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WEALTH MANAGEMENT review

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INSIDE

Mood swings

By Jim Allworth

Up until its final few weeks, the first quarter held no joy for investors. A promising end-of-year rally petered out in January, replaced by another slump that saw the broad market indices post new lows in early March.

Since then, global markets appear to have embarked on a rally phase that is showing signs of having legs. But, while most investors are relieved that prices have stopped falling for now, they are skeptical about the market's potential from here. Indeed, "skeptical" doesn't adequately describe how most are feeling.

As the market collapsed last fall, the operative emotions were extreme fear and finally panic. But when share prices reversed energetically in late November it seemed that investors, though shaken, were hanging on to their long-term optimism. To most, the stock market had been temporarily ambushed by the credit market shockwaves flowing from the mid-September Lehman Brothers bankruptcy.

But the rapidly expanding credit crisis had provoked a very large response from governments and central banks that rode to the rescue with unprecedented vigour. It was tempting to imagine that if the financial system, now pulled back from the brink, could be made to operate more normally then stocks would be able to recover – if not immediately to their old highs, then at least to some appreciably higher level that more accurately reflected their long-term value.

Unsustainable pessimism

By the time we arrived at the March lows, such a sanguine view was nowhere to be found. Panic and fear had been replaced by resignation and despondency. It wasn't so much that share prices might have further to go on the downside but rather that they might never recover – ever!

Of course, what had changed the most in the intervening 15 weeks was the tenor of the economic news. In November investors were still looking at economic data from September or from the third quarter: the economy was weak but still hanging together, as were corporate earnings. But thereafter, as credit markets seized up, the economy, we were to subsequently learn, went into free fall. By early in the new year we came to understand that not only was the U.S. now in recession but so too

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was Canada, Europe, Japan and most of the rest of Asia. And expectations everywhere were for the downturn to worsen. Earnings were now also falling, even outside the beleaguered financial sector.

Precarious forecasting

However, just before we all embrace the now widely expressed idea that the economy is irretrievably headed for a long, deep recession let us remind ourselves that economic opinions and forecasts change often and are frequently wrong – ours included. But aside from the not-surprising fact that individual forecasters from time to time get it wrong, the more germane observation is that a broadly held consensus – the one where increasingly everyone knows that such-and-such an outcome is inevitable – has a very limited shelf life.

Just think of the long list of expectations accepted as gospel at various times over the past decade: that oil could never climb back above $25 per barrel on a sustained basis (2000); that oil would never fall back below $80 (last fall); that the Canadian dollar would never move much above US$0.70 (2002); that the Canadian dollar was on its way to US$1.30 (late 2007); that inflation was about to become a big problem (last summer); that deflation is about to become a big problem (now).

Maybe this conviction that much worse lies ahead hasn't been around long enough yet to qualify as a doomed broad consensus. But there are at least two huge hurdles it's going to have to get past to have a chance of being correct.

The first is monetary policy, which has entered a new and potentially very potent phase. The U.S. Fed has informed the markets that in addition to setting and keeping short-term interest rates at zero it will now work to bring long-term rates much lower by buying massive amounts of U.S. Treasury bonds and other longer-dated bonds, including mortgage-backed securities in the open market.

This is likely to have several positive effects. First it will drive mortgage rates, already near 40-year lows, markedly lower. This should make new homes even more affordable, while allowing existing homeowners an opportunity to lower their monthly payments through refinancing. Together these should act to slow the rate of foreclosures, reduce the inventory of unsold homes, and put a firmer bid under the housing market. Lower long-term interest rates also make it much harder for banks to park their lendable funds in government bonds by squeezing the spread earned over the deposit rate closer to zero. And last, but most important, significantly lower interest rates across the maturity spectrum act to dynamite cash out of bank accounts and into the economy by eroding the after-inflation purchasing power of savings.

It's worth remembering that 35% of all U.S. households have no debt of any kind and that, excluding the sub-prime group, the U.S. middle class (more than 70% of all households) has an increasingly large pile of uncommitted cash in the bank. The dramatic merchandise markdowns of January and February tempted some of that cash out of hiding. Lower interest rates could have the same and more lasting effect.

