Serber Speaking

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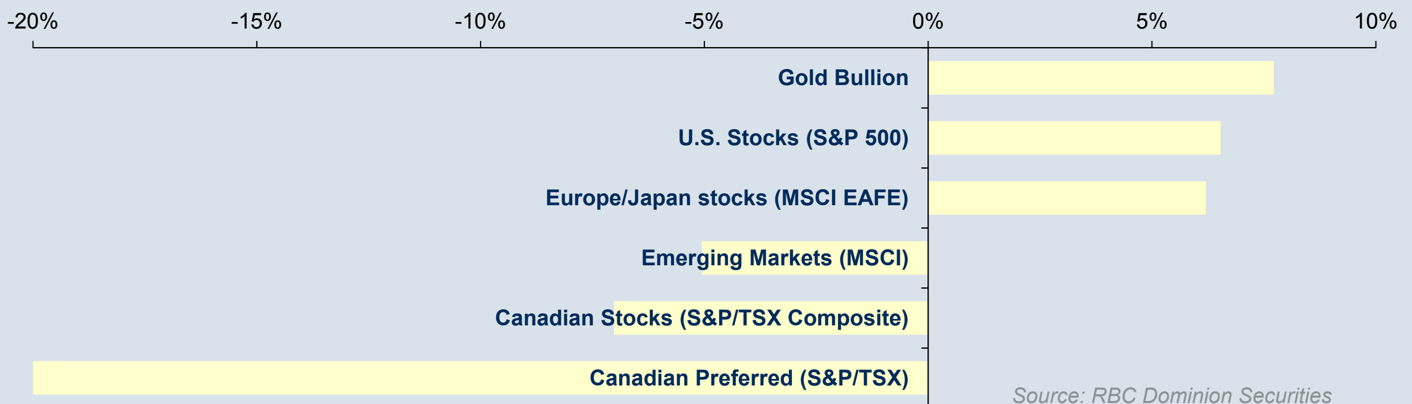
Commentary for the quarter ending September 30, 2015

In a word: Yuk

The third quarter of 2015 was decidedly negative. The Canadian stock market lost eight percent. Canadian preferreds and emerging market equities were both down 13 percent. All three are in negative territory for 2015, year to-date, with preferreds the biggest loser by a substantial margin, as seen on the graph below. The only asset class to record a positive return for the quarter was gold bullion, which is now in top spot on our year-to-date leader board, with a gain of eight percent (in CAD$).

Performance by Asset Class: January 1 to September 30, 2015 (in Canadian $)



Source: RBC Dominion Securities

As bad as financial markets have performed, there are some bright spots. The largest global stock markets—U.S., Europe and Japan—have generated positive returns of about six percent, year-to-date (in CAD$). This return is entirely attributable to the loonie's fall—down 15 percent against the greenback so far this year—and confirms that our strategy of diversifying investments outside Canada remains a good idea. In our average client's Managed Account, Canadian stocks represent about one-third of the equity portfolio, while foreign markets represent the remainder. That's why the equity portion of our average portfolio is at break-even, or slightly positive year-to-date, versus the Canadian market's seven percent loss.

What are the major issues facing financial markets?

China's slowdown

Since the 2008 global financial crisis, the developed world's economies have struggled to generate much in the way of economic growth. According to the World Bank's estimates, developed countries' GDP will have grown by a total of 8.4 percent from 2010 to 2015, while developing (emerging) countries' growth is much stronger at 27.5 percent. China's GDP growth over the five-year period is stronger still, at 39.2 percent. This helps explain why financial markets are so concerned about Chinese growth going forward. Healthy stock market returns depend on GDP growth to help drive profit growth and, lately, such growth has been dependent on China.

The good news is that the Chinese have many tools to stimulate growth, many of which are currently being deployed. The results should start to show up early next year and, if so, investments in Chinese companies should enjoy a nice bounce from current depressed levels at some point over the next six months or so.

A rebound in China would clearly be a boost for nervous investors worried about global GDP growth. In the meantime, bumps in the road remain. China recently devalued its currency by about four percent, and there could be pressure for additional devaluation in the coming months, which may bring with it some short-term turmoil.

U.S. Federal Reserve

For some time now, the U.S. Federal Reserve (The "Fed") has been broadcasting its intention to tighten monetary conditions by raising its key interest rate, the "Fed Funds" rate, before the end of this year. While this may make sense for the U.S. in isolation, as its economy is performing relatively well, it is unwelcome news for the rest of the world, where GDP growth is in short supply. For good or ill, the U.S. dollar is global money, and is the basis for global trade and finance. The actions of the U.S. central bank are felt around the planet, not just at home.

Tightening U.S. monetary policy at this time would be negative for global GDP growth. Financial markets know this, which in part explains why they have been going down more than up over the past six months. Fed Chair Janet Yellen acknowledged as much recently when she announced they would delay the rate increase originally expected in September because, among other things, they were "monitoring developments abroad."

