RBC Dominion Securities Inc.

Wealth Management
REVIEW

Wealth Management Dominion Securities

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A risk to watch

By Jim Allworth

Leaving potential trade wars aside for the moment, an unusual calm has descended on much of the global economic and investment backdrop:

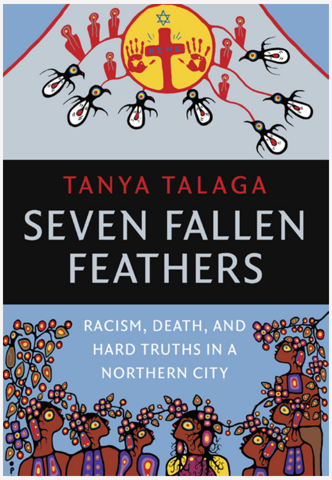
- Developed economies including Canada and the U.S. are growing at solid, if unspectacular rates, as is China and much of Asia. Russia and Brazil have pulled out of deep downturns.
- Economic activity indexes are at elevated levels pretty well everywhere except perhaps China. Forward-looking indicators suggest industrial output will continue to grow.
- Unemployment rates continue to fall everywhere. Businesses in the U.S., Canada and Japan cite difficulty in attracting and retaining qualified employees as a challenging business constraint. Wages are growing and consumers are confident.
- Corporate profits are strong while generally upbeat management guidance points to continued growth in revenues and earnings through 2019.
- Central banks remain mostly accommodative while commercial banks are out looking for creditworthy businesses and individuals to whom to lend.

What could disturb this happy, constructive equilibrium? In our view, something that is least expected, a sustained surge in core inflation rates, would substantially worsen the global economic and investment outlook.

On the policy front, it would force central banks to tighten faster than currently planned. The pace of inflation has been gradually picking up but remains below most central bankers' 2% target threshold. After trying to avoid slipping into deflation for several years, most policy makers would breathe a sigh of relief if inflation moved back up into a more "normal" zone.

But if it looked like inflation was headed toward 3%, asset markets might not wait for the Fed or the ECB to make up their minds. The ultra-low bond yields of the past several years have persisted because of persistently low inflation, as well as the assurances of policy makers that any move to "normalize" monetary conditions would be

Continued on page 2



In brief

2018 RBC Taylor Prize for Canadian non-fiction

The winner of the 2018 RBC Taylor Prize is Tanya Talaga for her book *Seven Fallen Feathers: Racism, Death, and Hard Truths in a Northern City*, published by House of Anansi Press. This is the 17th awarding of the $25,000 prize, which recognizes excellence in Canadian literary non-fiction. This national award was established in 1998 to commemorate the life and work of one of Canada's foremost literary non-fiction writers, the late Charles Taylor. To learn more, please visit www.thecharlestaylorprize.ca.

2018 *Euromoney* awards

RBC Wealth Management was honoured for the 11th consecutive year for "Best Overall Private Banking Services in Canada" in the 2018 *Euromoney Private Banking and Wealth Management Survey.*

A risk to watch ... Continued from page 1

undertaken gradually and patiently. Unexpectedly strong inflation rates would call both presumptions into question.

Bond investors usually want a coupon rate well above the prevailing rate of inflation to protect against any adverse move higher in the inflation rate over the life of the bond. Conviction that inflation was going to stay low has persuaded bond investors in recent years to accept an unusually low cushion of such protection. Upsetting the applecart of inflation expectations might push bond yields up by more than just the increase in the inflation rate.

Equity prices would probably undergo some recalibration too. Rising corporate bond yields often act to bring P/E multiples lower, while a faster pace of monetary tightening raises risks of future recession, bringing that much closer the prospect of an eventual decline in corporate profits and an accompanying bear market for equities.

Are there reasons to be concerned?

