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Economic Newsletter

CURRENT ECONOMIC TRENDS – UNEVEN PERFORMANCE

According to Statistics Canada, real gross domestic product (GDP) in Canada rose 1.8% on an annualized basis in the first half of 2012. While that represents the weakest first half since the same period in 2009, Canadian economic performance continues to be a bright spot amongst developed global economies. Domestic demand, business investment and consumer spending remain strong relative to other countries.

However, Europe's financial woes and the slowdown in the emerging markets, particularly China, the world's second largest economy, along with sluggish growth in the world's largest economy, the U.S, continues to affect global confidence and hiring in the United States. This global weakness and the lethargic employment market in the U.S. represent the most significant challenge to Canada's economy going forward.

Job creation in the United States has been sub-par. However, Canada's employment growth, while uneven on a month to month basis, has been better than expected and in line with longer-term trends. For the first nine months of 2012 the economy has produced more than 201,000 new jobs, a growth rate of 1.2%. Moreover, approximately 171,000 of the spots created or nearly 85 per cent have been full-time.

While interest rate hikes looked imminent last March, the quick deterioration in the European situation, the indication by the U.S. Federal Reserve that monetary stimulus will remain in place likely until 2015, along with low inflation and a strong Canadian dollar, is forcing the Bank of Canada to hold off. However, as pointed out by Eric Lascelles, Chief Economist at RBC Global Asset Management in the interview below, "The Bank of Canada's outlook is very 'model' driven and is focused not only on inflation but also on the output gap – economic slack. That economic slack resulting from the 2008-2009 recession is almost gone and could trigger a rise in inflation expectations. Thus the stated expectation of the Bank of Canada that interest rates will need to rise."

In the meantime, the federal government has introduced tighter mortgage rules in a bid to quell over-exuberant consumers. As Mr. Lascelles points out, "The government is imposing significantly tighter mortgage standards, with the result that the housing and mortgage market is slowing materially, despite low mortgage rates."

Recent housing data has been conflicting, but it is clear that a slow-down in activity is emerging. However, at this point in time it is difficult to ascertain the magnitude of that slow-down. In an interview in our previous newsletter, Sadiq Adatia, the Chief Investment Officer at Sun Life Global Investments, said, "This is probably the area where I have the biggest concern. Canadian housing prices have continued to soar higher and have actually moved higher than most developed countries over the past 5-10 years. A correction of 10-15% would not surprise me at all." According to our expert interviewee for this edition, "From an activity perspective, residential construction is currently an unusually large share of GDP. As it retreats to a more normal share, around 1.5 percentage points of economic growth will be shed relative to the normal trend. Similarly, home prices are perhaps 15-20% too high on a steady state basis."

With respect to the financial markets, the expectation of most observers and participants is that we will see continued volatility amid a rising stock market, continued relatively low bond yields and interest rates and somewhat elevated commodity prices. The implications of this are that appropriate asset allocation, proper diversification and prudent risk management will be required with each of these influenced by the specific circumstances and situation of each family and household.

QUESTION AND ANSWER WITH ERIC LASCELLES

Eric Lascelles is the Chief Economist at RBC Global Asset Management (RBC GAM), a division of RBC, Canada's largest financial institution. RBC GAM is a North American-based asset manager with global scope and the RBC GAM group of companies manage CAD $260 billion in assets worldwide as at July 31, 2012.

In his role as Chief Economist, Eric is responsible for maintaining the firm's global economic forecast and generating macroeconomic research. He is also a member of the RBC Investment Strategy Committee, the group responsible for the firm's global asset mix and he is also a frequent media commentator.

Prior to joining RBC GAM in early 2011, Eric spent six years at TD Securities with the last four as the Chief Economics and Rates Strategist, where he was responsible for heading the company's trading floor and identifying investment opportunities and market risks.

Mr. Lascelles holds a Master's degree in Economics from Queen's University as well as a Bachelor of Economics degree from Princeton University with a Minor in Finance.

EPB: What are your views on the current economic environment and financial market conditions?

EL: The global economy materially weakened over the summer, and is currently operating at a particularly sluggish rate. Much of the weakness has come from Europe and emerging markets. Europe was widely to weaken, but the emerging market slowdown has been disappointing, and somewhat unexpected. Fortunately, global growth seems to be stabilizing now, and I expect a quicker pace through the autumn and winter, in line with a seasonal trend that has developed over the past three years. Don't get me wrong – economic growth has been slow for several years, and will likely remain slow by historical standards due to a variety of post-financial crisis constraints. But a recession still looks unlikely outside of Europe, and consumers are starting to supplant businesses as a source of economic growth.

