

APRIL 2011

MD Perspectives

Markets rise as investors shrug off geopolitical and economic news

U.S. consumers, policy-makers and international trade hold the key to further gains

The first quarter of 2011 was one of the best starts to a year since the late 1990s bull market. This performance was all the more remarkable given the raft of unsettling geopolitical news from the Middle East and North Africa, a nuclear disaster in Japan, continued U.S. housing woes and looming government debt defaults in Europe.

The Standard & Poor's (S&P)/Toronto Stock Exchange (TSX) Composite Index gained 5.6% in the first quarter, and was up 20.4% for the 12 months ending March 31, 2011. By the end of the quarter, the S&P/TSX had surged more than 80% from the lows hit in March 2009 after the financial crisis erupted. The broader Canadian bond market was 0.2% lower in the first quarter, but it posted a 5.1% gain in the 12 months ended March 31, 2011.

The S&P 500 Index was 5.9% higher in U.S. dollar terms and up 3.4% in Canadian dollars in the first quarter. The MSCI World Index finished 4.9% higher in the first quarter in local currency terms and up 2.5% in Canadian dollars. The MSCI Europe, Australasia and Far East (EAFE) Index was up 3.4% in local currency terms and up 1% in Canadian dollars in the first quarter.

The global economy is increasingly showing signs of recovery from the deepest financial crisis since the Great Depression. As the recovery gathered pace, global demand for commodities like oil continued to grow and inflate prices. Oil pushed through the US\$110 per barrel mark in early April. The Thomson Reuters/Jefferies CRB Index, which tracks 19 commodities, gained almost 60% in the two years ending March 31, 2011. The Canadian dollar followed oil and other commodities higher. It spent the quarter at or above par with the U.S. dollar and traded at US\$1.03 at quarter-end.

The surging loonie continues to put manufacturers at a disadvantage. And while the commodities boom is adding to revenues in Alberta and Saskatchewan, it could lead to higher prices for consumers across the country. The Bank of Canada has expressed concern about the dollar's strength. The Bank's April Monetary Report Summary says the persistent strength of the Canadian dollar could create even greater headwinds for the Canadian economy.

Overall, however, the Bank is confident that the global

economic recovery is "becoming more firmly entrenched," which is good news for Canada's export-oriented economy. Canada's gross domestic product (GDP) growth was stronger than anticipated, growing at an annualized 3.3% in the fourth quarter of 2010. The Bank forecasts that the Canadian economy will expand by 2.9% in 2011 and 2.6% in 2012.

In our view, whether the Bank of Canada's forecasts ring true will depend on three factors: U.S. consumers, policy-makers and international trade. Together, they hold the key to the next phase of global economic growth.



Highlights

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U.S. consumers: Debt is decreasing and confidence is ticking upward

Even with the rise of emerging economies like China, Brazil and India, U.S. consumers remain the world's most important economic players. U.S. consumer spending accounts for about 70% of U.S. GDP, and this spending in turn accounts for about 20% of global GDP. Without a sustained rebound in demand from U.S. consumers, the global economy cannot continue to expand.

There have been some positive developments on the U.S. consumer front. Consumers continue to reduce debt, which is a positive sign and should help support more sustainable economic growth over the longer term. But, in the shorter term, debt reduction could mean lower consumer spending. For now, consumer spending data suggest good news for economic growth. Retail sales were up a robust 1% for the month in March, and have increased eight months in a row.

While retail sales show growing consumer confidence, when asked directly, consumers also expressed optimism. In early April, confidence among U.S. consumers rose for a third straight week. The progress was attributed to modest gains in the job market, which is improving Americans' outlook on their finances and the economy. The Thomson Reuters/University of Michigan Consumer Sentiment Index climbed in April to 69.6 from a 16-month low. March's 67.5 reading was the lowest since November 2009. The April index was forecast to rise to 68.8, according to economists surveyed by Bloomberg News. Unemployment and sliding home prices, however, still have the potential to undermine consumer confidence.