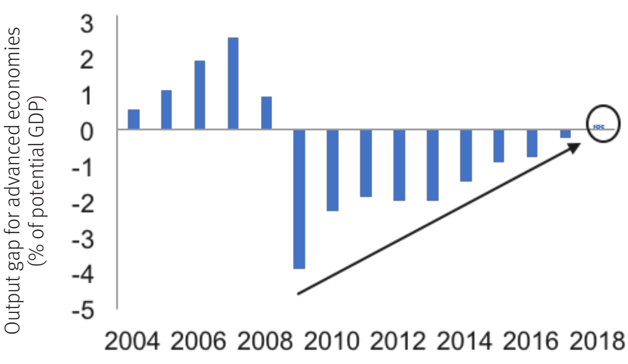
A damaging surge in inflation is not in our forecasts for any of the developed economies. We are looking for a little bit more inflation in 2018 followed by a little less in 2019. That is also the consensus view.

That said, two factors looked at together suggest there is a risk of underestimating inflation over the next couple of years. The old monetarist dictum states inflation is the result of "too much money chasing too few goods." Arguably there is too much money now, and has been ever since central banks adopted aggressively accommodative policies in the wake of the great recession. In the intervening nine years, money supply in the biggest economies has grown appreciably faster than GDP.

From the outset, this concerned many observers who expected an inevitable, damaging bout of inflation would be the result. But excessive inflation never arrived. Just the opposite: deflation has been a preoccupying worry of central banks until recently. One explanation is that since the recession ended, the "too few goods" part has been missing. There has been a great deal of excess capacity available in the developed economies even as China and much of emerging Asia were adding substantial new productive capability. This has kept prices of many goods subdued or even declining despite the growth in the money supply.

But today, fixed asset investment in China has slowed considerably while the government actively tries to shutter excess capacity in several basic industries. Meanwhile, the so-called "output gap" has closed in the developed world with "excess capacity" turning into "not enough capacity" in several countries including the U.S. (see chart). So, one has to acknowledge the combined conditions of too much money chasing too few goods may be increasingly operative over the next couple of years and for the first time in a decade.

Economic slack finally gone in developed world



Note: IMF estimate for 2018. Source: IMF, Haver Analytics, RBC GAM

Lean against risk

The appropriate investment stance is one that leans against developing risks. While our forecast is for some increased inflation in 2018, it's noteworthy that the Fed has recently pushed its own core inflation target to 2.1% for 2019, above its long-term target rate of 2.0% for the first time in years. But both are a long way short of a damaging surge in price pressures.

That said, higher inflation than anyone is expecting, were it to arrive, would pose a risk to an investment portfolio. In a world where the output gap is in danger of closing for the first time in a decade, and where there will continue to be excess money sitting in global bank accounts for some time to come, there is a greater probability that inflation expectations could undergo an upward shift that markets have not yet factored in.

Such a shift would hold ramifications for: the pace and eventual extent of central bank tightening; the spread between market interest rates and the inflation rate; the spread between corporate bond yields and government yields; the valuation (P/E ratio) of the equity markets; and the optimal sector make-up of equity portfolios.

For thoughts on how to consider the potential impact of these developing risks within investment portfolios ask for a copy of our latest edition of *Global Insight Monthly.*

Jim Allworth is co-chair of the RBC Global Portfolio Advisory Committee.

Annuities and retirement: Top 5 things you need to know

Annuities can provide guaranteed income for life, yet many Canadians are unaware of the importance they can have in their overall retirement income planning.

Purchased through a lump sum payment to an insurance company, annuities provide a pre-set distribution of income, usually on a monthly or annual basis.

"It's a good alternative for retirees who want predictability," says John Hamilton, Vice-President & National Manager of Insurance Services at RBC Wealth Management Financial Services Inc. "The idea of annuities is still foreign to a lot of people because they don't understand what they are."

Here are five things to know about annuities:

1. Annuities have a special tax status in Canada

Prescribed annuities can provide tax efficiencies as the income is taxed based on a blend of tax-free return on capital and a prescribed portion of taxable income, which is embedded in the product.

