozone is experiencing versus the good deflationary pressure the U.S. is experiencing. She points out that with high unemployment, Europe is experiencing downward pressure on already very low wage gains. In the U.S., unemployment is down significantly. So, although wage gains are low, underlying economic strength means the next leg will probably be for wages to increase. In addition, a weak Eurozone banking system (banks burdened with bad loans) and the need for the private sector to pay down debt and rebuild credit, are two additional significant deflationary headwinds that the U.S. has already dealt with. Declining commodity prices will continue to pull down core inflation in the U.S., but this is good deflation which will help support, if not accelerate economic activity by boosting incomes.

The good deflation in the U.S. means that real incomes for consumers and businesses are getting a nice lift, which should in turn continue help boost consumer spending and business spending. Real retail sales increased at a 3.5% annual rate in the third quarter and, based on the decline in commodity prices (cheaper gas) they are likely to accelerate in the run-up to the holiday shopping season. Declining commodity prices are also a boost for the Eurozone, but that stimulus is being offset by their bad deflationary head- winds.

Fed Treading Carefully

Meanwhile, the Fed continues to tread carefully. Despite low U.S. inflation, the Fed is unlikely to postpone raising interest rates, but its approach will be gradual. With private sector real GDP growth of 3% for almost five years now, the U.S. economy no longer needs 0% interest rates. We expect the Fed to begin raising rates in June 2015. It's likely that the Fed Funds short-term rate will be close to 1% by the end of 2015.

Stepping Up Stimulus

Even as the Fed finishes tapering and markets assess the possibility of a first rate increase in 2015, the European Central Bank (ECB) and the Bank of Japan (BOJ) are committed to stimulus well into the future. While it is true that the ECB has failed to convince investors in the past that it will do "whatever it takes", this time it is different. Now that Germany is feeling pain from the weakness from the rest of Europe, the probability that the ECB will act in favour of quantitative easing is greater. For global financial markets, this should take some of the sting away from the end of Fed QE in October and the start of a rate cycle next year. The prospect of an extended period of stimulus and low interest rates serves to extend the business cycle, which should be supportive of global equity markets. Historically, stocks have performed well for the first part of the interest rate tightening cycle. In addition, low yields on government bonds present paltry expected returns for investors. This creates the potential for a continued "melting upward" of stocks as investors allocate to risky assets in the absence of better alternatives. This is an important factor in why we still expect positive returns for risk assets in the coming few quarters, even if the risk-adjusted returns are likely to be low.

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Key Takeaways

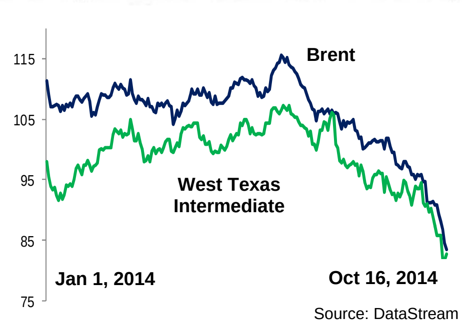
- Global economic growth is expected to be moderate — but uneven — through the end of the year, picking up in 2015.
- Monetary policy in major developed economies remains accommodative, but we're seeing divergence among countries and regions.
- Interest rates remain low, but we expect official U.S. short-term rates to begin rising by mid-2015.
- Equity returns should be attractive, but muted going forward, particularly in the US, but we see plenty of opportunities.
- Corporate fundamentals remain solid, and continued earnings growth should be the key driver of equity returns.
- Growth stocks and high-quality global dividend payers, corporate bonds and commercial mortgages are favoured in the current environment.

U.S. Energy Renaissance

The resurgence in the U.S. economy has been triggered by technological innovations in the energy sector which have dramatically increased the domestic production of oil and natural gas, while simultaneously reducing the importing of foreign oil. U.S. output is at its highest in 28 years. Within the next decade the U.S. is expected to be energy self-sufficient.

The domestic sourcing of energy has far-reaching implications. Already, the strong investment in energy and exploration has resulted in the highest oil production (and lowest level of oil imports) in the U.S. in several decades. At the same time, the abundance of cheap sources of natural gas, has the potential to fuel a rebuilding of many of the segments of the U.S. manufacturing sector that have been dormant for years.

Falling Crude Prices (Per Barrel)



Additionally, cheap energy is helping to improve the competitive position of U.S. manufacturing, already benefitting from innovations that have lowered operating costs and improved the quality of products. At this point, it's difficult to predict how far this energy-driven renaissance may go. Its accelerating strength will likely depend on other catalysts, such as removing the export ban on crude oil and legislative changes necessary for the U.S. to fully tap the opportunities that lie ahead—and in the process, permanently lift its growth.

The Kingdom Strikes Back

Oil is in the middle of one of its steepest selloffs since the financial crisis, with prices on the international market falling 20% since mid-June, to $83 a barrel on October 15. There are two factors at play—not enough demand from a stagnant Europe, slower growth in China, and flat gasoline consumption in the U.S. But the bigger factor appears to be surging global oil production as OPEC, led by Saudi Arabia, is resisting pressure to cut output, even as demand slumps, as it tests how low prices must go to make U.S. shale oil unprofitable. As producers become more efficient, that floor is sinking because only 4% of U.S. shale output needs prices above the $80 a barrel level. Canadian oil sands projects are the most dependent on high prices, with about a quarter needing oil above $80/Bbl to be profitable. Extracting oil from oil sands/shale costs $50 to $100/Bbl, compared with $25/Bbl for conventional supplies from the Middle East and North Africa. Other countries likely to be most hurt by falling prices as the Saudi's defend their market share, are Russia and Venezuela. Russia is vulnerable because it depends on oil at about $100 a barrel to break even.

