



PERSPECTIVES

Highlights

- ▲ Until we see more tangible signs of a sustainable economic recovery, we expect uncertainty to place a premium on caution and prudence as the global economy slowly grows stronger in 2010.
- ▲ Our analysis still shows the need for more liquidity and easier access to credit to deliver a sustained economic recovery. We are still watching for a clear long-term trend toward improved liquidity to emerge in the broader monetary system.
- ▲ The continuing market rally is welcome news, but prudence demands we resist the urge to chase returns as 2010 unfolds.
- ▲ We encourage investors to work with their advisors to get objective advice, and focus on portfolio rebalancing to ensure your current mix of investments matches your long-term strategic asset mix.

Markets build on impressive gains, but uncertainty remains the watchword for economic outlook

Housing, consumers, banks and credit still critical to sustainability of recovery

As the year opened, we saw global markets continue to build on the impressive gains of 2009. Equity markets have been climbing almost uninterrupted for a year. The first quarter of 2010 was the strongest first quarter posted by the Standard & Poor's (S&P) 500 Index since the first quarter of 1998. The index was 6% higher in U.S. dollar terms and up 2.2% in Canadian dollars. The S&P/Toronto Stock Exchange Index gained 3% in the three months ending March 31 and, over the past 12 months, it climbed 42.2%. The MSCI World Index finished just inside positive territory in the first quarter, after gaining 23.5% over the past 12 months.*

These gains have investors wondering whether the unfolding market rally is sustainable, as uncertainty persists. The debt crisis in Greece rattled markets, as it threatened to spill over into global financial markets until a bailout package was agreed upon by Germany and France in late March. Europe remains at risk of limited economic growth if it cannot get its fiscal house in order. Similar debt woes threaten Portugal, Italy, Ireland and Spain.



There were, however, positive signs that equities might continue to draw strength from an improving global economy. Oil prices continued to rise in the wake of increasing economic demand. At the end of the quarter, oil was trading around US\$82 per barrel. Higher oil prices helped push Canada's resource-heavy stock market higher; they also added some strength to the dollar, which was trading close to par with the U.S. dollar at quarter-end.

* MSCI World and MSCI Emerging Markets figures are stated in Canadian dollars (source: MSCI Barra website). TSX Composite figures are stated in Canadian dollars (source: DEX).

In January, Canada's gross domestic product (GDP) grew at the fastest rate in three years. The economy's strength is more widespread than many analysts had predicted. Recent gains likely indicate that the recovery has powered ahead, fuelled by government stimulus spending and record low interest rates.

This was good news for Canadians, but the U.S. economic picture, while also improving, remains less upbeat. Fourth quarter GDP growth was revised to 5.6%, downward slightly from earlier estimates. Year over year, real GDP growth stayed in positive territory, gaining 0.1%, after a drop of 2.6% in the third quarter. Inflation was still barely noticeable, with the core Consumer Price Index up 1.3% year over year in February.

Canada's stronger performance relative to the United States was also seen in a series of mortgage rate hikes by five of Canada's banks during the last week of March. Fixed-rate mortgages follow government bond yields, which began trending upward in February. Bond traders expect the Bank of Canada to either raise rates sooner than the often cited date of July 20, 2010 or be more aggressive in raising them.

More sluggish growth in the United States will likely mean that the U.S. Federal Reserve will delay raising interest rates for some time. But, at the beginning of April, the release of the Fed's March 16 meeting minutes showed that officials do not believe their pledge to keep interest rates

low for an "extended period" can be translated into a six-month time frame, which is how many analysts had interpreted the pledge. Fed officials said that the state of the economy ("not any fixed amount of calendar time") would determine when rates will rise. And, while higher interest rates are not typically welcomed by investors, their arrival would be a strong signal that the U.S. economy is moving toward a more sustainable footing.

Another piece of good, but perhaps not entirely welcome, news was the Fed's decision to follow through on its plans to end some of the stimulus measures that had been introduced to boost the economy and combat the financial crisis. For example, on April 1, the Fed's program to purchase mortgage-backed securities ended. These purchases had been part of the program of quantitative easing, designed to increase the money supply through alternative means.

