Serber Speaking

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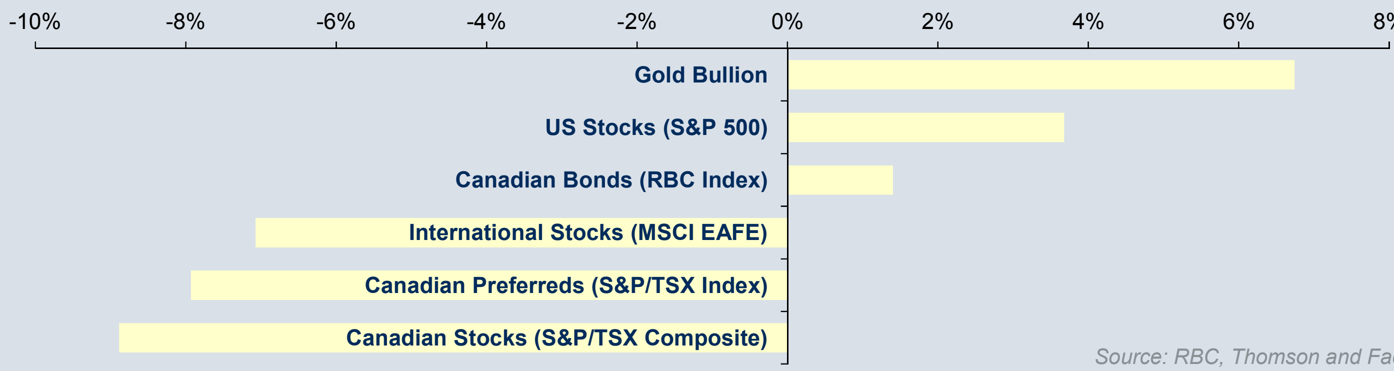
Commentary for the quarter ended December 31, 2018

And then things went sideways

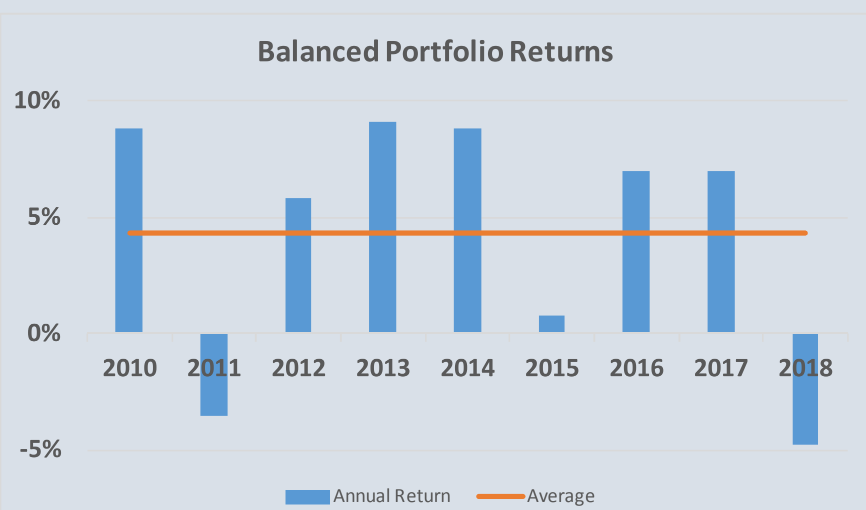
The fourth quarter of 2018 was a tough one for financial markets, with global stock markets falling almost 10 percent on average. Unfortunately, the year-end “Santa Claus Rally” failed to materialize – so 2018 is now in the books as a year of negative returns. A typical balanced portfolio was down roughly two to six percent, depending on its asset mix.

Performance by Asset Class: January 1 to December 31, 2018 (in Canadian $)



Source: RBC, Thomson and Factset

As the chart above shows, the best-performing asset category for the year was gold bullion with a gain of 6.7 percent, reflecting investors’ flight to safety in Q4 as the stock market rout intensified. Fortunately, we hold some gold in client portfolios, which helped offset some of the losses in other areas. US stocks gained 3.7 percent – but this was because the C$ fell versus the greenback. In local US$ terms, the S&P500 index was down 4.4 percent for the year. International and Canadian stocks generated losses of about seven and nine percent for the year, respectively. Meanwhile, preferred shares got hammered in Q4 on a combination of recession fears, falling interest rates, low liquidity and, in the final weeks, tax-loss selling. I used this weakness in late December to add more preferreds to many portfolios.



