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Perspective



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Cautious Optimism

The Bank of Canada continues to express cautious confidence in a continued recovery for Canada, suggesting in their last policy statement that the growth in consumer spending will remain strong and business investment is likely to rise. In consequence, they raised overnight interest rates one more notch, suggesting that the slowing in economic growth since the spring has resulted largely from weakness in the U.S. recovery.

There are some burgeoning signs of labour market improvement in the U.S.

The recent volatility in financial markets is reflective of worries south of the border. As long as the U.S. jobs market stagnates at 9.6% unemployment, government bond yields will trend lower and equity rallies will be short-lived. Even in Canada, where the economic landscape has been much brighter, the economy has slowed from its raucous first-quarter pace as housing activity has weakened sharply and business investment has lagged the recovery. Net exports to the U.S. remain a drag on the Canadian economy as the U.S. slowdown continues. The American economy has been growing at less than a 2% pace since the first quarter and the stock market is flat year to date. The TSX is up modestly so far this year, but continued nervousness about European banks, sovereign debt

and very weak U.S. employment continue to be negatives for the financial and commodity sectors.

All is not bleak, however. There are some burgeoning signs of labour market improvement in the U.S.. Household employment surged in August, posting the biggest month-over-month private sector gain in a decade and it was up 3.3% (at an annual rate) over the past eight months, representing a net creation of 2.3 million jobs. Private sector layoff announcements continue to make new lows and temporary employment is growing. Average hours worked are rising, as are disposable personal income and industrial production. There are even some signs that the worst might be over in the housing market.

In addition, the emerging economies, though slowing a bit from rocketing growth earlier this year, are still quite robust, which will help push up commodity prices, benefiting the TSX and the Canadian economy. Second quarter real GDP growth readings averaged 6.5% in India, Australia, Brazil, Hong Kong and Indonesia. China remains surprisingly strong.

At this point, additional monetary and fiscal stimulus in the U.S. is likely and is warranted. This will preclude a double-dip and eventually spur confidence. Though we are forecasting continued recovery, it will be a sub-par recovery, barely above 2% growth in the U.S. through 2011. Canada's economic growth will be somewhat stronger with much healthier household, business and government balance sheets and much lower unemployment—ending next year at roughly 7.5%. The real growth prospects remain in the emerging world, which will help support manufacturing, agriculture, energy, base metals and other commodity sectors in Canada. Canadian bank stocks will continue to provide healthy dividend yields and the Canadian dollar is likely to trade somewhat higher next year, but remain in a range below parity with the U.S. dollar.

Retirement Planning: Can I get back to you on that?

A recent survey of Canadians over the age of 35, conducted for the BMO Retirement Institute, found that Canadians have a good understanding of what they should be doing to ready themselves for retirement. Almost nine in ten survey respondents felt that retirement planning should begin before age 35. Yet knowing something and acting on that knowledge are two different things: almost 40% of the non-retirees surveyed acknowledged that they have done nothing to ensure they had enough money for retirement.



This lack of action could be, in part, attributed to behavioural tendencies. People tend to place less value on a reward in the future (i.e. a comfortable retirement lifestyle) than a benefit today (i.e. current consumption), and resent a “loss” today (i.e. reduced consumption) more than they value a “gain” in the future (i.e. adequate retirement savings).

Competing priorities also represent a major obstacle to retirement planning and saving. Respondents in the 35 to 44 age group as well as people with children under 18 in the household (a group that closely overlaps with the 35 to 44 age group) were found to be the most behind on retirement planning and saving. Their energy is instead focused on debt reduction. As people wait longer to start a family, there is a corresponding concern that they may delay getting serious about planning and saving for retirement.

In light of these findings, what should you do to put your knowledge into action?

Young adults (under 35 years old)

Retirement may seem far away, but this is the best time to start benefiting from the power of compounding. The focus should be on establishing a healthy spending habit and savings discipline now.