One of the most obvious signs that the U.S. economy is finally back on track will come from jobs data. The worryingly high unemployment rate remained unchanged at 9.7% in February, in line with market expectations. But, according to more comprehensive measures that include people who have given up looking for work, unemployment is running close to 17%. In comparison, during the Great Depression, this rate hit 24%. Still, while jobs data moves markets, it is a lagging economic indicator. By the time unemployment drops to levels associated with an expanding economy, the expansion is well under way.

If employment on its own can't tell us when the recovery is shifting to a sustainable path, where should investors look? Of course, no one can predict the future direction of the U.S. economy, but we can be sure that the current bull market in stocks will not continue without a strong economy



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to support it. To determine where sustained economic growth will come from, we continue to focus on four key areas: the U.S. housing market, U.S. consumers, the U.S. banking system and global credit markets.

The U.S. housing market

The U.S. mortgage crisis was at the centre of the financial meltdown, and homes remain the most important asset for the vast majority of U.S. consumers. This is why U.S. housing holds the key to any emerging economic recovery. Until housing prices recover, consumers will be wary about spending.

Significant numbers of U.S. homeowners still have negative equity in their homes, which means their mortgages are higher than the market value of their homes. A full economic recovery is likely impossible until we see a significant reversal in this level of negative equity.

Another important gauge of the health of the U.S. housing market is the S&P/Case-Shiller home price indexes. Although Case-Shiller's adjusted reading for its composite 20 index of major metro areas showed a 0.3% gain in January—the eighth straight monthly increase—the index was still down 0.7% from a year earlier. This was the smallest annual decrease in three years, and could mean housing prices are beginning to stabilize.

When prices begin to appreciate year over year, homeowners should start to feel more confident about spending, which will help to stimulate the economy. For now it is too early to point to a clear, sustained growth trend in the housing market.

U.S. consumers

U.S. consumers remain the world's most important economic engine. Their spending drives about 20% of the global economy; the more



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confident consumers feel about the economy, the more likely they are to spend. The Reuters/University of Michigan Consumer Sentiment Index climbed above 73 in March. Any reading above 50 indicates a positive level of consumer confidence. But as recently as November 2006, the index was at 97, so today's level shows that consumer confidence still has room to improve.

Employment worries and household debt are perhaps the biggest drags on consumer confidence and spending. The Conference Board reports that consumers continue to express concerns about current business and labour markets. On balance, our analysis suggests continued downward pressure on consumer confidence but that the overall mood is showing the potential to improve slowly.

The U.S. banking system

We are seeing improving profits and relative stability in the top 19 U.S. banks, which account for about 65% of all U.S. banking assets. But smaller regional banks, which often play a central role in local economies, are still struggling. The volume of bank

lending, a key measure of a bank's health, remains depressed, especially among smaller banks.

Banks also face an uncertain and likely much stricter regulatory environment. One concept to watch for from U.S. lawmakers is a move to impose some sort of contingent capital arrangement on banks. This could help governments avoid having to bail banks out because they are too big to fail. Contingent capital would compel banks to convert debt instruments, like bonds, into shares in the bank in an emergency. This would make it much easier for banks to increase capital holdings when capital markets are frozen, like they were during the recent financial crisis.

Government officials believe that if debt-holders face the possibility that their bonds could be converted into equity, it could force more market discipline on big banks. Some regulators, however, fear that contingent capital could harm good banks because it has to be issued at a premium to offset the cost of converting it from fixed income. This, in turn, could unnecessarily reduce the

profitability of sound banks. Whether or not contingent capital becomes accepted policy, it illustrates the very real state of flux the U.S. banking system finds itself in. Until a clearer regulatory environment emerges, U.S. banks will be prevented from properly playing the central role the wider economy needs them to play.

Global credit markets

Global credit markets must play a central role in any sustained economic recovery. Without consistent and affordable access to credit, businesses cannot expand and drive economic growth.

