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SPRING 2010

Perspective

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Canadian Calm in a Turbulent Sea

Canada's domestic economy has rebounded strongly from the financial crisis and global recession. And, while there are many uncertainties, the recently released fourth-quarter data show growth in Canada at a stronger-than-expected 5% annual rate, held down a bit by inventory depletion. Final sales jumped at a whopping 6.5% clip. Housing, government spending and consumer spending were all strong, with net exports chipping in a small gain as well. Business spending, however, remained weak despite a sharp quarter-over-quarter rise in corporate profitability. Still, the economy is likely to post very solid growth in the first quarter of this year as well.

As we vividly remember, 2009 ended on a far better note than it began. Overall growth for the year was -2.6%, only the third annual contraction in the past 50 years and the second deepest after 1982. The challenge for this year will be for businesses to improve their competitive position with the backdrop of a continued strong Canadian dollar. For that, we need to see investments in machinery and equipment, enhanced technology and processes that will boost our beleaguered growth in productivity. To date, Canadian business has been very cautious, as relatively low business confidence has dimmed the prospects for significant capital spending. While capex plans for this year have improved, they still remain listless, despite the strong Canadian dollar, which reduces the cost of capital equipment.

American business productivity growth has surged this cycle which, along with the greenback's weakness, has reduced the costs of production significantly south of the border. Manufacturing remains among the strongest sectors in the U.S. economy, culling strength from inventory rebuilding, the pickup in demand for business equipment, and firming foreign sales. Ironically, it is reduced inventory depletion and capital spending growth that have driven much of the fourth quarter gains in the U.S., in direct contrast to the continued contraction in capex in Canada, suggesting that there is a good deal less excess capacity than the sub-73% U.S. capacity-utilization rate would suggest. Much of the shuttered industrial space in both the U.S. and Canada is likely obsolete, but why American business is investing heavily in technology while Canadian business is not remains a mystery, especially given the relative strength of the loonie.

The U.S. economy, though growing at an upwardly revised 5.9% in the fourth quarter, appears to have hit a speed bump, as incoming data have been fraught with negative surprises. For example, the latest Conference Board consumer confidence survey plunged, existing home sales nose-dived again, new home sales fell to a record low, some house price indicators recently declined and unemployment insurance claims, a leading indicator of employment, surged – all very troubling harbingers of things to come. In addition, the level of disposable personal income was revised down for the fourth quarter and fell month-over-month in January.

Canada must tap new markets for our export products to assure greater economic stability and growth in the future. Opportunities are manifest in emerging Asia's outsized economic growth, especially in India and China, which boosts commodity prices and remains a largely untapped market for Canadian products. Growth in these economies is far more intensive in energy and industrial materials usage than in the developed world.

Despite these challenges, Canada looks like a bastion of stability and confidence when compared to Europe, the U.K. and Japan. The debt crisis in Greece and potential contagion to countries such as Portugal, Spain, Ireland and Italy have sent the euro reeling. There is likely going to be little growth in Europe this year, as Germany and France – mired by Greek debt guarantees and faltering growth – will post very meagre growth. The U.K. is also struggling with financial losses, enormous debt ratios and a stumbling recovery. Japan is scrambling to take actions to reduce government red ink without tipping the economy back into recession, mindful of its debt levels approaching nearly twice the size of the economy.

The Bottom Line: While Canada struggles with continued high unemployment and the deficit in our trade balance, most of our problems are caused by the turbulence emanating in the rest of the world. For risk-averse investors, Canada looks like one of the safest of havens ■

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Federal Budget Review 2010

On March 4, 2010, Federal Finance Minister James Flaherty released the 2010 Federal Budget which he described as a 'jobs and growth' budget. From a personal income tax perspective, the budget does not provide any broad-based tax cuts or rate hikes. Instead, it introduces some targeted measures intended to improve tax fairness and provides some relieving measures for specific taxpayers.

The most significant personal income tax measures are summarized below. Readers are cautioned to consult with their tax advisors for specific advice on how they may be affected by these proposals.

Summary of Personal Income Tax Proposals

Employee Stock Options

A taxable employment benefit equal to the difference between the fair market value of the security at the time of the exercise of a stock option and the amount paid to acquire the security is generally assessed to the employee. In many situations, the employee is entitled to a 50% deduction in this employment income inclusion.

The budget seeks to restrict the employee's 50% deduction to only those qualifying option exercises resulting in the issuance of shares – and to not allow this deduction where the employee disposes of their stock option rights for cash (unless the employer forgoes the tax deduction for the cash payment).

For options in publicly-traded companies, the employee is generally subject to tax in the year of the option exercise. However, a tax deferral election was introduced in the 2000 federal budget to allow the employee to defer the taxation of the employment benefit until the option shares acquired were subsequently sold (subject to certain limitations).

