Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

For the clients of Grimes Handscomb Asset Management of RBC Dominion Securities | Spring 2019

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Yield curve inversion: a shot across the bow

By Jim Allworth

Has inversion of the yield curve started the "recession clock"? The closing chapter of all economic cycles is a recession. The recent inversion makes it appropriate to start thinking about that eventuality but we believe it will take some doing to get the U.S. into recession from here.

The Treasury yield curve has inverted—short-term interest rates have moved above long-term rates. Or, more precisely in this case, long-term rates have fallen below short-term rates.

This has garnered a lot of attention because in past economic cycles "inversion" has proven to be a reliable signal that a U.S. recession was on the way—on average about 11 to 14 months from the date of inversion.

Long, bruising equity bear markets, not just in the U.S. but also in Canada, the U.K., Europe, and Japan, have been associated with U.S. recessions. These bear markets have typically started months before the recession gets under way. That makes inversion of the yield curve a valuable early warning signal that a more defensive investment state of mind is called for.

Is the recession clock starting?

The debate is already raging as to what, if any, credence should be given to the yield curve's signal this time. There are a number of arguments—some very compelling—asserting that this inversion has occurred for very different reasons than in past cycles and therefore can be safely ignored. Perhaps. But in our experience, arguments like this have always surfaced around the time of previous inversions and, even though the mechanical reasoning was often correct, a recession (and equity bear market) eventually arrived.

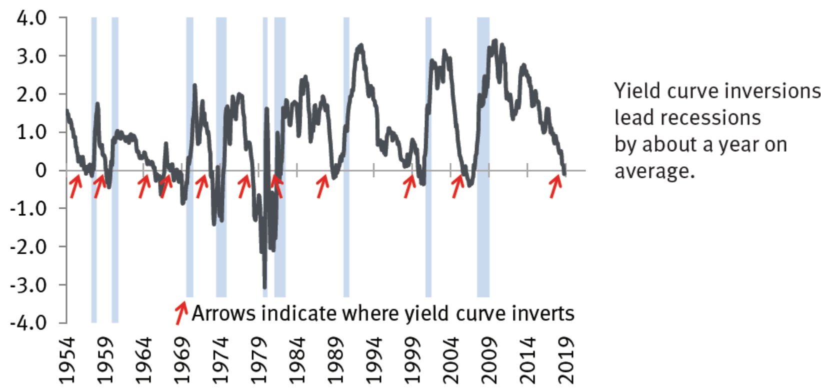
There was one exception. The yield curve deeply inverted in 1965 and no recession ensued. However, U.S. GDP growth went from 10.1% (yes, that's no typo, 10.1%!) in Q1 1966 to an effective standstill at 0.2% five quarters later. Around that time the stock market corrected by a brisk, but not disastrous, 20%.

Despite the wonderful track record of yield curve inversion as a recession/bear market early warning, we believe the routes taken by the economy and markets this time will undoubtedly wind up being different in some important aspects. That should make investors

Continued on page 2

Yield curve inversion
(continued from page 1)

Yield differential between the 10-year and 1-year U.S. Treasury notes



Note: Shaded areas indicate recessions
Source - RBC Wealth Management, U.S. Federal Reserve, National Bureau of Economic Research

Yield curve inversions lead recessions by about a year on average.

reluctant to bank everything on a signal given by just one indicator, no matter how historically reliable.

Eric Lascelles, chief economist for RBC Global Asset Management, rates 17 different economic variables and concludes that this longest of U.S. economic expansions is in its late-to-end-of-cycle phase. Of course, this last part of the expansion cycle before the next recession arrives could prove to be very drawn out. Certainly the early-cycle and mid-cycle phases were unusually extended.

Our U.S. recession scorecard follows six indicators, all of which have usefully warned of recessions ahead of time. Three (the yield curve, unemployment claims, and the Conference Board Leading Economic Index) have given their signals about a year ahead of the recession getting under way. The other three (see table) typically flash red much closer to the event. To date, only the yield curve has given a warning signal.

