One for the record books

As 2014 begins, the world economy and equity markets appear to be in a good place. Global growth continued to inch forward in 2013, U.S. stock markets wrapped up their best twelve month returns since the 1990s and most developed markets posted double-digit gains. The accelerating U.S. economy, a return to modest growth in Europe and a stabilizing Chinese rate of growth all point to a notable pick-up in the world's economic well-being in the year ahead, which should give a small boost to Canada's outlook, and maintain a positive backdrop for equity markets.

Uneven but Steady

The global economy's uneven but steady recovery inched forward in 2013 but, in something of a role reversal, the fast-growing emerging market economies lost pace while the developed nations gained strength. Leading "old world" economies such as the U.S., UK, Japan and Germany are at last showing some strength after years of notching far slower growth than the emerging economies.

The combination of emerging economies slowing slightly while the developed world picks up the pace sets the stage for more synchronized and balanced growth in the year ahead. The International Monetary Fund (IMF) forecasts that the world's economic growth will accelerate to its historical average rate of 3.6% in 2014, compared with 2.9% for 2013. Despite slowing slightly, China and the emerging economies, which account for 73% of the world's overall economic growth, are still expected to grow faster (+5% as a group in 2014) than the mature markets.

Growth in the "old world" countries in 2013 was driven largely by central banks in the U.S., Japan and Europe showering money on their economies, holding interest rates very low, and promising to continue to do so, in a bid to animate a recovery that has remained tepid five years after the worst recession since the Great Depression. Emerging economies, on the other hand, were hampered by rising inflation, softer domestic demand and interest rate risk emanating from the U.S. With the Fed keeping interest rates near zero for almost five years, investors have sought higher returns elsewhere, in part driving the boom in the emerging markets. As interest rates return to 'normal' levels in the U.S. and the developed markets, these global capital flows tend to seek out the higher rates and greater stability offered by the world's mature economies, which stokes volatility in emerging markets. So far, the global recalibration is playing out in a relatively measured way, despite the bumps in the emerging world. China has already perked up from slower conditions in the first half of 2013, and is looking at better than 7% growth in 2014. Rising consumer demand from the U.S. and Europe should support China and other emerging economies and help pull them out of their slowdown.

Exhibit 1 Extremely Steep Yield Curve Points to Continued Strong Economic Growth

"It is terribly premature to worry about the next U.S.-led global recession when the Fed and most central banks around the world are still erring on the side of stimulus, and when the yield curve is extremely steep and valuations and sentiment remain generally favourable." ~ *Richard Bernstein, U.S. academic, author and investment advisor.*

Positive for Stocks

The environment for stock markets in the developed world remains quite favourable heading into 2014; interest rates are low, inflation is well contained, corporate earnings are rising, companies are flush with cash and equity valuations are fair. While the gains of over 20% in major markets may not be repeated in 2014, equity prices in most of the world should continue rising in this environment — and bond prices should continue falling.

Stock market optimism seems justified for two reasons: First, Wall Street has now decisively broken a 13-year trading range. Past experience strongly suggests that this breakout signals the start of an upward trend for global equities that could last many years because we have only just entered the middle-phase of the economic cycle. Second, the 5.5%-6.0% nominal GDP growth (before inflation) expected in the global economy in 2014 should translate into similar growth in corporate revenues and earnings. And, given that equity valuations are still only slightly above their long-term average levels (Exhibit 2) and companies are flush with cash, there is scope for strong gains in the major equity markets.

With the policy backdrop suggesting a continuation of 2013 trends and the synchronized global economic expansion unfolding quite nicely as fiscal drag diminishes in the U.S. and Europe, and China continues to shock people by not having a hard economic landing, the path to higher equity markets in the year ahead is becoming increasingly clear. The U.S. is expected to find a higher gear in 2014, accelerating from 1.8% GDP growth in 2013 to 2.7% in 2014. While there are certainly still plenty of serious hurdles for Eurozone, and no-one will mistake it for a growth leader, the shift from a 0.5% drop in growth in 2013 to a gain of 0.8% next year is encouraging.

