Provisus Wealth Management

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Q4 2014

INVESTMENT REVIEW

INSIDE THIS ISSUE:

Q4 2014 RETURNS	
S&P/TSX	-1.5%
S&P 500 *	4.9%
MSCI EAFE *	-3.5%
MSCI World *	1.1%
DEX Bond Universe	2.7%
US Dollar (vs. C$)	3.5%

* Return in U.S. $

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MARKET COMMENT

The global economy experienced another year of modest growth yet with a lot of uncertainty going forward. Limited clarity in the marketplace will lead to a period of greater volatility for stocks and bonds around the world. And yet, despite the market uncertainty and relatively mediocre performance, the rays of further expansion are percolating to the surface.

The U.S. economy is humming along, buoyed by strong domestic demand and a rebounding manufacturing sector. While the labour picture is rosy, the lack of inflation, strong stock markets and the very strong dollar confirm that the recovery is self-sustaining. The U.K. is also recovering at a brisk pace, with its fastest growth in real income in twelve years. Unfortunately the U.S. and U.K. are anomalies. Japan has slipped into recession with significant economic and fiscal problems. The Eurozone's economies have weak growth and economic stagnation appears to be the new norm. There are also concerns over China's economy, the world's second largest, as it slows a little further but appears likely to avoid a hard landing. Most emerging market economies are struggling to even achieve positive real growth.

Canada's economy continues to shuffle along in tandem with the slow growth in Europe and anaemic growth in emerging markets. Optimism was beginning to permeate the Canadian market but oil's dramatic 46% price tumble is casting doubts as to whether a sustainable upswing can be achieved. Oil's decline could subtract 0.5% from Canada's economic growth this year but will likely generate meaningful long term benefits to economic activity. Still strong U.S. growth should reinvigorate demand for Canadian exports which will stimulate reluctant business investment in manufacturing and create more jobs. Consumers are instantly feeling the benefit at the gas pumps and will have extra cash available to spend.

The past quarter was full of concerns on many fronts and led to negative stock returns everywhere except in the U.S. which saw stock prices gain 8.8% (all figures in Canadian dollar terms). While the quarter was dismal, the full year results were relatively strong, especially after the Canadian dollar lost 10.6% which increased the returns achieved by foreign assets. For the full year U.S. stocks rose 22.8%, the third year in a row of double digit gains; while international stocks gained 6.1% and Canadian stock climbed 10.6%. Bonds rebounded over the year with an 8.8% rise. Gold posted a second straight year of losses for the first time since 1998 while commodities in general delivered poor results for the third year in a row.

Central bank stimulus was led by the U.S. Federal Reserve which has kept its key interest rate at close to zero for six years and in turn provided a strong propellant for stock markets. But the era of ultra low U.S. interest rates is likely to end this year. The Bank of Canada would like follow with an uptick in rates very shortly afterwards. As history shows this may not be a bad thing for stocks in general as they tend to perform well early on in the interest rate hiking process. Meanwhile, central banks overseas are looking to expand fiscal stimulus to shore up their ailing economies and avoid a debilitating bout of deflation. Deflation could choke their economies further as consumers delay purchases and effectively strangle the chance for any real economic growth for decades.

The new year will likely see another year of large divergence in performance across developed nations. With the U.S. in particular leading the way, Canada will be able to ride on our neighbour's coattails and grow at an accelerated rate. Given that this recovery began in 2009, it may appear to be long in the tooth but the reality is that the shallow growth attained so far has only just returned the world to its previous peak. Looking forward the economy is now all about achieving real expansion based on the improved fundamentals attained over the last many years.

Christopher Ambridge, CFA

Canadian Equities

Equity markets in Canada have been on a roller coaster for most of 2014 making the year one of the most extreme since the start of the current bull market cycle in 2009. The first half was very strong for the TSX as soaring energy prices reached $107/barrel in the summer, propelling the index to pre-crisis levels at around 15,000 points. But the turnaround in the second half has been swift and brutal. In the latter half of the year the crude oil benchmark plunged abruptly and steeply to a 5 year low. By year end the decline of more than 20% during the quarter was enough to make it the Canadian Press Business News Story of the Year. That was a sharp contrast to the strong momentum that the index enjoyed in the early months of 2014, having posted double digit returns on an annualized basis in the first quarter and outperforming the S&P 500 by a wide margin. From 13,500 points on January 1, 2014, the TSX finished the year at 14,600 points, a respectable return of more than 10% including dividends. Still it has lost a lot of ground relative to the S&P 500 which finished the year with an outstanding 25% return on a total return basis.

