GENUS Wealth Management

COMMENTARY

FOURTH QUARTER 2014

Decoupling Intensifies

U.S. economy is poised to lead global growth in 2015 as other nations struggle

The Great Decoupling between the U.S. and the other major world economies became even more apparent in the final three months of 2014. After long struggling to claw its way out of the Great Recession, the world's biggest economy is on an extended win streak that is edging it closer to full health. Things don't look quite so bright elsewhere, which is where we see potential bumps in the road and risks in the year ahead.

Exhibit 1 Global Economy in 2015 — Strength & Weakness

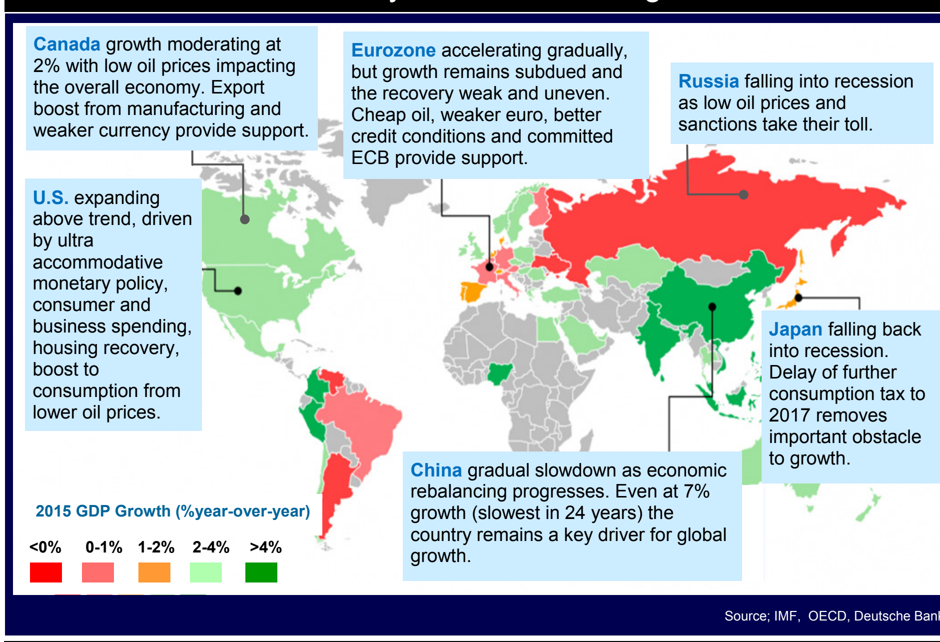


Exhibit 2 Plunging Price of Oil Drags Down Canadian Dollar...

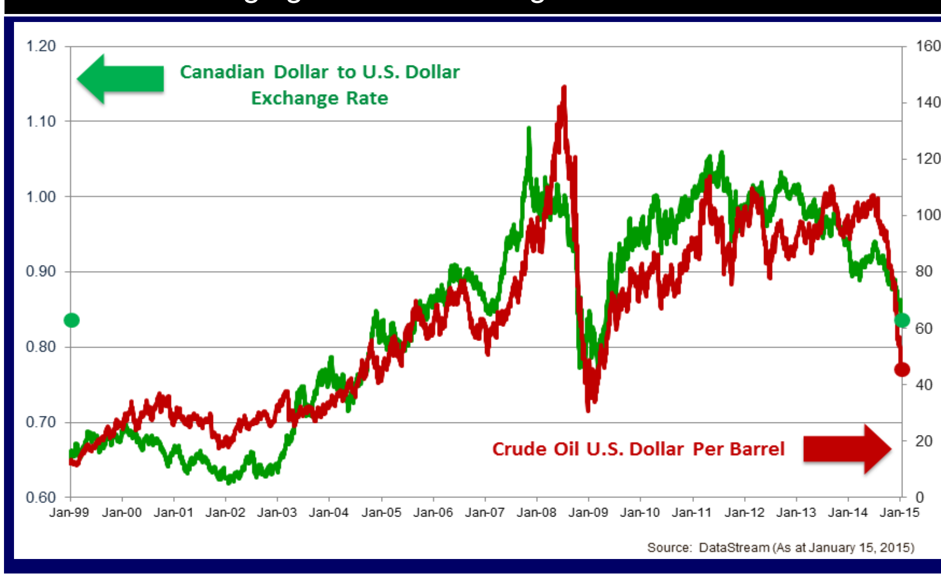
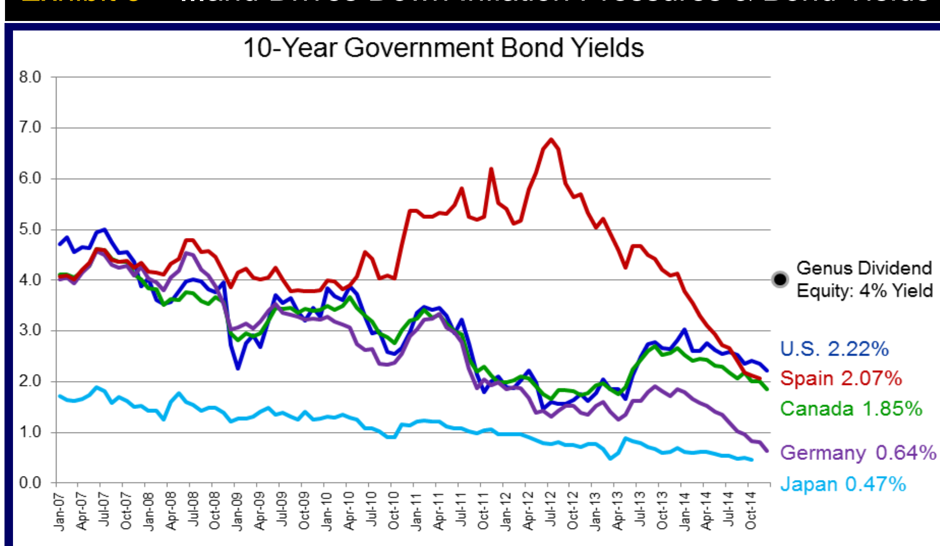