Importers Gaining Most

Consumers in oil importing nations stand to gain the most from falling prices, especially those in Japan, China and Europe. Japan imports all its energy after closing nuclear reactors because of the 2011 Fukushima disaster. Last year Japan bought 4.5 million barrels a day, outranked only by the U.S. and China. Current prices provide an opportunity for China to build up its strategic reserves. China relied on imports to meet 57.4% of its crude consumption in 2013. In the first eight months of this year, China imported about $157 billion worth of crude, with the most coming from Saudi Arabia at about 16% of the total, followed by Angola at 13% and Russia 10%.

Portfolio Positioning

As we embark on the last quarter of 2014, we remain constructive on equity markets but acknowledge and continue to monitor the risks that could disrupt our outlook. The mid-October correction was long overdue, in our view — the markets had been on an upward trend for more than 1,000 days. Overall, we continue to favour equities versus bonds in our balanced portfolios (see table, right) with an emphasis on market segments that offer good value and potential downside protection. Within equities, we still favour blue-chip defensive dividend payers and select household-name global growth stocks. Our portfolios are diverse with the top holdings straddling geographies, sectors and industries.

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. ◼

Genus Pooled Fund Performance

Returns are shown Gross of Fees

As at September 30, 2014	3 months	1 year	3 years	5 years	10 years
	Compound Annual Returns				
Balanced Fund	1.1	15.3	11.8	8.1	5.5
Equities					
Canadian Alpha[1]	-2.2	17.4	10.6	6.3	7.4
Dividend Equity	1.6	21.3	15.8	11.2	
Global Alpha[2]	2.2	24.3	23.6	15.3	6.1
CanGlobe Equity	1.2	21.7	17.0	10.1	
Emerging Markets	1.3	10.7			
Fixed Income					
Short-Term Corporate Bond	0.4	3.8	3.0	3.5	4.2
Strategic Bond	0.7	8.2	5.7	6.4	
Commercial Mortgage	1.2	5.2	4.1		
Biosphere SRI					
Biosphere Dividend Equity[3]	3.1	18.1			
Biosphere CanGlobe Equity[4]	2.5	23.6			
Biosphere Corporate Bond	0.7	7.8			
Index Returns					
S&P/TSX Composite	-0.6	20.4	12.1	8.7	8.5
S&P 500 Index (C$)	6.1	30.2	25.9	16.6	6.8
MSCI Emerging Mkt (C$)	1.4	13.8	10.1	5.6	9.7
MSCI World Index (C$)	2.8	22.6	21.4	12.4	6.4
DEX Universe Bond Index	1.1	6.3	3.4	4.9	5.4

Past performance is no guarantee of future results.

1 **Mandate change:** Genus U.S. Equity mandate changed to Global Equity (Sept 14, 2012) and Global Alpha (June 30, 2014).
2 Genus Canadian Equity changed to Canadian Alpha on June 30, 2014.
3 **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.
4 **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).

Japan and U.S. eke out modest gains as global stock markets struggle

Global stocks declined in U.S. dollar terms on a quarterly basis for the first time since 2012. Japanese equities delivered the strongest results in the developed world during the third quarter. They were helped by a rapidly depreciating yen, which fell 8% against the U.S. dollar. The MSCI Japan Index gained 6%.

U.S. stocks rose modestly, with the Standard & Poor's 500 Composite Index edging 1% higher for the three months ending September 30. After touching a series of all-time peaks through mid-September, the S&P 500 and the Dow Jones Industrial Average retreated late in the quarter amid a combination of geopolitical worries, a strong dollar and softer economic data.

The Canadian S&P/TSX Composite Index returned -0.6% as producers of commodities from oil to copper and gold slumped after leading gains in the first half of the year. Concerns about slowing economic growth in Europe and China impacted commodity prices. The energy component of the S&P/TSX, fell 18% from its June peak to erase its advance for the year. European stocks lost 7% in dollar terms while Emerging Markets lost 3%.

Bond yields moved lower, particularly in Europe, where even Spanish and Italian 10-year bond yields fell below that of U.S. Treasuries. ◼

Genus Balanced Fund Asset Allocation

(As at September 30, 2014)

Asset Class	Percent of Market Value
Government Bond	1.8
Short-term Corporate Bond	1.8
Strategic Bond	21.1
Commercial Mortgage	13.1
Total Fixed Income	**37.8**
Canadian Alpha	**3.1**
Dividend Equity	**23.2**
Canadian Equity	*8.9*
U.S. Equity	*7.3*
International Equity	*7.0*
CanGlobe Equity	**30.3**
Canadian Equity	*11.7*
U.S. Equity	*10.5*
International Equity	*8.1*
Global Alpha	**3.7**
Canadian Equity	*0.3*
U.S. Equity	*2.3*
International Equity	*1.1*
Emerging Markets	**1.9**
Total Equity	**62.2**
Total Portfolio	**100%**
Portfolio Equity Exposure	
Total Canadian Equity	38.5
Total U.S. Equity	32.3
Total International Equity	26.1
Total Emerging Markets	3.1
Total Equity	**100%**