Serber Speaking

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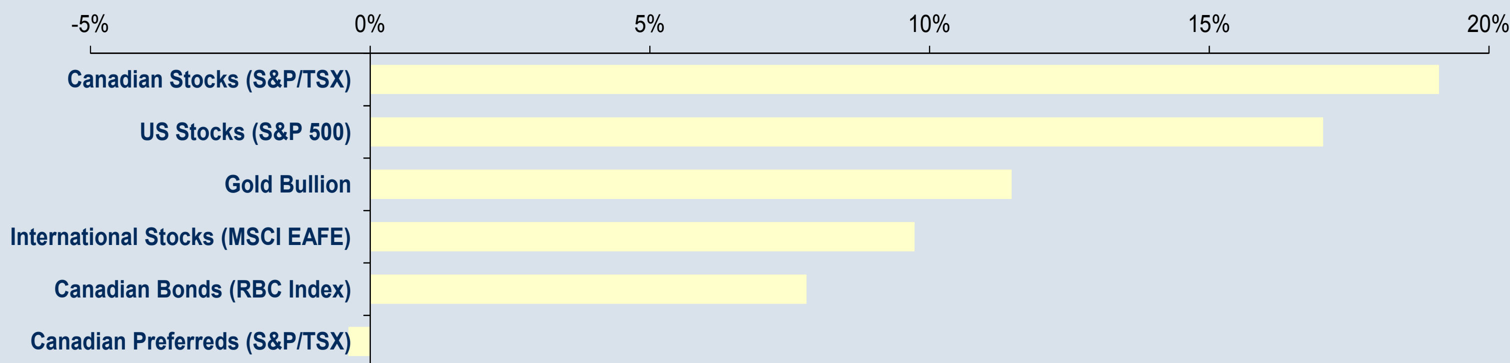
Commentary for the quarter ended September 30, 2019

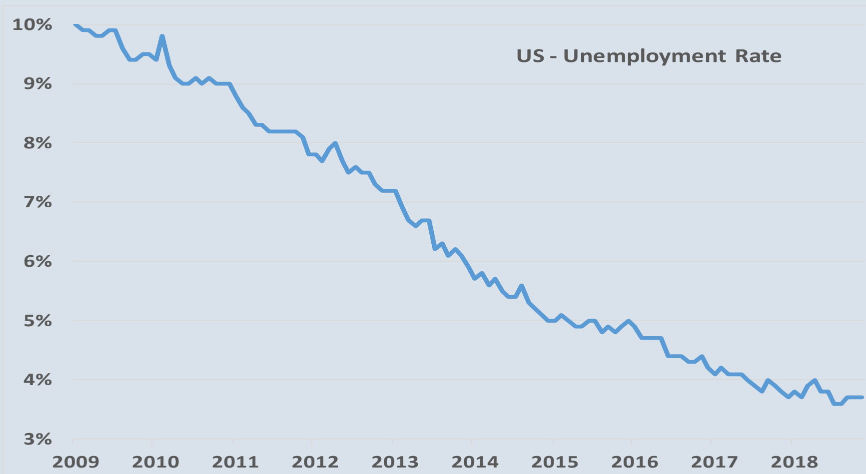
The Waiting Game: Will the Global Economy Respond to Lower Interest Rates?

Despite the never-ending stream of dire news over the past few months (Brexit, China trade war, Hong Kong riots, Trump, etc.), the third quarter was relatively calm for financial markets. Global equities traded up and down within the same range they have been in since April, ending the quarter near the high end of that range, for a Q3 gain of about two percent (MSCI World Index, in CAD$). As seen on the chart below, 2019 year to-date has been positive for investors, as markets staged a strong rebound earlier this year from the major drop in late 2018.



The focus for the past few quarters has been on central bankers, including the US Federal Reserve, the European Central Bank (ECB) and others, who are taking measures to ease domestic and global monetary conditions by lowering interest rates. Since I last wrote you in early July, the Fed has cut rates twice, the ECB slashed its overnight rate to negative 0.5 percent, and the Reserve Bank of Australia on October 1 reduced its rate to 0.75 percent - an historic low. These moves are in response to sluggish global business conditions and are intended to spur economic activity by stimulating both consumer demand and business investment.

It is worth noting that central bankers make these moves because they work - albeit with a lag. As a result, it is likely that we will see better economic numbers over the coming quarters as the stimulus from easier money conditions works its way through the global economy. To wit, we are starting to see some positive momentum: Over the past few months, the Citigroup Economic Surprise Index has moved from solidly negative to solidly positive for the first time since 2017.



Source: Factset

Most importantly, unemployment rates in Canada and the US remain stable, at or near historic lows. It will be time to worry if and when the unemployment rate begins a sustained rise, as this is a reliable sign that the economy has entered a downward trajectory, usually ending with a recession.

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Base case looks OK, but still plenty to worry about

Here is a list of current market risks identified by economic strategist Chen Zhao of Alpine Macro, one of several market watchers I regularly check in on.

1. **US monetary policy is still too restrictive, and the Fed is "behind the curve."** Under this scenario, the Fed's moves to cut rates this year turn out to be "too little, too late." If so, any hesitation to lower rates at the Fed's next meeting on October 30 would be a policy mistake, leading to worsening economic results and market turbulence.

2. **Escalation of the US - China trade war.** It is generally agreed that some form of short-term resolution is in the best interests of both China and the US. However, while most observers focus only on President Trump, Chen points out that "Washington is in the hands of China hawks," meaning that anti-China hard-line thinking goes beyond the president and will not be easily contained or controlled.