The biggest hurdle for stock markets in the year ahead will be rising interest rates since yields on 10-year U.S. Treasuries could increase to 3.5% as the economy accelerates. History shows, however, that stock prices usually climb alongside rising bond yields during periods of economic recovery, provided short-term rates remain low. This is, of course, the current case with the Fed committed to maintaining short-term rates at zero however much the economy accelerates in the near-term because it sees rapid growth as a very welcome development after five years of deep recession.

Fed's Focus Shifts From QE

The Federal Reserve's focus in 2014 will shift from Quantitative Easing (QE) to forward guidance about interest rate hikes.

Continued on Page 2 ►

Key Takeaways

- The environment for equities remains positive – central banks remain supportive, inflation is not an issue, global growth is moving in the right direction and stock valuations are in a normal range.
- China seems to have engineered a soft-landing, growth in the U.S. is accelerating and Europe has limped out of recession. Rising demand from the U.S. and Europe should bolster growth in the emerging markets.
- 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.

Exhibit 2 Stock Market Valuations are Reasonable

Source: TD Securities (As at December 31, 2013)

From Page 1 ► The U.S. central bank enters the new year with the idea that it will keep short-term rates near zero until at least the second half of 2015, and in spite of QE being phased out, Fed policy will remain very supportive of equity markets. If the economy worsens, QE will go on for longer and if the economy continues to grow at a moderate pace, as it is, QE will go away on schedule in the fall of 2014, but there won't be any rate hikes until at least the second half of 2015. These stances are obviously very equity-friendly. If the U.S. economy improves materially, rate hikes may well occur earlier, but that would be bullish for the equity market, not bearish: Historically, stock prices climb when the economy grows fast, regardless of Fed tightening.

Tailwinds in the U.S.

For 2014, there are many more tail-winds than headwinds for the U.S. economy with growth now driven more by business and private sector spending than either monetary or fiscal policy. The U.S. picked up momentum in 2013 as the drag from changes in government spending and taxation faded. In addition, the U.S. unemployment rate, at 7.0%, is well below its recession peak of 10% in October 2009, but still above the 4.7% prior to the start of the recession. More jobs, along with rising stock and housing markets, helped propel household net worth in the third quarter to a record level. Against this generally improved backdrop, the Fed judged the U.S. economy healthy enough to receive less support and decided to cut back its bond-buying program, starting in January 2014.

Better Year for Europe

The 28-country Eurozone continued to limp out of recession in 2013 with the north, led by Germany, having a solid year in terms of reducing unemployment and improving growth prospects. Across the Mediterranean the pattern was more disappointing, with Italy, Spain, Portugal and Greece all enduring a year of rising unemployment and political and social unrest. Although the numbers have started to improve, Europe is not out of trouble, but the acute phase of their difficulties may be past. All this bodes well for 2014, which may see better and more balanced growth than any year since 2007.

Canada Poised to Improve

Canada is poised to grow a bit faster than 2% after two years just below that line as manufacturing jobs improve on the back of a weaker Canadian dollar stimulating exports to the U.S. The Bank of Canada seems to be signaling that they may be favouring increasing export competitiveness through a weak currency rather than productivity gains. A weaker Canadian dollar, however, does not necessarily mean exports will increase dramatically, as some manufacturing, ie autos, have been moved offshore. To bring production back it would likely require the loonie to depreciate a lot more (to around 82 cents U.S.) and businesses would have to be convinced the lower levels will be sustained.

Investment Emphasis

As we move through the mid-stage of the current economic cycle, 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 are maintaining our emphasis on corporate bonds (versus government bonds) as well as our exposure to income-generating Commercial Mortgages.

Genus Pooled Fund Performance

	Compound Annual Returns				
As at December 31, 2013	**3 months**	**1 year**	**3 years**	**5 years**	**10 years**
Balanced Fund	6.7	16.0	7.7	8.6	5.2
Equities					
Canadian Equity	6.7	13.7	1.9	9.3	7.3
Dividend Equity	9.6	24.7	11.3		
Global Equity [1]	13.7	38.1	18.2	13.2	5.0
CanGlobe Equity	11.1	28.4	9.0	11.1	
Emerging Markets	4.0	4.9			
Fixed Income					
Short-Term Corporate Bond	1.0	2.2	3.3	4.4	4.3
Strategic Bond	1.0	1.1	5.9		
Commercial Mortgage	1.1	3.0			
Government Bond	0.2				
Biosphere SRI					
Biosphere Dividend Equity [2]	9.7				
Biosphere CanGlobe Equity [3]	11.9				
Biosphere Corporate Bond	0.9				
Index Returns					
S&P/TSX Composite	7.3	13.0	3.4	11.9	8.0
S&P 500 Index (C$)	14.2	41.3	18.8	14.5	5.3
MSCI Emerging Markets (C$)	5.3	4.3	0.5	11.7	9.4
MSCI World Index (C$)	11.8	35.9	14.7	12.3	5.5
DEX Universe Bond Index	0.4	-1.2	3.9	4.8	5.2