Fortunately, global credit markets continue to loosen after grinding to a halt in response to the financial crisis. During the first quarter, the difference (spread) between essentially risk-free debt instruments like U.S. Treasury bonds and the three-month London interbank offered rate (LIBOR)—a key measure of risk in the credit markets—remained at normal levels. The lower the spread, the lower the risk perception associated with extending credit. Lending is still not happening,

though, at the rate it needs to for the global economy to produce sustained growth. The broader market still needs better access to credit if the economy is to return to a sustainable growth path.

Our analysis still shows the need for more liquidity and easier access to credit to deliver a sustained economic recovery. We are still watching for a clear long-term trend toward improved liquidity to emerge in the broader monetary system.

Gloom slowly lifts, but uncertainty will continue to plague markets in 2010

The continuing market rally is welcome news, but prudence demands that we resist the urge to chase returns as 2010 unfolds. Still, it is important to emphasize that our prudence is not a synonym for complacency. We continue to require our investment managers to adhere to a rigorous due diligence process to ensure that their interests and yours are in sync.

We also continue to encourage you to work closely with your MD advisor. Together, you can focus on your

portfolio's purpose, and rebalance it so that your current mix of investments matches your long-term strategic asset mix. Your advisor can give you the objective advice you need to avoid common investing pitfalls, like succumbing to recency bias (assuming that the past will define the future) or confirmation bias (acting on information that fits a predetermined view of events).

We are pleased that the recession is over, but we must continue to moderate our expectations until more tangible signs of a sustainable economic recovery emerge. Until then, we expect uncertainty to place a premium on caution and prudence as the global economy slowly grows stronger in 2010.

Now is an ideal time to revisit your long-term financial plan and ensure that you are up to date with the appropriate strategic asset mix. To make sure you are in the best position to keep your financial future on track in the face of economic uncertainties, talk with your MD advisor, or call MD at 1 800 267-2332 to be put in touch with an MD advisor near you. ▲

Rising interest rates... do you need to worry about your bond portfolio?

Continued recovery in our Canadian economy in recent months has sparked debate over the potential of higher inflation and possible interest rate hikes. With short-term interest rate increases on the horizon, you may be worried about the potential negative impact to your existing fixed-income portfolio.

For investors, the fear is that a rise in interest rates by the Bank of Canada will result in rising bond yields and falling bond prices—resulting in a negative impact on an investor's total return.

The relationship between inflation and interest rates

Inflation refers to a general increase in the price of goods and services, or an increase in the average level of prices over time. The Bank of Canada plays a key role in inflation control; the Bank's

inflation-control system is, in fact, the cornerstone of its monetary policy, with a goal of keeping the inflation rate near an annual rate of 2%. Low, and predictable, inflation is the best way to maintain a productive, stable economy and encourage consumer spending. When economic growth is strong, there will be pressure for higher inflation. For example, when unemployment is low, additional demand for labour will tend to push up the growth in wages.

Interest rates are used to keep economic growth in line. Lower interest rates encourage borrowing, and tend to enhance economic growth. Higher rates

increase the cost of borrowing for consumers, businesses and governments, encourage saving, and tend to slow economic growth.

Over the past 15 years, the Bank of Canada has maintained inflation within its target range, resulting in a level of comfort regarding the volatility of interest rates. The general consensus today is that, unless the pace of economic growth stalls, rates will

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gradually drift upward. Both the federal government and the Bank of Canada continue to monitor economic growth and the potential for inflation. The Bank of Canada will take a cautious approach to raising rates, however, and will do so only as it sees the economy able to withstand them.

How might rising interest rates affect your existing bond portfolio?

When interest rates go up, the price of a bond portfolio will drop, but the income paid by the bonds will continue to benefit the portfolio. Coupon rates for most bonds are fixed when the bonds are issued, so when rates rise and new bonds with higher coupon rates become available, investors will pay less for existing bonds with lower coupon rates. In other words, the value of existing bonds declines, and their yields compete with new fixed-income offerings.