If the Fed does indeed hike the rate before the end of the year, I expect we will see an initial negative "knee-jerk" reaction on financial markets, but do not think it is a big worry in the medium to longer term. If it turns out that global growth is too fragile to withstand U.S. monetary tightening, this will become manifest and the Fed will act pragmatically.

Bottom line: If markets fall further in anticipation of, or in the event of, an increase to the Fed Funds rate, it will create a buying opportunity. (Reasonable buying targets are about 10 percent below current levels for developed markets and 15 percent for emerging markets.)

Commodities

Global growth weakness, particularly in China, is being felt most heavily in commodity markets. According to leading global research firm BCA Research, China consumes more copper, zinc, aluminum and iron ore than the U.S., Europe and Japan combined. With the slowdown in Chinese GDP growth, demand for commodities is shrinking. At the same time, high prices through the 2000s encouraged producers to invest in new capacity, raising supply. With demand falling in the face of rising supply, the prices of many commodities are already way down—and are still falling.

This is bad news for companies and countries that produce and export commodities, such as Canada. The 50-percent drop in the oil price over the past year or so has wreaked havoc on parts of the Canadian economy, resulting in negative GDP growth for the first two quarters of 2015.

A Chinese rebound in 2016 may give a boost to commodity demand and beleaguered prices, but this will likely prove temporary. The Chinese economy is in the early stage of transition away from pure industrialization toward more consumer goods and services, a less commodity-intensive phase of development.

As regards crude oil in particular, additional global forces are acting to push prices lower. The "fracking revolution" that began in the U.S. and continues to expand, has created a large and economical new source of oil supply. The era of Saudi Arabia and OPEC dictating the world price for oil is over, replaced for the most part by supply-and-demand market forces. Since the marginal cost of production for U.S. frackers is around US$55 per barrel, and falling, it is unlikely that the oil price will get sustainably above US$50 to US$60 for the foreseeable future – and a US$40 long-term price is not an unreasonable forecast.

Other factors holding constant, this is bad news for commodity/oil producers such as Canada, Russia, Latin America including Brazil, and the Middle East. What is the offset? A fall in the currency exchange rate helps an economy adjust when a major trade dislocation such as this occurs. The drop in the CAD/USD exchange rate from 0.95 to 0.75 over the past year is a case in point. Over time, the lower exchange rate will help improve Canadian business competitiveness in global markets, creating new growth and new jobs to replace those lost in the energy sector. But this process takes time. Depending on how things evolve, Canadian interest rates and the Canadian dollar may have to fall further to offset the lost GDP growth and stimulate other export industries.

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Advanced Wealth Planning

I mentioned last time that I will be dedicating a portion of upcoming *Serber Speaking* newsletters to financial planning, estate planning and tax planning. One of the strategies I will outline today is use of the **RBC-DS Family Trust**. This is a strategy that can save thousands of dollars in tax for people in a particular situation, who

a) pay for children's or grandchildren's programs such as private school, university, summer camp, sports, etc., and

b) pay tax on investment income – in other words, have a non-registered investment portfolio.

As seen in the rough example at right, a family trust structure on a $1 million portfolio could save $12,500 in tax per year, or $125,000 over a 10-year period!

If you or someone you know meets the above two criteria, I would be pleased to discuss this "no-brainer" strategy in more detail.

Family Trust - Tax Savings

Portfolio size	$1,000,000
Investment return	5%
Investment income	$ 50,000
Estimated Tax	$ 18,000
Estimated Tax using Family Trust	**$ 5,500**
Annual Savings	**$ 12,500**

Estate Planning Seminar

I am pleased to announce that I am hosting, along with some of our RBC partners, an Estate Planning seminar on November 18. Entitled "The Role of the Executor," it features speaker Leanne Kaufman, Head of RBC Estate and Trust Services, and author of *The Executor's Handbook*. Most people are named as the executor of someone's estate and/or have named someone to act as executor for their own estate. Yet the vast majority do not truly understand what the executor's role involves. Why not invest an hour to find out more?

Date & Time: **Wednesday, November 18 at 10:00 a.m**. Light refreshments will be served.

Location: 2345 Yonge Street, just north of Eglinton Avenue

Attendees will receive a copy of Leanne's book, *The Executor's Handbook*. The event is complimentary, but space is limited. If you are interested, please RSVP to melissa.bellamy@rbc.com as soon as possible.

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I wrote in January that "portfolio returns in the four-percent to five-percent range for the year ahead seems like a reasonable expectation." At this time, most balanced portfolios are at or near zero returns year to-date. Historically, markets have had their worst months in September and October and have a stronger history over the November-to-January period. Hopefully, this year will follow that pattern and, if so, there is still a reasonable chance to meet my original returns forecast for 2015.

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