COMMENTARY

GENUS Wealth Management

FIRST QUARTER 2014

Uncle Sam, the Dragon, and the Bear

It's a divergence of fortunes few would have predicted. In the five years since Wall Street's 2008 collapse, it's Uncle Sam and the US economy and markets that seem to be doing fine while the voracious Chinese Dragon appears to be running out of steam. Adding to the world's issues and immediate risks, the Russian bear satisfied its territorial appetite by meddling in Ukraine and annexing Crimea, which prompted retaliatory economic sanctions from western nations.

On the whole, despite the geopolitical issues, the global economy is expected to grow at 3.0% in 2014. While positive economic growth does not necessarily correlate with strong market outperformance, there are a number of factors that will be supportive of global equity markets, particularly in the US, in the year ahead.

Key Takeaways

- The environment for equities remains favourable – central banks remain supportive, inflation is not an issue, the global economy as a whole is moving in the right direction, and stock valuations are in a normal range.
- The US economy continues to pick up steam, China is slowing to a more sustainable pace, and the Eurozone recovery has become entrenched.
- Geopolitical risk centres on the Ukraine-Russia situation where any escalation of the crisis could trigger more outbreaks of market volatility.
- 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.

Picking up Steam

Economic indicators in the US continue to point to the fact the economy has been picking up steam since March 2013. Strong household spending, robust manufacturing, steady exports, increasing business spending, and the restocking of warehouses, combined to keep the US economy on solid ground through the first three months of 2014.

The big question now is whether strong US growth is possible in the face of Ukraine-Russia tensions in particular, emerging market strains in general and China's modest slowdown. The answer appears to be yes. In addition to being a beneficiary of lower commodity prices from slower emerging market growth, the US enjoys a number of tailwinds, for example; low inflation, the positive impacts of the manufacturing and energy renaissances, restrained labour costs, rising real estate values (which are supporting consumer confidence and spending) and the declining trend in unemployment.

Further evidence of a rebounding US economy can be found in rising corporate profits, which are now 20% above their 2006 peak. In addition, corporate bond spreads, a great leading economic indicator, continue to decline. All these factors indicate that the US economy is strengthening with real (minus inflation) growth expected to accelerate to 4.0% in the second quarter and 3.5% over the second half of the year. With inflation low, and likely to remain low through 2015, the US economic expansion could last another 3-to-5 years, which will support both the stock market and the US dollar.

Yellenomics and Growth

Monetary policy under the new Federal Reserve chairman Janet Yellen is expected to be very supportive of the US economic expansion, as inflation at 1.1% remains well below the Fed's target and the labour market is far from full employment, with the jobless rate currently at 6.7%. The implications of "Yellenomics" is that US monetary policy will likely remain quite stimulative until after the next US presidential election in 2016, and with meaningful hikes in short-term interest rates postponed until 2017 or 2018.

Twin Deficits Improve

More evidence that the US is on solid footing is provided by the Twin Deficits (federal budget and current account), which have both improved significantly. This suggests the US dollar too will increase significantly as it did during the mid-1990s. Since 1995, the Twin Deficits and the trade-weighted dollar have had an 80% correlation, with the Twin Deficits leading by two years (Exhibit1). The substantial improvement in the Twin Deficits suggests the trade-weighted dollar increases to roughly 100 over the next two years, which would be a 17% increase from its current (March 31, 2014) level. The stronger US dollar will continue to exert increasing downward pressure on global commodity prices and inflation.

Turning Point for China

China's year-over-year economic growth is expected to slow to 7.5% in 2014. Some economists are forecasting growth as low as 6.5%. Either way, it appears that the era of China (and the emerging markets) driving global growth and commodities could be over. Indeed, over the past 30 years, at the beginning of every decade, there has been a major change in the global backdrop:

1980: End of 1970s commodity boom.
1990: End of 1980s Japanese boom.
2000: End of 1990s US tech boom.
2010: End of 2000s China and emerging markets boom.

At each major turning point, it has been difficult for investors, companies, and analysts to let go of those 'old' drivers, in part because there has been so much investment in that sector; for example, Japanese real estate. To capitulate is hard, given that so much time and energy have been invested in those areas.