A look at the yield curve offers an interesting reference point for forecasting interest rates and economic activity. The yield curve depicts the relationship between short- and long-term interest rates using a graph that plots the yield of bonds of the same class with differing maturities. We are currently in a situation that is typical for a recession recovery: the yield curve is very steep and short-term rates are extremely low. While many investors may think the solution is to try to time the market and go into short-term fixed-income investments, this is the point where we may in fact see the most volatility, as interest rates may not go up evenly along the yield curve.

Our approach to bond investing

A managed approach to bond investing, as offered through MD's bond funds, enables investors to maintain a long-term approach and takes away the worry of trying to time the markets. Our fixed-income portfolio managers monitor a variety of economic, financial and environmental variables, and make changes to portfolio strategies accordingly. For example, given the significant monetary easing that has been brought to the market, Howson Tattersall Investment Counsel, managers of the MD Bond Fund and MD Bond & Mortgage Fund, has been cautiously and selectively taking advantage of opportunities and historically low prices to increase the portfolio's weight in high-quality corporate bonds.

The portfolio managers also monitor the yield curve—they expect to see the yield curve flatten in the near future as a result of a more substantial rise in shorter-term rates. A flat curve

means there is very little difference between short- and long-term bond yields.

As a result, the portfolio managers have begun repositioning MD fixed-income securities using a 'barbell' strategy. A barbell strategy involves investing similar amounts of money in both short- and long-term maturities, with less invested in mid-term maturities. Just as investors are advised not to place all their money in a single investment, a barbell strategy avoids placing the entire portfolio in a single maturity. This strategy enables one end of the barbell to capture more attractive long-term rates, while the other end provides the flexibility that shorter-term investments provide.

Maintain a long-term approach

When it comes to concern over rising interest rates, we believe investors can benefit from a rising rate environment by taking a long-term investment approach, and thinking about their fixed-income exposure as part of a diversified asset allocation strategy. Upcoming interest rate increases by the Bank of Canada will likely occur gradually, and should not result in negative bond returns for extended periods. Over shorter periods, bond prices may experience declines, but we anticipate that these declines will be short-lived, and income will continue to flow to investors in those bonds.

To learn more about the effects of interest rates on your bond portfolio, or on any of your debt repayment strategies, speak with an MD advisor today. ▲

Maximizing tax efficiency with eligible dividends

If you've chosen to set up a professional corporation, ensuring that its investment strategy maximizes the potential for asset growth and income generation for retirement is crucial. An investment strategy that includes dividend-producing investments may be beneficial.

Several years ago the federal government introduced the concept of eligible dividends—a significant tax policy change that can benefit incorporated physicians. One advantage is that Canadian dividends (including eligible dividends) received by a professional corporation are more favourably taxed than interest income; another is that eligible dividends can provide a tax advantage over realized capital gains (once taxable dividend distributions are made from the corporation to shareholders). An investment strategy that includes dividend-producing investments can also provide a consistent and reliable source of income, combined with the potential for capital appreciation.

The content of this article is presented for information purposes only, and is not intended to offer taxation or legal advice. A tax advisor should be consulted for purposes of determining any corporate and personal tax liabilities.



Dividend-producing investment solutions

The MD Dividend Fund and the MD Income & Growth Fund are two ideal dividend-producing investment solutions, each strategically managed to provide investors with exposure to high-quality, dividend-producing Canadian equities. Clients benefit from tax-efficient dividend income, as well as the potential for asset appreciation. The end result is increased after-tax income compared with fixed-income securities.

An MD advisor can help you develop a comprehensive investment strategy for your professional corporation that includes eligible dividends, if appropriate, to meet your financial goals, as well as your (and/or your corporation's shareholders') tax-efficiency needs. ▲

Need more information?

At MD, we're committed to helping physicians and their families realize the full benefits of careful planning, personalized advice and tailored financial solutions. You can find out more about eligible dividends by visiting our website and listening to our podcast. The podcast goes into more detail about the benefits of holding eligible dividends in a professional corporation's investment strategy.

Talk with an MD advisor today to learn more about effective strategies to make the most of the income produced by your professional corporation.

Contact your MD advisor today.
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