Financial markets have been rather more optimistic, responding to aggressive monetary stimulus and acknowledging that many of the downside risks to future growth have abated. In particular, Europe is now more credibly on a path to sustainability – admittedly a long and winding path – and the U.S. fiscal cliff is likely to be dealt with in a constructive fashion.

EPB: What is your view for 2013 for the overall economic activity?

EL: We look for economic growth in 2013 that is broadly similar to 2012 – about 2% real GDP growth in North America. Fiscal austerity will remain a central drag, but monetary stimulus will provide an important offset. For Canada, fiscal austerity is not a central constraint, but a slowing housing market is. Countries like China are unlikely to see growth accelerate, but they can probably hold on to recent trends, as opposed to suffer a further deceleration

EPB: What is your view for 2013 for hiring and employment?

Canada's labour market has outperformed its developed markets peers over the past 4 years. In particular, it has outpaced our neighbour to the south. Historically, our unemployment rate has tended to be about 2% higher than the U.S. rate. However, the current unemployment rate in the U.S. is near 8%, where in Canada it stands at 7.5%

So far in 2012, the overall data has been "lumpy" – the beginning of the year and early spring was good, the late spring and mid-summer was "grim" and the last couple of months have been very good.

I think Canadians became a bit spoiled in 2005-2007 period when our unemployment rate dipped to below 6%. Looking ahead, the trend line employment growth of 10,000 to 20,000 new positions per month is sustainable with an employment rate of around 7% being the norm

The U.S. job market remains lacklustre. We believe some modest improvement is possible, for two reasons. First, there is subtle evidence of healing beneath the surface – the rate of job openings has increased nicely for instance. Second, the U.S. Federal Reserve has clearly articulated a desire for a lower unemployment rate, and appears intent upon delivering unlimited stimulus until that goal has been achieved. But robust hiring is unlikely because economic growth will likely remain slower than the historical norm.

EPB: What is your view for 2013 for the financial markets?

EL: No one likes investing into an environment of slow growth, low rates and high volatility. Alas, that is the investing environment we find ourselves in, and we must make the best of it. Bond yields are likely to remain quite low, and while it is conceivable they could drift a little lower yet, we are worried about the opposite scenario – higher yields translating into material capital losses. And even if they don't, the yield on offer isn't even keeping pace with inflation. So the bond market is unlikely to provide a particularly good return. The stock market seems more fruitful to us. To be sure, slow economic growth does not traditionally translate into robust profit growth. But economic growth usually means some sort of equity return, and equity valuations are still attractive, suggesting the potential for gain as price-earnings multiples expand.

EPB: In looking ahead to 2013, what is your outlook for inflation?

EL: Inflation will likely experience a moderate move higher due to incipient food inflation and higher oil prices making their presence felt.

In Canada, both total inflation at 1.2 per cent and core inflation at 1.6 per cent, are at the low end of the Bank of Canada's 1-3 per cent inflation-control target and well below the desired mid-point of 2 per cent.

Moreover, the Federal Government has articulated a strategy of shifting focus – temporarily – from inflation to unemployment, potentially allowing inflation to drift higher. But disaster is unlikely, and inflation should remain broadly within the "normal" range.

EPB: In looking ahead to 2013, what is your outlook interest rates and bond yields?

EL: The Bank of Canada's outlook is very "model" driven and is focused not only on inflation but also on the output gap or the economic slack. That economic slack resulting from the 2008-2009 recession is almost gone and could trigger a rise in inflation expectations. Thus the stated expectation of the Bank of Canada that interest rates will need to rise

However, with the crisis in Europe and the Federal Reserve's outlook that monetary policy may need to remain accommodative until 2015, central bankers should keep interest rates extremely low. There is a chance the Bank of Canada could tighten rates in 2013, but this is far from guaranteed.

Accordingly, bond yields should remain low. A slow growth environment is simply not conducive to outright high bond yields. But our expectation is that bond yields will be somewhat higher than today.

EPB: In looking ahead to 2013, what is your outlook on mortgage rates?