Source: RBC Balanced Fund

While we all understand that a balanced portfolio will have good years and bad years, the latter are always disturbing. As the chart at the left shows, annual portfolio returns this decade, after fees, have ranged between minus five percent and plus nine percent, with an average of plus 4.3 percent. Since investment returns tend to mean-revert over time, a good year or two is followed by a bad year or two, and vice-versa. You can see that the bad years of 2011 and 2015 were followed by good years, and I’d expect something similar for 2019-2020.

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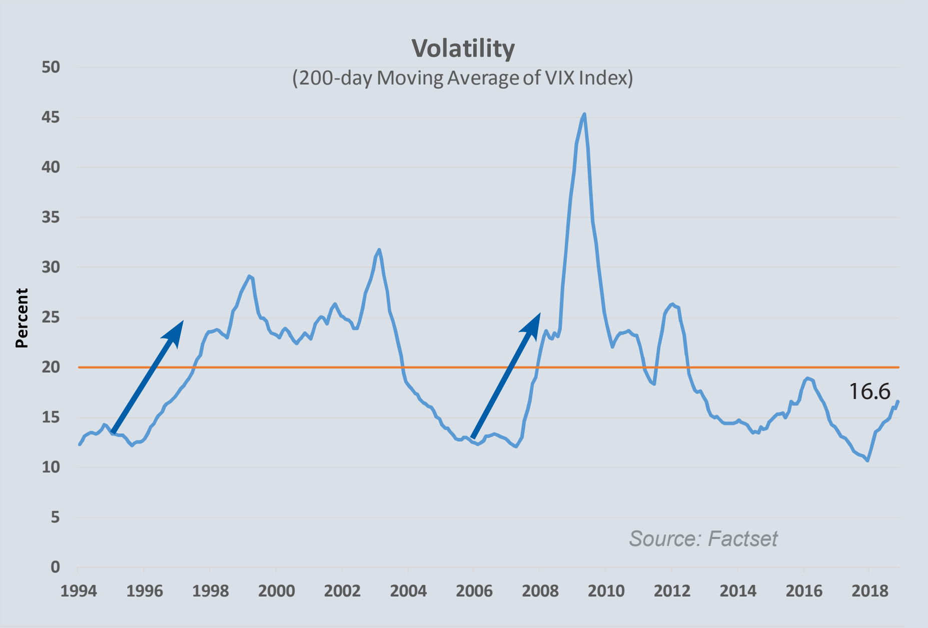
Keep an eye on volatility



The word "volatile" is often used to describe negative episodes in financial markets. That said, it is worth noting that volatility, in and of itself, is not necessarily bad. I'd rather own an investment that goes up 30 percent over 12 months with high volatility than an investment that goes down 30 percent with low volatility. If that's the case, why pay attention to volatility? One answer is because changes in market volatility over time can be a useful indicator.

The VIX index measures the implied volatility of S&P500 stocks. Without getting too technical, implied volatility reflects current market conditions and is more meaningful than, for example, historical volatility. Mathematically the value of VIX is the standard deviation of the next 12-month's expected returns. In other words, a VIX reading of 15 means there is a 68% expected probability of the market moving up or down 15 percent over the next year. I think of the VIX as being like a seismograph – it measures fluctuations in the stock market in real time much as a seismograph measures the fluctuations of movements within the earth's crust. It is perhaps reasonable to think that a sustained buildup of seismic activity over time increases the odds of a damaging volcano or earthquake.

Similarly, it may be that a sustained buildup of volatility in financial markets over time increases the odds of a blow-up. The chart above tends to confirm this. The last two times the moving average of volatility went over the index level of 20 percent, in 1998 and early 2008, we wound up with bear markets and recessions. So far, this indicator is not flashing red – as seen on the chart, the current reading is 16.6 percent. I will be keeping a watchful eye on this one – and, so long as it stays below 20 percent, history suggests we should avoid a major shock.