Fiscal tide about to come in

The other wave that is likely to float the economy higher is fiscal stimulus. Government spending is now about 21% of GDP. The deficit this year is expected to come in at 12% of GDP and next year at 9%. This will represent a much, much larger fiscal injection than anything attempted by government in the Great Depression. Arithmetically, it will be very hard for the overall economy to continue contracting when the gap between what government is putting into the economy and what it is taking out is surging to such a massive extent. Especially since inventory liquidation, which has been very pronounced in the most recent quarters and the source of the worst statistical weakness in the GDP accounts, will likely have run its course by the beginning of summer.

Fiscal stimulus has other important tangible effects. The most important is breaking the downward momentum of growth and employment. Significantly, this package provides important fiscal support to states, which are the big government employers. Unemployment is likely to grow into next year but the fiscal plan should sharply curtail the growth of the "Am I Next?" group. That in turn should make the monetary impetus to consumer spending described above that much more effective. Happily Canadian economic policy is moving down the same two paths: very low interest rates and quantitative easing on the part of the Bank of Canada coupled with extraordinary stimulus from government. The same is true for virtually every industrialized economy.

Feeling better – for now

At the March lows stock markets were valuing businesses at levels that suggested corporate earnings had much further to fall and that there was no plausible path to a recovery in those profits anywhere in sight. Without making any judgment about how much traction and success all these policy initiatives will eventually have, we anticipate that investors, at least for a while, will be persuaded to abandon their most negative expectations and move to price stocks at levels that incorporate improved odds of eventual economic recovery.

Jim Allworth is Vice-Chair of the RBC Investment Strategy Committee.

A unique opportunity for significant tax savings

The Spousal Loan Strategy

By Marlena Pospiech, CFP

Do you have non-registered assets exposed to your high marginal tax rate? Do you also have a spouse earning little or no income? If so, you may be able to reduce your family's tax bill significantly each year with the Spousal Loan Strategy.

With the Canada Revenue Agency's (CRA's) prescribed interest rate on spousal loans at a historical low of only 1%, you currently have a unique opportunity to maximize this strategy by locking in this rate.

How it works

With the Spousal Loan Strategy, you loan cash to your lower-income spouse in order to take advantage of their lower marginal tax rate on future investment income. This results in significant annual tax savings for your family, which can grow even larger over time as your spouse accumulates income on the income.

To put the strategy in place, you simply make a demand loan to your lower-income spouse at the CRA's prescribed interest rate. This loan is backed by a demand promissory note and a loan agreement that sets out the terms of the loan.

Next, your spouse invests the entire amount of the loan in their own name. To maximize the strategy, your spouse designs their portfolio to generate income exceeding the interest they pay you on the loan. Between April 1, 2009 and June 30, 2009, the interest rate prescribed by the CRA is at a historic low of 1% – making now an opportune time to consider this strategy.

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Greater tax savings over time

The table (right) shows how you could save $80,447 in taxes over 10 years and $282,206 over 20 years with a $500,000 Spousal Loan Strategy. For this illustration, we assume the lower-income spouse has a 20% marginal tax rate and the higher-income spouse 45%. We also assume an annualized 7% annual rate of return comprised of 1% eligible Canadian dividends, 2% interest and 4% realized capital gains.

	Without strategy	With strategy	
	High-income spouse	**High-income spouse**	**Low-income spouse**
Initial asset value	**$500,000**	**0**	**$500,000**
Income generated	$35,000	0	$35,000
Prescribed rate of interest **paid by** lower-income spouse and **received by** higher-income spouse	n/a	$5,000	($5,000)
Income — before taxes	$35,000	$5,000	$30,000
Less — taxes	($10,125)	($2,250)	($3,050)
Income — after taxes	$24,875	$2,750	$26,950
Comparison of combined after-tax income after one year	$24,875	$29,700	
Total tax savings in one year		**$4,825**	
in 10 years		**$80,447**	
in 20 years		**$282,206**	

Note: Assumes 1% interest payment on spousal loan (CRA's prescribed rate from the period April 1, 2009 to June 30, 2009). Future rates may vary. Check with your advisor for the current rate.

