Serber Speaking

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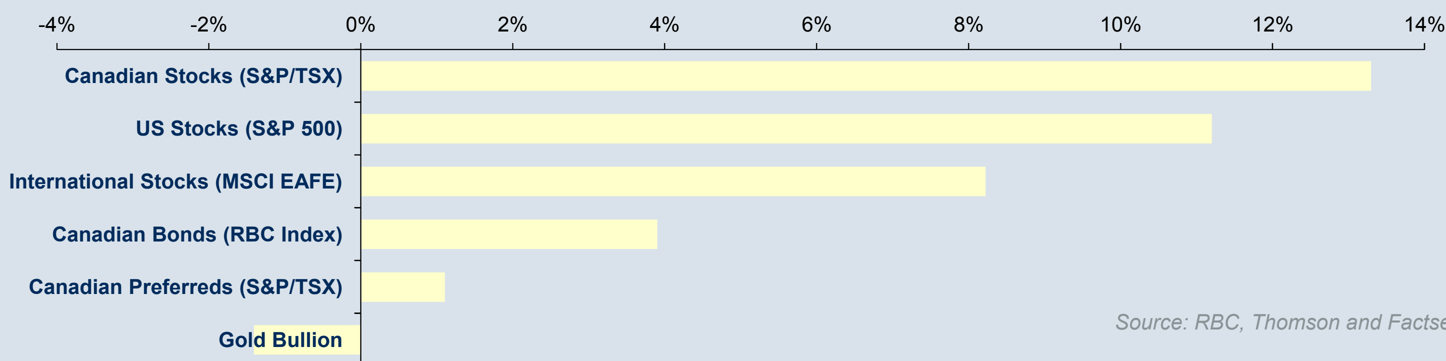
Commentary for the quarter ended March 31, 2019

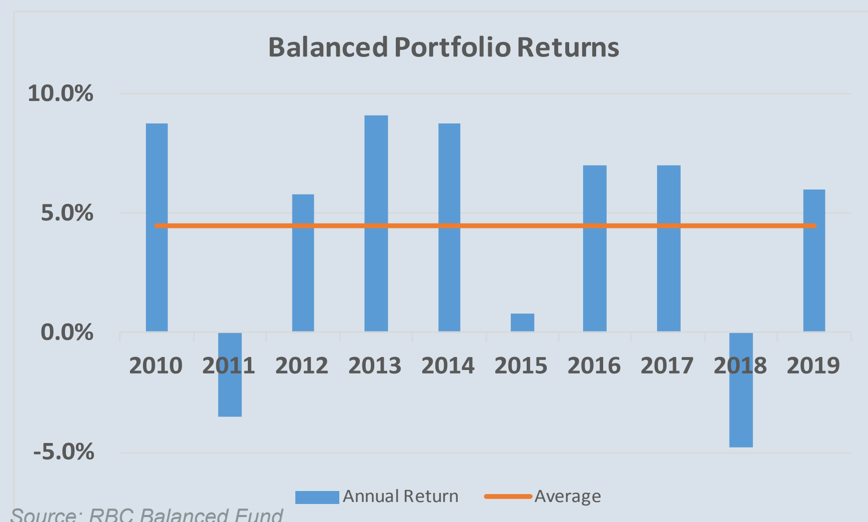
Santa Delivers

After a very negative fourth quarter for financial markets, I wrote last time that the year-end “Santa Claus Rally” had unfortunately failed to materialize – but it turns out I was a bit premature. Markets hit bottom at the closing bell on December 24 and ever since Santa’s global journey that very same evening, stocks have rebounded. Strongly. The MSCI World Equity Index is up about 16 percent since Xmas Eve - so, Santa, my apologies for doubting you - and thanks for the rally.



As the above chart shows, the rebound has been especially kind to Canadian stocks, leading the pack with a 13.3-percent gain for Q1, more than offsetting the 8.9-percent loss for the Canadian market in all of 2018.