Consider this (assuming a rate of return of 6% per annum):

- Scenario One: if at age 45 you begin saving \$200 every week in an RRSP, by age 65 your investment will grow to \$401,755.
- Scenario Two: if instead you begin early, at age 25, and save \$100 per week, by age 65 your investment will grow to \$867,354, even though the total savings amount is the same (\$208,000) as in Scenario One. In fact, even if you stop contributing at age 45, by age 65 your investment will still grow to \$644,242, notwithstanding that, the total savings amount is only \$104,000!

People in the 35 – 44 age group (especially parents with young children)

You are likely faced with competing financial priorities, so it is essential to make a conscious decision to save. The following strategies may be helpful in combating the natural tendencies to procrastinate:

- Enrol in employer pension plans and other employer sponsored savings programs.
- Set up tax-favoured investment vehicles (e.g. RRSP and TFSA) to start taking advantage of tax-deferred/tax-free compounding investment growth.
- Enrol in automatic savings programs to “pay yourself first”.

People over 45 years of age

Most likely, you are in your prime earning years, so profiting from greater financial resources will help you catch up on retirement planning and saving:

- If you belong to a defined benefit pension plan, consider whether it makes sense to buy back pension credits if the option is offered to you.
- Make full use of your tax-advantaged investment vehicles by maximizing contributions and utilizing all unused carry forward room.

As you are getting closer to retirement, you should also develop a retirement plan with quantifiable financial goals. Don't hesitate to seek professional help if necessary.

The decisions that you make today will affect your lifestyle for a period that can potentially last longer than your entire working career. Contact your BMO Nesbitt Burns Investment Advisor to start planning for your retirement today.



Changes to the Canada Pension Plan

Significant changes to CPP will start to take effect in 2011. Other than the change regarding contribution to CPP while working (item 4 below), these changes will not affect those who are already receiving or will start receiving CPP benefits before the changes come into force.

1. When calculating a person's CPP retirement pension, years with low or no earnings can be dropped out. This general low earnings dropout rate will be increased from 15% to 17% by 2014.
2. Currently, if you start receiving your CPP retirement pension before age 65, you have to either stop working or significantly reduce your earnings. This requirement will be eliminated in 2012.
3. Currently, if you start CPP before age 65, your pension is reduced by 0.5% for each month you're under 65 and increased by 0.5% for each month after age 65. In 2011, these rates will change as shown in the table below.

4. Currently, if you are collecting a CPP retirement benefit you are not required or allowed to contribute to CPP. Beginning in 2012, working CPP retirement benefit recipients who are under 65 years of age will be required to contribute to CPP (with matching employer contributions). After age 65, they may voluntarily elect to make CPP contributions (in which case the employer will also be required to contribute). These additional contributions to CPP will result in higher CPP benefits for them.

To obtain more details about these changes to the CPP and how they may affect you in the context of your overall retirement plan, contact your BMO Nesbitt Burns Investment Advisor and ask for a copy of our client article *How the New Canada Pension Plan Rules may affect you*.

	2010	2011	2012	2013	2014	2015	2016 and after
% change for each month CPP is taken before age 65	-0.5	-0.5	-0.52	-0.54	-0.56	-0.58	-0.6
% change for each month CPP is taken after age 65	+0.5	+0.57	+0.64	+0.7	+0.7	+0.7	+0.7

Portfolio Strategy

Michael H. Herring, CFA, CMT
Investment Strategist

Market Recap

Global equity markets were mixed in August, after rallying sharply in July. In August, the S&P/TSX Composite Index in Canada rose 1.7% on a price basis, while in the U.S., the S&P 500 Index fell 4.7% in price terms. Global equities, as represented by the Morgan Stanley Capital International World Index, fell 3.7% in August in U.S. dollar terms. The broad Canadian fixed income market, as represented by the DEX Universe Bond Index, rose 2.0% on a total return basis in August.



Asset Allocation

We continue to recommend that investors hold relatively high allocations to equities in their investment portfolios. We believe that equity markets are roughly at fair value and investor sentiment remains quite bearish, which is a positive for equities from a contrarian perspective.