EL: Mortgage rates operate in lockstep with the bond market, and so slightly higher bond yields should translate into higher mortgage rates as well. But mortgage rates should remain quite attractive by any historical standard. Just keep in mind that in Canada, the mortgage market noose is being tightened via other means. The government is imposing significantly tighter mortgage standards, with the result that the housing and mortgage market is slowing materially, despite low mortgage rates.

EPB: In looking ahead to 2013, what is your outlook on commodities in general and gold and oil in particular?

EL: Commodity prices remain elevated for now as the effects of U.S. quantitative easing percolate through the system. However, there is a distinct risk that this momentum will be difficult to sustain due to slower emerging market growth. Emerging market nations constitute virtually the entirety of new demand for commodities, and their economies have recently slowed substantially. This is unlikely to be permanent, but it represents a headwind. For gold, the combination of unorthodox monetary stimulus and political uncertainty should keep gold prices quite elevated, perhaps even allowing them to rise further. But do keep in mind that gold is incredibly expensive by historical standards, and I am not at all convinced it will retain this lofty valuation forever. For oil, prices are likely to remain in the $80 to $100 range. Saudi Arabia needs oil prices close to $100, but given growing energy supply in the U.S. and softening demand among emerging markets, it is unlikely to sustainably crack that threshold, barring intensified conflict in the Middle East.

EPB: In looking ahead to 2013, what is your outlook on the Loonie?

EL: The Canadian dollar is justifiably strong due to commodity prices, interest rate spreads and foreign appetite for the safety of Canada. However, our models suggest the currency has gone a little too far, and a softer Canadian housing market should contribute to a moderate depreciation of the currency toward the 95-99 cent range.

EPB: What are your thoughts on the housing market in Canada at the present time?

EL: The Canadian housing market has been extraordinarily strong for many years, and is beginning to show its age. The government has expressed a clear desire for the market to cool, and this is beginning to happen. From an activity perspective, residential construction is currently an unusually large share of GDP. As it retreats to a more normal share, around 1.5 percentage points of economic growth will be shed relative to the normal trend. Similarly, home prices are perhaps 15-20% too high on a steady state basis. It is unlikely that this fully unwinds because affordability is actually decent so long as interest rates remain so low. But some price softness is occurring on the West Coast, and may trickle across the rest of the country. If it is any consolation, the systemic risks in Canada appear to be rather low – the similarities with the U.S. housing correction are quite limited

EPB: What opportunities, if any, exist in the current economic and market conditions for employment seekers?

EL: Canadian hiring has been reasonably broad based such that it is difficult to identify a single sector enjoying unusual health. Certainly, the resource sector and Canada's West remain the most fruitful areas for employment, though this form of employment is not for everyone. The best message I can convey on employment is still that being well educated remains the key to gainful employment. Not only is the unemployment rate lower for people with university degrees, but wages are higher, and the gap between skilled and unskilled compensation continues to grow due to the downward pressure on unskilled wages coming from emerging market competition.

> "The best message I can convey on employment is still that being well educated remains the key to gainful employment.

EPB: What opportunities, if any, exist in the current economic and market conditions for small business?

EL: Small businesses exist right across the full spectrum of the Canadian economy, and research suggests they neither lead nor lag the broader economy. What's good for the economy is usually good for them, and vice-versa. Here are a few general thoughts. First, small businesses suffered through the worst of the credit crunch because lenders became very conservative in their lending. That seems to have opened up again, allowing small businesses to be competitive. Second, small businesses must not be afraid to become large businesses. A favourable tax rate shave induced many small businesses to remain small. This is ultimately unwise, and a burden upon the Canadian economy. Don't be afraid of expanding!

EPB: What opportunities, if any, exist in the current economic and market conditions for investors in general and conservative and income investors in particular?

EL: As I mentioned earlier, this is not a great investing environment. But equally, it is not a horrible one. Both the bond market and the stock market have provided attractive returns over the past several years. Periods of slow growth and low bond yields actually tend to be fairly good for other investments, like dividends, high yield and corporate bonds. This remains true today. For conservative investors, it is important to understand that holding only cash is not a viable long-term investing strategy.

Cash offers little to no return, and when inflation is factored in, the real value of one's portfolio is declining. By all means, have a well balanced portfolio that is in alignment with your risk tolerance. But don't shun equities, and don't be caught up in the game of identifying ever more downside risks – the vast majority of which might never materialize.

