Wealth for Life

Wealth Management
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Green shoots & blossoms

The green shoots of economic growth are evident in most global economies. Blossoms of economic growth are evident in more developed economies experiencing vaccine success and broader economic reopening. The second quarter of 2021 confirmed the building economic momentum experienced in Q1, setting the foundation for continued growth. In general, the success of vaccine deployment has ushered in an unprecedented surge of "pent-up demand" from consumers & businesses, affecting everything from products to services. Product shortages and inventory rebuilds will take quarters to rebalance setting the stage for robust future economic growth.

Discovery of evolving COVID variants continues to play havoc with the reopening status of many jurisdictions and their respective recovery plans. Canada, for one, has been stymied by prolonged restrictions; however, accelerated vaccine success points to reduced restrictions and reacceleration of the recovery. Although vaccine acceptance has been met with less enthusiasm in the U.S., its reopening is leading the developed world and its economy is following suit. Drug companies and health agencies are hard at work evaluating variants and vaccine effectiveness. Make no mistake, headlines pertaining to COVID variant evolution will drive volatility/corrections in financial markets. Given the stability of the economic foundation in place and current momentum, the probability of future economic growth is considered to be above average.

Consumer spending, supported by government stimulus, is the cornerstone of economic momentum. Although the chart below (Bloomberg) presents U.S. personal income, it's indicative of many developed economies, including Canada.

Government stimulus ushered in unpresented personal income growth in 2020 and Q1 2021, which is still working through the economy. The significance of the stimulus provided to consumers is evident from the June announcement by the U.S., that in Q1 2021 U.S. household net worth reached an all-time high. Not surprisingly, equities and real estate values were a very big contributor to household net worth.

The direction of inflation has been a key driver of market volatility and central bank attention. Surging consumer demand has driven higher prices for services and products leaving many to ponder whether the current

Continued on page 2

Green shoots & blossoms

Continued from page 1

inflationary trend is transitory or a longer term risk. The market concern over inflation in the short term will be based on what investors believe central banks will do going forward. A central bank tightening (increasing interest rates) would ultimately restrict growth by making the cost of funding more expensive. Although interest rates are extremely low and higher interest rates would actually still be accommodative, financial markets would still behave erratically in the short term with any hints by the central bank of higher interest rates. Many would warn of a market sell off on rising interest rates; however, in the 30 months from April 2016 to November 2018 the interest rate on a 10-year bond increased from 1.5% to 3.25%. The S&P 500 increased by 40.9% over the period and the TSX by 17.4%. The 10-year bond is currently at 1.35%, so interest rates could rise easily and still provide an accommodative economic and business environment to foster positive equity markets. Inflation may not be the "enemy of stocks" as it's made it out to be.

Inflationary pressures will dictate the reaction of central banks and the direction of interest rates in the future. Presently the U.S. Federal Reserve is of the view that inflation is transitory. Many question the transitory theory given the price increases migrating through supply chains and into finished goods like autos and construction materials. The Fed would argue that once the supply chain bottle necks subside, input prices will normalize—whatever that might be. In the end, future job growth, consumer income growth and the consumers' propensity to continue spending will be a major driver of future prices and inflationary direction. Presently, inflationary pressures are noteworthy to be watchful and as expected given the dire "pandemic lows."

During the quarter equity markets powered to new highs, propelled by "reopening optimism." The TSX delivered an 8.5% return for the quarter while the S&P 500 provided an 8.5% in $USD and 7.1% in $CDN, thanks to a stronger Canadian dollar. Interest rates for a 10-year bond turned unexpectedly lower in the quarter, declining from 1.75% to 1.45%. Dovish comments by the U.S. Fed, confirming its "transitory" inflation expectations and commitment to inflation "tolerance" sent inflationary expectations lower. Late in the quarter, a plateauing of the U.S. unemployment rate and a modest deceleration of U.S. wage growth caused further uncertainty about the "stickiness" of current inflation numbers.

