Serber Speaking

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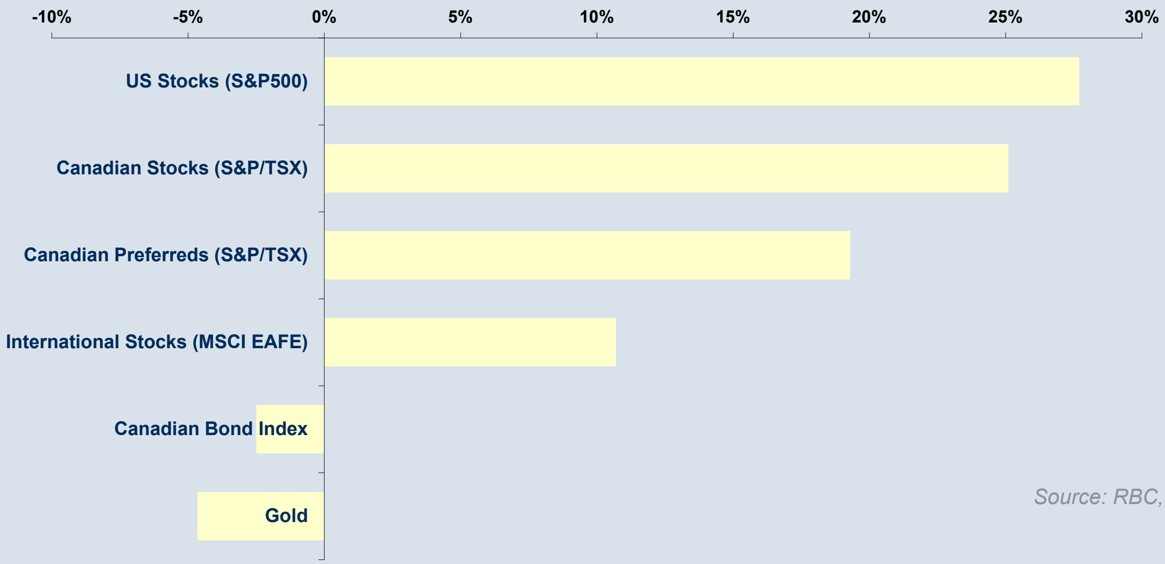
Commentary for the quarter ended December 31, 2021

Now what?

The books are closed on 2021, and it was a stellar year indeed for equity investors, especially those focused mostly on US and Canadian stocks, which gained 27 percent and 25 percent respectively (see chart below). To put this into dramatic perspective: short-term cash investments, such as high-interest bank accounts or GICs, paid only one percent or so. This means stocks in one year generated over 20 years' worth of the returns available in secure short-term investments. Truly remarkable.

Canadian preferred shares also continued to do well, generating a total return (dividends plus price appreciation) of about 19 percent. Over the past two years, since Jan. 1, 2020, preferreds have generated a return of 41 percent and have been a top contributor to our clients' portfolio results over that period. As also seen on the chart, the capital preservation categories of bonds and gold both saw negative returns for 2021. Clearly, money flowed in the direction of "risk-on" investments and away from "risk off."

Performance by Asset Class: January 1 to December 31, 2021 (in Canadian $)



Source: RBC, Factset

The question, as always, is "Now what?" There are reasons to be worried about the economy and stock valuations. After gaining 25 percent or more, aren't stocks set for a fall? Is inflation going to stay high and get worse? Aren't rising interest rates bad for stocks?

These concerns are all valid. However, the same drivers that moved stock markets higher last year will largely remain in place this year: namely, low interest rates, falling unemployment, above-average global economic growth along with high cash balances supporting demand for goods, services and investments.

A stock market's value is the total value of the companies that make up that market. And the value of those companies is a function of their ability to grow revenues and profits, both of which are looking positive for 2022. And with the yields on bonds and GICs still very low, money will continue to flow into equities.

So, my base-case scenario for 2022 is that stocks will once again do better than bonds. Return expectations for stocks, however, should be lowered: a return between five and eight percent this year seems reasonable. While not as rewarding as 2021's torrid pace of gains, it's well above the one or two percent available on bonds or GICs.