Last time, I also showed the chart below and observed that after a down year like 2018, a balanced portfolio would typically have a couple of good years. To date, 2019, now added to the chart, is tending to confirm this thesis, so far. Which leads to the question of why markets fell in late 2018 and rallied in early 2019. To sum it up, the answer is “The Fed.” It was becoming apparent in Fall 2018 that global economic growth and financial markets were showing some stress. Notwithstanding these concerns, the Fed stated in September that interest rates were “well below neutral.”



Source: RBC Balanced Fund

Markets, sensing that the economy was a bit more precarious than the Fed acknowledged, began to sell off in October and November. At its December meeting, the Fed did nothing to assuage the market’s concern that its plan to continue raising interest rates in 2019 was an error, and markets tanked anew. In January, the Fed finally relented, indicating no interest rate increases for the rest of this year. This changes the architecture of the markets and may pave the way for renewed economic growth and investment returns over the 2019/20 period.

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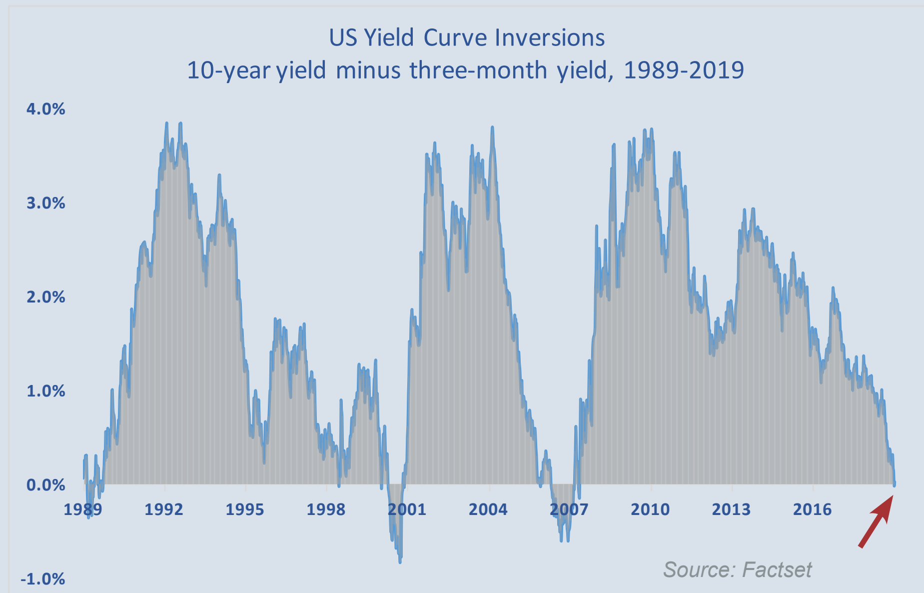
So - we had a lousy end to 2018 and a strong beginning to 2019. Now what?

The fact is, if you can get the recession call right, you can get the market call right. But it's not that simple. Markets peak, and begin falling, well before an actual recession is recognized. In the last cycle, the stock market peaked in October 2007. Fourteen months later, in December 2008, the NBER, arbiter of US business cycles, declared that the economy had peaked in December 2007. On the day of that announcement, the S&P500 index had fallen some 40 percent from its October 2007 peak. Clearly, for investment strategy purposes, we need to know the odds of recession well in advance of any official announcements.

Why are recessions so important? Because they cause a material drop in business profits and, generally speaking, all investment returns come from business profits, one way or another. This means investment analysts and strategists are always on the lookout for indicators that suggest a coming recession. One such indicator, which has been particularly reliable in the past, is the yield curve inversion.



Yield Curve Inversion

Normally, interest rates are structured such that the rate on longer-term loans is higher than the rate on shorter-term loans. This is true most of the time and is known as a normal yield curve, with positive slope. On rare occasions, short-term rates move above long-term rates. This is known as a yield curve inversion.

As can be seen on the graph at right, the yield curve has experienced material inversions three times in the last 30 years: 1989, 2000 and 2006/07. Each was followed by a bear market and recession.

