Serber Speaking

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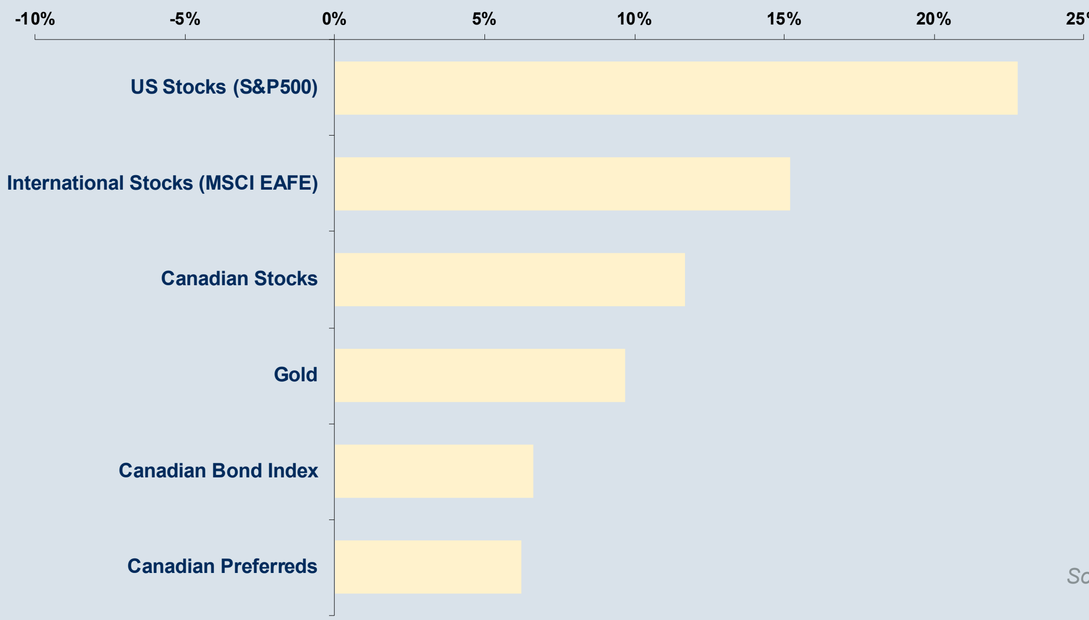
Winter 2024

Break Out the Champagne?

I hope you and yours enjoyed a Happy New Year! Financial markets certainly did and, in fact, began their celebration well in advance of New Year's Eve. Back in September and October, investors were in the doldrums as interest rates were ratcheting higher over fears of inflation and as stock prices were falling. Then, suddenly, in early November, everything changed. After its policy meeting on November 1, the US Federal Reserve indicated that the battle against inflation was all but won and that rate cuts were likely in 2024 in order to forestall a damaging recession, which could be triggered by keeping rates too high for too long. This news was akin to bringing a punch bowl to the party—and since then everyone has been having a really good time.

Performance by Asset Class: January 1 to December 31, 2023 (in Canadian $)



Source: Factset

As can be seen on the performance chart above, all categories reported positive returns in 2023. The US stock market was the clear leader, gaining more than 20 percent. This performance was fueled in part by truly stellar returns for a small group of growth stocks such as Facebook/Meta (+194%),Tesla (+100%), Amazon (+80%), etc. Canadian and International stock exchanges also had a decent year in the plus 10-to-15 percent range.

Ironically, last year at this time the consensus was that 2023 would be a terrible year for the economy and for financial markets. As I wrote in my Winter 2023 edition of this newsletter:

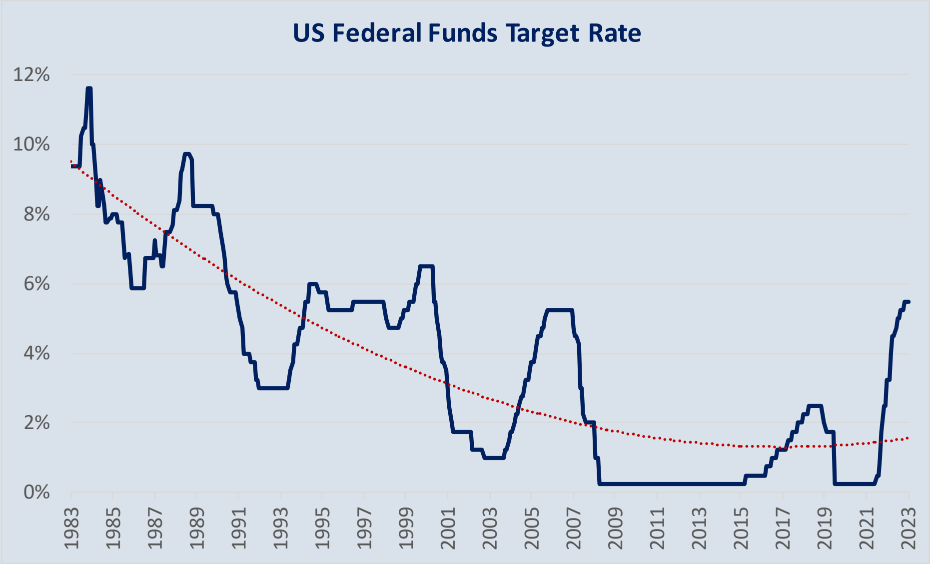
"Professional forecasters currently put the probability of recession over the next 12 months at the highest level in more than 50 years... My observation, after 30 years following financial markets, is that the economy, and markets, rarely follow the path expected by the majority consensus. As such, 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."

