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Financial Focus

Wealth Management
Dominion Securities

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RBC Dominion Securities Inc.

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Dear Clients and Friends,

It is so great to finally see some nice spring weather here in Victoria. I am always grateful to live in such a beautiful place in the world.

After a tough 2022, markets are showing a good recovery for 2023 thus far. However, there are still some challenges that remain. Inflation is too high, stresses in the banking system have appeared and the risk of a recession looms. A mild recession in both Canada and the U.S. is still probable, which is part of every normal business cycle. Recessions are not catastrophic for investors who have planned for short-term income with risk-free investments and therefore they can allow their growth investments to continue to have a longer-term objective.

Inflation is coming down, but not quite as fast as we would like to see so far this year. Central banks have increased rates dramatically over the last 12 months to attempt to slow the economy which will eventually result in lower inflation. It doesn't happen overnight, and it could take a few more months before we see enough changes with inflation to warrant any decreases with interest rates. We expect rates to remain level over the summer to allow inflation to adjust to a lower level and once central banks feel that we have reached the point of slower growth, they can start to decrease rates again. From an investment perspective, this presents us with the opportunity to lock in some longer-term fixed income rates this year to extend out terms to have the benefit of higher rates for a longer time period.

Throughout history, markets have endured all sorts of events. Financial crises, geopolitical conflicts, and inflation to name a few. Despite these challenges, the market ultimately carried on providing strong returns to investors who patiently weathered the storm. Once positive sentiment starts to brew, the market can move swiftly to the upside. These short but powerful rallies can be a major component of the long-term return potential we talk to clients about. They're not something we want to miss as investors.

My approach to financial planning continues to be managing investment accounts to reflect your current and future income goals. This is simply pre-planned savings to support future pre-planned spending – a very simple strategy to provide predictable income amounts based on your expenses. Annual reviews to understand your cash flow requirements are important and would be revealed in my usual question to clients "do you anticipate any larger expenses in the next 12 months?". Be sure to keep me in the loop!

After a very busy tax season this year, I am very grateful for my two amazing team members, Mary Howley and Heather Murdock. These wonderful ladies quickly responded to dozens of enquiries from clients and accountants with regards to tax documentation. I feel very lucky to have them on my team!

Best wishes for a safe and happy summer,

Sandra

What Exactly is a Recession and Are We In One?

Recession is one of those terms you hear a lot in tough economic times. Yet what exactly does it mean?

The most common definition is two quarters in a row of declining Gross Domestic Product (GDP). GDP is a measure of the value of all the goods and services a country produces and sells in a specific time period. Think of the food you buy, the work you do, every time you get a haircut, order in a meal or take a vacation. Or the equipment a business buys, the staff they hire and what they sell – all these things and more are part of GDP.

Yet even when a country sees a drop in GDP across two quarters, it's not always considered a true recession. This was the case in the U.S. in 2022. Why?

What makes a recession? A deeper dive

In practice, the experts look at more than GDP to assess what's going on in the economy. For example, they consider:

Real income

This number measures how much people earn, adjusted for inflation. It's not just the pay you receive. It's about how far your money goes. When real income drops, you can't afford to buy as much. When this happens to a lot of people, demand for goods and services falls.

Industrial production

This number can help us determine if a recession is starting. When companies see demand is falling, they may cut back their production. This lowers GDP – which in turn drives the economy closer to recession.

Employment

Combined with real income, this number gives us a clearer picture of the financial health of the consumer. Are they working and earning money they can spend? This is important since consumer spending makes up 65-70% of GDP.

Wholesale and retail sales

These numbers can be used to assess the spending of consumers.

These indicators work together to help us understand the business cycle – including the stage that's called a recession. Economists look at all these things and more to understand the expansion and contraction in economic activity over time.