Since February, equity markets have been rolling through cycles of sector corrections, defying strategists calling for a "market correction". Late in Q1, technology corrected and has seen recent strength as COVID variants and the Fed have cast doubt on continuing robust economic growth. More recently, transports, consumer discretionary and industrials have moved through a weaker period. Equity markets have in turn been carried by strength in sectors like financials, energy and health care. The sector corrections have been manageable at say 5% to 12%, while others have traded sideways, all the while corporate earnings continue to surprise on the upside. Interestingly as time passes and earnings rise, equity market valuations migrate downward, an elegant and comfortable form of market re-evaluation takes place. In essence investors are confident enough in future economic growth and corporate earnings to continue buying equity, but are maybe more discerning. The investors' appetite for growth as impacted by the Fed or COVID variants, is virtually reflected in the sectors of choice in the short. In the longer term, economic fundamentals will prevail.

Much of equity strategists' discussion revolve around market valuations and a call for a market correction. As investors, and by human nature, we strive to time the market before any correction—which is understandable. What we've learned over time is that timing the market on any consistent basis is futile. As markets march higher in the face of strategists' calls, what is being missed? What has been happening consistently through the pandemic recovery, is that corporations' earnings have consistently been beating analyst estimates.

Economic growth, as measured by GDP, has been hitting levels not seen in years in developed economies like Canada & the U.S. as well as in China. What we haven't appreciated is that this growth is being achieved generally with far fewer workers employed. I recently heard a report from the U.S. that 7 million are still unemployed compared to pre-pandemic levels. So how is it that the U.S. can grow at such elevated levels with many fewer workers? One answer, as we have seen in corporate reports, is the digitization of business is driving productivity and corporate profitability. Just think of how "curbside pick-up" has improved at your go-to retail and shopping destinations. What if the corporate / business digital learning curve is just getting started? Perhaps equity markets have figured out digital productivity is accelerating through the business landscape and will drive future corporate margins and profitability higher. Equity share prices and market valuations will surely follow the evolving digital productivity learning curve.

As we move through a much sought after reopening through COVID variants, we salute the unwavering commitment of all our heath care employees and first responders (including our grocery & essential workers) for the sacrifices they and their families make for all of us.

Steve Lester

The Lester Wealth Management Team works with clients across Canada and globally & Steve is also U.S. licensed and deals with U.S. residents on a discretionary basis. Referrals from our clients are the utmost form of flattery and are always greatly appreciated.

Fewer taxes, please … we're Canadian

However you invest, do it tax-smart

From sea to shining sea, taxes are as much a part of Canadian life as talking about the weather and the metric system. But wherever you invest, if you're north of the 49th parallel, take heed of how your investments are taxed to get the greatest after-tax benefit – and keep more of those earnings in your pocket.

Start your tax-smart engines

As a rule of thumb, tax minimization is a part of any sound investment strategy, but shouldn't eclipse the other reasons to invest. Your decision to invest in a certain stock, asset class or region should be based on your goals, how long you plan to invest, your risk tolerance and a host of other factors.

Average versus marginal tax rates

Your average tax rate (also referred to as your "effective" tax rate) is the percentage calculated when the total tax paid is divided by your taxable income. Your marginal tax rate is generally the percentage of tax paid on the next dollar of taxable income. There is a difference between the two rates because Canada has a system of progressive tax rates. The average tax rate is always equal to or less than the marginal tax rate.

Not all investment income is created tax-equal

Different types of investment income receive different tax treatment, so don't be blinded by an investment's pre-tax rate of return. Instead, look beyond to the after-tax return potential, taking into consideration your income level and marginal tax rate, as well as any other considerations that might apply to your situation and affect the eventual return.

Once you've evaluated the investment's after-tax returns, consider other factors, such as the investment's risk level, the opportunity for capital appreciation, its liquidity and so on. In most cases, you will retain more after-tax income from capital gains and dividends from Canadian companies than from interest income and foreign dividends. As the chart on page four illustrates, what you keep from $1,000 of interest, Canadian-source eligible dividends and capital gains varies relative to your tax bracket.

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Class by class, how it all breaks down

Interest income

You may receive interest income at varying frequencies during the year, such as semi-annually or monthly. This interest income is fully taxable at your marginal tax rate, like salary income. It is taxable in the year it is received, and must be declared on your tax return.