The Current Consensus

Now that things seem to be going well for inflation, and for financial markets, it is somewhat predictable that the consensus forecasts have become relatively positive. As of December 2023, the average forecast from the major US investment firms for the US stock market was for a positive 2024 (BCA Research).

Also, the mood of the average investor has improved markedly since my last report. According to the latest numbers from the American Association of Individual Investors, about half of those surveyed are currently bullish on equity markets and only about one-quarter are bearish. This is the opposite of the readings three months ago, when there were more bears than bulls. At that time, I wrote that, "I believe financial markets will have a decent Q4 overall, with a recovery potentially continuing into January and beyond. So, in the short term I see some gain, longer term though, could be some pain." Part One of this forecast has proven to be accurate. Let's talk about Part Two.

The second half of 2024 could turn negative



Source: Factset

As shown on the chart at right, interest rates are currently well above the average level of the last 15 years, since the Great Financial Crisis of 2008. Even if the peak in rates is behind us and central banks are prepared to begin lowering rates sometime this year, the fact remains that rates are high.

High interest rates have the effect of lowering demand in the economy. The initial impact of lower demand is to reduce price pressure, so the rate of inflation begins to fall. This is what happened in 2023. However, demand is currently high enough to keep businesses operating reasonably comfortably, in aggregate. This is the current state of play and is the Goldilocks scenario, where supply and demand are in just the right equilibrium. However, if rates remain high, demand will continue to fall as the year progresses. If so, demand would soon fall below supply, and firms would begin to cut back production and lay off workers. Higher unemployment means lower aggregate income, which means less aggregate demand, which leads to more layoffs. This is a feedback loop, and it typically leads to recession.

Once a recession hits, the authorities rapidly stimulate the economy through lower interest rates. As can be seen on the US Federal Funds chart, when central banks cut rates due to a recession or crisis, they fall quickly and fall by a lot. I expect such a cycle in 2024 would be no different. The consensus right now is that if rates fall, they surely won't fall by much. I disagree. When the next recession/crisis arrives, which I believe will be later this year or next, my guess is that rates will fall dramatically as the authorities eventually panic and "put the pedal to the metal."

So what's the plan?

Putting this all together, the plan is relatively clear: We stay with a "neutral" exposure to stocks for now. At some point in 2024, likely in the first half, we reduce stock exposure toward minimum levels. We use those funds to buy bonds. If and when interest rates drop, and stock prices fall, we sell the bonds at a profit and buy back the stocks at a discount.

Simple, right? Wrong - it's never simple. But at least it's good to have a plan.

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From the Planning Notebook

A few Basics

Here are a few useful points to know as tax time looms:

1. **Canadians are required to report all of their worldwide income to the CRA**. This is an important point and can be an issue, especially for those who immigrated to Canada and who receive, or will be receiving, income from foreign countries, such as pension income or investment income. Failure to report this income can result in penalties and interest charges, which compound over time and can become very substantial. If anyone you know is or will be receiving income from a foreign country, they should be aware of this reporting requirement.

2. **The three main types of investment income are interest, dividends and capital gains**, each of which are taxed at different rates. For an Ontario taxpayer in the top tax bracket, the tax rates are 53 percent, 39 percent and 27 percent respectively. It is, therefore, more favourable to earn dividends, and especially capital gains, versus interest, in a taxable investment account, other factors holding constant. I always keep this in mind when making investment decisions and recommendations, because what ultimately matters is the after-tax return. This is why I might buy a five-year bond for $85, which pays only one-percent interest, but will mature for $100, instead of a five-year GIC paying 4.5 percent. On the surface, it doesn't make sense, but for a taxpayer at a high marginal tax rate, the bond is the better deal since most of the return will be taxed favourably as a capital gain.

3. There are now three main tax-saving "registered" accounts available in Canada:

a) **RRSP -** Contributions are deductible, but all principal and earned income will eventually be taxed when the funds are withdrawn.

b) **TFSA --** Contributions are not deductible, and no tax is ever payable on withdrawal of principal and earned income.

c) **FHSA** – This is the new First Home Savings Account. Contributions are deductible, like the RRSP. Withdrawals of principal and earned income are never taxed, like a TFSA, so long as the money is used to buy a home within 15 years of the opening of the plan. If not, the full amount of principal and earned income can be rolled over into an RRSP.

Sometimes it is not clear which savings plan is the best fit. If you or someone you know is trying to decide whether to contribute to any or all of these registered plans, feel free to reach out to me and I'd be happy to discuss it.

If you have any questions, you can reach 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.