Wealth Management
Dominion Securities

Cooper Wealth Management of
RBC Dominion Securities

Thoughts on the market

May 13, 2024

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Inflation vs. Productivity

"Productivity growth, however it occurs, has a disruptive side to it. In the short term, most things that contribute to productivity are very painful."

– Janet Yellen, *US Treasury Secretary*

Over the last six months, the global stock markets have moved higher as inflation fell and the prospect of declining interest rates grew closer. Now that US inflation has increased slightly at the end of March to 3.5%, we have seen the market have impatient sell offs in April as the number of projected rate cuts has dropped. What is seemingly being ignored at the moment is the ongoing strength of the US economy and the productivity gains being made. This month, we will examine Secretary Yellen's comments and consider their implications for both the US economy and the stock market.

One of the largest pain points is the loss of jobs due to technology. With the growing influence of generative artificial intelligence, we have already seen US productivity rise to 3.2%, up from its long-term average of 2.1%. An increase of this size usually means substantial job losses, but the US unemployment rate has remained steady at 3.8%. The reasons for this are twofold: first, while immigration remains strong in North America, the domestic workforce is aging and retiring, and therefore helping to keep the numbers in balance. Second, despite continued warnings from economists and analysts about recession, the US economy has continued to grow, with Gross Domestic Product up a healthy 3.3% last quarter and more growth generally means more jobs.

Innovations such as mass production and the rising productivity since the invention of the computer have changed the world forever and will continue to do so. One of the best examples of Secretary Yellen's comment on productivity was the decline and fall of the newspaper industry. The internet allows us to be constantly updated in real time on global events and the daily sales of newspapers has fallen to a tiny fraction of its former glory. While the major newspapers have adapted as best as they can by largely moving online, the number of people employed has greatly decreased. While great pain was felt by the newspapers, the new Information Age has brought fantastic new investment opportunities and one of our primary focal points as investment managers is to be on the right side of these trends as they develop.

A secondary concern is upward pressure on inflation. The theory is that with fewer workers producing more, they would demand higher wages and thereby increase the overall rate of inflation. While wages have increased since Covid, the level of wage increases has fallen as the overall inflation rate has dropped. The wave of immigration in North America, particularly in Canada, has helped to keep the labour market well supplied and has kept wages in check as a result.

Secretary Yellen's short term concerns regarding productivity are seemingly under control at the moment but what about the long term? The US has been among the top five countries in productivity gains since the Second World War. Currently, the US is fourth and Canada comes in at forty fourth globally, which helps to clearly illustrate the growth disparity between our countries. It also explains how the US has managed to become the most globally dominant economy. Historically, inflation has come and gone but productivity increases, particularly in technology, are here to stay.

The key questions at this stage of the market is: Will the focus come off the Federal Reserve and interest rates and what will it take to get the market to change that outlook. The reality is that one or two interest rate cuts by the Fed are not really going to move the economic needle in the US or anywhere else, but the psychological impact is important to the current market mindset. A change in thinking about the coming year will likely only occur if a number of factors come together: 1) Inflation needs to remain either flat or declining- if inflation remains the same or moves lower, then the market will turn its attention back to fundamentals. A move in the other direction could send markets lower. 2) The US economy needs to keep growing - If the US consumer continues to spend, unemployment remains low, and productivity gains are maintained, the market will appreciate it as a strong economy usually leads to 3) Stronger corporate earnings - with many of the major US companies reporting better earnings in the first quarter, the corporate outlook remains positive for the balance of the year. Ironically, if all these factors remain strong, the Fed will likely delay rate cuts further but at some point, the market will recognize the value these companies are creating.

As we enter Spring, we expect stable corporate and economic growth to be ongoing. For Canada, this means banks and other high dividend stocks may not see much movement until rates are cut but oil stocks continue to perform as geopolitical tensions remain high around Israel and the Ukraine. We have also seen strength in the consumer discretionary section of the market with our portfolio holding in Dollarama being a notable standout.

On the fixed income side, we also expect prices to remain range bound, as it will take actual interest rate cuts to move the dollar values higher. In the meantime, we will continue to collect the highest yields we have seen for many years.

The news on the inflation front has been mixed. While US headline inflation in the form of the Consumer Price Index has ticked higher to 3.5%, the Producer Price Index, which measures the average change in prices received by domestic producers, is down to 2.1%, which is a hopeful indicator that CPU will follow. The sticking points on inflation are still housing, food, and gasoline prices. While housing and food inflation have steadied, we saw gas prices rise. It will take a cooling of political concerns to bring oil prices down, but we believe the overall inflation trend will stabilize and gradually move lower.

A further hindrance to productivity is taxation. We have had a number of calls about the pending increase in the capital gains inclusion rate and we wanted to provide an example for clarity:

Let's assume we have two identical portfolios, both worth $1,000,000 all in unrealized gains. The current capital gains inclusion rate is 50%.

Portfolio A:

If we sold everything now, $500,000 would be taxable at today's 50% inclusion rate. Using a 50% marginal tax rate for ease of calculation, your tax bill is $250,000 and you have $750,000 left to invest. If we earn 7.2% per year for the next 10 years, our money doubles and you now have $1,500,000.

Portfolio B:

If we don't sell now, you have $1,000,000 in unrealized gains. If we earn 7.2% per year for the next 10 years, our money doubles and you now have $2,000,000.

Next, let's assume you sell both portfolios on a later date under the new capital gains inclusion rate of 67%:

Portfolio A:

Your portfolio now has $750,000 in unrealized gains. If we sell everything again, $500,000 would be taxable at the new 67% inclusion rate. You would have to pay another $250,000 tax bill on these gains. Your net portfolio is $1,250,000 free and clear.

Portfolio B:

Selling this portfolio now at the new inclusion rate of 67% would result in taxable gains of $1,340,000 with a tax bill of $670,000 (assuming a 50% tax rate). Your net portfolio is now at $1,330,000 free and clear.

The unrealized gains provide cost free leverage to your portfolio returns over time and it doesn't make sense to rush out to sell stocks just to beat the tax. In Portfolio B, you actually pay $170,000 more in tax over time but wind up better off thanks to the time factor. That being said, this is strictly correct if your intention is to buy and hold in a non-corporate account. For holding companies, it is necessary to consider the capital dividend account and its benefit for future tax-free distributions from the company. We will be reviewing all our corporate clients this month and advise on any action required.

The current mega trend in technology is definitely the driving force of productivity growth and will continue to be. As this trend continues, market expectations will also rise and while there will be some uncertainty along the way, we strongly believe the global economy will enjoy long term benefits, despite any short-term adversity. Until next month, stay well.

As always, questions, concerns, comments, and feedback are always welcome.

Yours truly,

Trevor, Walter, and the Cooper Wealth Management team

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