Serber Speaking

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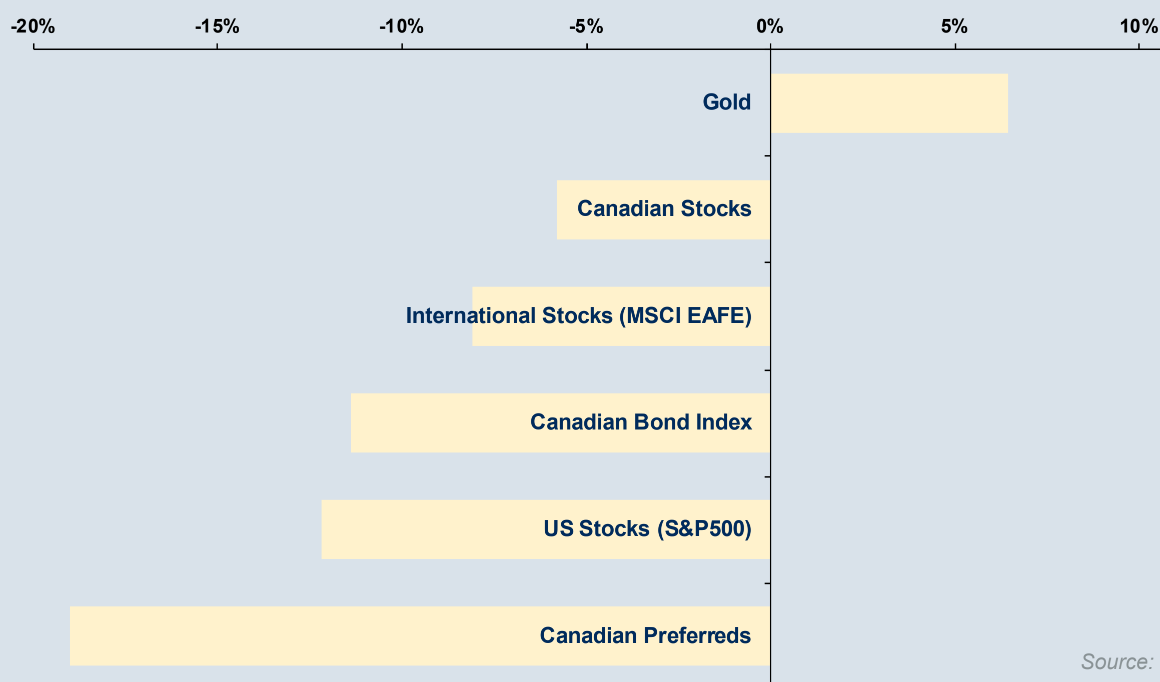
Commentary for the quarter ended Dec. 31, 2022

Hoping for a Soft Landing

The fourth quarter of 2022 saw a decent rebound in global financial markets, with the MSCI World stock index gaining about eight percent (in Canadian dollar terms). While this was a very welcome move, it did not offset the drop suffered over the first three quarters of the year—stocks and bonds closed the books on 2022 with losses across the board. The only 2022 bright spot was gold, which, as seen on the chart below, gained about six percent. Canadian Preferred shares were the worst performers, down almost 20 percent for the year.



Still betting against the crowd

Last quarter, I observed that sentiment had become overly bearish and suggested that a rebound was likely. In the event, this turned out to be the case. Notwithstanding this bounce, sentiment is still quite negative, which, in fact, is a positive. This sounds illogical on the surface, but it makes sense. Sentiment is backward looking. When markets go down, people in general get pessimistic after the fact, but it is precisely when markets are down that buying opportunities occur. This is why market strategists consider sentiment to be a contrary indicator. Very negative sentiment could mean it's time to buy, and vice-versa. The bottom line is that I think there is some additional upside over the coming months. Investors will become less bearish and put more money to work, once they hear more good news on the inflation front. The next two US inflation reports are due on January 12 and February 14. If these reports show continued declines in inflationary pressures, which seems likely, markets will rally further.

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The mechanics of supply, demand, inflation and employment

The Number One issue now facing financial markets is inflation – or, more specifically, central banks' efforts to curb inflation by raising interest rates. Higher interest rates decrease aggregate demand, and it is intuitive that if demand falls relative to supply, prices in general should decline or, at the very least, stop going up.

What investors worry about is that lower demand leads to layoffs and rising unemployment. Increased unemployment leads to even lower demand, and a downward spiral ensues -- in other words, a recession. Central banks understand this, and their objective is to reduce demand just enough to lower inflation, but not enough to spark a recession - the scenario known as a "soft landing."