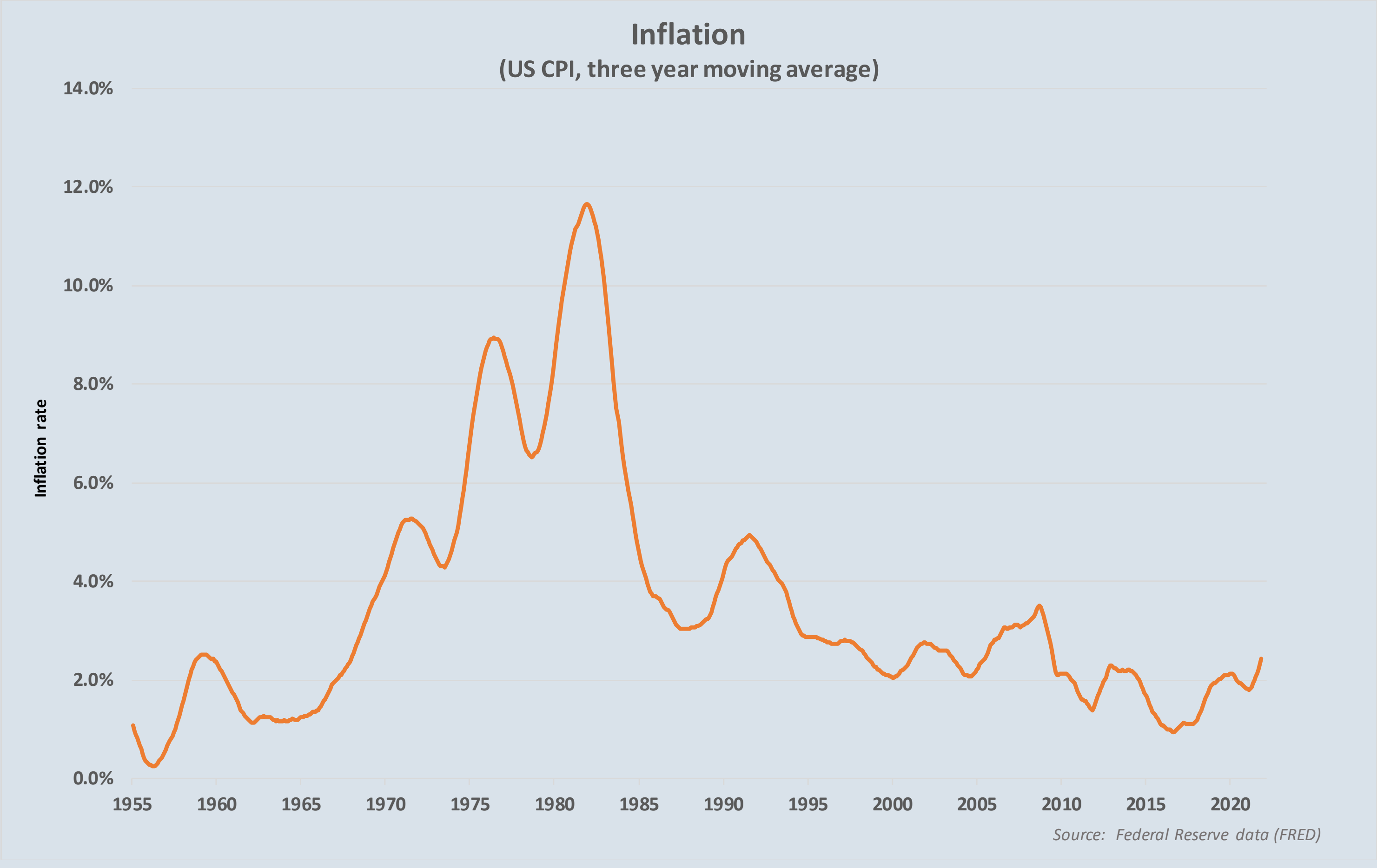
That said, we also must acknowledge that the risk/return equation has become less appealing. The higher the valuation goes on a security, the less the upside potential and the greater the downside risk. As a result, if prices continue to move higher as the year unfolds, I will slowly reduce exposure to "risk-on" investments such as stocks and preferred shares to protect capital. Better to be too early than too late.

