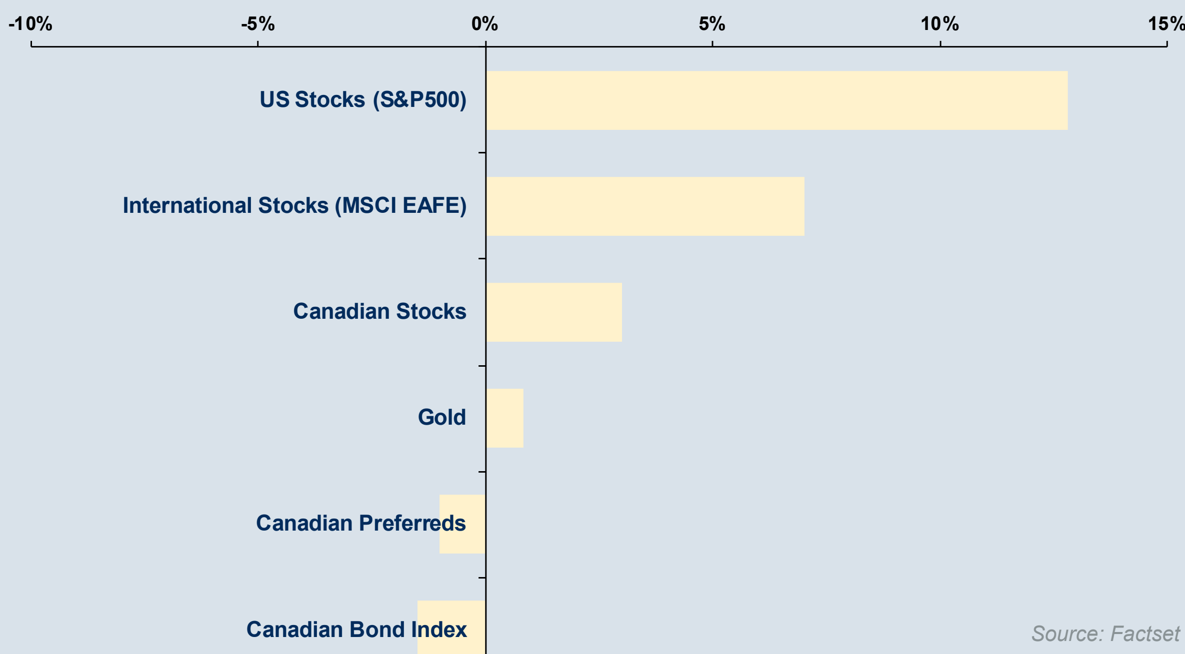
Serber Speaking

David Serber
Senior Portfolio Manager and Wealth Advisor david.serber@rbc.com

Fall 2023

Gathering Clouds

Before we undertake our forecast, let's review 2023 so far. Bond markets have suffered as interest rates continue to spike higher, driving bond prices lower. As a result, the Canadian Bond Market Index lost about four percent in Q3 and is now in negative territory for the year. Global stock markets were down about 1.5 percent in Q3, but are still positive for 2023, year-to-date, with a gain of about 10 percent (MSCI World Index in $CAD). As seen on the chart below, US stocks are the year's top performers so far, buoyed by strong performance from the tech sector in the first half. Overall, a balanced portfolio is up about three percent, give or take, year-to-date.