The budget proposes to further revise the taxation of employee stock options by:

(i) immediately repealing the ability of taxpayers to make this tax deferral election;

(ii) clarifying the requirement for employers to withhold and remit income tax on behalf of the employee in respect of the employment benefit associated with the issuance of a security; ***and***

(iii) providing elective relief for taxpayers who previously took advantage of the tax deferral election and experienced a subsequent decline in the value of underlying shares acquired.

Enhancements to Registered Disability Savings Plans (RDSPs)

RDSPs were introduced in 2008 to allow parents and other individuals to save and provide for a disabled child. An RDSP is a tax-deferred plan where the income grows on a tax-free basis until it is withdrawn by the disabled beneficiary. The budget proposes a number of measures to enhance RDSPs, including:

- Extending the existing RRSP/RRIF roll-over rules to allow the roll-over of the deceased individual's RRSP/RRIF proceeds to the RDSP

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of a financially dependent infirm child or grandchild. The amount of proceeds rolled over to the RDSP can not exceed the beneficiary's available RDSP contribution room which is subject to a $200,000 lifetime maximum contribution limit. The roll-over amount will be included in the beneficiary's income when withdrawn from the RDSP. This measure will be effective for deaths on or after March 4, 2010 but transitional rules may apply for earlier deaths.

- Starting in 2011, allowing a 10-year carryforward of Canada Disability Savings Grants (CDSG) and Canada Disability Savings Bonds (CDSB) entitlements.

U.S. Social Security Benefits

For Canadian residents who have been receiving US social security benefits since before 1996 (and for their spouses or common-law partners receiving survivor benefits), the budget reinstates the income inclusion rate to the pre-1996 rate of 50% (from 85%) for benefits received after 2009.

Other Measures

Reform of the Disbursement Quota for Charities

The disbursement quota requirement for a charity ensures that the charity devotes a significant portion of its resources to charitable activities. The proposals in the budget will significantly reform the calculation of the disbursement quota, including the elimination of the rule requiring charities to spend 80% of the previous year's tax receipted donations (plus other amounts) on charitable activities each year.

Foreign Investment Entities and Non-Resident Trusts

Several years ago, proposals were introduced to enhance the existing anti-avoidance tax legislation dealing with offshore investments. These "foreign investment entity" proposals remained in draft form largely because of their broad scope and complexity. The government now intends to replace these earlier detailed proposals with more modest enhancements to the existing legislation.

Similar proposed enhancements to the existing tax legislation that can potentially subject non-resident trusts to Canadian taxation were also previously introduced. In the budget, the government has revised these outstanding proposals to simplify and better target the scope of these amendments.

Tax Avoidance Transactions

The government also announced that it will release proposals aimed at improving the fairness of the Canadian tax system by requiring increased disclosure for aggressive tax planning arrangements. These proposals will be subject to further public consultation.

If you have any questions regarding these budget proposals, please consult with your tax advisor for further details ■

Portfolio Strategy

Michael H. Herring, CFA, CMT, Investment Strategist

Market Recap

North American equity markets were strong in February, while European equities were under mild pressure. This disparity may be largely explained by the fiscal crisis in Greece and the attendant uncertainty it created about the European economy and the fate of the Euro.

Asset Allocation

We continue to believe that investors should emphasize risky assets – ideally stocks – in their portfolios because government bond yields persist at low levels, North American stock markets appear reasonably valued, and important drivers of corporate profits continue to power earnings higher. Our recommended asset allocation for three different investor profiles (Income, Balanced and Growth) stands as follows: *(see chart below)*

Monetary and Fiscal Stimulus Still in Train

In broad terms, the monetary and fiscal backdrops to the economy and markets continue to be highly stimulative. On the monetary policy front, the main policy tool used by central banks – the overnight rate – is still at ultra low levels in all major economies. However, the so-called "unconventional" tools, i.e., the panoply of liquidity facilities created by the U.S. Federal Reserve ("the Fed") and the Bank of Canada are beginning to be wound down.

For example, in the U.S., the Fed in February hiked the Discount Rate, the rate at which banks borrow from the Fed, by one-quarter percent, taking the rate to 0.75 percent. Many analysts and commentators interpreted this move as a significant step towards tighter monetary policy. From our point of view the move was significant, but not for that reason. We view the move as important because it is an important step in the removal of the unconventional tools the Fed has been using in the past couple of years. As such, the hike in the discount rate tells us that the Fed has tangible evidence that markets are getting back to normal.

For its part, the Bank of Canada reiterated its conditional commitment to keep the overnight rate at its record low until the end of the second calendar quarter of 2010. It too has communicated to markets its intention to unwind the unconventional measures put in place during the crisis.