The bad news is that the yield curve briefly inverted last month, and many take this as a sign that the end of this cycle, and the beginning of the next bear market, is nigh. This may be true, but it is also worth noting that the yield curve briefly inverted in late 1998, over two years before the ultimate end of that economic cycle and bull market.

John Lonski, Chief Economist at Moody's Capital Markets Research, was the only strategist I follow who correctly predicted last Fall that the US 10-year Treasury yield would be below three percent by the end of 2018 (it is currently 2.5 percent). He recently stated that the "weight of the available forecasts strongly suggests a need for lower short- and long-term interest rates in order to stay safely distanced from recession." If he is right, then another standoff between markets and the Fed may be in the offing. If markets sniff out the need for lower rates as suggested by Lonski, stocks will fall. The Fed will prove reluctant to admit it was wrong, but will capitulate in the end.

It is safe to say that we are in the final innings of the current economic cycle. The peak could come this year or next or, in a best-case scenario similar to 1998-2000, maybe as late as 2021. Peter Bezerin, Chief Global Strategist at BCA Research, thinks it will be the latter. Bezerin sees markets peaking late next year, followed by a bear market and recession starting in 2021. According to his forecast, the cause of recession in 2021 will be higher interest rates in late 2020 and 2021, as the Fed is forced to be more aggressive with rate hikes due to emerging inflation. Indeed, it has been a very long time since we have had an outbreak of inflation. Many forecasters over the last decade have seen inflation lurking around the next corner. So far, they have been wrong, but that is no reason to be complacent. Time will tell if Bezerin's view proves accurate. If so, one of the strategies to consider is to accumulate gold (and other commodity-related investments) over the coming year. I will be adding to gold positions (currently about four percent of my typical balanced portfolios) if the gold price falls below US$1,275/ounce.

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From the Planning Notebook

Strategies to incorporate TFSA's into your financial plan

TFSAs are a type of registered plan in which your contributions grow without attracting tax. Funds can be withdrawn tax-free at any time. On withdrawal, TFSA contribution room is not lost, and the full value of the withdrawal can be recontributed the following calendar year or in future years. This means TFSAs can be used for a wide range of goals — from emergencies to renovations and other special purposes, or to supplement retirement income. Since TFSAs started in 2009, the cumulative maximum contribution allowed is $63,500.

- Unlike RRSPs, there is no maximum age or earned income requirement to make a TFSA contribution. If you're no longer working but have excess cash flow, you can continue building your savings through TFSA contributions, even though you no longer have earned income with which to generate new RRSP contribution room. You can withdraw funds from your TFSA if needed and re-contribute them later, without tax consequences.

- You can contribute to a TFSA even after the end of the year you turn 71, when you're no longer able to contribute to your RRSP. This feature means you'll be able to preserve some tax-free growth, and you won't be required to convert it to an income vehicle at any time in the future. If you are over 71 and receive RRIF income, use your annual RRIF withdrawal to contribute to your TFSA (to the allowed maximum), thereby maintaining tax-free status on a portion of your investment income.

- TFSA withdrawals do not impact federal income-tested benefits and credits. Examples of federal income-tested benefits include the Guaranteed Income Supplement and Old Age Security.

- You can use a TFSA in combination with an RESP to increase the size of a post-secondary education fund for children or grandchildren. You can withdraw funds tax-free when they're needed for education or for any other purpose.

- You can gift funds to a child who is at least 18 years old, and they can use these funds to contribute to their own TFSA. This may be a strategy to consider when you've maxed out your own TFSA contribution room and have excess non-registered funds. A $63,500 TFSA, earning four percent, will generate over $2,500 per year tax-free to help cover, for example, university expenses.

Anyone who has excess cash available and has not done so, should consider maximizing their TFSA balance.

Please consult a tax expert before implementing any of these strategies. If you would like to learn more about tax planning or any other aspect of planning for your financial future, including investment management, estate planning and insurance, please get in touch.

Until next time, best regards,

David Serber

Feel free to forward ***Serber Speaking*** to anyone you think would find it of interest.

RBC Wealth Management
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