Serber Speaking

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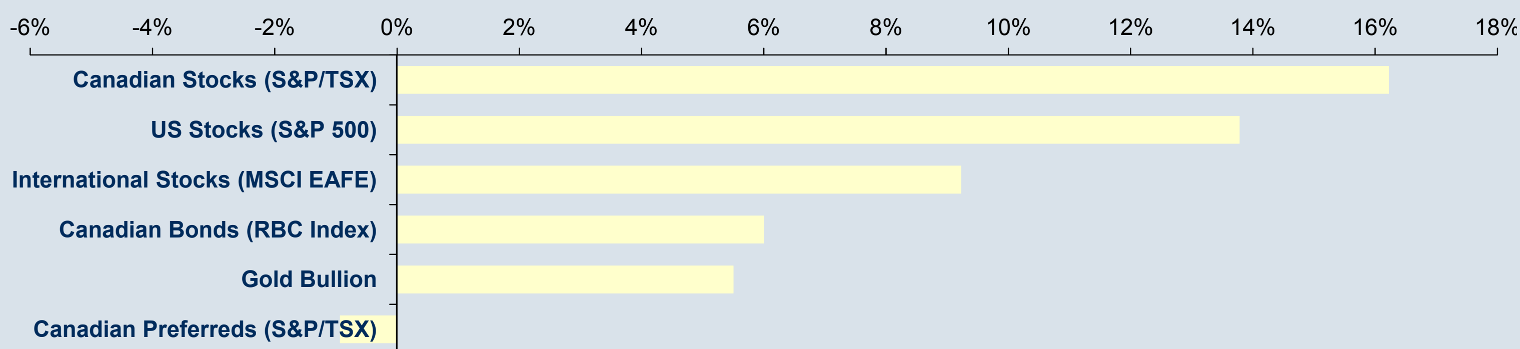
Commentary for the quarter ended June 30, 2019

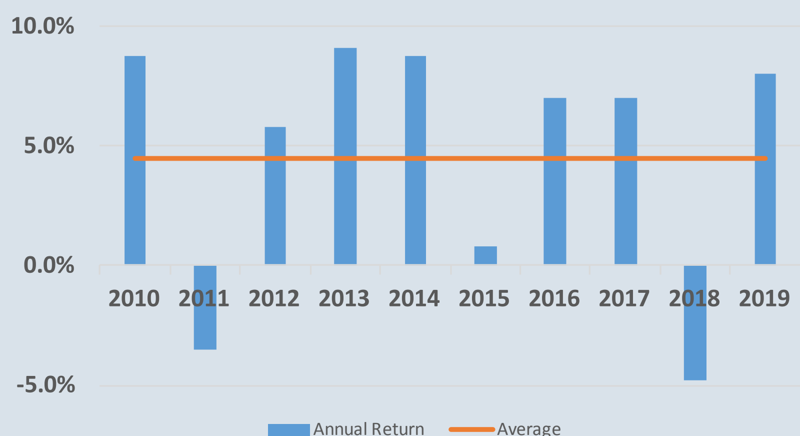
Market Response to the Fed? Up, Up and Away!

After 2018's very negative fourth quarter, I wrote last time that global markets generally staged a strong rebound in the first quarter of 2019. The second quarter was more muted but still positive, with the MSCI World Equity Index posting a two-percent gain (in CAD$), bringing its 2019 return to date to a robust 12.3 percent. Of the markets shown on the asset-class chart below, the top performer has been the TSX (yay Canada!) with gains across all sectors.



Source: RBC, Thomson and Factset

This year's stock-market upswing indicates investors are adding risk exposure to their portfolios in search of higher returns. That said, the first half of 2019 also saw a reasonably strong showing from bonds and gold, of about six and five percent respectively (more than 10 percent annualized). Some investors, not ready to jump on the equities bandwagon, have been pursuing capital protection, which explains the strong flows into bonds and gold. However, I expect money will start flowing out of bonds in the coming quarters as economic growth revives, so I would not be a bond buyer today. Instead, I am happy to buy preferreds at current levels, as they have not yet recovered from Q4 2018's drubbing and, indeed, are in negative territory for 2019 (see above). As well, gold, which I hold in all Managed Portfolios, should continue to benefit from central banks' recent tilt toward easier monetary policies.

