Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

For the clients of Grimes Handscomb Asset Management of RBC Dominion Securities | Spring 2023

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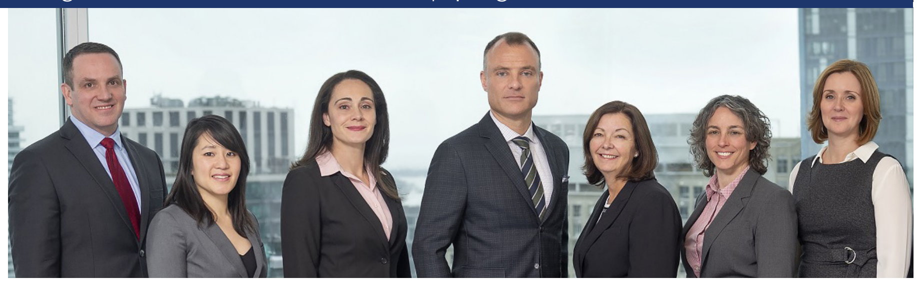

Markets, recessions, and telltale signs

by Jim Allworth

We look for a U.S. recession to get started sometime in the second half of this year. U.S. recessions have always been associated with bear markets for U.S. equities. But American economic downturns have always reverberated beyond the U.S., ushering in challenging periods for stocks in Canada, Europe, the UK, and Japan, as well as in most of the developing world.

Following are some historical observations that might be useful references for investors looking to navigate through the coming 12 to 18 months.

It's not over until it's over ... the economic expansion that is

The economy goes on growing right up to the point where it rolls over into recession. Today, it is still in that pre-recession growth phase. Q1 2023 data has so far fared somewhat better than most expected going into the quarter. As we see it, credit conditions are not yet restrictive enough nor the all-important consumer weakened enough to make the start of recession imminent.

Along with GDP, Q1 earnings are likely to have held their own vis-à-vis Q4 2022 results. Nor can some further improvement be ruled out for Q2 – one of the reasons why major stock indexes have been able to remain above their October lows despite the banking turmoil.

S&P 500 earnings estimates for 2023, after falling steeply from $251 per share in May last year to $218 per share recently, look to have pulled out of that drop and have stabilized around current levels. We believe the index may be able to post further advances for some weeks or months as long as the economy remains able to gain some ground.

But it will be over later this year

The two most reliable leading indicators of U.S. recession—the inversion of the yield curve and the year-over-year downturn in the Conference Board's Leading Economic Index—gave negative signals in July and September of last year, respectively. Both have "perfect" track records of signalling a U.S. economic downturn is on the way well in advance of the recession getting started.

Their respective histories would point to mid-2023 as the most likely start

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date for the coming U.S. recession. A bit earlier or somewhat later is always possible, but as far as these two series are concerned, the U.S. economy is now about to enter “the zone” where a recession could be expected to get underway.

Waiting for two more shoes to drop

Two other recession indicators we follow normally flip to negative just before or just as a recession starts. The first of these is the unemployment rate. Usually, it declines rapidly during an economic expansion, then plateaus at a low level over several quarters before reversing course and trending decisively higher. In this case, it has meandered at or near current levels for 12 months. It would only take a move up to 4.0% from the latest reading of 3.5% and January’s cycle low of 3.4% to turn the series trend higher and start the countdown clock for recession in earnest.

The second indicator that typically crosses its “red line” just as a recession is getting under way is the federal funds rate moving higher than the six-month annualized run rate of nominal GDP growth. (Nominal GDP is GDP that is not adjusted for inflation, and distinct from the most often cited real GDP, which takes out the effect of price increases.) As of Q4, the run rate of nominal GDP growth had subsided to 7.2% (down from a cycle high of 12.8% in Q2 2021), still well above today’s fed funds rate of 5%. We expect nominal GDP will slow further and by Q3 of this year will have fallen below the fed funds rate, meeting that pre-condition of all previous recessions of the past 70 years.

Fed cutting won’t save the day

But the sooner the rate cutting happens, the shorter and shallower the recession will likely be. The Fed and most other central banks, mindful of the late ’70s experience, are leery of cutting too soon. However, the banking turmoil now has them reconsidering the wisdom of any further increases. We think a pause may be seen within the next couple of months. (The Bank of Canada has already gone there.)

But rate cutting, in our view, probably awaits a year-over-year inflation rate of close to 3% (it was down to 5% in March) with a clear indication of lower inflation readings on the way. We expect inflation could reach those encouraging levels by late summer. More often than not, the Fed began cutting before most past recessions started. Notable exceptions were the downturns of 1973–75, 1980, and 1981–82—all ultra-high inflation periods—when Fed rate cutting started only after the recession was already underway..

Nobody rings a bell

In the U.S., the job of officially determining the start and end of recessions (and expansions) goes to the National Bureau of Economic Research, a private, nonprofit, nonpartisan organization. Its objective is accuracy, not speed. On average, it has made the call about a year after the event. So there can be a long stretch where debate continues to rage about whether the U.S. economy is or is not in recession without “a referee” making the call.

And the same goes for recoveries from recession. The global financial crisis and the accompanying recession ended in Q2 2009, but it was 2012 before most consumers and many businesses came around to accepting that.

While one waits for the referee’s call, the yield curve has proven to be a useful timing tool. One of the yield curve’s great strengths as a leading indicator, in our view, is that it works equally well in both directions. Inversion happens on average about 11 months before the recession starts, while normalization (i.e., short-term interest rates fall back below long-term rates) occurs about 11 months before the economy pulls out of recession.