The end of China's boom and transition to a slower but more sustainable rate of growth is being driven by a combination of issues. *Continued on Page 2* ►

Exhibit 1 Improving Twin Deficits Signal US and Dollar Strength

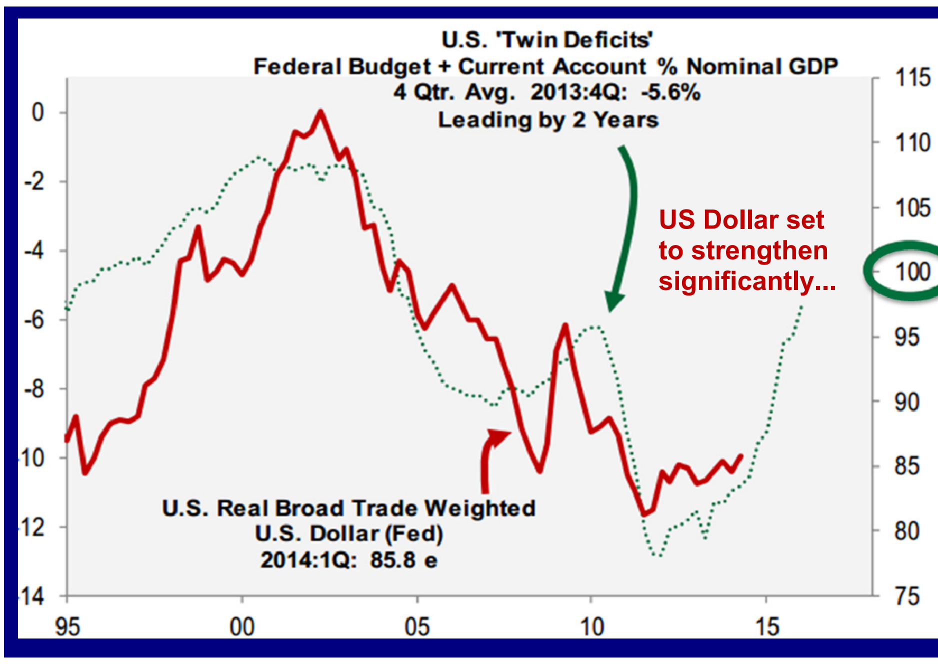


Exhibit 2 Declining Exports / Imports Weigh on China's Growth

Sharp Decline in China's Exports

Imports Stuck in Sideways Trend

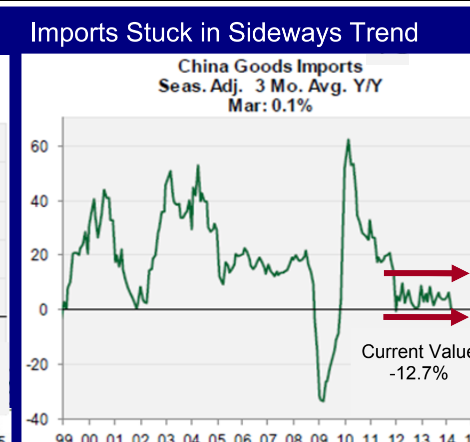
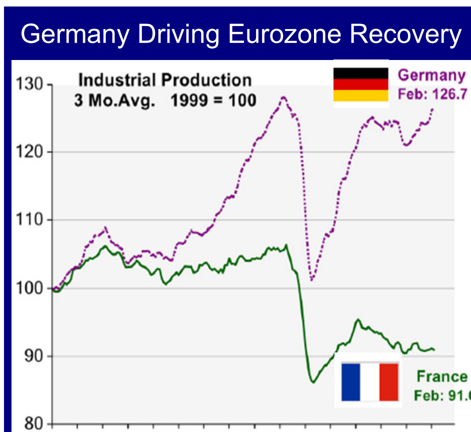
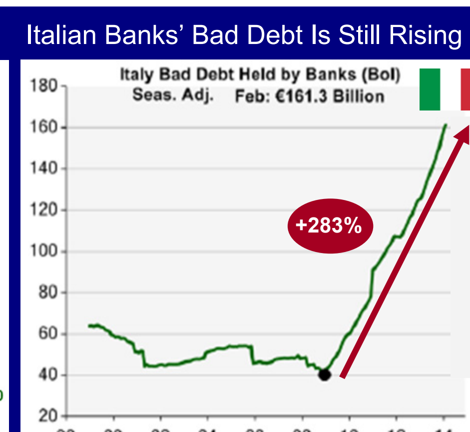