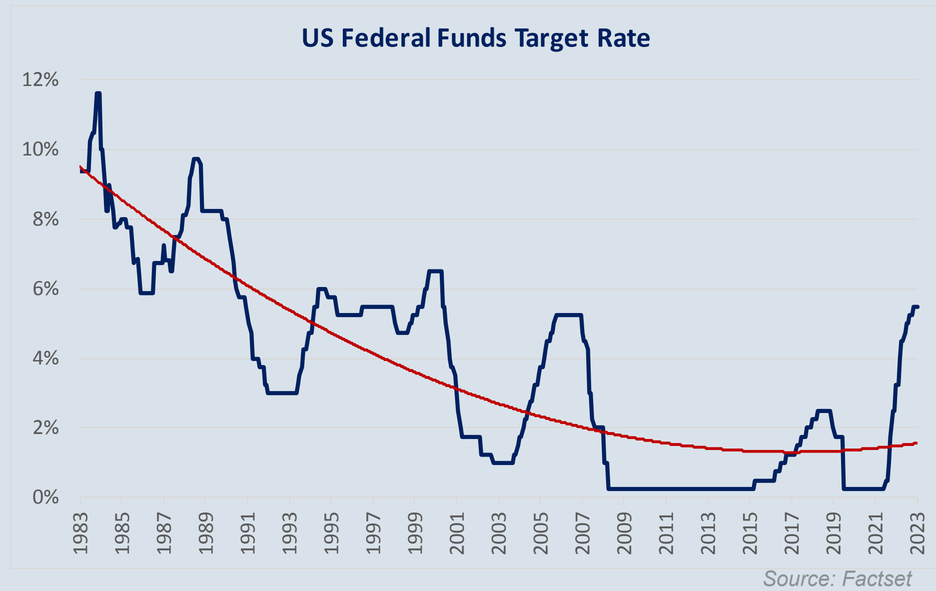
The Path Ahead

The current mood in financial markets has been quite negative. As I've pointed out in previous reports, this is, paradoxically, a sign that markets may be approaching a short-term bottom. According to the American Association of Individual Investors, about 42 percent of investors are currently bearish versus 30 percent bullish. Of course, things can certainly get worse before they get better. If the lead of bears over bulls widens from the current level of 12 percentage points to 20 or 30 percentage points, it will be a strong contrarian buy signal.

Based on the above, as well as on other indicators, I believe financial markets will have a decent Q4 overall, with a recovery potentially continuing into January and beyond. So - in the short term I see some gain, longer term though, could be some pain.

Mean Reversion of Interest Rates

Central banks influence interest rates primarily by adjusting their overnight rates. In the US, the overnight rate is known as the Federal Funds Target Rate. As seen on the chart at right, the Fed Funds rate has been in an overall declining trend over most of the last 40 years.



Source: Factset

That said, the Fed Funds rate has not followed a smooth downward trend (like the smoothed red trendline). Rather, it has jerked up and down, somewhat violently, only to revert to the mean over time. It seems that the authorities have a propensity to raise rates too high, then lower them too low, then repeat the process, over and over.

On a certain level, the whole system is a bit bizarre. A group of 12 individuals comprising the Federal Open Market Committee sit in a boardroom, look at some tea leaves, er, I mean economic data, and decide on the path of interest rates, impacting millions if not billions of people. Most countries have similar systems. It would be fascinating to delve into the whys and wherefores of this approach, but that is beyond the scope of this report. More important is to understand how it tends to work, and to make an educated guess about what comes next.

After rate increases peaked in 1984, 1989, 2000, 2006 and 2018, rates fell rapidly and dramatically, as seen on the chart. In each of these previous episodes, high interest rates were eventually followed by a recession/crisis, prompting a dramatic lowering of interest rates. The implication is that the current round of rate hikes will be followed by a recession/crisis at some point, and when that happens, interest rates will fall significantly.

The difficulty is one of timing, as crises do not arrive on a set schedule. For example, in the mid-2000s the Fed's campaign of rate increases peaked at 5.25 percent in June 2006. But the "great financial crisis" didn't reach its full force until the fall of 2008, more than two years later. So, even if we could accurately predict that the Fed Funds rate has peaked for this cycle, which is not yet clear, it may be another year or two until the next crisis arrives.

One difference going forward is that we may be on the cusp of a change in the direction of interest rates from a long-term downtrend to either a sideways or even a long-term uptrend, similar to the 1965-1981 period.

How does this help us make investment decisions today?