Spousal Loan Strategy: Key advantages

- Lowers your family's combined taxes by transferring income to your lower-income spouse, so it is taxable at their lower rate.
- Offers potentially increasing annual tax savings over time.
- Historically low 1% interest rate until June 30, 2009 provides an attractive entry point now.

Why not just make a simple transfer of funds instead of going through all the effort of shifting capital to your lower-income spouse through a Spousal Loan Strategy? Quite simply, if your spouse does not pay any consideration to you, the CRA will attribute the investment income back to you for tax purposes and the simple transfer of funds will not work.

To avoid income being attributed back to you, and taxed at your higher tax rate, your spouse must pay you the interest annually at the CRA-prescribed rate no later than 30 days after year-end. This interest can be paid to you directly from the earnings in your spouse's portfolio.

Should the CRA-prescribed interest rate subsequently go up, the rate your spouse pays on the loan remains fixed at the lower CRA-prescribed rate in effect when the loan was made. This provides another compelling reason to look at this strategy now, with the interest rate so low.

If you have an existing prescribed rate loan at a higher interest rate, you may consider modifying it to take advantage of the lower rate.

The historically low 1% CRA-prescribed interest rate may change after June 30, so make sure you consider this strategy well in advance to ensure adequate time to put it in place. As with any tax strategy, you should also consult with your tax advisor prior to implementing the Spousal Loan Strategy.

For more information about the Spousal Loan Strategy, please request a brochure and a personalized Spousal Loan Strategy illustration from your Investment Advisor.

Marlena Pospiech, CFP, is a Financial Advisory Consultant with our Wealth Management Services team.

INTEREST RATES APPLIED TO ACCOUNT BALANCES*

As of March 22, 2009 our interest rates are as follows:

Credit balances	Canadian dollar accounts	US dollar accounts
Under $10,000	0.10%	0.10%
$10,000 – $24,999	0.10%	0.10%
$25,000 – $49,999	0.10%	0.10%
$50,000 – $59,999	0.10%	0.10%
$60,000 – $99,999	0.10%	0.10%
$100,000 and over	0.10%	0.10%
Debit balances	**Canadian dollar accounts**	**US dollar accounts**
Under $10,000	4.50%	5.50%
$10,000 – $24,999	4.25%	5.25%
$25,000 – $49,999	4.00%	5.00%
$50,000 – $99,999	3.75%	4.75%
$100,000 and over	3.50%	4.50%

Registered accounts

All credit balances 0.10% All debit balances 4.50%

The interest rates that will be in effect for debit balances in cash and margin accounts fluctuate with Royal Bank prime rate as follows:

Debit balances	Canadian dollar rates†	US dollar rates†
Under $10,000	$CDN Prime + 2.00%	$USD Prime + 2.25%
$10,000 – $24,999	$CDN Prime + 1.75%	$USD Prime + 2.00%
$25,000 – $49,999	$CDN Prime + 1.50%	$USD Prime + 1.75%
$50,000 – $99,999	$CDN Prime + 1.25%	$USD Prime + 1.50%
$100,000 and over	$CDN Prime + 1.00%	$USD Prime + 1.25%

†Based on Royal Bank prime rates as of March 22, 2009.
$CDN Prime= 2.50% and $USD Prime= 3.25%. Rates are subject to change.

*RBC retains the right to change interest rates on a discretionary basis. A committee comprised of individuals representing various authorities within RBC Dominion Securities administers these interest rates. These rates are adjusted from time to time based on various factors, including, but not limited to, competitive analysis, Bank of Canada and other bellwether rates, and/ or cash rates. Interest amounts less than $5 are neither charged nor paid on regular accounts and interest amounts less than $1 are neither charged nor paid on special product accounts. Rate changes of less than 1% will be processed on the 22nd of the month. The average daily cash balance for the month determines the tier that will be used to establish the rate.

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