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Quite simply, the removal of these unconventional measures is happening because they are no longer required. It is not a tightening of policy to wind down programs that are not in use. The fact that they are not being used is evidence they are not needed. If they are not needed, that is evidence that normality is returning to the financial system. And that is an unmitigated positive for markets and the economy.

Where do we stand?

On our long-term gauges of equity valuation for Canada and the U.S., both equity markets are still at approximately fair value. In our experience, one key ingredient for a top in a cyclical bull market in equities is overvaluation on a price/peak earnings basis. With the equity markets typically swinging from undervalued to overvalued and back again, we believe that the equity markets have further to run before caution is warranted.

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	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	55	70	30	45	10	25
Equity	35	25	65	50	85	70
Canadian Equity	20	15	30	25	40	35
U.S. Equity	15	5	30	15	35	20
EAFE Equity	0	5	5	10	10	15

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Another key ingredient for a major market top is excessively bullish investor sentiment. There is little evidence that investor bullishness, most particularly small investor bullishness, is anywhere near an extreme.

For perspective, consider that 2009 was the best year for U.S. mutual fund sales in the history of the business, with more than US$385 billion in net inflows, and yet stock mutual funds experienced net redemptions. Instead of exhibiting performance chasing in the stock market, small investors in 2009 played it safe, plowing money into bond mutual funds, particularly into investment-grade and high-yield corporate bond mutual funds.

In the history of mutual fund data, which admittedly is not that long, the one glaring conclusion that may be drawn is that in the two prior instances where mutual fund investors on net redeemed equity mutual funds were, with hindsight, those periods when it was an excellent time to be buying, not selling, stocks. To see net redemptions of equity mutual funds in the face of one of the strongest rallies in market history suggests that it will be some time yet before small investors exhibit extreme bullishness on stocks again.

Catalysts for the next leg up

We continue to expect one of the key catalysts for the next leg up in this cyclical bull market to be increasing corporate earnings, as well as an increase in the quality of these earnings, i.e., improving top line in addition to improved profitability. As earnings reports for Q4 2009 wind up, we see clear evidence that earnings are increasing, and that the quality of earnings is improving.

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

We believe that this is setting the stage for the next leg up in the bull market, but of course we do not know when it will get underway.

In combination with the reductions in labour and non-labour costs, we believe that the low rates at which corporations are able to borrow will be a major profit driver in the future, and are supportive of further gains in equities.

Another possible catalyst is levels of cash that corporations currently have on hand. According to JP Morgan, S&P 500 companies are holding very high levels of cash on their balance sheets – approximately US$428 billion of excess compared to historical norms. In addition, S&P 500 companies generate about US$800 billion per year in free cash flow.

Eventually, this money will have to be put to work. Possible uses for the funds include capital investment, dividend initiations/increases, stock buybacks and mergers and acquisitions activity.

Outlook

Our basic thesis is that this cyclical bull market has further to run because bull markets 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. BMO Capital Markets Equity Research Portfolio Strategist Ben Joyce has set a one-year price target for the S&P/TSX Composite Index of 12,500 and raised his target to 1,200 for the S&P 500. This suggests that investors could expect total returns in 2010 of approximately 9 percent for the S&P/TSX Composite and the S&P 500 in local currency terms ■

BMO Retirement Institute Examines Working Longer

Working longer is currently top of mind with some pre-retirees – even some retired Canadians are seriously considering returning to work. If you have recently retired or retirement is on the horizon, you may be contemplating a change in plans given the recent market turmoil. A few years ago, the decision to work longer had more to do with self-fulfillment than financial preservation. Today, working longer may become a necessity for some Canadians as they try to protect their nest eggs from volatile market conditions, and many are worried about not having sufficient income from their RRSPs, CPP\QPP and OAS to afford daily living expenses.

According to a survey conducted in early 2009 by the BMO Retirement Institute, 57% of Boomers polled were either planning to or were considering delaying their retirement. The lack of confidence in knowing how much savings they will require to fund their retirement as well as the concern of outliving their capital are reasons why some Canadians might consider extending their working years. Working longer is seen as a suitable solution as it allows them a few more years to accumulate more savings and provides their portfolio time to recover. Surprisingly, over 50% of Boomers surveyed said they had not already spoken with and do not plan to speak with a financial advisor about the potential impact of their decision on their financial plan. This means some Canadians are making a decision to work longer without a clear understanding of their retirement income gap; the difference between how much is needed and how much is available from various sources including personal savings, employer and government benefits.