EPB: With respect to risk and risk management, please provide your opinions on how would you guide investors to manage their risk?

EL: The best way to manage risk is to have a well diversified portfolio, both on the basis of asset classes and geography. It is riskier to your long-term well being to be all in cash than it is to have a well diversified portfolio because purely cash holdings will never provide the returns necessary for retirement.

EPB: What would be your advice to consumers on risk, in particular regarding consumer debt?

EL: Consumers need to live within their means. Absolutely, it makes sense for young families to acquire debt since this is an especially expensive time of life when salaries are low and families are growing. But the debt must be within reason, and should be acquired with the full understanding that future interest rates could be notably higher. Moreover, the debt should be directed toward productive ends, such as an education or buying a home to live in.

EPB: Is there any other insight that you would like to share with our readers?

EL: I'd like to conclude by acknowledging that this is a difficult economic and investing environment. Economic growth is sub-par, and risks are high. But if there is a lesson I've learned from my experience, it is that even this economic environment is consistent with half-decent investment returns. Moreover, when disaster strikes – such as in the fall of 2008 – this constitutes an enormous buying opportunity, not a time to flee from the market. Let's be frank – predicting the future is enormously difficult – but that's why sound, long-standing investment principles need to be employed.

THE REALITY OF ENTREPRENEURSHIP: A CONVERSATION WITH A VISIONARY ENTREPRENEUR AND A VENTURE CAPITAL INVESTOR

Entrepreneurship can be both an exciting and daunting endeavour. Often, people have many questions when considering becoming an entrepreneur. That's why we took a few minutes to speak with both Rahim Fazal, a successful entrepreneur, and Moez Virani, Chief Financial Officer and Chief Operating Officer of Northgate Capital, a worldwide investment company focusing on private equity and venture capital funds and co-investments in both developed and emerging markets.

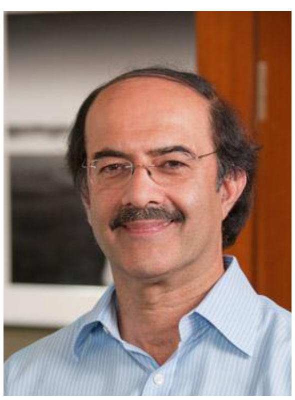
Rahim and Moez each bring an interesting and diverse perspective to what it takes to be an entrepreneur. Rahim who sold his business to Oracle in July and is now an executive there, and Moez who is with Northgate and provides investor relations and investment management support to the firm in addition to managing the global operations. Their insights are extremely valuable, and they've agreed to share their experience with us.

To begin, let's get a little background on both Rahim and Moez.

Rahim is a serial entrepreneur, start-up adviser and public speaker born and raised in Vancouver, BC. Most recently, Rahim was the Founder and CEO of Involver, a venture-backed social media marketing platform used by more than one million companies and many Fortune 500 brands. Involver was acquired by Oracle in July 2012, and Rahim is now an executive there.

Rahim co-founded a web-hosting company and negotiated its sale for $1.5 million while taking his Senior Year final exams in high school. He then started a web services platform business and took it public, becoming one of the youngest directors of a publicly traded company in the United States.

Moez has served as the CFO and COO of Northgate since June 2011. He is responsible for all the finance and administrative functions of the firm. He also provides close support for the investor relations and investment management activities.



Moez joined Northgate after 12 years at Mohr Davidow Ventures (MDV), where he worked as the administrative general partner responsible for all company operations and limited partner relations. At MDV, Moez actively supported the investment team and helped to design and implement the framework for investment decision making, developed serious modeling and analysis capabilities for helping with financing decisions and managed LP relations. In addition, Moez was responsible for implementing highly effective reporting systems to ensure timely and seamless communications between MDV and its investors, and was also responsible for creating multiple internal reporting systems and processes to help improve the performance of the firm.

We asked Rahim to tell us his story. At age 16, Rahim started his first company and became a technology entrepreneur. "The day after I turned 15, I got my first job -- taking orders at McDonald's. As you can imagine, I was pretty excited. Six weeks later, I got fired (long story, but basically they didn't think I was working hard enough). That day I vowed to never let anyone do that to me again. My best-friend Husein and I had been messing around with computers since we were five or six (our parents used to drop us at school super early, so we spent a lot of time in the library and eventually taught ourselves how to code). In the summer of grade ten, we realized a lot of people were trying to setup websites, but website design and hosting were expensive. So, we decided to build software that would let any company get on the web with their own site in under five minutes. A year after we launched, we had 25,000 customers and soon after, a few weeks before graduating high school, we sold the business. Since then, I've launched two other businesses, both in technology, and couldn't see myself doing anything else."