Firstly, it is time to err on the side of caution, but probably too early to go 100-percent defensive. The upside I expect from stocks in the short term should be used to further reduce risk exposure.

Secondly, one should lock in currently high interest rates for longer periods - but not for too long. Currently, one can get six percent on cash balances at certain online banks and 5.5 percent or more on one-year GICs, whereas the five-year GIC rate is a bit lower, around five percent. Many are, therefore, tempted to keep their investments in fixed income/safe money mostly short term. I advocate that investors fight the urge to stay mostly short-term, and instead maintain a ladder of maturities. If interest rates fall dramatically in the next crisis, it will be a solace to have five percent-plus, risk-free returns locked in for a few more years.

More active traders could consider buying longer-term government bonds now, and add to positions if bond interest rates go higher in the coming weeks/months. If and when rates drop in the next crisis, the prices of government bonds will rise, and these bonds could be sold at a profit.

From the Planning Notebook

A Refresher on RRIFs

An RRSP must be closed at the end of the year you turn 71, and most people opt to move their RRSP funds into a registered retirement income fund (RRIF). Starting in the year after a RRIF is opened, and for all subsequent years, you must withdraw a minimum prescribed amount and report it as taxable income. Some or all of your RRSP can be converted to a RRIF prior to age 71, although most people choose to delay as long as possible to defer income taxes.

The minimum withdrawal amount depends on your age at the end of the previous calendar year and is based on a percentage formula. In the case where the RRIF was created in the year you turned 71, the minimum withdrawal the following year is 5.28 percent of the plan's value at the end of the previous year. So, for example, if the RRIF value at the end of the previous year was $500,000, the minimum withdrawal amount would be $26,400.

However, if you have a younger spouse, you can set up your RRIF based on your spouse's age, thereby lowering the minimum withdrawal amount—and your tax burden. For RRIFs based on an age less than 71, the formula is 1/(90-age). For example, if your spouse is 65 at the time you create your RRIF at 71, the first minimum withdrawal would be 1/(90-65) or four percent. In the above example, this would lower the minimum withdrawal to $20,000, reducing your taxable income by $6,400.

There is no tax withheld on the minimum RRIF withdrawal unless you specifically ask for it. However, if you choose to withdraw more than the minimum amount, which you can do at your option, your financial institution will withhold tax on the amount that exceeds the minimum.

If you are 65 or older and have a spouse with lower taxable income, you can also benefit by allocating up to 50 percent of your RRIF withdrawals to them. In the above example of a $20,000 minimum withdrawal, this means you would pay tax at your higher rate on $10,000, and your lower-income spouse would pay tax at their lower tax rate on $10,000. Also, since this lowers your income, you could potentially benefit by reducing any clawback of your Old Age Security amount.

In addition, if you are 65 or older, you can claim the federal pension income tax credit of $2,000 since RRIF withdrawals are generally considered to be pension income. If you allocate 50 percent of the RRIF income to your spouse (if they have no other pension income), they would also be able to claim the $2,000 tax credit.

In certain cases, depending on expected income from all sources, it may make sense to convert some or all of one's RRSP to a RRIF before age 71, starting as early as age 65.

I hope you find the above information useful. This is only a partial review of the ins and outs of RRIFs. If you have any questions, or would like to discuss this topic in further detail, please reach out to me at 416-974-3530 or at david.serber@rbc.com.

Until next time, best regards,

David Serber

If you would like to discuss your personal situation please feel free to contact me. Also, feel free to forward this copy of ***Serber Speaking*** to anyone you think would find it of interest.

RBC Wealth Management
Dominion Securities

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The strategies and advice in this report are provided for general guidance. Readers should consult their own Investment Advisor when planning to implement a strategy. Interest rates, market conditions, special offers, tax rulings, and other investment factors are subject to change. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / ™ Trademark(s) of Royal Bank of Canada. Used under licence. © 2022 RBC Dominion Securities Inc. All rights reserved.