"That tax is smoothed out over the life of the annuity contract and is the same in year one as in year 20," says Mike Macoun, Vice-President & Estate Planning Specialist at RBC Wealth Management Financial Services Inc.

For example, a 65-year-old male who buys a $1-million annuity at today's rates generates about $60,000, the majority of which is return on capital (based on an actuarial calculation of the typical lifetime of the annuitant). Of that, $9,000 is taxable each year. That compares to someone who buys a $1-million GIC at 3% and pays tax on the entire $30,000 in interest income.

"As lifetime income, your rate of return on your annuity increases the longer you live, because payouts continue," says Macoun. "When calculating retirement income, you're always trying to find the highest income with the most tax-advantaged position."

2. Annuities can be structured to rise with inflation

"Once you purchase an annuity it's a locked-in proposition," says Macoun. "You are releasing capital to an insurance company in exchange for an income stream for life."

While one potential drawback of an annuity is its lack of liquidity, Hamilton notes, some insurance companies offer indexed annuities, meaning they're able to increase in value with inflation over time.

"That strategy offers investors some inflation protection," says Hamilton. Still, he recommends investors only use annuities for a portion of their portfolio, and leave the remainder in more liquid assets.

3. Annuities can be held by your corporation

Many hold annuities in their corporations as a type of self-imposed pension plan or where formal plans may not exist.

"Business owners who have retired and have a large amount of wealth in their company are looking for ways to provide a pension for their business assets," says Hamilton. "Annuities provide that vehicle, tax efficiently."

4. Annuities can be used for philanthropy

When looking to support charitable causes, gift annuities offer a fixed income alternative that may offer preferential tax treatment. By purchasing an annuity, a donor can seek to lower their taxable income, guarantee annual gifts and benefit from donation tax credits for those gifts. Only a portion of the payment is taxable, and it can provide a better return than a GIC or bond, says Macoun.

Continued on page 4

Annuities ...
Continued from page 3

"The donor is able to realize the benefits of their money while living, and sees it being put to good use," says Macoun. "Of course they get a tax receipt, but most people aren't doing it for that reason."

With charitable insured annuities, donors give ownership of the life insurance policy to the charity, while receiving guaranteed fixed monthly income payments from the annuity, for life. Donors receive an annual tax receipt for the insurance premiums paid from the annuity. Only the income portion is taxable.

"That provides significant tax savings over a traditional insured annuity and higher annual income over a GIC, while at the same time providing a charitable donation," says Macoun.

5. Annuities offer solutions for estate planning

Annuities can provide some control on how your money is distributed to beneficiaries.

They can be purchased for the surviving lifetime of the spouse, which is usually recommended if they are older, or for a specified term for children.

"People want to make sure their money is safe when passed down," says Macoun. "With kids, it gives the parent comfort, as children cannot unlock the capital and potentially lose the income." Purchasing an annuity as part of an estate plan can also be less expensive and easier than setting up a trust, he adds.

Given the multiple solutions annuities can provide, they should be part of ongoing financial, estate and retirement planning conversations.

For more information, please contact us.

Interest rates applied to account balances as of March 22, 2018*

	Canadian dollar accounts	U.S. dollar accounts
All credit balances	0.05%	0.05%
Debit balances under $10,000	5.45%	7.00%
Debit balances $10,000 – $24,999	5.20%	6.75%
Debit balances $25,000 – $49,999	4.95%	6.50%
Debit balances $50,000 – $99,999	4.70%	6.25%
Debit balances $100,000 and over	4.45%	6.00%
All debit balances for registered accounts	5.45%	7.00%
All credit balances for registered accounts	0.05%	0.05%

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

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

† Based on Royal Bank prime rates as of March 22, 2018. CAD Prime = 3.45% and USD Prime = 4.75%. 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. For interest rates on balances other than CAD or USD, speak to your advisor, or go to www.rbcds.com/cash-margin-rates.html.

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