Exhibit 3 ...and Drives Down Inflation Pressures & Bond Yields



Breaking Away

The U.S. economy is expected to expand by 3.2% or more in 2015, its best performance since 2005, as an improving job market leads to stepped-up consumer spending, which is 69% of the economy. The U.S. is breaking away from the rest of the world primarily because of monetary stimulus, its focus on working off the debt-driven excesses that precipitated the worst recession since the Great Depression, and the restructuring of the economy.

The U.S. economic expansion from July through September — a 5% annual rate — was the swiftest for any quarter since 2003. That pace will likely ease a bit. Nevertheless, as far as the rest of the world is concerned, the sustained acceleration of U.S. growth is a key reason most economists expect the global economy to grow at about 3.1% in 2015, up from 2.5% in 2014.

> **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.

The U.S. is expected to contribute close to 18% of total global growth in 2015 compared with 11% for all other industrial countries combined. Soft oil prices, continued low global interest rates and benign inflation pressures in the developed economies also will provide a boost for global growth.

BRICs Faltering

While the U.S. is gathering strength, the BRIC nations — Brazil, Russia, India and China — are facing tougher times after spending much of the past 15 years basking in the attention of global investors.

Brazil's debt was downgraded in 2014 for the first time in a decade while Russia is heading into recession, its economy pummeled by the collapse of oil prices and U.S. and European sanctions. Growth in China and India has slowed as both countries grapple with revamping their economies. China's bumpy down-shift is expected to see growth slow to a still robust 7.1% in 2015 from 7.4% in 2014 as it continues its very carefully managed transition from an investment (still in bubble territory at 47% of GDP) to a consumption driven economy. Even at "just" 7%, China remains a key driver for global growth in the year ahead.

Better Policy-Making

The U.S. has pulled ahead of other industrial nations partly because its policy-making has been better. For example, the European Central Bank is still weighing whether it should buy government bonds to fight off deflation — a step that the Federal Reserve first took back in 2009. U.S. budget policy also has been more effective than the Eurozone's austerity strategy, which has undercut the continent's economy.

Compounding Europe's challenges is the precarious situation in Russia. The significant plunge in oil prices is unmistakably detrimental to the Russian economy, particularly as they try to withstand sanctions imposed because of their political aggression in Ukraine. Whether Europe's already fragile banking system can absorb a significant downturn or outright financial crisis in Russia, remains unknown. In addition, the re-emergence of Greece in the headlines as they contemplate their membership in the European Union comes at a particularly vulnerable time.

Commodity Prices

Commodity prices are projected to stay soft in 2015 with oil sinking to around U.S.$40 per barrel by the end of the year. Not only is there excess U.S. supply, and the recent announcement from OPEC to maintain production, but it is also coming at a time when there is weak global demand and a stronger U.S. dollar. Given this backdrop, it will take some time before oil prices can begin a sustained recovery.