Thoughts about inflation

Inflation has certainly been making headlines lately and is an issue of legitimate concern. Still, I believe that concern has been somewhat exaggerated because inflation is almost always reported as a one-year rate of change. Given the dramatic shorter-term distortions to both supply and demand related to COVID-19, I believe the one-year rate of change is perhaps too volatile a measure to be entirely useful currently. To smooth out short-term volatility, I have calculated a three-year moving average, shown as the orange line on the chart below, which I believe is a more meaningful gauge of the longer-term inflation trend.

We can see that the recent inflation uptick has moved my indicator from about 2.0 percent to around 2.5 percent. This is not a problem. However, if it marches higher and higher over the next couple of years, it will be bad for investment markets. It is worth noting that recessions or bear markets are not directly caused by rising inflation. Rather, recessions and bear markets are caused if and when the central banks (e.g., US Federal Reserve) become so alarmed at inflation trends that they raise interest rates dramatically.

In the current environment, dramatic central bank intervention is not in the cards. Yes, the Fed will likely raise rates once or twice this year, from 0.25 percent to 0.50 or even 0.75 percent -- but this merely changes monetary policy stimulus from "extreme" to "substantial." One key indicator to keep an eye on is long-term inflation expectations, which are currently sitting at around 2.5 percent. If these move up dramatically, it will be time to worry. We will be watching.



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From the Planning Notebook

Tax-Free Savings Accounts (TFSA) are growing in size and significance as contributions and investment returns accumulate, with many plans now worth more than $100,000. It is, therefore, increasingly important, for estate planning purposes, to understand how TFSA beneficiary designations work and to ensure your plan is set up according to your wishes. There are three main scenarios:

1. Name your spouse as successor holder. In this case, your spouse automatically receives your TFSA account at the time of your death and, importantly, the TFSA continues to exist. Your successor holder (i.e., surviving spouse) can make tax-free withdrawals or make contributions to that account after your death, depending on their own unused TFSA contribution room. The value of the TFSA upon your death, as well as any income earned after your death, will continue to be sheltered from tax. If your spouse already has their own TFSA, they will now have two accounts. If they wish to consolidate their accounts, they can directly transfer part or all of the value from one account to the other.

2. Designate a third party as a beneficiary. You can designate a beneficiary (your child, grandchild or anyone else) on the TFSA contract or in your will. The value of your TFSA on your date of death will go to that beneficiary tax-free. Any amount paid to your beneficiary that represents an increase in the value of your TFSA after the date of death will generally be taxable to your beneficiary. If you do not have a spouse, distributing the funds directly in this manner, and not through your estate, may be preferred to avoid the time and cost of probate.

Note: If you name a minor child or grandchild as beneficiary, provincial law may prevent them from directly receiving the TFSA proceeds. This is because a minor child generally does not have the legal capacity to receive TFSA proceeds or to provide a valid discharge to the financial institution administering the TFSA. In most cases, it would be best not to name a minor as a direct TFSA beneficiary.

3. No named beneficiaries. Where you have not named a successor holder or beneficiary, your TFSA assets will form part of your estate and be distributed to your beneficiaries according to the terms of your will or, if you have no will, provincial intestacy laws. Still, any income earned or capital gains accrued in your TFSA to the date of death are exempt from tax.

When creating your estate plan, it's important to consider the appropriate beneficiary to inherit your TFSA. In general, you should review all of your beneficiary designations (RRSP/RRIF, TFSA, life insurance policies, etc.) regularly to ensure that they are up to date and that they reflect any changes to your personal family situation.

If you would like to discuss your TFSA, or any other wealth planning issues, please reach out to me any time at david.serber@rbc.com.

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.