"A year after we launched, we had 25,000 customers and soon after, a few weeks before graduating high-school, we sold the business."

Rahim sure does make entrepreneurship sound easy. However there is a lot of work and commitment involved in becoming successful. A lot of that success relies on the type of financing you pursue.

We asked Moez to differentiate between angel investing, venture capital and debt financing, and how one determines the best financing source for their business.

Moez shared the following: "these three forms of financing are complimentary, but they're appropriate at different stages of the business cycle."

Angel investors are private investors who use their own capital to provide entrepreneurs capital for a business start-up, usually in exchange for convertible debt or ownership equity. Angel investments typically are extremely high risk, and as a result, require a very high return on investment. The benefit of Angel investors is that they have the ability to coach entrepreneurs. And this is the reason why over time, Angel investing has developed. Money and experience is exchanged for ownership. In the financing cycle, Angel investing is typically the first outside money, and occurs in the beginning when it's difficult to get the attention of a venture capital firm.

Venture capital companies also specialize in financing new ventures. They provide significant know-how to the company. They commonly have expertise in marketing, technology, business models, business development and strategy. They also have extensive networks of executives, customers, investors and strategic partners that they can access for the benefit of the company. Their risk appetite is generally lower than that of an Angel investor. Typically a venture firm will purchase 25-50% of a company's equity in their first round of financing. Debt financing is typically later in the financing cycle, and is usually available when a company has hard assets or growing revenues. At this stage, a company will try to acquire debt so as to not give up any more equity ownership. However, since debt needs to be repaid, any failure to repay principal and interest may result in a default and the debt provider getting hold of the assets of the company.

So where did Rahim get his funding/capital for his initial start-up, Involver? "Initially, funding came from the founders, and a small group of angel investors. With a small amount of capital, we were able to build the business to about fifty employees and profitability. As the market continued to grow, so did our business, and pretty soon we had a number of high profile Silicon Valley venture capital firms knocking on our door. We finally decided to raise a large round of capital from Bessemer Venture Partners (the same firm that backed Skype, LinkedIn, Yelp and Pinterest), Western Technology Investments (Facebook, Google), and Cervin Ventures."

We asked Rahim what led him to pursue Angel investing over other sources. His response: "I think matching the type of capital with the stage of the company (and the interests of its owners) is really important. When we were just getting started, it made sense to raise money from angel investors who were really sharp entrepreneurs, and could roll up their sleeves and help us get the business off the ground. Almost all of the early money went into R&D and signing up early customers. When we had figured out the business model (few hundred paying customers) and were ready to scale, we took venture capital, which allowed us to really pour gas on the fire and rapidly build our sales and marketing teams. If we had stayed independent and not been acquired by Oracle, we would have likely been on a path to going public."

Of course, funding would not have been provided if it wasn't for a strong business case. Given his expertise, we asked Moez what he would be looking for in a pitch from an entrepreneur. His response? He wants to know, "What problem are you trying to solve? And why is it a big problem? Or what opportunity do you see in the market place?"

"Typically, from a venture capital company point of view, as an early investor in the entrepreneur, the thing that matters most is, how big is this opportunity? Is it just a feature on some existing product, is it a single product, or is this really a company, which over time could produce multiple products and scale to a large enterprise?" said Moez. "The potential for the idea and how big it can become is much more important than any early financial projections. They are kind of place holders."

Later on, as a company becomes more mature, then cash flow matters a lot to the investor. "Valuations become more important and the decision around financing is now driven by the numbers."

What does Moez think of pursing entrepreneurship in this economic environment? From the investors' perspective, "The economic environment should not matter," he says. "Most investments have several years before gestation and they have several years before you see traction. There really is never a bad time to start a company."

"However, the economic environment might influence the amount of funding that is available," he notes. This is important to realize as an entrepreneur looking for funding.

Moez thinks that in this economic environment, the investor should be making investments. "The best investor returns often happen from investments made during downturns in slower economic environments. "When there is an economic bubble, prices are grossly inflated and investors should beware.