Confidence matters

Indicators aside, we believe it will take some doing to get the U.S. into recession from here. One need only check in on the American consumer who thoroughly dominates the U.S. economy at almost 70% of GDP. Consumers are confident and for many good reasons. The unemployment rate was last below 4% in the mid-1960s; unemployment claims recently hit all-time lows; there are 7.6 million unfilled jobs on offer, according to the Labor Department; wage rates are rising nicely; home values and other components of household wealth are elevated and don't look frothy or otherwise overly vulnerable; and consumer spending has remained mostly in line with income growth, suggesting household debt has not become unmanageable.

It has usually taken the arrival of tight monetary conditions to tip the economy into recession. "Tight money" has two necessary components: prohibitively high interest rates and banks that have become noticeably more restrictive in their lending practices. Neither is present today and with the Fed apparently on hold for the rest of this year restrictive credit conditions still lie some ways off. Looking at the latest monthly survey of thousands of small and medium-sized U.S. businesses by the National Federation of Independent Business, just 3% of respondents (historically very low) report being unable to get the credit they need, while 51% say they need no credit.

And what does this say for investment strategy?

The "inversion signal" has always been hard for investors to get behind precisely because it has given such a long early warning. It is usually followed by several quarters of positive economic growth—one such interval lasted almost two years. And the stock market typically has some months or even quarters to go before it sets its final high. It is difficult for investors to adopt a defensive approach when the economy continues to perform and earnings look set to go on growing.

For our part, we note that most stock markets are still slightly below last year's highs. Price-to-earnings multiples are reasonable and no longer as extended as they were in early 2018. We have been impressed by the power and breadth of the liftoff from the ultra-depressed December low point. We expect new highs lie ahead for the U.S. broad averages and for most developed economy stock markets.

We are content for now to maintain our target weight exposure to stocks in portfolios. However, we are treating the inversion of the yield curve as a "shot across the bow" for equity investors.

Only the yield curve is giving a warning signal

RBC Wealth Management U.S. economic indicator scorecard

Indicator	Status		
Yield curve (12-month to 10-year)	–	✓	–
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–
	Expansion	Neutral	Recessionary

Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed

This last part of the expansion cycle could prove to be very drawn out.

Highlights from the 2019 Federal Budget analysis

The Liberal government tabled its pre-election budget on March 19, 2019. The budget announced spending initiatives with a special focus on housing, skills for a changing job market, targeted measures for seniors, new support for zero-emission vehicles, steps toward implementing national pharmacare, and a commitment to bring high-speed internet to every Canadian home and business. The budget also aims to reduce inequity in our tax system, for example, by announcing the government's intention to limit the stock option deduction available to employees of large, established corporations. There were no changes to personal or corporate income tax rates. The spending measures and updated economic forecast results in an updated annual budgetary deficit for the 2018-19 fiscal year of $14.9 billion, compared to the $18.1 billion annual budgetary deficit forecast by the government in its Fall Economic Statement (November 21, 2018). We highlight a few of these announcements below.

Personal tax measures

Employee stock options

Employee stock options, which provide employees with the right to acquire shares of their employer at a designated price, are an alternative compensation method used by incorporated businesses. The difference between the fair market value of the shares on the day the options are exercised and the amount that is paid for the shares is considered a taxable benefit. The tax rules provide employee stock options with preferential personal income tax treatment in the form of a stock option deduction which effectively results in the benefit being taxed at 50% of the normal rate of personal taxation, the same rate as capital gains.

The budget proposes to apply a $200,000 annual cap on the employee stock option grants (based on the fair market value of the underlying shares) that may receive tax-preferred treatment for employees of large, long-established, mature firms. For start-ups and rapidly growing Canadian businesses, employee stock option benefits will remain uncapped.

Further details of this measure will be released before the summer of 2019. Any changes will apply on a go-forward basis only and will not apply to employee stock options granted prior to the announcement of new legislative proposals.

Zero-emission vehicle measures

The budget proposes the following measures that will make it easier and more affordable for Canadians to choose zero-emission vehicles:

- The Government will provide Natural Resources Canada with funds to deploy new recharging and refuelling stations in workplaces, public parking spots, commercial and multi-unit residential buildings, and remote locations.
- A new federal purchase incentive of up to $5,000 for electric battery or hydrogen fuel cell vehicles will be provided where the vehicle's manufacturer's suggested retail price is less than $45,000. More details of this program will be provided at a later date.
- Businesses will be able to fully write-off, for tax purposes, the cost of qualifying vehicles in the year they are put in use. Qualifying vehicles will include electric battery, plug-in hybrid or hydrogen fuel cell vehicles purchased by a business.

