Serber Speaking

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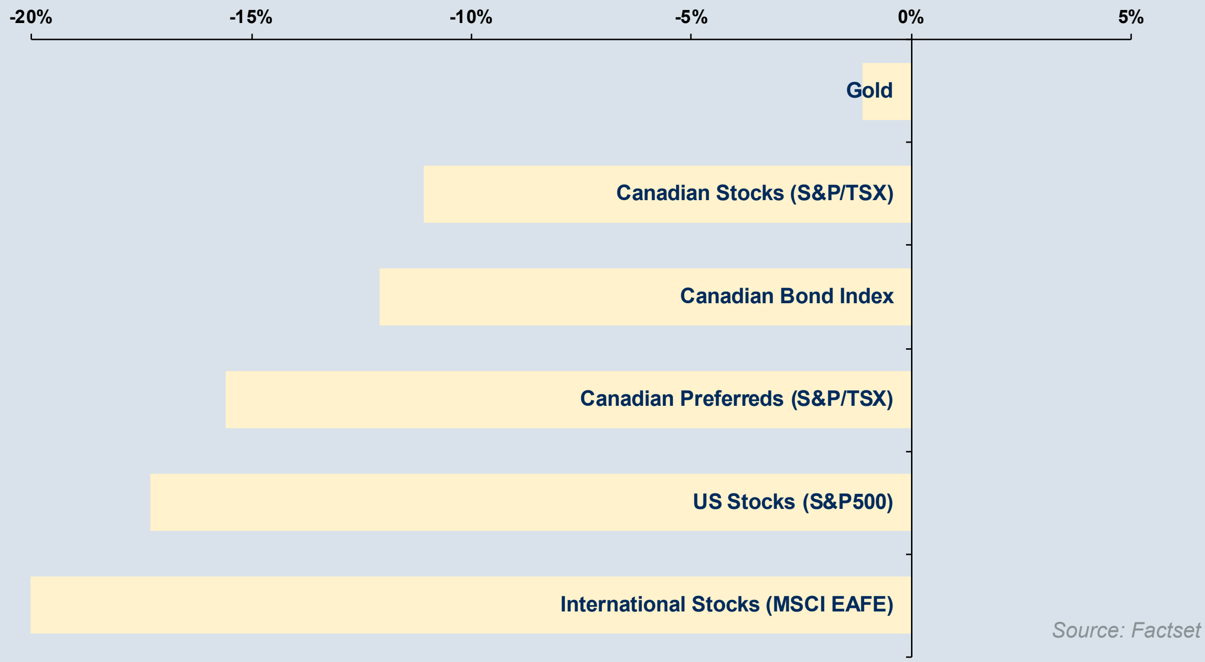
Commentary for the quarter ended Sept. 30, 2022

Not Great Expectations

The third quarter of 2022 was a bit of an up-and-down roller coaster ride. Global stock markets rallied about 10 percent from early July to mid-August, only to fall back to their June lows by the end of September. As a result, the year to-date chart below looks quite similar to how it looked in my last report, for the quarter ended June 30th -- which is to say, not very good. The main contributor to the negative tone is rising interest rates, caused by central bankers' efforts to battle a persistent inflation problem. Higher interest rates are bad news for most financial assets. This is why we see all the asset classes below in negative territory so far in 2022.

Performance by Asset Class: January 1 to September 30, 2022 (in Canadian $)



Time to bet against the crowd?

Reading or watching the news, or talking with clients and colleagues, it is clear that expectations for financial markets are not great, and that the general mood is pessimistic. That said, it is important to understand that investor sentiment is often a lagging indicator - more a reflection of what has already happened, as not necessarily a reliable indicator of what's in store going forward. When sentiment is particularly negative, markets often surprise on the upside, and vice-versa.

The American Association of Individual Investors' weekly survey currently indicates that only 20 percent of investors are bullish, versus 60 percent bearish (and 20 percent neutral). These are similar to readings last seen in 2020, the year of the COVID-19 breakout. As we can recall, the news back then was terrible, people were worried, and markets dropped about 20 percent. Then, from the depths of the crisis in March-April, to the end of 2020, global stock markets rallied 35 percent.

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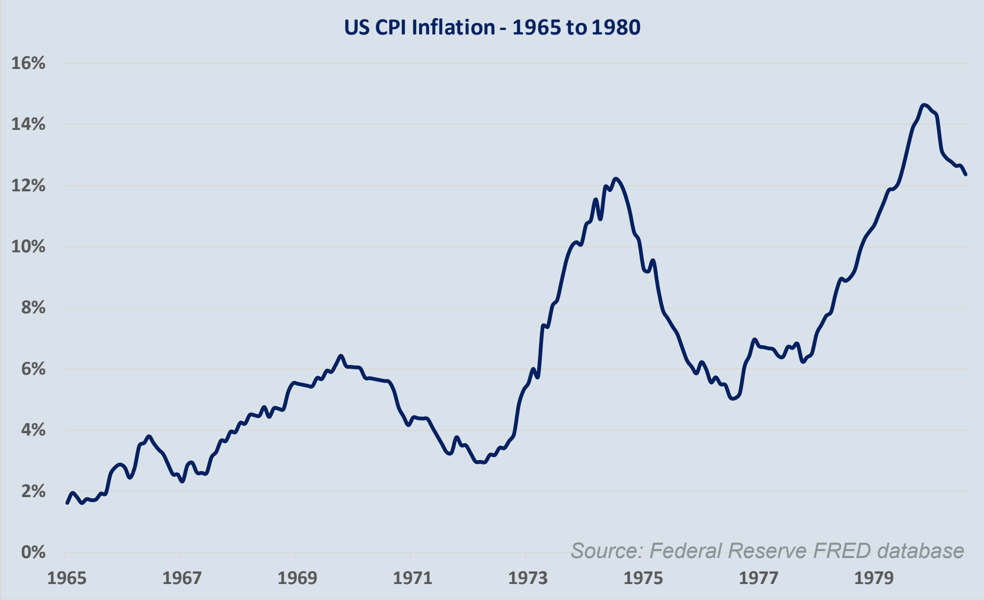
Of course, COVID-19 is a different issue than inflation, and I don't mean to equate the issues facing investors then, with the current problems we are dealing with today. Rather, I am illustrating the principle that the way people feel about financial markets at any given time reflects what has already happened, not what's to come.

