Scotiabank
investmentinsights
Dedicated to helping you get ahead financially.
Summer 2010

What interest rates mean to the economy and your investments

A recovery to invest in. It's been just over a year since the market lows of early March 2009. Most markets have experienced gains since then, rewarding investors who maintained a balanced and disciplined investment strategy.

You can still position your portfolio to benefit from the recovery that's happening right now despite the interest rate uncertainty associated with the current environment.

Interest rates primer—the economic story

Monetary policy — or setting interest rates — is a main function of a country's central bank. By raising or lowering short term interest rates, or the cost of money, the Bank of Canada can affect the amount spent and borrowed by businesses and consumers.

During the economic downturn, interest rates fell to stimulate borrowing and in turn our economy. Now that a recovery is underway, interest rates may start to rise again — to prevent inflation.

The Bank of Canada recently raised its policy rate a quarter point, to 0.5 percent. Canada was the first of the G7 nations to raise interest rates.

So what does this mean to you as an investor?

continued inside >

Interest rates and your investments *(continued)*

As a consumer, higher interest rates influence mortgages, home equity loans, credit cards and other borrowing. As an investor, the impact of higher interest rates really depends on what types of investments you own. Here's a look at how a rising interest rates can affect different investments.

1 Cash

Includes high interest savings accounts, GICs, and cash or cash-based investments — How could a rising interest rate environment impact me?

High interest saving accounts are popular now. They offer the ultimate access and flexibility for investments, without incurring any penalties for withdrawals.

Rates on these accounts typically fluctuate in tandem with the interest rate environment, so if interest rates do rise, accounts like high interest savings may too. This could mean an immediate, positive impact on your investment portfolio.

2 Term Deposits

Includes deposit accounts like Term GICs — How could a rising interest rate environment impact me?

Having a plan, like a GIC laddering strategy, takes the guesswork out of trying to pick the best time to invest, or the best term. In a rising rate environment, you'll benefit from the lift in rates, as maturing investments come up for reinvestment.

3 Equities

Includes equity mutual fund investments — How could a rising interest rate environment impact me?

Rising interest rates (often a precursor to higher inflation) mean higher borrowing costs, which could impact your ability to spend. It's difficult to predict if higher rates will be a positive or negative for equities, as the impact may be company specific. The safest strategy is to hold a diversified portfolio of quality companies, across a variety of sectors and industries, over the long-term.

4 Fixed Income

Includes bonds and bond funds — How could a rising interest rate environment impact me?

Unlike the case for equities, the impact of interest rate increases on bonds is relatively straightforward — as rates rise, bond prices typically fall.

When interest rates rise, newly issued bonds typically offer higher yields to keep pace, while existing bonds with lower interest rates are less attractive, reflected in lower prices. If you plan to hold a bond until maturity, it's reassuring that you'll continue to receive regular income payments and the face value of the bond in this environment.

The bottom line

While rising interest rates could have an impact on whatever your portfolio looks like, it's likely temporary. A balanced portfolio that has exposure to cash, term deposits, bond and equity mutual funds, provides the opportunity to participate in the growth of each, while managing risk.

For further expert guidance through the rising interest rate environment, visit **scotiabank.com/helpmeinvest** or speak with your *Scotia*® advisor to discover the options available to you.

Encouraging retirement savings

The federal and provincial governments are in the process of taking a close look at our entire system of retirement savings to see if there are ways it can be improved.

As part of the process, the Senate Committee on Banking, Trade and Commerce has been asked to examine the role that RRSPs and Tax-Free Savings Accounts play in the retirement planning of Canadians. I had the privilege of being invited to give my views to the Committee and as a result I have paid close attention to the ideas put forward by other witnesses.

One issue the senators are examining is measures that might be taken to increase the use of RRSPs and TFSAs for retirement savings. Baxter Williams, a senior official of the Department of Finance, told the Committee that as of the 2006 tax year (the latest for which figures were available) Canadians had accumulated $470 billion worth of unused RRSP contribution room. That's a lot of money that could be used to build retirement nest eggs.

So how can the Government help us all to save more? Andrew Dunn of Deloitte, a leading professional service firm, offered three interesting ideas.

First, Dunn suggested that the Government extend tax credits on investment income earned in a non-registered account to RRSPs, RRIFs, TFSAs, etc. By extending the dividend tax credit and the 50% capital gains rule to payments made to registered plans, the government would encourage people to save more and to invest in dividend-paying stocks which, historically, produce better returns over time than bonds, GICs, and the like.

Pape's Corner

Gordon Pape has authored or co-authored more than 40 books on investing and personal finance. His latest book is *Tax-Free Savings Accounts: A Guide to TFSAs and How They Can Make You Rich.*

Dunn's second suggestion is to dramatically increase the contribution TFSA limit for everyone over 55. He suggested a limit of $100,000 to accumulate more money for retirement during what should be peak earning years.

Lastly Dunn proposed increasing the limits on RRSP contributions, which are currently capped at 18% of the previous year's earned income, to a maximum of $22,000 for the 2010 tax year.

Good ideas all. We'll wait to see if any of them become government policy for the benefit of all Canadians.

From recession to recovery, and beyond

Stronger now, slower later. The global economic recovery has accelerated and become more broadly based, supported by very low borrowing costs, massive government fiscal stimulus, a rebound in consumer spending, and inventory rebuilding in many sectors.

Despite investor concern about the challenges confronting some industries and nations, the recent robust pace of revival in Canada and the U.S. appears sufficient to raise output in both countries by well over 3% in 2010, more than regaining the ground lost during the recession. In contrast, Europe and Japan are likely to suffer from lingering economic lethargy that prolongs their recuperative phase through 2011.

Asian and Latin American nations continue to outperform the developed world, led by China where annual growth is again close to 10%. Even with higher interest rates and less fiscal stimulus, domestic demand has become an increasing source of economic momentum in these nations. The outperformance of China and other emerging powerhouses, alongside the rekindling of growth in developed nations, has prompted a strong revival in energy and industrial commodity markets.

With resources accounting for nearly half of Canada's merchandise exports, our trade balance has swung back into surplus and the loonie may again reach parity against the U.S. dollar, depending on the rate of European and global growth. At the same time, the rebound in energy prices has pushed the U.S. trade deficit higher.

In general, the U.S. dollar is prone to further weakness against commodity currencies (Canadian and Australian dollars) and the emerging nations' currencies where growth and investment fundamentals remain attractive. The U.S. dollar may also strengthen against sterling and the euro, as investor concern tempers investment flows.

Even with the sharp appreciation of the Canadian dollar, the Bank of Canada has signalled its intent to begin raising interest rates in June in reaction to stronger-than-expected domestic demand and core consumer inflation. The U.S. Federal reserve may delay following suit until late this year, due to their subdued inflation, uneven domestic demand, and an historically high jobless rate.

The different timing of interest rate moves has the potential to push the Canadian dollar solidly above parity with the U.S. in the months ahead. Central banks in Europe and Japan are likely to stay on the sidelines longer, further weakening in their currencies. While the timing of rate hikes will vary, with significant impact on exchange markets, bond yields will continue rising as investors become increasingly nervous about the ability of governments to rein in their fiscal deficits.

Your feedback and questions are always welcome. You can contact us at feedback@scotiabank.com

9040013 (07/10)