Business tax measures

Strengthening Beneficial Ownership Transparency

The budget proposes further amendments to the Canada Business Corporations Act to make the beneficial ownership information maintained by federally incorporated corporations more readily available to tax authorities and law enforcement.

The 2018 budget had proposed the introduction of enhanced tax reporting requirements for trusts, effective for the 2021 and later taxation years, in order to improve the collection of beneficial ownership information for income tax purposes.

Beneficial ownership refers to the identity of individuals who own, control or profit from a corporation or trust.

Closing tax loopholes

The budget proposes to close the following tax loopholes they perceive may result in some taxpayers paying less than their fair share.

- Prevent the use by mutual fund trusts of a method of allocating capital gains or income to their redeeming unitholders where the use of that method inappropriately defers tax or converts fully taxable ordinary income into capital gains taxed at a lower rate.
- Improve existing rules meant to prevent taxpayers from using derivative transactions to convert fully taxable ordinary income into capital gains taxed at a lower rate.
- Stop the use of Individual Pension Plans to avoid the prescribed transfer limits. These limits are meant to prevent inappropriate tax deferrals when individuals transfer assets out of certain types of pension plans. When an individual terminates members in a defined benefit plan, a tax-deferred transfer of all or a portion of the commuted value of accrued pension benefits can be made to another defined benefit plan sponsored by another employer or to a locked-in plan (subject to prescribed limits). As such, it may be possible to transfer 100% of the

Continued on page 4

commuted value of the pension plan to an IPP that is sponsored by a newly incorporated private corporation that is controlled by the individual who has terminated employment with their former employer. To prevent this type of planning, the budget proposes to prohibit IPPs from providing retirement benefits in respect of past years of employment that were pensionable service under a defined benefit plan of an employer other than the IPP's participating employer (or its predecessor employer). This measure applies to pensionable service credited under an IPP on or after March 19, 2019.

Prior to implementing any strategies, individuals should consult with a qualified tax advisor, legal professional or other applicable professional.

While it has been the long-standing practice of Canada Revenue Agency (CRA) to allow taxpayers to file their tax returns based on proposed legislation, a taxpayer remains potentially liable for taxes under current law in the event that a budget proposal is not ultimately passed. Therefore, if proposed legislation does not become law, it is possible that CRA may assess or re-assess your tax return based on existing legislation. It is recommended that you consult a qualified tax advisor to assist you in assessing the costs and benefits of proceeding with specific budget proposals as they relate to you.

This is an abbreviated version of the article. For the full version please visit our website: www.grimeshandscomb.com.

Announcement

A note from our Branch Manager:

It gives me great pleasure to congratulate Julie Handscomb on her recent appointment to the position of Vice-President at RBC Dominion Securities Inc. Our firm has a long and proud tradition of recognizing loyalty and superior business results among our Investment Advisors and Portfolio Managers.

This is a significant achievement that recognizes Julie's commitment and dedication to her clients and the firm over the years. Julie has worked hard at providing her clients with superior investment advice and client service, and it shows. Julie demonstrates the qualities of the very best Investment Advisors in the industry, and this title will serve as a reflection of her status in the firm.

Sincerely,

Caroline Kelly

Benchmarks

Equity market 12-month trailing return (for month ending March 31, 2019)	
S&P/TSX composite total return index	8.1%
S&P 500 total return (C$)	13.4%
S&P 500 total return (U$)	9.5%
DJIA total return (C$)	14.0%
DJIA total return (U$)	10.1%
Nasdaq composite price return (C$)	13.3%
Nasdaq composite price return (U$)	9.4%

RBC Capital Markets Canadian Bond Market indexes 12-month trailing return (for month ending March 31, 2019)	
Short-term index	3.5%
Intermediate term	5.7%
Three-month T-Bill (C$)	1.4%
Three-month T-Bill (U$)	2.0%

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