The Canadian economy has shown many signs of revival in 2014 with some revisions of GDP growth to the upside. From 1.0% real GDP growth in the first quarter, the GDP growth surged to 3.6% and 2.8% respectively in the second and third quarters. That level of growth appears to be decent given the uneven pace of growth around the world and the geo-political challenges that the global economy faced during 2014. The job market has been erratic despite a decent growth level. From late 2012, job surveys have alternated between losses and gains. Although September and October 2014 had a positive trend with 74,000 and 43,000 new jobs respectively, November and December posted negative numbers with 11,000 and 4,000 job losses respectively. The losses appear to be benign as the unemployment rate continues to hover around a relatively acceptable 6.6%. Inflation has been subdued for many months and the recent pullback in energy prices is likely going to keep the inflation level below the Bank of Canada's 2% inflation target. As a result rates are likely to remain low for many months to come, a situation that will continue to be supportive for the economy.

Ari Abokou, MBA, CIM, FCSI

Fixed Income

The Canadian FTSE TMX Universe Bond Index rang up a healthy 2.7% gain in the fourth quarter of 2014. For the full year the index rose 8.8% which more than made up its 2013 loss of 1.2%. Five and ten year Canada government bond yields began 2014 at 1.9% and 2.8% but continued to fall and closed the year at 1.3% and 1.8% respectively. The Bank of Canada confirmed that it would maintain its benchmark overnight interest rate at 1.0% after its most recent meeting on December 3rd. That rate has been unchanged since September 2010, the longest period of rate stability since the early 1950s.

2015 may finally be the year that interest rates begin to rise but keep in mind that a bet on higher interest rates was likely the call most investors got wrong in 2014. The decision to raise rates will be made by the Bank of Canada which is guided by its monetary policy, established in 1991, to preserve the value of money by keeping inflation low, stable and predictable. The Bank aims to keep the rate of Consumer Price Index (CPI) inflation at 2%, the midpoint of a target range between 1 and 3%. Currently the CPI is running at 2% so the outlook for inflation is key to making an interest rate call. After its final rate setting meeting of 2014, the Bank's Governor Stephen Poloz confirmed that Canada's economy is showing signs of a broadening recovery as he acknowledged that the economy is stronger than he previously thought thanks to Canadian exporters selling to a strengthening U.S. economy and a lower Canadian dollar. On the other hand, the outlook for both growth and inflation will be restrained by much lower fuel prices, a weak global economy and anaemic wage growth.

Following its December monetary policy meeting, the central bank noted that although inflation had risen more than expected, it was "largely due to the temporary effects of a lower Canadian dollar and some sector-specific factors." The statement also pointed out that the "hoped-for ....

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CANADIAN ECONOMIC STATISTICS	
Real GDP Growth	2.8%
CPI - Headline	2.0%
- Core	2.1%
Unemployment Rate	6.6%

Fixed Income

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sequence of rebuilding that will lead to balanced and self-sustaining growth may finally have begun" as signs of increased business investment are being seen. This was one of the strongest indications from the bank since the recession began in 2008 that the recovery is expanding across the country. The consensus among economists is that the bank will start raising its key overnight lending rate in the fourth quarter of 2015, or a few months after the U.S. Federal Reserve starts raising rates.

In the U.S., the Federal Reserve ended its quantitative easing program in October. The massive bond buying program was credited with helping to hold down long term rates and allowing easier credit conditions to boost economic growth. The Fed has kept its benchmark interest rate near zero since December 2008 and the economy has rebounded as GDP recorded a very strong annualized growth rate of 5.0% in the third quarter. The U.S. central bank, which has a 2% inflation target, cut its inflation forecast for 2015 to between 1% and 1.6% in 2015, mainly due to falling energy prices. The Fed also dropped its pledge to keep rates close to zero for a "considerable time" and replaced it with new language that the central bank "can be patient in beginning" to tighten monetary policy. The language change signals that the central bank is preparing to raise short term interest rates, perhaps as soon as the middle of 2015.

Peter Webster, CFA

U.S. Equities

The S&P 500 rose 4.9% in U.S. dollar terms in the fourth quarter of 2014 and was up 13.7% for the year. In Canadian dollar terms the index was up 8.4% over the three month period and 22.8% for the full year as the Canadian dollar continued to weaken. The U.S. economy, helped by a strong job market and a boost in consumer spending linked to falling fuel prices, should enjoy the fastest economic growth in a decade this year. Nearly 3 million new jobs were created in the U.S. in 2014, the best rate since 1999, according to the Labor Department. In December the unemployment rate fell to 5.6%, down from 8.5% three years ago, as 252,000 jobs were created. This marked eleven consecutive months of job growth above the 200,000 level.