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).

Downsizing of Fear in 2013

Although investors had plenty of reasons to think 2013 would go miserably for the stock market, nothing, it seemed, could slow the major stock markets' profitable runs in 2013.

U.S. and Japan Outperform

In the U.S., despite worries about the outlook for Federal Reserve policy, turmoil in the Middle East, a narrowly-averted military showdown with Syria and a federal government shutdown, stock markets experienced only small and short-lived pullbacks. There were just five selloffs of 2% or more for the S&P 500 in 2013, the worst being a 5.8% decline from May 21 through June 24 amid fears the Fed would soon dial back on its market-friendly bond-buying stimulus program.

In the horse race among global markets, U.S. stocks trailed only the explosive and often-volatile rally in Japan's Nikkei Stock Average which soared 57%, largely due to aggressive monetary easing by the Bank of Japan. In the U.S., the Dow Jones ended the year with a gain of 29%, including dividends, while the S&P 500 index climbed 32% with dividends. Both set more than 40 record highs in the course of the year with eventual gains far outpacing the rally predicted by even the most bullish Wall Street strategists.

Double-Digits for Canada

Canada's TSX returned 13% for the year. Consumer stocks, health care holdings, information technology and bank stocks posted the best returns. The market was dragged down, however, by Materials and Utilities which generated negative returns. Materials was dragged down by very large declines among gold stocks, many of which lost more than one third of their value in 2013 as the price of gold plummeted 30% during the course of the year, its biggest drop since 1981.

Markets Surge in Europe

European stocks cemented their biggest annual gains since 2009, with the pan-European Stoxx 600 rising 17% for the year, boosted by the gradual improvement in the European economy and the easy-money policies of global central banks. London's FTSE 100 index was up 14% for the year, France's CAC 18% and Germany's DAX 26%. With the region's debt crisis easing through the year, investors stepped in to pick up bargains. Countries that fell out of favour during Europe's debt woes were strong performers in 2013. Stock markets in Spain and Italy gained 21% and 17% respectively, while Greece was up 28%.

Emerging Markets Decline

Emerging market stocks, which often perform best during global economic expansions, declined in 2013, with the MSCI Emerging Markets index down 5.1%. Reflecting the fraught relationship between policy in developed markets and performance in emerging markets, the prospect of the Fed cutback in its bond buying program roiled financial markets in many developing countries in 2013.

Genus Balanced Fund Asset Allocation

Asset Class	**Percent of Market Value**
Government Bond	1.9
Short-term Corporate Bond	4.7
Strategic Bond	18.9
Commercial Mortgage	10.0
Total Fixed Income	**35.5**
Dividend Equity	**24.5**
Canadian Equity	*10.8*
U.S. Equity	*6.4*
International Equity	*7.3*
CanGlobe Equity	**30.6**
Canadian Equity	*13.3*
U.S. Equity	*8.4*
International Equity	*8.9*
Global Equity	**6.4**
Canadian Equity	*0.1*
U.S. Equity	*3.4*
International Equity	*2.9*
Emerging Markets	**3.0**
Total Equity	**64.5**
Total Portfolio	**100%**
Portfolio Equity Exposure	
Total Canadian Equity	37.5
Total U.S. Equity	28.3
Total International Equity	29.5
Total Emerging Markets	4.7
Total Equity	**100%**

The Genus Commentary is published quarterly by Genus Wealth Management, a division of Genus Capital Management Inc. 6th Floor~900 West Hastings Street, Vancouver, BC, V6C 1E5
Phone: 604.683.4554 Email: info@genuscap.com Website: www.genuscap.com