The steep decline in oil prices in the second half of 2014 is helping to reduce inflationary pressures and improve current account and fiscal balances in oil importing developing countries such as Brazil, Indonesia, China and India. However, sustained low prices will weaken economic activity in exporting countries; quite significantly in Russia, with GDP contracting to -2.9%, and to a lesser degree in countries such as Canada and Australia.

Headwinds for Canada

The impact of weak oil prices and declining commodity exports for Canada will be partially offset by an uptick in manufacturing. Exports will receive a boost from a weaker Canadian dollar, an accelerating U.S. economy and, to a lesser degree, an improving European economy. Exports, which make up 30% of the Canadian economy, are expected to increase by 5% year-over-year in 2015. Canadian sectors and stocks with high exposure to the U.S. economy, the destination for 76% of Canadian goods, and in particular the U.S. consumer, should do well in the year ahead. Canadian economic growth is expected to be between 2%-2.3% in 2015.

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Oil Shaping 2015 Outlook

The key event that will likely shape the global economy and the outlook for Canada in the coming year is the impact of the 50% decline in oil prices since mid-2014. Low oil prices will give the global economy a much needed boost. Oil price declines are equivalent to a "tax cut" that frees up discretionary income for households. For example, the U.S. consumes $400-billion of gasoline annually; consequently, a 50% price decline frees up some $200-billion of discretionary income for spending, which is equivalent to more than 1% of GDP. While good for the global economy, the downside risks posed by lower oil prices and an over-priced housing market, are both wild cards in Canada's outlook.

Alberta Hit Hardest

The sharp fall in oil prices has hit the energy-intensive Alberta economy the hardest and could push the province into recession. Alberta Premier, Jim Prentice, says oil prices have plunged "so far, so fast" that 2015's projected budget surplus will now be a $500-million deficit.

The housing market in Alberta also has been severely impacted. Since 2009, Calgary house prices have soared 49% and Edmonton's 33%. Now, however, with oil prices plunging, these bubbles are probably popping. House sales slumped 6% across Canada from November to December, led by declines of about 25% in Calgary and Edmonton.

Housing Vulnerable

Residential investment as a percentage of Canada's GDP has been almost 7% for nine years. During Canada's last housing bubble in the late 1980s, it was also 7% of GDP. In the U.S., residential investment as a percentage of GDP peaked at 6.7% in 2005, and then declined sharply. Bank of Canada governor, Stephen Poloz, has stated that housing is a "very vulnerable" part of the economy and that "stretched valuations and some signs of overbuilding (would) expose the financial system to a sharp correction in house prices." It is no small coincidence that Canada's bank stocks were the worst performers in December; down 3.2% as a group for the month.

Bank of Canada Options

Given the knock-on effects of the plunge in oil prices, the BoC may have to reduce interest rates in 2015. With rates at just 1%, after first taking rates to zero, the BoC may have to consider some form of quantitative easing. On the upside, if there is a sharper-than-expected economic slowdown in Canada, there is room for fiscal stimulus. With a small budget deficit, the government has room to accelerate its spending, which at 21% of GDP, could be potential support for growth.

Sinking Bond Yields

The steep drop in oil prices also will have a pronounced effect on global inflation, especially in the first half of 2015 when inflation in the developed economies is expected to be flat, and down slightly in the core Eurozone countries such as France and Germany. This development has pushed yields on Eurozone government bonds to their lowest levels in history. Accordingly, there is growing concern (see our Third Quarter 2014 Commentary) about the threat of deflation in the Eurozone.

The declines in European bond yields have also contributed to declines in Canadian and U.S. 10-year bond yields. It is unlikely, however, that U.S. yields will remain at these low levels, considering that core inflation readings have not declined very much and the U.S. economy is in much better shape than Europe. Should core inflation approach the Fed's target of 2%, we would expect the Fed to begin raising interest rates gradually (while the Bank of Japan and the ECB are expected to expand their balance sheets considerably to bolster their economies). However, the Fed has considerable latitude in deciding when to begin raising rates if core inflation stays below that level.

Investment Focus

We remain constructive on equities as we head into 2015 but, given the current backdrop, we expect to see increased volatility in the coming year, especially in the first half. This is largely due to the risks to growth posed by China and the Eurozone, as well as the impact of low oil prices on energy producers.

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 should an unfavourable global economic scenario unfold. We continue to favour blue-chip defensive dividend payers and select global growth stocks. We have reduced our exposure to commodities.