Economic data confirmed a strong U.S. rebound as GDP recorded a much better than expected annualized growth rate of 5.0% in the third quarter. This result was largely attributed to a recovery in consumer spending. The GDP number was 1.1 percentage points better than the government's earlier estimate and is the fastest rate of quarterly economic growth in more than a decade. Following the release of the strong GDP number, the U.S. dollar rallied higher on expectations that interest rates could go up sooner than was previously anticipated. Over the last half of 2014 the U.S. dollar has moved up by more than 12% compared to a basket of international currencies. This means that while the economy is picking up steam, a stronger dollar will make it harder for U.S. companies to sell goods overseas. The improving U.S. economy is an anomaly in a global context as the rest of the world's economies are showing signs of weakness and it will be a challenge for the U.S. to maintain a high growth rate if the rest of the world is shrinking. Selling American made goods overseas contributed nearly 20% of the 2014 GDP growth.

While a problem for energy exporting countries, the nearly 30% drop in energy prices in the fourth quarter is a good news story for the U.S. economy. Cheaper oil significantly reduces the costs of U.S. imports and helps lower the trade deficit. Lower fuel prices have also put more dollars into the pockets of U.S. consumers for spending or paying off debt. The overall outlook remains favourable for U.S. equities as financial conditions are still stimulative and longer term bond yields continued to ease. While the low cost of borrowing has sent a flood of money into world stock markets; pumping up prices, helping pension plans recover and giving households a greater sense of wealth, the underlying risks to the market have not changed materially. In the long term these conditions offer uncertainty but remain supportive for U.S. equities in the near term.

Peter Webster, CFA

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U.S. ECONOMIC STATISTICS	
Real GDP Growth	5.0%
CPI - Headline	1.3%
- Core	1.7%
Unemployment Rate	5.6%

INTERNATIONAL EQUITIES

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Global economic growth is anaemic with little or no growth in Europe and Japan, while China's economy continues to slow. Overlaying this are numerous pockets of political turmoil which will increase the level of uncertainty on a global scale. On the other hand, the U.S. economy is marching steadily higher though unfortunately this means that the U.S. Federal Reserve can now take its foot off the gas pedal and start raising interest rates for the first time since 2006. This will likely drain capital from developing nations as other countries increase stimulus measures which could further exacerbate the situation.

Europe is caught in limbo. With minimal economic growth, the currency at 5 year lows, inflation remaining alarmingly weak, and high unemployment, the region remains stuck in a deep structural slump with not enough momentum to break free. After premature optimism a year ago when the Eurozone exited its last recession, the overall economic picture has not substantially improved. Compounding this situation is the increasing spectre of deflation developing and without a catalyst for real recovery, Europe faces a lost decade of growth like Japan's. Europe has introduced negative interest rates on deposits to encourage banks to lend to households and businesses to support the recovery. Still the European Central Bank is now poised to loosen monetary policy even further to battle the region's multiple issues.

Japan's economy fell into a triple dip recession after a sales tax hike in April crushed consumer demand and weaker than expected business investment has also caused the recession to become even deeper. With the Japanese Yen hitting a seven year low versus the U.S. dollar and its credit rating being cut, something needs to be done to drive consumption. The Bank of Japan will have to aggressively increase its monetary stimulus efforts to boost manufacturing and get consumers spending again.

Emerging markets can't be easily categorized due to the divergent nature of the countries. China's economic growth fell to a five year low of 7.3% prompting China's central bank to cut interest rates. Their first rate cut since 2012 was done to inject extra credit into the financial system. Manufacturing in Brazil contracted in seven of the past eight months. Oil prices have collapsed 48% since June, squeezing exporters like Venezuela, Russia and Nigeria, and contributing to the drop of emerging market currencies to their lowest levels since 2003. Russia's central bank took the drastic step of raising its main interest rate to 17% in the middle of the night, a rise of 6.5 percentage points, in a desperate attempt to restore confidence in the rouble. Observers expect the high rates will hurt business and cause Russia to fall into a deep recession.

With the exception of India and China, which gained 31.3% and 63.8% for the year respectively (all returns are in U.S. dollar terms), all other international stock markets were a sea of negative performance for both the fourth quarter and the entire year. As a whole, international developed stocks were down 4.5% and emerging markets declined 4.6%. European stocks as a group were the big losers, falling 8.6%. Lastly, Asian stocks fell by 3.7% for the year.

The world economy may regain its footing in 2015 but a complete recovery from the global financial crisis of 2008 is still some time in the future. With growth remaining lacklustre and inflation drifting lower, accommodative monetary policies and ultra low yields will be critically important. And while there may be instances of positive developments, much of the world will remain on the cusp of a recession for some time.

Christopher Ambridge, CFA

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