The job market is showing signs of strengthening, which may help sustain gains in consumer spending. Unemployment has fallen for four consecutive months. This supports the view of U.S. Federal Reserve policy-makers that the job market is

showing signs of healing. But the pace of employment gains is still anemic, and overall unemployment remained stubbornly high, at 8.8% in March.

The real estate market is another source of angst for U.S. consumers. Residential real estate prices dropped in January by the most in more than a year, raising the risk that U.S. home sales will keep slowing. The S&P/Case-Shiller index of property values in 20 cities fell 3.1%



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from January 2010, the biggest year-over-year decrease since December 2009. Foreclosures continued to add to the supply of houses on the market, something that will likely keep downward pressure on prices. Equity in homes represents a significant component of net worth; a drop in home prices reduces consumer confidence about current spending.

On balance, while significant challenges remain for U.S. consumers, we expect them to continue to gain confidence in the future. As their confidence increases, U.S. consumers will play a growing role in sustaining the unfolding global economic recovery.

Policy-makers: Low interest rates and other stimulus measures bode well

Policy-makers continue to support the economic recovery with historically low interest rates, as well as unconventional monetary and fiscal stimulus.

Central bankers in developed markets are almost uniformly committed to keeping interest rates low. The Bank of Canada has kept the overnight rate on hold at 1% in its last five rate announcements. The U.S. federal funds rate is being maintained between 0% and 0.25%. The European Central Bank raised overnight rates by 0.25 percentage points on April 7, 2011, but the rate is still historically low at 1.25%. These low interest rates should continue to support markets and economic growth this year.

There are concerns, however, that emerging market countries will continue to tighten monetary policy to combat inflation. Emerging markets have been key drivers of global economic growth and the accompanying rise in commodity prices. If higher interest rates and other monetary tightening stifle growth, it could have a knock-on effect in the wider global economy.

Interest rates are not the only tool at policy-makers' disposal. Unconventional monetary and fiscal stimulus continued to prove its worth in the first quarter. The most powerful example is a U.S. Federal Reserve (Fed) program dubbed "QE2" by traders. The Fed's November 3, 2010 decision to buy \$600 billion of Treasury securities through June 2011 became known as "quantitative easing 2" because it followed \$1.7 trillion of asset purchases that ended in March 2010.

A mid-March report from Bloomberg made the case for QE2's positive impact on the global economy by citing the following facts:

- ▶ The S&P 500 Index of stocks has climbed 18% since August 27, 2010, when the Fed announced that additional asset purchases might be warranted.
- ▶ The risk premium on high-yield, high-risk bonds has narrowed to 5.16 percentage points from 6.81 percentage points.
- ▶ The U.S. unemployment rate has fallen to its lowest level in almost two years.

Other notable examples of policy-makers using unconventional means to support the global economy come from Europe. The European Union and the International Monetary Fund have bailed out Greece and Ireland to help them avoid defaulting on their bonds, which in turn would have set off a wave of global financial instability. In the first quarter, Portugal was added to the list of potentially insolvent countries in need of a bailout.

Although these monetary and fiscal measures are supporting global growth, they come with a cost. The gridlock in the first quarter in the U.S. House of Representatives over government debt

shows that deficits are becoming an increasingly tense political topic as policy-makers attempt to strike a balance between the stability of economic growth and the long-term impacts of unconventional stimulus measures and increasing fiscal deficits.

We see these efforts to acknowledge the threat that mounting government debts pose as a positive first step in a long process to put government policies on a more sustainable footing. Meanwhile, the willingness of policy-makers to continue to support global growth should help to keep the economic recovery on track.

International trade: Return to pre-crisis levels shows global economy returning to health

In February, data releases were showing that international trade volumes had returned to levels not seen since before the financial crisis. The CPB Netherlands Bureau for Economic Policy Analysis reported that global trade expanded by a record 15.1% in 2010. Markets hailed the data as more evidence of a buoyant global economy, with the full-year expansion in trade more than compensating for the 13% decline in 2009 in the wake of the financial crisis. The 2010 and 2009 figures were, respectively, the biggest expansion and contraction since the institute started compiling the data in 1991.