The big question for financial markets this year is whether this is a realistic possibility. To explore this question it is important to understand that the relationship among supply, demand and prices is not linear. For example: If a factory can produce 10,000 widgets per month, and demand for widgets goes from 8,000 to 10,000, there is no immediate pressure to raise prices. If, however, demand then goes from 10,000 to 12,000 per month, the factory owner will raise prices to allocate the available 10,000 units to those buyers who are willing to pay more.

The central bank doesn't want this outcome, so it raises interest rates to reduce widget demand, which slowly declines from 12,000 widgets per month back to 10,000. The factory is still producing at capacity, and the owner is happy. No need to lay off workers and no incentive to raise the price. Remember, what we refer to as "inflation" is the rate of change in price - not the level of price. If widgets went up from $100 to $110 last year, we have 10-percent inflation. If widgets stay at $110 for all of this year, we have zero-percent inflation.

If we generalize the above to the entire economy, we see that, conceptually, in an economy where demand is greater than supply, the effect of a reduction in demand will be a reduction in inflation, without necessarily causing increased unemployment. If at that point the central bank stops raising rates, there will be equilibrium, with the economy producing and consuming at around its level of capacity.

The hope is that central bankers know what they are doing. They know that demand must be reduced to stop inflation. They also know that once demand and inflation are falling, the mission is accomplished and they can stop raising rates. This is what will likely occur over the course of this year. As we see in the simplified example above, it is not necessary for central banks to cause a recession in order to solve the inflation problem.

That said, professional forecasters currently put the probability of recession over the next 12 months at the highest level in more than 50 years (Source: Federal Reserve Bank of Philadelphia Survey of Professional Forecasters). My observation, after 30 years following financial markets, is that the economy, and markets, rarely follow the path expected by the majority consensus. As such, my guess is that the most widely anticipated recession in modern times will not happen this year. If so, this will be a big positive surprise, and investors will react accordingly.

In practical terms, I think this means stocks have about 10-percent upside in the first half of 2023 as pessimism wanes. This should coincide with interest rates at or near their peak for this cycle, so you can pencil in a shift at that point, to some extent, from stocks to bonds,

If, on the other hand, central bankers misjudge and keep rates too high for too long, or an external shock causes additional demand destruction, then a recession will likely occur. This is a non-trivial risk, which encourages us to keep a decent portion of portfolios in safe investments such as GICs and government bonds.

In summary, to position portfolios this year, aggressive investors could consider overweighting stocks now, with the idea of reducing positions on market strength sometime this year. Conservative investors can maintain neutral stock weightings for now, with the idea of moving to underweight if and when the rally I expect does indeed materialize.

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From the Planning Notebook

Planning items for 2023

2022 RRSP contribution deadline. The deadline for RRSP contributions, to be claimed as a 2022 tax deduction, is March 1, 2023.

2023 RRSP contribution room. It's generally a good idea to contribute to your RRSP early in the year, to maximize the tax-deferred growth in your plan. Your 2023 RRSP deduction limit is 18 percent of your 2022 earned income, up to a maximum of $30,780.

Tax-free savings account (TFSA). If possible, contribute to your TFSA early in the year to maximize the tax-free growth in your plan. The TFSA contribution limit for 2023 is $6,500, up from $6,000 previously. If you've been eligible to open a TFSA since 2009 and have not yet contributed to one, the contribution limit is $88,000 as of Jan. 1, 2023. We will be processing 2023 contributions for most of our clients over the next week or so.

Family income-splitting loans. A potential way to split income with family members to reduce overall taxes involves setting up a prescribed rate loan with your spouse, adult family members or minor children through a family trust. If you've previously set up such a loan, it's critical that the annual interest on the loan be paid on or before Jan. 30, 2023.

Fixed-income securities. If you buy GICs in your non-registered (taxable) accounts, January is a good month to do so. Since the next annual interest will be paid (or accrued, in the case of compound GICs) in January 2024, the full year's interest is 2024 income with taxes not due until April 30, 2025.

Also, if you pay tax at a high marginal rate, consider buying bonds that are selling at a discount. For example, you can buy a three-year corporate bond today, paying interest at 1.7 percent, for about $89 per $100 par value for an overall yield of about 4.9 percent per annum. However, when you consider that a large portion of the return will be taxed as a capital gain ($100 less $89), it becomes the equivalent of making about seven-percent interest, for investors at the top marginal tax rate.

Deadline for corporate taxes. Generally, corporate taxes are due within two months after the corporation's year end. If your corporation's year end is Dec. 31, 2022, you'll need to pay any tax owing by March 1, 2023. That said, in certain circumstances corporate taxes can be due within three months after the corporation's year end.

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.

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