Serber Speaking

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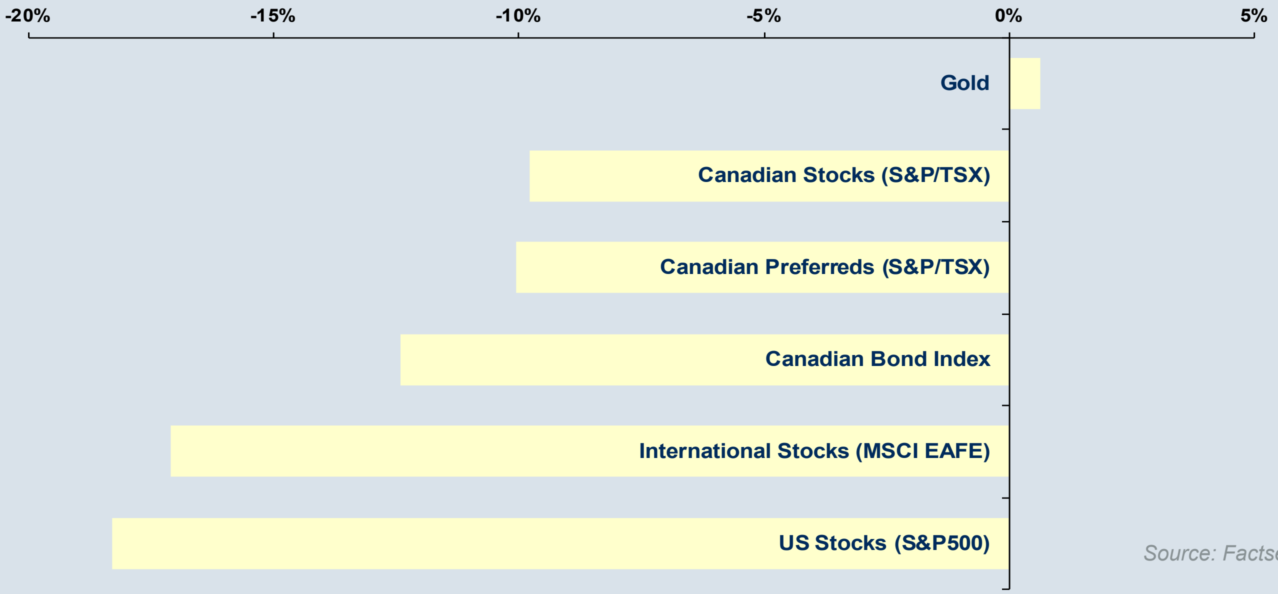
Commentary for the quarter ended June 30, 2022

Central Banks: Tight talk sinks stocks

The second quarter of 2022 was a rough one for financial markets. If the consequences of world events, including Russia's invasion of Ukraine, and China's COVID lockdown weren't enough of a challenge, central banks added to the fray by making it clear they were willing to do "whatever it takes" to stop inflation from getting out of control. This means significantly higher interest rates. At the beginning of the year, the US Fed expected to raise it's overnight "Fed Funds" rate to about 1.25% by mid-2023. Their latest projection shows the rate at 3.75% this time next year. That is a huge change in expectations.

Higher interest rates are bad news for most financial assets. This is why, on the chart below, we see that not only are stocks down 10 to 20 percent this year, but preferreds and bonds are also down double-digits, by about 10 and 12 percent respectively.

Performance by Asset Class: January 1 to June 30, 2022 (in Canadian $)



Source: Factset

Will there be a recession?

There are three main scenarios to consider when thinking about investing over the next 12 months. No recession, a mild recession, or a severe recession. Highly respected investment strategist Peter Bezerin of BCA Research currently assigns odds of 60%, 30% and 10% to the three scenarios, respectively. If there is no recession, he sees stock markets up 20 percent over the next year. In the mild recession and severe recession scenarios he sees markets down 10 and 25 percent respectively. If he is correct, what does this mean for investment portfolios? Firstly, we should maintain current exposure, as there is a better-than 50 percent chance that markets move higher over the next 12 months. Secondly, keep a decent amount in liquid cash or short-term investments, and use this to add to positions, slowly, if further weakness develops. This down-cycle will eventually end and a new up-cycle will begin. This could be in a month or two, or could take a year or more. Be prepared for either scenario.

What About inflation?

Inflation has gone from being a non-issue for the last decade or two, to the most important issue, it seems almost overnight. A year or two ago inflation was less than two percent, and the biggest concern, if there was one, was that it was too low. Fast-forward to today and we are seeing eye-popping inflation numbers like nine percent. What is going on?

The shorter term factors pushing up inflation come from supply chain disruptions, caused by two disparate sources: the COVID pandemic, and effects stemming from Russia's invasion of Ukraine. Both of these have the effect of interrupting the supply of goods getting to market. Since price is a function of supply and demand, if supply is constrained, and demand remains unchanged, prices go up.