Still, the gains were uneven, with trade expanding the most in the emerging markets of Latin America and Asia. Growth in imports and exports in the United States was close to the world average, but growth in the euro area lagged considerably.

Canada had a \$9-billion merchandise trade deficit last year, nearly double what it was in 2009, as the value of imports rose faster than exports to other countries, Statistics Canada reported in early April. Exports from Canada to all countries rose 9.5% in 2010 to \$404.6 billion, while imports rose 10.6% to \$413.6 billion. The U.S. share of Canada's merchandise trade fell in 2010, although it still accounted for 62.5% of Canada's total merchandise trade, down from 76.3% in 2001. The United Kingdom and China were the second and third most important destinations for Canadian exports.

The rapid growth in both GDP and exports in emerging economies has expanded on significant trade imbalances, which will likely remain a key point of contention among world leaders. We do see resurgent global trade as another important sign of the sustainability of the ongoing global economic recovery.

Cautious optimism remains justified

We are maintaining our cautiously optimistic stance as the global economic recovery strengthens. We continue to encourage you to work closely with your MD advisor to focus on your portfolio's purpose and time horizon, with a view to rebalancing, so that your current mix of investments matches your long-term strategic asset mix.

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're in the best position to keep your financial future on track in the face of emerging economic opportunities, talk with your MD advisor, or call MD at 1 800 267-2332 to be put in touch with an MD advisor near you. ■

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Emerging markets taking centre stage

Today's globalized world is continuing to witness a remarkable shift in leadership as advanced economies are becoming less dominant in the global economy, and emerging markets play a more significant role. The term 'emerging markets' was first introduced by World Bank economist Antoine van Agtmael in the 1980s in reference to nations undergoing rapid economic growth and industrialization. In other words, emerging markets are those countries that are considered to be in a transitional phase between developing and developed status. According to the World Bank, the five largest emerging markets are China, India, Indonesia, Brazil and Russia.

As evidence of the increasing strength of emerging economies, in many cases, these economies have weathered the global financial crisis better than advanced economies. Growth rates have recovered quickly and, as a group, emerging economies are projected to record strong growth over the next few years.

Consider the facts. From 1960-1985, advanced economies made up about three-quarters of global GDP. Since that time, this share has declined steadily; by 2008-2009, it was down to 57%. Contrast that with emerging markets, whose share grew from approximately 17% in the 1960s to an average of 31% in the mid-1980s. By 2008-2009, it was roughly 40%. Given demographic trends, according to the International Monetary Fund, the emerging world's share of global GDP is forecast to grow to 51% by 2014.¹

Growth in emerging economies is being driven by several factors:

- ▶ **Globalization.** Globalization is a broad term that describes the integration of economies through society, politics, ideas, goods and services and information and technology. While the benefits of globalization are clear—

increased trade and competition leading to lower prices, greater efficiency and stronger economic growth—this growth can come at a cost, increasing the gap between the rich and the poor. Economic growth can result in improved living standards, but it's how this growth is distributed throughout the population that determines the sustainability of development.

- ▶ **Innovation.** Many emerging markets are becoming more innovative, as they move from being primarily sources of cheap labour to becoming business innovation leaders. Consider China, for example. The country's rapid economic growth in recent years has been driven mainly by exports—in 2008, the total value of China's exports made up 32% of the country's GDP. Because the Chinese economy is export-driven, the economy is vulnerable to external shocks like the recent U.S. sub-prime credit crisis and recession, which resulted in less demand for Chinese-made products. As a result, over the past few years, spending on research and development, as well as an increase in domestic patents, have both exploded, as China works hard to transform its economy into one that is more productive.

- ▶ **Rural-to-urban migration.** As economic growth continues as an overall result of innovation, emerging markets are beginning to see a rural-to-urban migration, driven by job possibilities in urban areas. As this rural-to-urban population attains better employment and higher incomes, they are becoming a strong consumer market, with unique needs and preferences. Most Western economies saw a similar migration in the 20th century. This shift is also creating potential social problems, however, given the widening wealth disparity between urban and rural populations.