The stock market peaks before the recession starts …

The market has set its bull market high on average about seven months before the recession begins. If the peak of the S&P 500 almost 15 months ago in early January 2022 marked the beginning of the bear market associated with the coming recession, then the time gap between the start date of the market downturn and that of the recession will be the longest on record. Even more so if the recession doesn’t get underway until Q3.

The rally from the October lows is still intact despite the Russia-Ukraine war, banking turmoil, as well as Fed and other central bank tightening. Breadth among the large-cap stocks has been stronger than the S&P 500 Index and is already close to setting a new all-time high—often a sign the index is going to follow suit. However, small caps have lagged badly both in index performance and breadth, usually an indication that the overall market advance has limited room and time to run.

… and the market typically turns higher before the recession ends

Such upward moves have usually emerged four to six months before the recession concludes. However, the market has never bottomed before the associated recession even began.

Bottom line

We expect a U.S. recession will get underway later this year, ushering in another period of challenging stock market performance with knock-on negative implications for economies and stock markets in other developed countries.

That said, we believe bear markets can provide once-in-a-decade buying opportunities. The yield curve, when it normalizes, should give some idea of when the recession will end. Stock indexes would typically embark on a new bull market upleg some months/quarters prior to that.

Wealth Transfer strategy

by Barrington Grey, CFP, CLU, FEA, Estate Planning Specialist

A lifetime of hard work, smart investing and sensible financial planning are factors that help build your estate. Representing your legacy to your loved ones, the transfer of your estate will happen only once.

When we consider the effects of taxation on our savings, it can be an estate's worst enemy. Taxation can reduce growth on assets when they are kept in taxable investments. There is an alternative to paying tax on the investment growth earned on your savings. You may re-allocate the funds using the Wealth Transfer strategy, which will allow you to maximize your savings, and provide a larger tax-free benefit for your heirs.

This attractive alternative to traditional investments offers the following:

- A tax-free maturity value at death
- Reduced estate settlement costs if a beneficiary is named
- A wide range of investment choices
- Tax-deferred growth of investment earnings
- Potential for creditor protection if a beneficiary is named[1]

How it works

An option to diversify your non-registered savings in taxable investments like mutual funds, GICs or other investments exposed to income, dividend or capital gains taxes, you may re-allocate these excess savings[2] in a tax-exempt life insurance policy. You must be able to medically qualify for the life insurance policy.

The investments within a tax-exempt life insurance policy grow tax-deferred as long as they remain within the exempt portion of the policy. This means you don't lose your investment earnings to taxes as you might have had you kept them in taxable investments.

The policy provides an immediate estate value as well as tax-sheltered growth on the cash value accumulating within the policy. At death, the proceeds of the policy are transferred outside of your Will, avoiding probate fees, if applicable, and paid tax-free to your designated beneficiaries on your policy.

By taking advantage of the Wealth Transfer strategy, you move your savings from a tax-exposed environment to a tax-sheltered environment, maximizing the amount to be passed to your beneficiaries at death.

Why you should consider this solution

Individuals who are disciplined savers often meet their retirement objectives through the money invested in their pension program, Registered Retirement Savings Plan (RRSP) and Tax-Free Savings Account (TFSA). However, many people also accumulate funds in a non-registered investment portfolio. Although these extra assets often provide financial security and peace of mind, they may not be effective vehicles to transfer wealth to beneficiaries after death.

This Wealth Transfer strategy provides you with the opportunity to enhance your estate and protect it from taxation. It is ideally suited for those who have maximized their RRSP and TFSA contributions and are looking for ways to shelter substantial non-retirement savings from taxation and add a life insurance component to help increase their estate.

If you are a business owner with large retained earnings, you should consider the Corporate Wealth Transfer solution as an option that offers the ability to transfer business values tax-efficiently.

To learn more about the Wealth Transfer strategy, please call or email us.

1. The ability to name a beneficiary within the policy may allow for the assets to be protected against potential creditors. It is essential that you speak to a qualified legal advisor regarding any asset protection options available to you.

2. Up to certain maximums defined in the Income Tax Act regulations 306 and 307.

Market updates and special commentaries

As part of our commitment to keep you informed, a reminder that we regularly update the *Special Commentaries* section of our website (www.grimeshandscomb.com), which includes our firm's perspective on a wide variety of timely subjects related to investing and personal finance. Some recent examples include:

- *The investment outlook and implications for investors* - audio commentary from Jim Allworth (April 2023)
- *A crisis for a few banks is not a banking crisis* (March 2023)
- *Federal Budget 2023* (March 2023)
- *Hitting the [debt] ceiling hurts, even if nothing breaks* (January 2023)

We also maintain an e-mail distribution list for our *Global Insight Weekly* and *Global Insight Monthly* investment strategy publications. If you wish to receive these publications regularly in your inbox, please e-mail Karen at karen.murphy@rbc.com to let us know.

Benchmarks

Equity market 12-month trailing return (for month ending March 31, 2023)	
S&P/TSX composite total return index	-5.2%
S&P 500 total return (C$)	-0.2%
S&P 500 total return (U$)	-7.7%
DJIA total return (C$)	6.0%
DJIA total return (U$)	-2.0%
Nasdaq composite price return (C$)	-7.1%
Nasdaq composite price return (U$)	-14.1%

RBC CM Canadian bond market indices 12-month trailing return (for month ending March 31, 2023)	
Short-term index	0.7%
Intermediate-term	0.0%
Three-month T-Bill (C$)	2.4%
Three-month T-Bill (U$)	2.2%

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