In terms of fixed income, we continue to avoid government bonds in favour shorter-term investment grade corporate issues and select commercial mortgages. ▫

Key Takeaways

- Global economic growth is expected to be moderate in 2015 but with even more intense decoupling with the U.S. accelerating, China slowing, Russia moving into recession, and the Eurozone remaining sluggish.
- Declining demand and over-supply could see oil prices fall to U.S.$40 a barrel by the end of 2015 — a positive for disposable income and economic growth, but stress for producers and producer-countries.
- 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.
- Markets will be choppy in the first half of 2015. With government bond yields sinking, high quality dividend-paying stocks are still very attractive. Growth stocks, investment grade corporate bonds and commercial mortgages are also favoured in the current environment.

Genus Pooled Fund Performance

Returns are shown Gross of Fees

	Compound Annual Returns				
As at December 31, 2014	3 months	1 year	3 years	5 years	10 years
Balanced Fund	1.7	9.8	11.1	8.0	5.2
Equities					
Canadian Alpha[1]	-1.5	8.4	9.0	5.5	6.4
Dividend Equity	2.0	12.9	14.7	11.0	
Global Alpha [2]	4.5	14.2	22.1	15.4	6.3
CanGlobe Equity	1.6	11.2	15.7	9.6	
Emerging Markets	-2.6	3.6			
Fixed Income					
Short-Term Corporate Bond	0.9	3.7	3.1	3.5	4.0
Strategic Bond	2.2	9.4	5.9	6.8	
Commercial Mortgage	1.3	5.4	4.2		
Biosphere SRI					
Biosphere Dividend Equity [3]	4.7	12.8			
Biosphere CanGlobe Equity [4]	4.6	15.5			
Biosphere Corporate Bond	2.3	9.3			
Index Returns					
S&P/TSX Composite	-1.5	10.6	10.2	7.5	7.6
S&P 500 Index (C$)	8.8	23.9	25.7	17.8	7.3
MSCI Emerging Mkt (C$)	-1.0	7.0	9.0	4.2	8.4
MSCI World Index (C$)	4.8	15.0	21.2	13.0	6.2
DEX Universe Bond Index	2.7	8.8	3.7	5.4	5.3

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 **Mandate Change:** 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).

Markets post gains for 2014 despite Energy's second half collapse

Major stock markets around the world ended 2014 with positive gains. In Canada, The S&P/TSX posted a 2014 total return of 10.6%. However, most of these gains came in the first half of the year, with the S&P/TSX Composite reaching a 2014 peak on September 3 (17.1%) and subsequently declining 5.6% through year-end.

In Canada, after peaking on gains of 22% at the end of August, the Energy sector declined more than 32% to return -7.8% for the year, making it the worst performer of 2014. Consumer Staples (+46.9%) posted Canada's best returns.

Gains in the U.S. were again stronger than in Canada with the S&P 500 Index was up 13.7% (including dividends) in U.S. dollar terms for the year. This was the fourth consecutive year of annual out-performance by the S&P 500.

The 15% gain in the MSCI World Index (C$) for the year (+4.8% for the quarter) was once again the by-product of exceptional U.S. equity market returns which offset lackluster results in most other parts of the world. Emerging Markets posted a 7% return for the year after dropping 1% in the fourth quarter.

Meanwhile, expectations that bond yields would rise and hamper bond returns proved once again to be unfounded. Despite healthy economic expansion in the U.S., global uncertainty and geo-political instability, yields in most developed markets, including Canada, to move lower through the fourth quarter. ▫

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

Asset Class	Percent of Market Value
Cash Asset CAD	-1.4
Government Bond	3.9
Strategic Bond	17.9
Commercial Mortgage	13.0
Total Fixed Income	**34.8**
Canadian Alpha	**3.8**
Dividend Equity	**23.7**
Canadian Equity	*9.3*
U.S. Equity	*7.9*
International Equity	*6.5*
CanGlobe Equity	**33.3**
Canadian Equity	*12.8*
U.S. Equity	*12.4*
International Equity	*8.1*
Global Alpha	**3.9**
Canadian Equity	*0.1*
U.S. Equity	*2.7*
International Equity	*1.1*
Emerging Markets	**1.9**
Total Equity	**66.6**
Total Portfolio	**100%**
Portfolio Equity Exposure	
Total Canadian Equity	39.1
Total U.S. Equity	34.5
Total International Equity	23.5
Total Emerging Markets	2.9
Total Equity	**100%**