3. **US Corporate debt is historically high.** Low interest rates over the last decade have encouraged corporate borrowing, resulting in increased corporate debt levels. At the same time equity has decreased due to share buybacks. The result is a highly leveraged corporate sector, which amplifies downside risk if the economy and financial markets head south.

4. **Not enough fiscal stimulus in Europe.** The ECB is doing "whatever it takes" to provide the European economy with monetary stimulus, but the same cannot be said for the EU providing fiscal stimulus. Unless European governments, led by Germany, the largest EU economy, ramp up fiscal stimulus (deficit spending and/or tax cuts) the Eurozone will stagnate.

While the above list provides plenty to worry about, Peter Bezerin, Chief Global Strategist at BCA Research, asserts the economic outlook is still generally positive, based on the following:

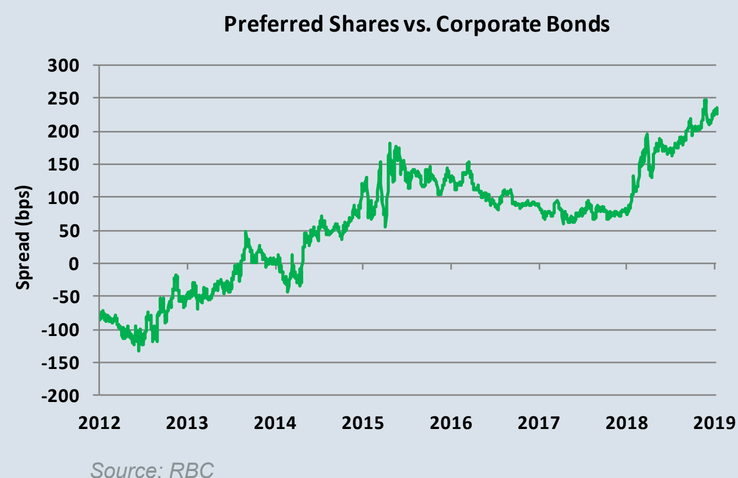
1. **Global financial conditions have eased significantly.** The Goldman Sachs Global Financial Conditions Index is at its highest level since 2013, due to interest rate cuts by many central banks over the past several months. Based on the historical record, when financial conditions are this stimulative, a pickup in economic activity is not far behind.

2. **Interest-sensitive sectors are showing positive signs.** US residential investment (homebuilding) has turned up and will likely climb further given the large drop in mortgage rates over the past six months. Also, demand in the auto sector is showing signs of a pickup, as banks are reporting increased demand for auto loans. Since the recent slump in manufacturing has been concentrated in the auto sector, increased demand would be a significant positive.

3. **Chinese and European growth should improve.** Stimulus in both regions will likely be increased to forestall a decline in economic activity.

According to Bezerin, markets have entered a "show me" phase where improved economic data and some form of resolution or detente in the US-China trade war will be necessary for markets to move higher. Given the above, I am inclined to hold equity/risk weightings a bit below neutral for now. Any meaningful correction in Q4 (i.e., a 10-percent drop from previous peak) will represent a buying opportunity.

In the meantime, while we wait for these issues to play out, I see excellent value and a buying opportunity in the Canadian preferred share market. The average preferred share has fallen from its original issue price of $25 to about $18 in recent years, and the average dividend yield is about six percent. Since dividends are taxed favourably, this is the equivalent of making about 7.5 percent interest. The graph at right highlights the relative value of preferreds. Seven years ago, in 2012, a preferred paid about 100bps (one percent) less than a comparable bond. Currently, preferreds yield some 200bps (two percent) more than comparable bonds. As a result, there is better value currently in preferreds compared to bonds.



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From the Planning Notebook

The Tax Benefits of Income Splitting

The top marginal tax rate in Ontario is 53.5 percent, among the highest in the developed world. As a result, it is understandable that clients with taxable income of roughly $225,000 or more per year, who are subject to the top rate, are on the lookout for ways to reduce their tax bill.

Since Canada has a graduated personal income tax system, one of the simplest ways for a family to reduce its overall tax bill is to shift income from high-income to low-income family members -- a strategy known as "income-splitting."

Of course, the Department of Finance and the CRA would prefer to collect tax at the higher rate, so they have created rules that make it tricky, but not impossible, to income split, so long as you know the rules.

The key concept used to discourage income splitting is "attribution." Under the attribution rules, if income is improperly shifted to a lower-tax family member, the CRA will "attribute" that income back to the higher-rate taxpayer and, as a result, no tax savings are achieved.

But there are various legitimate ways to ensure that split income is not caught under the attribution rules. One is for the higher-taxed family member to loan money to a lower-taxed member, for example to a spouse, who invests the money to earn investment income. The lower-tax spouse then pays tax on that income at the lower rate. In order to avoid attribution, the borrowing spouse must pay interest on the loan annually at the minimum allowed rate, called the "prescribed rate," which is currently two percent. Once the loan is advanced, the rate is locked in indefinitely.

According to my calculations, if a high-tax family member were to loan $500,000 to a spouse with no other income, they could generate about $5,000 per year in after-tax "free money" with very little effort. For people who fit the profile, this strategy is close to a no-brainer.

If the high-income earner has multiple family members to split income with (spouse, children, grandchildren, parents), this strategy can be multiplied by creating an income-splitting family trust and funding it with a prescribed-rate loan.

I am experienced with all of the above so feel free to call or email with any questions. *As always, please consult tax and legal experts 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,

David Serber

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

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