If you are considering working longer, here are some suggestions to keep in mind:

- **Plan and Save –** More burden of funding retirement has shifted to individuals and away from government and employers. Hence, a combination of government and company pensions, personal savings, home equity and insurance products may be necessary.
- **Healthcare –** Many future retirees have not set aside enough funds to deal with rising healthcare costs. It may be prudent to continue working to ensure continued healthcare benefits and look for employers that have a comprehensive benefits package.
- **Inflation –** Living longer creates the need to save more and comes with other financial considerations. Even a relatively low inflation rate of 3% can significantly reduce purchasing power over a 20 to 30 year period.
- **Withdrawals –** Withdrawing money during a period of declining markets can greatly reduce how long retirement savings will last. Instead, reducing withdrawals during the first few years of retirement, as a result of working longer, can significantly extend the duration of savings.

To ensure that you have not overlooked any choices or factors, you should talk to your employer to understand all of your options for working longer. With the information gathered, your Investment Advisor will help you determine the best course of action most suitable for you. Finally, it is important to keep things in perspective. Changes in the financial landscape may result in a change in priorities from consumption to savings not only for the Boomers but for other generations as well. When and if retirement must be put on hold, life doesn't have to be, making it more important than ever to have a documented retirement plan and to review it regularly ■

Take Charge of your Long-term Care

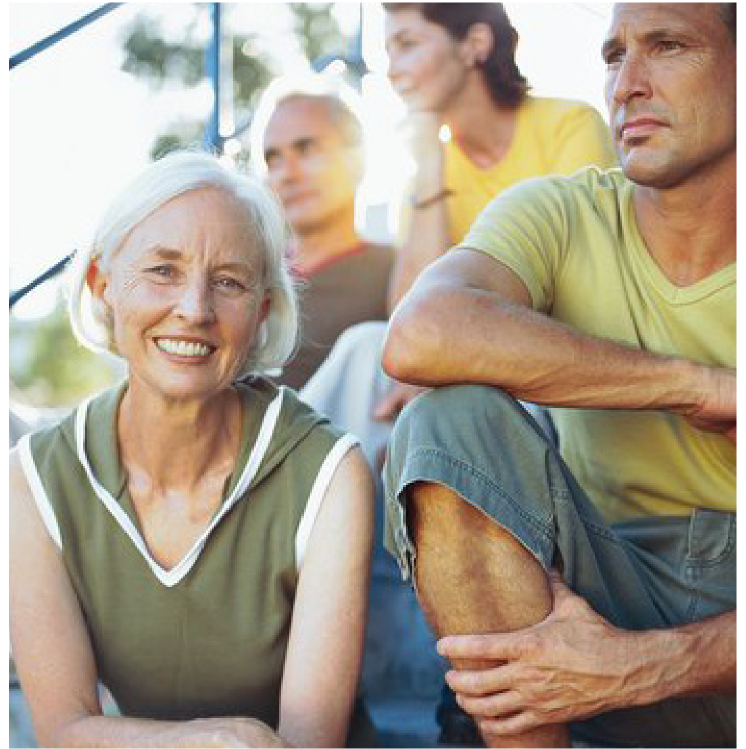
To live life on your terms regardless of how advanced your age is takes planning, and the sooner the better. Thanks to medical developments, increased knowledge about healthy living and time-saving conveniences we are living longer and more active lives. However, according to the World Health Organization (WHO), as a population we should expect to experience an extended period of ill health at some stage of our later life. At some point in time most of us will become involved in planning for our own care or that of a family member. Long-term care comes in many forms and at many price points. Which one you select may be your choice or, if left until a critical life event, somebody else.

Currently, planning for a time when assets will be needed to fund long-term care services does not appear to be an action item in the wealth management plans of Canadians. The most common reasons not to consider funding scenarios are:

- "The government will take care of me."
- "I won't be travelling or engaging in my hobbies if I need to have in-home care support or live in a nursing home."
- "I'll move in with my children."
- "It's too early – I don't want to think about it."

However, consider this: Public health care programs are limited, with increasing support for user-funded medical services. In addition, the Boomer generation could put enormous strain on government-funded programs.

The annual cost of a private assisted living facility (versus full nursing care) can range from $36,000 to $70,000, depending on the location and type of facility. Home care is more common and more expensive in Canada, ranging from $18 to $38 per hour for a caregiver. It can be like setting up a nursing home for one. The bills can quickly add up. How will that impact your retirement income plan? If you move in with your children, how will this impact their lifestyle and financial well-being? Waiting to plan may result in ineligibility for some funding strategies – like long-term care insurance.



An important first step is to meet with your Investment Advisor to explore "what if" scenarios related to allocating a portion of your portfolio to health care expenses. Once you've identified the potential impact of unforeseen events on your finances, the next step is to consider strategies to mitigate the risk. Start the conversation with your Investment Advisor to find out how to incorporate funding of long-term care costs into your wealth management plan ■

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