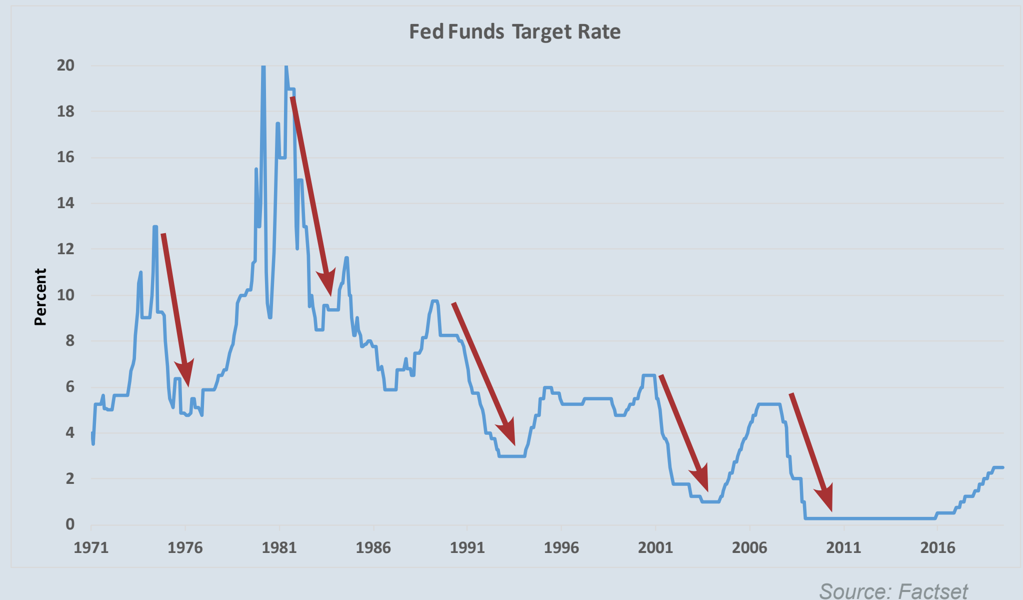


Source: RBC Balanced Fund, Class A

Before I delve into central bank policy moves in more detail, it is worth reviewing the balanced-portfolio chart at the left. As I observed in January, after a down year like 2018 or 2011, or a lacklustre year like 2015, a balanced portfolio typically posts a few good years. To date, 2019 is tending to confirm this thesis. Indeed, the average annual balanced-portfolio return is 4.7 percent over 10 years - not bad - but one must be prepared to put up with a couple of negative years along the way.

A Topic of Interest

One of the crucial questions always facing the economy and financial markets is determining the ideal interest rate. There are two answers: one is to let market forces do the job, while the other is for a central agency to set the rates.



Source: Factset

An interest rate is simply the price for borrowing money. Most economists agree it is better for market forces to determine prices. Prices tell producers what to produce and in what quantity. For example, if the market price of corn is rising, farmers plant more corn. (As a result, the supply increase brings the price back down.) If the market price of CDs falls too low, companies stop producing CDs. The market pricing system generally works. But not always. In 1907, a major financial panic started in New York when, amidst a recession and a major stock market speculation gone wrong, banks and trust companies found themselves very short of cash. Overnight interest rates soared as high as 70 percent, a series of bank runs ensued and a tidal wave of bankruptcies swept the land. In response, the federal government decided it needed a central bank to control the money supply and manage interest rates, and in 1914 it created the Federal Reserve. All major nations now have central banks that control the money supply and also have the power to set interest rates.

So far so good... only one major problem: How do central banks know what interest rate is the best rate at any given point in time? Short answer: they don't. The truth is that neither they nor anybody else is able to predict the future with any degree of accuracy. As a result, central banks are generally reactive, despite their sincere attempts to be proactive. For evidence of this, I present the above graph. Over the last 50 years, there have been roughly five periods when the Federal Reserve rapidly cranked up interest rates, only to cut them dramatically a few years later. Example: between 2004 and 2008, the Fed Funds rate rose from 1.00 percent to 5.25 percent, then went down to 0.25 percent. It seems they had no clear knowledge what the optimal rate of interest was—or should have been.

Fast forward to the present... Last fall, Federal Reserve Chairman Jerome Powell said that the Fed Funds rate, after being raised from 0.25 percent to 2.25 percent over the past two years, was still "below neutral" and that the Fed expected to raise rates gradually another two, three or four times in 2019. In the months that followed, stock markets tanked, and the bond market reacted in such a way as to show the Fed it was dead wrong (see my discussion last quarter on yield-curve inversion). To its credit, the Fed has now admitted as much, indicating it currently has no plans to raise rates in 2019 and more likely will be cutting them at least once (perhaps at the end of July). Markets have rejoiced at this news — and some stock indices, such as the S&P500, have recently hit new all-time highs. So, where do things go from here?

Here's a notable recent prediction from Peter Bezerin, Chief Global Strategist at BCA Research:

"Fed policy is likely to proceed in two stages: An initial stage characterized by a highly accommodative monetary policy, followed by a second stage where the Fed is raising rates aggressively in response to galloping inflation.

The first stage, which will end in late 2021, will be heaven for risk assets. The subsequent stage, which will feature a global recession in 2022-2023, will be hell."

To the extent this proves accurate, the correct strategy would be to maintain exposure to stocks to benefit from buoyant growth over the next year or two, add gold to benefit from a re-emergence of inflation, and avoid bonds, which fall in value when interest rates rise. Then, sometime in 2021, prepare to batten down the hatches.

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From the Planning Notebook

What is the Lifelong Learning Plan?

Canada's Lifelong Learning Plan (LLP) has been around since 1999 but is not well known. If you've never heard of this plan, or have but never understood what it was, here is a primer:

- The LLP allows Canadians to withdraw up to $10,000 in a calendar year ($20,000 lifetime total) from their RRSPs if they are enrolled in qualifying post-secondary education or training.

- A qualifying program must be at a post-secondary level or be of a technical or vocational nature at a designated educational institution that includes at least 10 hours of class or training time per week over a minimum of three consecutive months.

- You do not need to spend the withdrawn funds on school - you can use them for any purpose.

- LLP withdrawals are made by using CRA Form RC96, *Lifelong Learning Plan (LLP) – Request to Withdraw Funds from an RRSP*. The financial institution administering your RRSP should not withhold tax from your withdrawal.

- You have up to 10 years to repay the LLP amount to your RRSP. Typically, you would repay one-tenth of the total per year.

- You cannot use the LLP for the education of anyone other than yourself or your spouse. If you are planning for your child or grandchild's education expenses, you may want to consider setting up an RESP or an income-splitting trust.

In summary, if you or your spouse are interested in taking post-secondary courses to enhance your knowledge or technical training, you may be able to use the LLP program to withdraw up to $20,000 from your RRSP, tax-free. Or, if you know someone for whom this plan may make sense, you now know enough to explain the main points to them.

As always, please consult a tax expert before implementing any tax 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 and happy summer,

David Serber

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

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