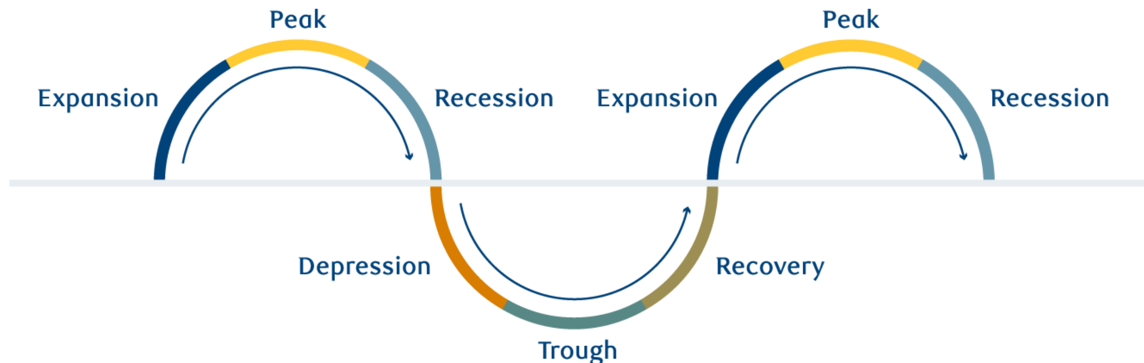
Are we heading into a recession in 2023? What might that look like?

Economic activity began to slow in late 2022 while interest rates continued to rise. However, there's no indication yet that a recession has arrived. Employment remains strong. Consumers and businesses are sitting on healthy cash balances. Industrial production is rising.

While it's likely we may experience a recession in 2023, our Chief Economist Eric Lascelles believes that employment may remain stronger than in previous recessions. This could lead to a shorter, shallow recession. A smaller trough would then set off the next wave of recovery and growth in the economy.

How does a recession fit into the business cycle?

Think of the business cycle as a natural cycle, like the four seasons – although often stretched out over years, rather than months. Roughly speaking, the business cycle is marked by six different stages as shown below. How long each stage lasts and its impact varies from one cycle to the next.



Each stage of the cycle reflects a different level of economic activity. By the time the business cycle passes through expansion and into the "peak," we often see areas of the economy beginning to overheat. This happens when the economy starts to run at a pace that it can't sustain. There simply isn't enough supply to meet all the demand. This often fuels inflation, as scarce supply can drive prices up.

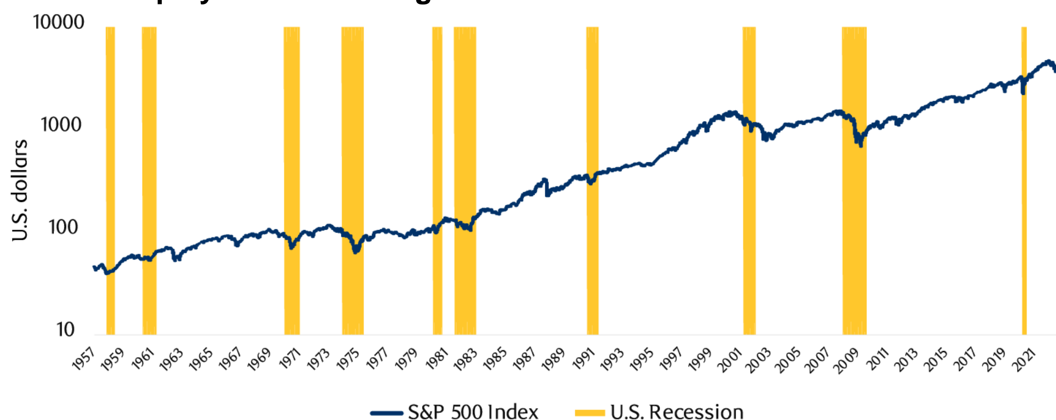
In response, central banks like the Bank of Canada or U.S. Federal Reserve may raise interest rates. This is called tightening monetary policy. It's designed to slow consumer spending and bring economic activity back into balance.