If you do not actually receive the interest income during the year, you still must declare it as "accrued interest." Accrued interest means the interest you earned in the year – even if it is not paid in the year. Investments that require the annual accrual of compound interest include compound Canada Savings Bonds, strip coupons and compound GICs. If the term of an investment is not more than one year, such as a T-bill, the income should be reported in the year it is received.

Canadian-source dividend income

Dividends received from Canadian corporations are effectively taxed at a lower rate than interest income, due to the Dividend Tax Credit that is applied to the federal and provincial tax payable. This tax credit is meant to recognize that the Canadian corporation paying the dividends has already paid tax on its earnings, which are now distributed to its investors.

Foreign income

Foreign income is fully taxable at your applicable marginal rate. If you receive a dividend from a foreign company, you will pay tax on that dividend at the same marginal tax rates as interest income. You won't be able to use the Dividend Tax Credit, which is only available for dividends from Canadian corporations.

Return of capital

You may sometimes receive a non-taxable payment called a "return of capital" from an investment such as a Real Estate Investment Trust (REIT), royalty income trust or mutual fund. These return of capital distributions reduce the adjusted cost base (ACB) of your investment for income tax purposes, and the reduced ACB results in a larger capital gain or smaller capital loss when you eventually dispose of the investment. Think of return of capital distributions as tax-deferred income.

Capital gains and losses

You may realize capital gains, or losses, when you sell an investment. Half of a capital gain is taxable at your marginal tax rate and half of a capital loss can be used to reduce your taxable capital gains. It is the most tax-efficient source of investment income at higher tax brackets.

Consider income-splitting strategies that can transfer the tax-reporting obligation for investment income from higher- to lower-income family members, reducing your family's overall taxes.

Tax-loss selling and superficial losses

Tax-loss selling allows you to offset taxes on your capital gains, first within the current tax year, and if there are any remaining net capital losses, you can use the losses to reduce any taxable capital gains reported in any of the three previous calendar years, or carry them forward to reduce any taxable capital gains you may realize in future years.

A superficial loss may take place if you sell any security at a loss and then acquire an identical security in the period starting 30 days before the disposition and ending 30 days after the disposition. The result of a superficial loss is that the capital loss will be denied, and that denied capital loss will be added to the ACB of the identical acquired investment. Essentially this means the capital loss cannot be immediately claimed for tax purposes. But if you delay your repurchase until after the 30-day period, superficial loss rules don't apply – and you can claim your capital losses.

Minimize taxes like a pro

Once you know how your investments are taxed, get wise to the following tax-smart planning tips:

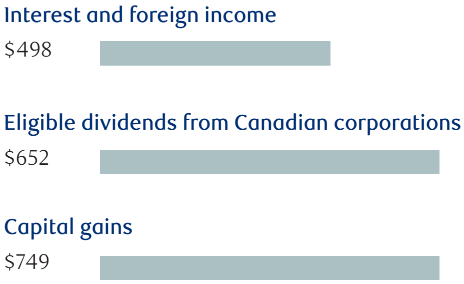
- Consider income-splitting strategies that can transfer the tax-reporting obligation for investment income from higher- to lower-income family members, reducing your family's overall taxes.
- Hold a greater proportion of your Canadian dividend-paying stocks outside your RRSP, RRIF or other registered plans to take advantage of their tax-preferred treatment.
- Look into a Dividend Reinvestment Plan (DRIP) that automatically reinvests your dividend payments into additional shares of the corporation – for even more powerful compound growth.
- Before the end of the calendar year, think about selling certain investments to recognize capital losses – to reduce taxable capital gains realized on other investments during the year.
- Structure your fixed-income purchases so the maturity dates fall after the end of the current calendar year – potentially deferring tax for up to 16 months.

Be sure to consult with your professional tax advisor before taking any action on any tax strategy.

How much do you keep?

The investment income you keep, after tax, per $1,000

The amount of investment income that you keep from various types of investment income will depend on your tax bracket – and the characteristics of the investments themselves. For example, dividends from Canadian corporations are taxed more favourably than dividends from foreign corporations that have not already contributed to Canada's tax system. The illustration below assumes you are in the highest marginal tax bracket (based on the average Canadian marginal tax rate across all provinces and territories).



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