Right now, according to Moez, what he's seeing in the technology space are entrepreneurs pitching ideas that generally are coming from these three areas: social media, big data and cloud computing "These are likely to be long lived trends and ideas and ideas that are focused within these three areas are really taking off in the market," he says. Moez also continues to see opportunities in mobile applications and the infrastructure space.

Perhaps more important than the economic environment are the skills and traits needed to be a successful entrepreneur.

As a venture capital investor, Moez looks for someone who has passion and commitment to their idea and someone who has deep domain knowledge. "In the early stages though, you're looking for someone who has a single mindedness of purpose," he says. "They need to have that manic desire to create the opportunity or to solve that problem." Moez knows that sometimes that trait turns venture people off. "But many of the more successful entrepreneurs are like that, and the savvy venture firms know that and have learned how to harness the passion of such entrepreneurs. Google was such an example.

According to Rahim, there are a lot of different skills or traits that help someone become a successful entrepreneur. Three important ones are self-awareness, resourcefulness and competitiveness.

"Self-awareness helps entrepreneurs understand what they're uniquely qualified to do," says Rahim. "The most important decisions an entrepreneur makes will be driven from the answer to this question, beginning with: 'What kind of business should I start?'"

"Resourcefulness helps entrepreneurs make something out of nothing," he says. "To get a business off the ground, and then to grow it, you need someone who can pick up the phone and make things happen like hiring potential employees or prospective customers."

"Competitiveness is what makes entrepreneurs continually ask themselves 'what could we be doing better than the other guys?' or 'how could we be growing faster?' Great entrepreneurs want to be the best at what they do. #2 isn't good enough. They want to win."

There is no doubt that Rahim possess those three traits. But along with success comes failure. And Rahim was open with us in sharing failures.

"One of my biggest failures was my second company. We had to shut it down. Husein and I started the company right after selling the first one, and graduating high school. We were so consumed by the grandeur of being our own bosses, we forgot why we had started the company in the first place -- to build awesome software that helped our customers run their businesses better."

Like a true entrepreneur, Rahim took away key lessons from that experience.

"Cash flow is more important than your mother (not my mother if she's reading this)," Rahim jokes. "Put another way, it's the oxygen your business needs to survive. No cash, no oxygen. No oxygen, and you die. Quickly. Be smart about managing your finances!"

"Market timing is everything," he adds. "You might have the right product, but if the market isn't ready for it, you could spend years spinning your wheels. Talk to your customers early and get them to pay."

Finally, "Choose your business partners like you'd choose your wife (or husband!). Are these the type of people you are ready to go to battle with? Will they be there for you through the good and the bad? Do you want the same thing for this business? Have an exit plan if things don't work out well."

We asked Moez if he thinks Canadians have had a fair share of entrepreneurial successes, in particular in the United States.

"There are a lot of Canadian entrepreneurs here in the Bay area. They are welcome and integrated into the community. This is a receptive environment."

And Moez points out that Rahim is a good example of this – a young, Canadian entrepreneur who came into this environment without knowing many people, quickly established a network through Ismaili and non Ismaili contacts and made a success of himself and his business in the Bay area.

> "There are a lot of Canadian entrepreneurs here in the Bay area. They are welcome and integrated into the community. This is a receptive environment."

So what's Rahim's advice to individuals wanting to become entrepreneurs?

"Making mistakes is OK. Some entrepreneurs are afraid of making them. Don't be. If you're not making mistakes, you're not trying hard enough."

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ENTREPRENEURIAL INSIGHTS FROM STARTUP CANADA

He also stresses that you need to be vulnerable. "As an entrepreneur, we're expected to man the ship, but that doesn't mean we're expected to know all the answers. If you don't know something, ask; being vulnerable is the only way people can help you. When Involver really started to grow, I can't tell you how many times I had to admit "I really have no idea what I'm doing". Thankfully, I had some great advisors around me, and was pretty good about asking for help (most of the time!)."

His final piece of advice, "Join the world on your terms. When it comes to your career, we all have caring people in our lives who have opinions about what we should do: our friends, family, teachers, counsellors, whoever. It's ok to listen to everyone (who knows maybe you'll learn something), but in the end, remember, it's your life and you're responsible for the outcome. So, have the confidence to come up with your own definition of success, own it and make it your north star. There's a great quote by Ralph Waldo Emerson who said: "Don't go where the path may lead, go where there is no path and leave a trail."