Our recommended asset allocation for three different investor profiles (Income, Balanced and Growth) stands as follows:

	Income		Balanced		Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	10	5	5	5	5	5
Fixed Income	60	70	35	45	15	25
Equity	30	25	60	50	80	70
Canadian Equity	15	15	25	25	35	35
U.S. Equity	15	5	30	15	35	20
EAFE Equity	0	5	5	10	10	15

Investors Fretting Over the ‘D’s’ – Deflation and a Double Dip

Since the recent equity market peak in April 2010, investors have been disheartened by economic data which show the U.S. economy slowing markedly from its earlier recovery pace and stalling housing and labour markets.

This has left investors obsessed with the prospect of deflation and a double-dip recession. It is important to keep in mind that governments and central banks worldwide are doing their best to strengthen the ongoing, albeit weak, recovery.

Deflation Unlikely

The fears of incipient deflation get scant support from commodities prices, which are good leading indicators of future inflationary pressure. For example, the Reuters/CRB U.S. Spot All Commodities Index is within 1% of its 2008 all-time high and the year-over-year rate of change is solidly in double digits. Rising commodities prices also suggest stronger economic growth in coming months.

Housing prices have been a negative influence on the Consumer Price Index for much of the last three years, but in recent months housing prices have stabilized in the 20 major U.S. markets and have actually risen somewhat from their lows. Currently, investors are worried that another leg down in housing prices is in prospect. If this occurs, inflation measures would again be under pressure. But lower housing prices are not a certainty and in the context of very stimulative monetary policy and rising commodity prices, we think fears of a deflationary outcome are overblown.

Double-Dip Unlikely

As for the fear of a double-dip recession, the behaviour of sub-sectors of the broad U.S. stock market is more suggestive of continued economic growth. For example, the outperformance trend of the Consumer Discretionary and Industrial sectors relative to the S&P 500 Index remains intact, something we would not expect if the economy was tipping back into recession. Both of these sectors are highly cyclical, i.e. they tend to move in concert with trends in the broader economy. This ongoing relative strength suggests to us that fears of a double dip are misplaced.

Where do we stand?

Valuation and Prospective Returns

On our long-term gauges of equity valuation, North American equity markets are hovering between mild overvaluation and undervaluation. At present valuations, our gauges point to an average 5-year compound annual rate of total return in the range of 7–9% for the broad Canadian and U.S. equity markets. We emphasize that these expected rates of return are averages; there can be considerable variation away from these averages. If price/earnings multiples expand over the next five years, the return from equities will be higher than the average. If price/earnings multiples contract over the next five years, returns will be lower than the average suggests.

What we believe is compelling about present valuations is that, compared to alternative asset classes, equities have rarely been so cheap on a relative basis. For example, as we write, the yields on 5-year U.S. Treasury Notes and Government of Canada bonds are 1.30% and 2.10%, respectively. On the corporate debt front, the DEX Corporate Bond Index of Canadian investment-grade corporate debt had a weighted average yield to maturity of 3.50% at the end of August 2010, while a comparable measure in the U.S., the iShares iBoxx \$ Investment Grade Corporate Bond Fund ETF (ticker: LQD) had a weighted average yield to maturity of 4.02%.

Market Sentiment Is Too Negative

Individual investors are still quite negative on the prospects for equity markets, as may be seen in surveys of investor sentiment and in mutual fund sales activity.

Since late 2008, individual investors have been redeeming domestic equity mutual funds and pouring money into fixed income funds, particularly corporate bond funds. This has led to the lowest corporate bond yields in generations.

We Believe the Equity Bull Market Has Further to Run

We note above the compelling valuations for equities, both in their own right and as compared to competing asset classes. Corporate profitability and cash flow continue to improve and, with corporate bond yields at or near their lowest level in generations, corporations have tremendous flexibility to alter their capital structure to further improve profitability.

With high levels of cash on corporate balance sheets and high levels of cash flow, it would be only a matter of time before corporations initiate/increase dividends, embark on capital investments and/or engage in merger and acquisition activity. All these activities will tend to lead to higher equity prices.

This cyclical bull market has further to run because bull markets typically do not end at fair value, they end at overvaluation.