Exhibit 3 Eurozone Recovery Remains Fragile & Divergent

Germany Driving Eurozone Recovery

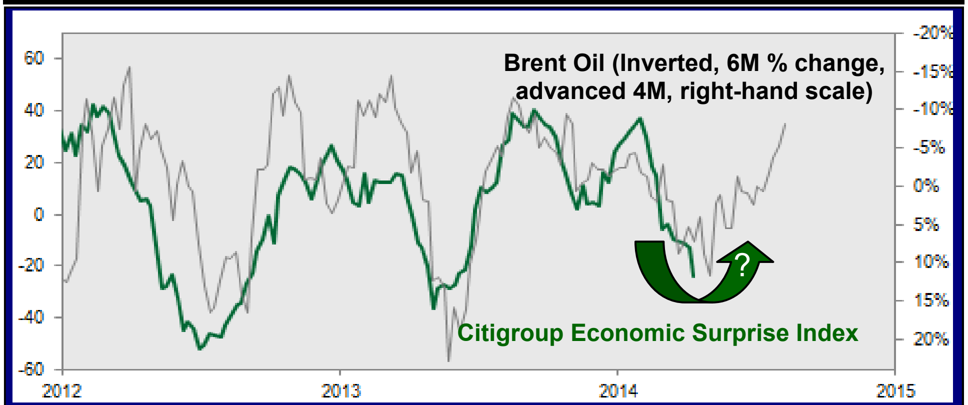


Italian Banks' Bad Debt Is Still Rising



Source for all charts: CornerstoneMacro

Exhibit 4 Global Economy Could Surprise on the Upside



Citigroup's Economic Surprise Index is closely correlated with changes in the price of oil (Brent crude). The index (green line) looks set to surprise on the upside, according to this measure.

From Page 1 ► The issues China is dealing with include excessive credit growth, outlandish property price appreciation, unsustainable investment growth, and severe pollution, which is making some cities barely suitable for living. The Chinese government appears to realize the only way to effectively deal with these excesses is through slower growth, which will allow the 'bubbles' to unwind. In this regard, policymakers have been effective in slowing down credit growth, which has also slowed down overall economic activity.

Slowing growth and higher rates after a credit bubble usually foreshadow significant credit problems and, in turn weaker growth. There are already negative credit events unfolding in China with companies defaulting on bond interest payments, others failing to pay back overdue bank loans (Haixin Steel) and real estate developers collapsing under mountains of debt; the most recent being Zhejiang Xingrun Real Estate which owed $565 million.

Japan is the only other major country to experience a recent investment boom similar to China's, but China's investment as a percentage of GDP growth (49%) is significantly higher than Japan's was at its peak (32%). As Japan's bubble burst, investment declined for 20 years. China's unwind could take as long, if not longer, to play itself out – and it could be a bumpy ride. Investment growth has created many jobs in China and a slowdown in investments is likely to weigh heavily on the labour market, consumer confidence and consumption.

China a Game Changer

The developments in China are game-changers for the world economy and markets, largely because investment growth in China has driven the economic growth of commodity-exporting emerging markets and played a significant role in the rise of commodity and oil prices over the past decade.

Thus far, the slowdown in China has brought good news to the developed world and to the US in particular. The decline in commodities of the past couple of years has allowed the US and other developed nations, including Canada, to grow without the fears of inflation. On the other hand, China's rebalancing is likely to mean slower global growth for all economies, including Canada, that are tied to commodities and those that export heavily to China.

Progress in Eurozone

The Eurozone recovery is becoming more entrenched. Growth accelerated to a two-year high at the end of 2013, and recent survey and official data point to a further strengthening in early 2014, supported by an encouraging pick-up in domestic demand. The main impetus behind the Eurozone's recovery is Germany, which makes up nearly 30% of the currency club's collective output, and which is predicted to grow by 1.8% in 2014. The Eurozone recovery will not be strong enough to make any real dent on unemployment this year, forecast to fall from 12.1% last year to 12.0% in 2014. That labour-market slack will keep inflation low, which leaves the European Central Bank with plenty of room, and reasons, to reduce interest rates. Outside the euro area, Britain is experiencing a robust recovery and the economy is forecast to expand by around 2.5% a year in both 2014 and 2015.

Ukraine-Russia Crisis

In late February, the markets' focus shifted to the events in Ukraine where the country's political crisis led to Russian intervention in the region, including the annexation of Crimea. This was immediately followed by economic sanctions being imposed on Russia by western nations.

As far as Russian President Vladimir Putin's gambit is concerned, it is hard to understand his motives. Although both the Ukraine and Crimea have at times been part of Russia, and Crimea is 60% Russian-speaking, the annexation seems to add nothing but economic woes to Russia's economy, which was already weak going into the crisis, expanding only 1.3% last year. For this year, forecasts for growth of 2% have been written off altogether, with no growth expected at all. The impact extends further than that: Russia's stock market tanked 10% in March, wiping out billions in capitalization and the ruble has lost 9% against the US dollar in less than three months, which makes imports more expensive. In addition, investors have yanked some $50-billion from Russian banks since the beginning of the year.