- ▶ **Population demographics.** The world population is projected to increase by three billion—to about nine billion by 2050—according to the United Nations. The majority of this increase will take place in developing countries, where the population is increasing more than five times faster than in developed countries. China and India, the only two countries in the world with a population greater than one billion, already comprise more than one-third of the world's population. The implications of this population growth on the global economy are significant. Emerging countries like



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¹ The International Monetary Fund. December 2010.

China and India, with a younger demographic, have the advantage of a cheaper labour pool and can use this advantage to ultimately become economically stronger. Developed countries, with an older demographic (like Canada, the United States and many European countries), will see diminished population growth and have fewer human resources available to contribute to stronger economic growth. These economies will rely on efficiencies and the services component of gross domestic product (GDP).

What does this mean for Canada's economy?

In Canada, as is the case with many established economies, we are faced with certain unavoidable facts. Our workforce is aging, and we're seeing a declining growth rate in our labour force. According to information released by Statistics Canada in 2010, by 2036, the number of seniors is projected to reach between 9.9 million and 10.9 million. These figures are more than double the level of

4.7 million in 2009. As the marketplace continues to become more globalized, we must compete against faster-growing emerging economies. As a result, becoming more competitive and increasing our productivity are crucial in contributing to future economic growth. The Bank of Canada (BoC) recognizes that business investment has been weak in recent months due to recent global uncertainties, and this in turn risks holding back economic activity in Canada. The BoC will be closely monitoring the unwinding of the second round of quantitative easing in the United States, and its effect on global markets over the shorter and long term. Business investment and net exports need to play a stronger role in the near future to ensure that our economy continues to grow.

Our view is that the global recovery is likely to be characterized by low growth rates for an extended period of time. Central banks and policy-makers will need to act in a prudent manner to promote economic growth without inducing inflation.

What does this mean for your investment portfolio?

While Canadian investments have outperformed recently, it's important to remember that Canada accounts for about three percent of the world's stock markets. Expanding your investment horizon means taking advantage of sectors like health care, industrials and information technology, which are under-represented in Canadian stock markets, and expanding your opportunity to find the most compelling investment ideas available.

When you invest with MD, you're benefiting from the knowledge of proven experts—both within MD and from among the world-class investment companies we've selected to provide valuable investment insight. We actively manage geographic exposures and asset classes across portfolios. In turn, our fund managers in the underlying funds/pools actively manage the securities in fund portfolios to benefit from short- and long-term growth trends. ■



Is incorporation right for you?

Get all the facts at md.cma.ca

Choosing whether or not to incorporate may be one of the more important decisions you make in your professional career. Considering the advantages incorporation may offer, you owe it to yourself to carefully explore this option. However, given the complexities involved, objective professional advice is equally invaluable.

Why incorporate?

In essence, a corporation “owns” your medical practice—and you become a shareholder, director and employee. The corporation is a separate legal entity from you, and it is regulated by the provinces and the provincial medical colleges. The two biggest potential advantages of incorporation are the opportunities to defer taxes and split income with family members.

Maximizing the benefits of a corporation

Even if you’re already incorporated, you may not be aware of various options to get more from your corporation, through estate planning, corporate-owned life insurance, retirement planning and optimal asset allocation. You truly need a board of advisors who can help you maximize every opportunity. No one knows medical practice incorporation better than MD.

Incorporation website—everything you need to be informed

Not sure if incorporation is right for you? Find out about all the benefits by exploring MD’s incorporation website at md.cma.ca. If you’ve already incorporated your practice, the site offers advice about how to realize even greater benefit from your incorporated medical practice. The



site features informative videos that take a closer look at the benefits of incorporation, explain the power of deferring taxes and offer ways to reduce your household tax bill.

Our knowledgeable experts

MD has the in-house expertise and tools to help guide you through this all-important decision. Our 250-plus trained incorporation experts provide

advice to more than 40,000 physicians with billions of dollars in corporate assets, and we’ve been doing it since 1976. Asking your MD advisor for the right advice up front could save you thousands of dollars on legal and tax advisors—and many hours of time—later on. ■

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