Outlook

Our basic thesis is that this cyclical bull market has further to run because bull markets typically do not end at fair value, they end at overvaluation. Similarly, bull markets do not end with sentiment readings at the levels we see at present. While he has slightly lowered his forecast for 2010 S&P/TSX Composite operating earnings, BMO Capital Markets Equity Research Portfolio Strategist, Ben Joyce, maintains his one-year price targets for the S&P/TSX Composite Index and S&P 500 Index at 12,750 and 1,275, respectively. For investors, this suggests high single-digit returns from Canadian stocks and double-digit total returns from U.S. stocks over the next 12 months.



Give Back to Your Local Community

The desire to give is strong in Canada and the ways to do so are many. Donors are looking for opportunities to learn and grow through their involvement with the charities that they support. Giving back to our communities with donations of time and/or money engages thousands of Canadians every day. In many cases it is the backbone of needed local services.

You can make initial and ongoing contributions while receiving important tax benefits.

If you like the idea of a long-term giving strategy where you can direct the annual disbursements but are unable to commit the amount of funds required to set up a

private foundation, consider the BMO Nesbitt Burns Charitable Giving Program. The partnership between BMO Financial Group and Community Foundations of Canada provides you with access to front-line expertise about the issues and organizations in your community. Community foundations work closely with the charities in your community and have a deep understanding of local priorities.

For as little as \$25,000, you can set up a donor advised fund through a local community foundation while enjoying many of the benefits of having a private foundation.

With the BMO Nesbitt Burns Charitable Giving Program, you can make initial and ongoing contributions while receiving important tax benefits. This unique, flexible solution provides a simple, efficient way for you and your family to build a lasting legacy for tomorrow – while supporting charitable causes you care about today.

Key Benefits

- You have the benefits of running your own foundation, with none of the administrative worries. Your donor advised fund can be set up quickly and all the record-keeping and tax reporting is looked after for you by the community foundation.
- Recommend grants to the areas and issues that matter most to you. You have the opportunity to focus your giving, which can be an important element of your overall financial plan.
- Involve family members in the grant making process and name a family member or another individual to succeed you as advisor for grants from your donor advised fund after your death.
- Establish a donor advised fund with a minimum initial contribution of \$25,000. Additional contributions in increments as low as \$1,000 can be made at a later date.

If you would like to learn more about how both you and the community you care about can get the most out of your donation, please contact your BMO Nesbitt Burns Investment Advisor.

Year-End Tax Planning Tips

Tax planning should be a year-long event; however, here are some last minute quick tips and reminders to help reduce income tax costs for you and your family for 2010. Be sure to consult with your tax advisor for assistance in your particular situation.

Tax Loss Selling

Review your non-registered investment portfolios to consider a sale of securities with accrued losses before the end of the year to offset capital gains realized in the year or in the three previous taxation years (if a net capital loss is created in the current year). Watch the superficial loss rules that can deny the capital loss on the sale of an investment if it is repurchased within 30 days by you, your spouse or another affiliated entity. Ask your BMO Nesbitt Burns Investment Advisor for a copy of our publication *Understanding Capital Losses* for more information on this strategy.

Dividend Income

The personal tax rates on eligible dividends were increased in 2010 and further rate increases will occur in 2011 and 2012. Ask for our publication entitled *Eligible Dividends* for further details and review your portfolio with your BMO Nesbitt Burns Investment Advisor to consider whether any changes to your investment mix are warranted.

RRSP/RRIF

If you turned 71 in 2010 and have earned income in the year which generated RRSP contribution room, before converting your RRSP into a RRIF, consider making a 2011 RRSP contribution in December 2010. The one per cent penalty tax will apply for December; however, the tax savings should exceed the penalty tax.

Charitable Donations

To realize maximum tax savings from charitable giving, make all of your charitable donations by December 31. Consider donating appreciated qualifying publicly traded securities instead of cash for enhanced tax savings. Ask for a copy of our publication *Donating Appreciated Securities* for further information on the possible tax incentives of this strategy.



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