At the time of writing, the jury is still out as to how the situation will unfold, but any further escalation could trigger more outbreaks of market volatility, especially if reciprocal tit-for-tat sanctions (Russia provides 30% of Europe's energy needs) escalate into actual trade embargoes.

Investment Emphasis

We are maintaining our emphasis on stocks versus a relatively low allocation to bonds in our clients' balanced portfolios. Our equity focus remains on high-quality dividend-payers and 'best of best' blue-chip companies from around the world with good fundamentals, attractive share price momentum and durable earnings growth. Within bonds, we continue to emphasize corporate bonds and income-generating Commercial Mortgages. ▪

Genus Pooled Fund Performance

As at March 31, 2014	3 months	1 year	3 years	5 years	10 years
		Compound Annual Returns			
Balanced Fund	**4.0**	**14.7**	**8.4**	**10.4**	**5.1**
Equities					
Canadian Equity	**5.9**	**16.7**	**2.3**	**10.9**	**7.3**
Dividend Equity	**5.0**	**21.3**	**11.6**	**13.6**	
Global Equity[1]	**5.4**	**32.0**	**18.7**	**16.9**	**5.2**
CanGlobe Equity	**4.9**	**25.0**	**9.6**	**13.9**	
Emerging Markets	**2.8**	**6.9**			
Fixed Income					
Short-Term Corporate Bond	**1.5**	**2.5**	**3.7**	**4.3**	**4.2**
Strategic Bond	**4.0**	**2.9**	**7.1**	**8.3**	
Commercial Mortgage	**1.6**	**3.9**			
Biosphere SRI					
Biosphere Dividend Equity[2]	**3.8**				
Biosphere CanGlobe Equity[3]	**6.2**				
Biosphere Corporate Bond	**3.8**				
Index Returns					
S&P/TSX Composite	**6.1**	**16.0**	**3.6**	**13.7**	**8.1**
S&P 500 Index (C$)	**5.8**	**32.4**	**19.6**	**18.0**	**5.6**
MSCI Emerging Mkt (C$)	**3.5**	**7.5**	**1.7**	**11.9**	**8.5**
MSCI World Index (C$)	**5.3**	**30.1**	**15.6**	**15.9**	**5.6**
DEX Universe Bond Index	**2.8**	**0.8**	**5.0**	**5.0**	**5.1**

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 show resilience in face of strong headwinds

After a powerful rally in 2013, the first quarter of 2014 saw the bull market demonstrate a measure of resilience in the face of several headwinds.

In the latter half of January, stocks fell sharply on emerging-market concerns, but bounced back strongly in February and in the US, the S&P 500 went on to record a new all-time closing high on March 7. Performance was choppy in the final few weeks of the quarter, as investors digested mixed economic reports, geopolitical issues and the latest US Federal Reserve meeting.

The Canadian stock market was up 6.1% for the quarter, while in the US, the S&P 500 was up 1.8% (US$) and 5.8% (C$) Emerging markets continued to be impacted by capital outflows as monetary policy returns to normal in the developed world. The MSCI Emerging Market Index was up 3.5% (C$) for the quarter while the MSCI World Index was up 5.3% (C$).

Equity markets as a whole should continue to rise during 2014, with the US leading the way as company earnings continue to advance, but at a slower pace than in 2013. In addition to earnings, dividend increases are running at a record rate and merger and acquisition activity continues to pick up. Equity buybacks also remain strong. Moreover, 2014 will continue to be challenging for fixed income as QE tapering could effectively lead to modest rate rises. All of those elements will likely drive investors toward equities and the so-called 'Great Rotation' out of bonds into equities will continue this year. ▪

Genus Balanced Fund Asset Allocation
(As at March 31, 2014)

Asset Class	Percent of Market Value
Government Bond	1.8
Short-term Corporate Bond	4.2
Strategic Bond	20.4
Commercial Mortgage	9.8
Total Fixed Income	**36.2**
Dividend Equity	**22.6**
Canadian Equity	*10.6*
U.S. Equity	*6.4*
International Equity	*5.6*
CanGlobe Equity	**30.4**
Canadian Equity	*13.7*
U.S. Equity	*7.9*
International Equity	*8.8*
Global Equity	**8.3**
Canadian Equity	*0.1*
U.S. Equity	*4.5*
International Equity	*3.7*
Emerging Markets	**2.5**
Total Equity	**63.8**
Total Portfolio	**100%**
Portfolio Equity Exposure	
Total Canadian Equity	38.4
Total U.S. Equity	29.5
Total International Equity	28.3
Total Emerging Markets	3.9
Total Equity	**100%**