While we do not know when or if these supply issues will subside, their impact on inflation will fade. For example, if the Russian invasion of Ukraine causes the price of wheat to go up 50 percent, it pushes up the inflation rate. If Russia is still in Ukraine a year from now, and the price of wheat is still up 50 percent from the pre-invasion price, the impact on inflation is zero. This is because what we refer to as inflation is not the level of prices per se, it is the rate of change of prices.

This waning impact on inflation from COVID-induced bottlenecks and the Russian invasion of Ukraine, combined with the pending slowdown in GDP growth (i.e. demand), will eventually reduce inflationary pressures, and the inflation rate will almost certainly decline over the coming year. Once this becomes clear, the central banks will take a break from increasing rates. Financial markets will sniff this out well in advance, and when that happens there will likely be a relief rally. The magnitude and staying power of such a rally is of course an open question.

So - the good news is that inflation will be coming down in the near term - i.e. over the next 12 months. The question is, what happens after that? One way of glimpsing the possible future path for inflation is by comparing current yields on regular bonds and inflation-protected bonds. Investors have the option to buy either regular bonds or inflation-protected bonds, issued by the federal government. By comparing the yields on these bonds it is possible to calculate investors' implied predictions for inflation. The nice thing about this method is that it is "crowd-sourced," based on the collective decisions of many many investors, putting up real money. This has a certain credibility, as opposed to any one individual "expert" expressing their particular opinion on the matter.

Currently, this analysis shows that bond investors are implicitly predicting that inflation will be around three percent two years from now, and around 2.5 percent 5 years from now. Of course we do not know if this will turn out to be the case or not, but at the very least it should give us pause, to consider the possibility that the current spike in inflation could be transitory.

That said, inflation may turn out to be a longer-term problem. We know that central banks created trillions of dollars and euros "out of thin air" over the last decade or so -- firstly to repair the global financial system after the Great Financial Crisis of 2008-2009, and again during the COVID pandemic. The consequence of a dramatic printing of "paper" money, is inflationary pressure. It remains to be seen how this will play out.

As always, we do not bet on one outcome, rather, we diversify our portfolios to account for multiple scenarios. Right now I am buying bonds at attractive yields which we have not seen in many years. I am also buying stocks of certain companies which have the ability to increase prices, and maintain profits and dividends, if inflation turns out to be more persistent. I also hold some gold, which has traditionally been a good hedge against inflation. In addition, I am maintaining relatively high cash positions, in case there is further downside, and lower prices become available in the financial markets over the coming weeks and months.

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From the Planning Notebook

OAS (Old Age Security) - some interesting things to know

OAS is a monthly federal retirement benefit payable for life to individuals who are age 65 and over. Unlike CPP, you don't have to make contributions to receive OAS retirement benefits; this program is funded through general tax revenues.

To be eligible for OAS, if you live in Canada, you must be 65 years old or over; be a Canadian citizen or a legal resident at the time your application is approved; and have lived in Canada for at least 10 years since the age of 18.

If you live outside Canada, you must be 65 years old or over; have been a Canadian citizen or a legal resident of Canada on the day before you left Canada; and have lived in Canada for at least 20 years since the age of 18.

Most Canadians are automatically enrolled for OAS, in which case a notification letter is sent from Service Canada the month after turning age 64. If the information in the letter received is accurate and a deferral is not desired, no further action is required. If the letter is not received from Service Canada, an OAS application will be required.

You're eligible to receive a full OAS pension if you've lived in Canada for at least 40 years after turning age 18. If you lived in Canada less than 40 years since age 18 your OAS entitlement is pro-rated. So, if you lived in Canada for, say, 20 years after age 18, you would be entitled to 50% of the maximum amount. There are exceptions to the above but these are somewhat complex. If you are interested send me an email requesting our full OAS article.

In July 2022, the OAS pension will increase by 10% for those who are age 75 and over. This permanent increase will apply regardless of whether you receive a full or a partial OAS pension, and will apply for the period that begins in the month after you turn 75.

If your net income exceeds a certain minimum threshold for the year, you may have to repay all or part of your OAS pension. This is referred to as the OAS pension recovery tax, more commonly known as OAS clawback. For 2022, if your income is greater than $82,000, some of your OAS will be clawed back. If it is over $133,000, all of your OAS will be clawed back.

If you are close to the above thresholds, you may consider strategies to lower your net income and thus keep all, or more, of your OAS. These strategies include favouring investments that generate capital gains; making RRSP or Spousal RRSP contributions if applicable; splitting your pension income and CPP income with a lower-income spouse; and possibly deferring OAS to age 70 if you are still working and earning employment income at age 65.

You can postpone receiving your OAS pension for up to five years after age 65, in exchange for a higher monthly amount. Your monthly OAS pension payment increases by 0.6% for every month you delay receiving it, up to a maximum of 36% if you delay until age 70. There is no financial advantage to deferring OAS after age 70.

I hope you found this review of OAS of interest. If you have any questions about this topic, or anything else, please feel free to reach out to me 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.