Serber Speaking

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When Good News Could Be Bad News

As seen on the chart below, the main benchmarks we track are all positive for 2023 so far. Continued good news on the inflation front, and the absence of imminent recession signs, are serving to buoy investor confidence. So far so good.

Last quarter, I wrote that bad news could be good news. The idea was that the mini-banking crisis we saw in March would restrict lending activity, thereby doing some of the "heavy lifting" to slow down the economy, reducing the pressure on central banks to raise rates.

This quarter, I would like to make the case that good news could be bad news. By knowing this, we can stay well ahead of the curve. The good news in question is that inflation is, indeed, coming down nicely, further reducing the pressure on central banks to raise interest rates. At the same time, GDP growth is positive, and unemployment is low. In other words, it looks like we are entering the much hoped-for "soft landing" scenario in which the economy slows down enough to quell inflation, but not enough to cause a difficult recession. This is a goldilocks scenario for financial markets, and stocks are responding accordingly - trading at or near their 52-week highs.

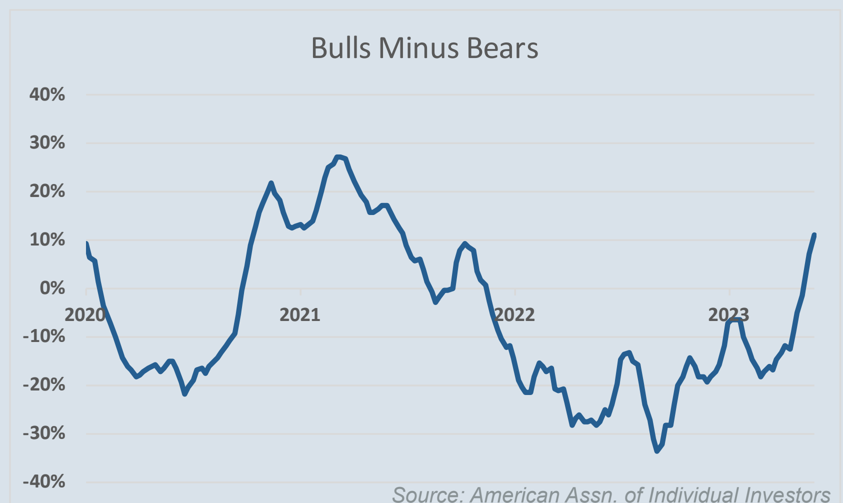
It is quite possible that this positive environment lasts through the remainder of 2023 and even into 2024. The problem is what may come next. It is intuitive that when demand exceeds supply, the result is higher prices, aka inflation. As the authorities take steps to reduce demand by, for example, raising interest rates, the initial impact

of a demand slowdown is a reduction in inflation, but not a reduction in output. As I wrote in a previous note, if a factory produces 10,000 widgets per month but demand is 11,000, the factory owner will presumably raise prices, contributing to inflation. If demand begins to fall, and goes from 11,000 to 10,000, the result is a drop in inflation pressure but no change in output—the factory is still producing 10,000 per month. The problem occurs if demand continues to decline. If demand falls from 10,000 to 9,000 widgets per month, output declines in response and workers lose their jobs. This is what will likely start occurring some time in 2024.

We are currently in the sweet spot where demand is gently falling toward supply, and the impact is mainly seen as lower inflation. But as demand continues to decline later this year and next, due to high interest rates, cautious lending from banks and depletion of COVID-related excess savings, it will fall below supply, which will lead to layoffs. And this rising unemployment will accelerate the decline in demand, which will cause even more layoffs. In other words, a recession. At that point, central banks will cut interest rates significantly, and the cycle begins again.

Betting against the crowd

In my last two newsletters, I observed that investor sentiment had been quite negative, and that this was, paradoxically, a good thing. Now, however, the tables are turning. Six months ago, as can be seen on the accompanying figure, the bears exceeded the bulls by 30 points (50 percent of investors surveyed were bearish, vs. only 20 percent who were bullish). Currently, the bulls exceed the bears by about 15 points. In other words, sentiment, as a contrarian indicator, is no longer signalling “buy.”



Source: American Assn. of Individual Investors

In addition to betting against the crowd, it is also sometimes a good idea to bet against the experts. Last winter, I wrote that:

“Professional forecasters currently put the probability of recession over the next 12 months at the highest level in more than 50 years... 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.”

My current expectation is that professional forecasters will increasingly turn to the idea that deft handling of interest rates by the central banks has resulted in a soft landing, and that the risk of recession is much lower for the rest of 2023 and 2024. When we get to the point where there is a general consensus that a difficult recession has been avoided, it will be time to worry.

What to do?

Putting the above observations together, I believe it is time to consider slowly reducing exposure to equity markets. That said, as noted above, the positive environment could extend into late 2023 or early 2024, so I don’t think there is a big rush. Instead, I plan to gradually reduce exposure to stocks over the coming months and increase exposure to bonds.

Speaking of bonds...

Now is an excellent opportunity to magnify returns from low-risk bonds in taxable accounts. During the 2019-2021 period, interest rates were very low, and bonds issued during that time carry unusually low interest rates. These bonds can be bought today at steep discounts to their issue price. As a result, most of the return will be in the form of capital gains, taxed favourably. Investors in high-tax brackets can make the equivalent of about seven percent interest on short-term bonds, with little or no risk, compared to about five percent on GICs. It’s a great deal

From the Planning Notebook

Handy 2023 Financial Planning Facts

TFSA

Maximum contribution limit is **$88,000** for an individual with no previous contributions, who was born in 1991 or earlier, and who has lived in Canada continuously since 2009, the year TFSAs began. For those born after 1991 the maximum will be lower, depending which year they were born. Note: be careful when reviewing your TFSA contribution room as reported by CRA. Their numbers are always one year behind—whatever they show in 2023 is based on your TFSA contributions (and/or withdrawals) at the end of 2022.

RRSP

Maximum contribution for 2023 = 18% of 2022 earned income, to a maximum of **$30,780**. Deadline for 2023 contributions is February 29, 2024.

CPP Maximums (actual amounts are based on contributions made into the plan)

Age 60 and starting payments this year:	**$ 836/month** or $10,034/year
Age 65 and starting payments this year:	**$1,307/month** or $15,679/year
Age 70 and starting payments this year:	**$1,855/month** or $22,264/year

OAS Maximums (actual amounts are based on number of years lived in Canada after age 18)

Age 65 and starting payments this year:	**$688/month**	or $ 8,250/year
Age 70 and starting payments this year:	**$935/month**	or $11,221/year

OAS clawback begins if net income exceeds **$86,912**. OAS is fully clawed back if net income exceeds **$141,917.**

Tax Rates (Ontario, numbers rounded off)

Low Bracket ($16,000 - $48,000)	Interest: 20%	Dividends: 0%	Capital Gains: 10%
Mid Bracket ($88,000 - $100,000)	Interest: 34%	Dividends: 15%	Capital Gains: 17%
Top Bracket (over $235,000)	Interest: 54%	Dividends: 39%	Capital Gains: 27%

Telephone Numbers

CRA General inquiries **800-959-8281** CPP / OAS Inquiries **800-277-9914**

I hope you find the above information useful. If you have any questions, please reach out to me at 416-974-3530 or 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.

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