Thoughts for 2019

While there is plenty to worry about for 2019 (ongoing US government shutdown, Fed interest rate policy, trade wars, Brexit, Italexit, etc.), it is also true that the recent drop in market prices has discounted a fair bit of bad news. Valuations in certain market areas are now reasonably compelling, and I predict positive returns for equities in 2019. Highly respected forecasting firm BCA Research expects a 10-percent return for the S&P500 this year.

Economic factors that will help turn the tide include: 1) **Lower interest rates**. The US 10-year Treasury bond yield has dropped from a high of 3.25 percent in November to 2.67 percent today. Lower interest rates spur consumer spending and business investment, and reduce interest expenses for corporations - all of which will kick in over the coming months. 2) **Lower energy prices**. The crude oil price has fallen from a recent high of US$76 per barrel to US$48. This acts like a tax cut, putting more money in consumers' pockets and more profit on corporate bottom lines (except, of course, for oil companies). 3) **Low unemployment**. Canada and the US are enjoying the lowest unemployment rates in decades. There is a very low chance an economy will fall into recession when unemployment is low and falling, as consumer income and, therefore, spending are growing. The time to worry more seriously will be when the unemployment rate bottoms and begins to tick upwards.

John Lonski, Chief Economist at Moody's Capital Markets Research, was the only strategist I follow who correctly predicted three months ago that the US 10-year Treasury yield would be below three percent by the end of 2018. In his current report, dated Jan. 3, 2019, he states that "...benchmark US Treasury yields will continue to decline until interest-sensitive spending in the U.S. improves prospects by enough to materially increase risk tolerance." This is the way an economist says, "Things may have to get worse before they get better, but they will get better."

So, best to keep your seat belt buckled for now. The path to a positive return in 2019 could include a bouncy ride in the first half followed by a potentially strong rally in the second. Or it could be vice-versa. Stay tuned.

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From the Planning Notebook

Four Strategies to pay less tax by splitting income with a lower-income spouse

Canada has a progressive tax system. This means that tax rates in Canada increase dramatically as your income increases. As a result, you could save significant amounts of tax annually if, for example, you and your spouse each earn $50,000 in taxable income as opposed to one of you earning $100,000 and the other zero. Equalizing your income as much as possible could achieve significant tax savings year after year.

Strategy 1: Spousal RRSPs. If you project your retirement income to be higher than that of your spouse, one of the simplest ways to equalize your future retirement income—and lower your combined tax burden—is by making contributions to a spousal RRSP. The sooner you start, the more income you'll be able to shift to your lower-income spouse's spousal RRSP by the time you retire.

Strategy 2: Pension income splitting. If you are receiving a pension, you may be able to reduce your family's total tax bill by allocating up to 50 percent of eligible pension income to your spouse. Keep in mind, however, that only certain income is eligible for pension splitting. The age of the primary recipient of the income is a factor in determining whether income is eligible. Since income from a RRIF is considered pension income, which can be split, it may make sense to convert from RRSP to RRIF prior to the mandatory age of 71 in certain circumstances.

Strategy 3: CPP sharing. Although the CPP pension is not considered eligible pension income for the purpose of pension income splitting (described in Strategy 2), you may achieve tax savings by asking the government to pay a portion of your CPP pension directly to your spouse. This may be a particularly viable strategy if you have a spouse with low income and limited working history who thus made limited CPP contributions.

Strategy 4: Spousal loan. Generally, you achieve no tax advantage when you simply give funds to your lower-income spouse to invest — this is because of "attribution". The Canada Revenue Agency (CRA) attributes any investment income earned on these gifted funds back to you, as if you had earned it yourself. The spousal loan strategy, however, may help you reduce your taxes payable. By making a bona fide loan to your lower-income spouse at the CRA-prescribed interest rate (currently two percent), you can avoid triggering the CRA's income-attribution rules. The prescribed rate in effect at the time your loan is established remains in effect for the lifetime of the loan. In the end, you pay tax on the two percent interest received on the loan, and your spouse pays tax on whatever the portfolio makes above and beyond two percent.

Please consult a tax expert before implementing any of these strategies. If you would like to learn more about tax planning or any other aspect of planning for your financial future, including investment management, estate planning and insurance, please get in touch.

Until next time, best regards,

David Serber

Feel free to forward ***Serber Speaking*** to anyone you think would find it of interest.

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