What typically follows is a recession, as tighter conditions often reduce demand for goods and services. As consumers spend less, this impacts how much companies produce, their willingness and capacity to hire, and ultimately leads to a general slowdown in economic activity.

How do recessions affect investors?

Recessions and bear markets tend to go hand in hand. Investors will often feel short-term pain. But recessions don't usually disrupt investors over the long term. As you can see in the chart below, historically markets have risen over time.

U.S. recessions and equity bear markets go hand in hand



To sum it up, the economy and businesses are constantly adapting to changing conditions. Sometimes that process is painful. But if recessions are painful, they are typically very short. Over the years included in the chart above, the economy was in recession for a total amount of time equivalent to 9.1 years. That's less than 15% of the time.

That's good news for investors who stay in the market for the long term – whether we're in a recession now or not.

Source: RBC GAM, Bloomberg. For the period of January 1, 1957 to December 15, 2022. Shown on a logarithmic scale. This graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. An investment cannot be made directly into an index.

Bond Prices and Interest Rates

When you purchase a bond, you lend money to governments or companies for a certain length of time. The borrower then promises to pay the lender a specified interest rate at fixed intervals and repay the loan principal at a specified time.

Key attributes of bonds include:

Income Predictability - High quality bonds can provide a series of predictable cash flows with minimal risk to your invested capital (the principal). This can be beneficial to individuals like retirees looking for a steady stream of income to draw from to support their living expenses.

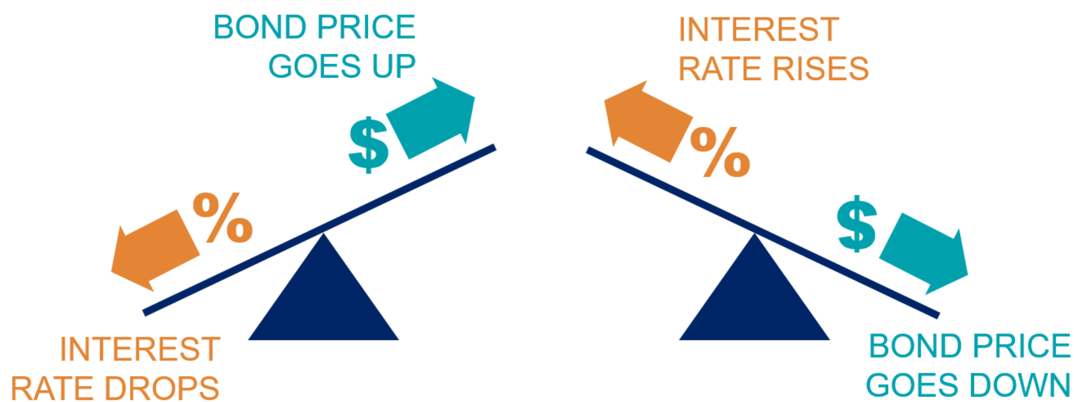
Diversification Benefits - Adding bonds to an equity portfolio reduces portfolio risk – the risk inherent in your combined investment holdings.

Choice - Bonds issued with a variety of coupon rates and maturity dates are available to help structure cash flows that match the timing of your income needs.

Safety - Depending on their quality, bonds can offer you a high degree of certainty that the interest and principal repayment will be received in full at maturity.

Bond prices can be impacted by several factors including interest rates, inflation, default risk, liquidity, market supply and demand, and economic conditions.

A key concept specific to bond investing is the **inverse relationship** between **interest rates** and **bond prices**. They move in opposite directions.



Bond prices increase when interest rates are dropping as existing higher rate bonds will be sold at higher prices (investors will pay more for a 4% bond than they would for a 3% bond). We are now starting to see an opportunity in bonds as central banks appear to be pausing their interest rate hikes. Bonds should provide above average returns over the next 2 years as interest rates come back down to normal levels.

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