With this is mind I can envision a decent rise in financial markets over the coming six months or so. It will not take much in the way of "good" news to shift overly-bearish investors from fear mode to greed. Once markets sniff out the possibility that central bankers will start slowing down, or pause, their campaign of rapid interest rate hikes, a rally will be in the cards.

The extent, and staying power, of such a rally is an open question. Even if there is a pause in the coming months, it is likely that the fight against inflation will continue for some time. One reason is that the amount of fiscal and monetary stimulus unleashed by governments of the world over the past several years was extreme, and will take time to work itself out. Another factor is that, in general, globalization of trade is disinflationary and protectionism is inflationary. We have been shifting from increasing globalization to increasing protectionism for several years now.



The last major inflation outbreak, which occurred between 1965 and 1980, evolved in rising up-and-down waves, as seen on the chart at right. If something similar is unfolding, we may be nearing the top of the first wave in the coming months. As this wave peaks and declines, we will likely see a relief rally in financial markets. However, we must be on guard for a second inflation wave developing, perhaps later in 2023. BCA Research, a leading investment strategy publication, expects this will be the case, and currently projects that US interest rates will peak between five and six percent in late 2023 or 2024, as the authorities resume their battle against inflation. If so, this will likely spark a more serious recession and a bear market. If and when that happens, the authorities will lower rates fairly quickly to cushion the blow, and the cycle will start again.

So what is the right investment strategy?

Based on the above, there may be a more severe recession and bear market in the cards, if inflation turns out to be a persistent problem. The question is when. My base case is that this doesn't become a serious problem until the second half of 2023. If so, we should maintain exposure to risk, i.e. stocks, and expect a decent recovery over the coming six months. After that point, if BCA's forecast proves accurate, we can and will become more defensive, by moving money from risk assets to government bonds or GICs, at yields of five percent or more. More aggressive investors could therefore add to their stock holdings now, with the prospect of a profitable six to nine-month "trade."

A worse case scenario is that central banks do not take a pause, rates continue to move higher, and we end up with the more severe recession and bear market scenario sooner rather than later, without an intervening medium-term rally in risk assets. Since this possibility cannot be ruled out, more conservative investors should consider holding their stock portfolio at or a bit below their neutral levels for now, with the idea of decreasing towards their minimum equity levels over the coming year, if a decent rally materializes.

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From the Planning Notebook

The tax rate on investment income matters!

There are three main types of investment income: interest; dividends; and capital gains, each of which are taxed at different rates.

Within tax-sheltered investment accounts the different ways these types of income are taxed is not material. So, in this article we will look at investment income earned in regular, taxable investment accounts.

Interest income is taxed at the highest rate, the same as employment income or other types of regular income. In Ontario, the tax rate on interest, in the top tax bracket, is 53.5%.

Dividends are taxed at a lower rate. This is justified because dividends are paid by corporations out of their after-tax income. Since the company has already paid tax on its income, it is considered a form of double-taxation if that money, when paid to a shareholder, is fully taxed for a second time. For this reason such dividends are taxed at a favourable rate. The top marginal rate for dividends in Ontario is 39.3%.

Prior to 1972, capital gains were not taxed in Canada at all, as they were not considered to be income. Starting that year however, 50 percent of any realized capital gain was included as taxable income. In the 1980s and 1990s this “inclusion rate” was increased to 66.7% and then to 75%, but was lowered back to the original 50 percent in 2000, and has remained there ever since.

Since what you keep in your pocket after-tax is what really matters, it is important to keep these different tax rates in mind when evaluating investment options, and your investment results. For example, $100 of dividend income is worth the same as about $130 of interest income, and $100 of capital gain equates to about $157 of interest.

$100 of	Tax Rate	After Tax
Interest	53.5%	$ 46.50
Dividend	39.3%	$ 60.70
Capital Gain	26.8%	$ 73.25

In the current environment this creates some interesting investment opportunities. For example, it is possible to buy bonds today, issued over the past few years at low interest rates, at a steep discount. What if you could buy a bond with an interest coupon of one percent, at a price of $89, maturing in about three years? You would only make one percent per year in interest, but you will make $11 in capital gains (buy for $89, matures for $100). When you do the math you see that on the surface you make an overall yield of about 4.8 percent per year. However, due to the favourable tax rate on capital gains, your after-tax return is the equivalent of making almost **seven percent** per year in interest (for someone at the top tax bracket) which is better than what you can make on a regular GIC.

If you have any questions please feel free to reach out to me any time at david.serber@rbc.com. Note: Please check with a qualified tax advisor before acting on any ideas expressed above.

Until next time, best regards,

David Serber

If you would like to discuss your personal situation please feel free to contact me. Also, feel free to forward this copy of ***Serber Speaking*** to anyone you think would find it of interest.