Wealth Management
Dominion Securities

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Inflation Success
May Be Closer Than It Appears

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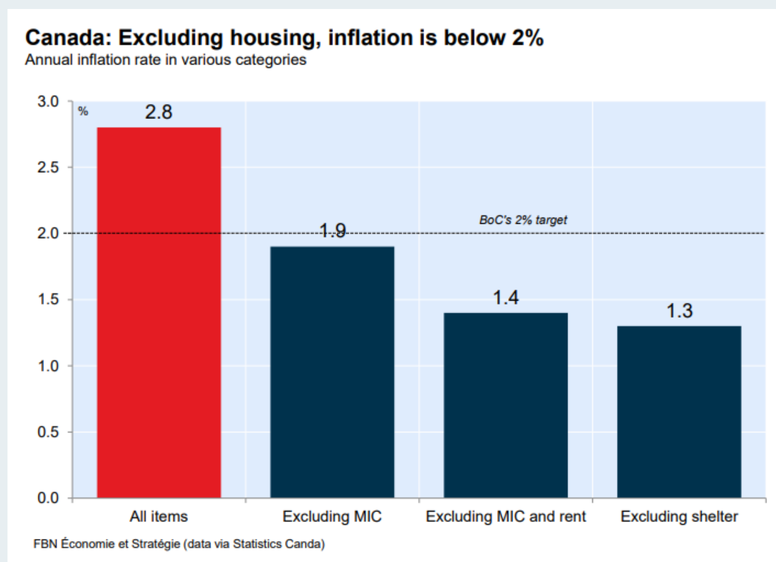
To be honest, we were hoping to repeat last year's "Maple Leafs in May" newsletter theme, which was written shortly after Toronto won their first playoff series in a generation. However, Game 7 against the Bruins put a bit of a damper on things, so we'll have to try to find other "non-Leaf" sources of positive inspiration this month (clearly that also excludes the Blue Jays...) Ok, so with the Toronto sports scene being absolutely no help, **I guess we'll just have to dive into a topic sure to bring a smile to everyone's face... INFLATION!**

Wait! Before you start booing us: there is actually some optimistic news on the inflation front! We haven't dug into this topic here for several months, so let's set the scene:

For the past 3 months, the Year-over-Year (YoY) change in Canada's Consumer Price Index (CPI) has been under 3%. This is much better than the 7%+ readings we saw in 2022, but still not back to pre-COVID levels. The Bank of Canada's (BOC) long-term target for inflation is around 2% (similar to the Federal Reserve in the United States), so they are not too far away from achieving that goal. The BoC also has short-term interest rates set at a target of 5% in an attempt to drive inflation even lower toward that 2% target. In most cases, higher interest rates will slow demand in the economy, resulting in more stable prices. You may be wondering, why do we keep hearing about a potential interest rate cut by the Bank of Canada, if they have not yet fully achieved their goal? Well, **if you take a closer look at the current cause of inflation, it becomes clear that this central bank has already accomplished what it set out to do.**



Housing (Shelter) costs are the most significant weighting in the CPI, currently making up over 28% of the index. **Sustained increases in housing costs will keep the CPI reading elevated, even if most other prices in the economy are under control (hint: this is where we are now).** As we have mentioned in previous newsletters, there is a lagged effect to housing readings in the CPI, which can cause them to remain elevated over time even if the "real-time" rental rates or housing costs are telling a different story. More importantly to this discussion, **most of the current causes of shelter inflation cannot be controlled by interest rate policy.** It's also becoming clear the Bank of Canada's interest rate policy is unintentionally causing a certain component of housing inflation (Mortgage Interest Cost – or MIC) to explode higher, which is having an outsize effect on the CPI. Please see this nice, simple chart on the previous page from National Bank that provides greater detail.

It's not hard to understand why Mortgage Interest Costs would be going higher. If you have a variable mortgage, your interest costs go higher as rates go up. Have you spoken to anyone that had a fixed-rate mortgage came up for renewal recently? The rate they are locking in for a new 5-year mortgage is MUCH higher than it was half a decade ago. Unsurprisingly, this has pushed MICs up by 26% over the past year. In this specific case, **the Bank of Canada is actively causing this relatively small input (only 3.8% of the entire CPI) to represent almost 1% of current inflation! If you just remove MIC, then inflation is already running below the BoC's desired target of 2%.** Starting the rate-cutting cycle would help relieve some pressure on this input.

In addition, the lack of available housing supply and increased immigration has driven rental costs higher, and that issue doesn't look likely to be resolved any time soon. **Since rental costs are mostly determined by supply and demand (and not interest rate policy), keeping rates higher will have a negligible effect on rent prices** and could potentially become inflationary. If some homeowners are unable to afford the cost of their mortgage renewal, then they would join an already large pool of renters in Canada. This would increase demand for rental units and likely push up the monthly rent demanded.

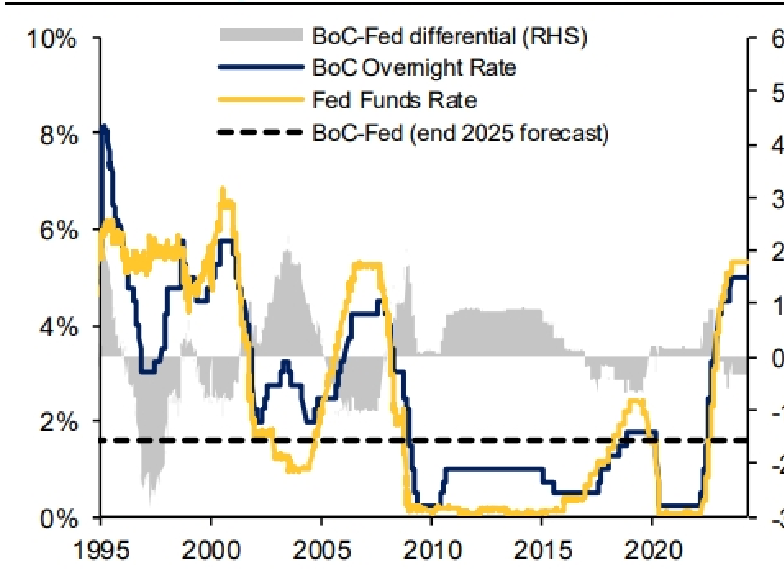
Back to CPI: **if you now leave out the cost of mortgage interest AND rent, then Canada is only at 1.4% inflation YoY.** More simply put: **Half of the existing inflation in Canada will not be reduced through higher interest rates.**

So, if the Bank of Canada listens to us and decides that they should cut interest rates, then what about the US Federal Reserve? They don't appear to have any desire to cut rates until at least the fall, as they remain "data-dependent" with the US economy

continuing to outperform expectations. But don't the two central banks usually move in lockstep when it comes to interest rate policy? Well, as the graphic below will show, the Bank of Canada and the Fed have a long history of decoupling and following their own separate path when necessary. It is true that their policy rates have trended closely together for the past several years, but it hasn't always been that way.

Since Canada's economy is more reliant on the real estate market than the US, it would only make sense that we see the first rate cut happen north of the border. We're sure there would be plenty of homeowners with upcoming mortgage renewals cheering that decision!

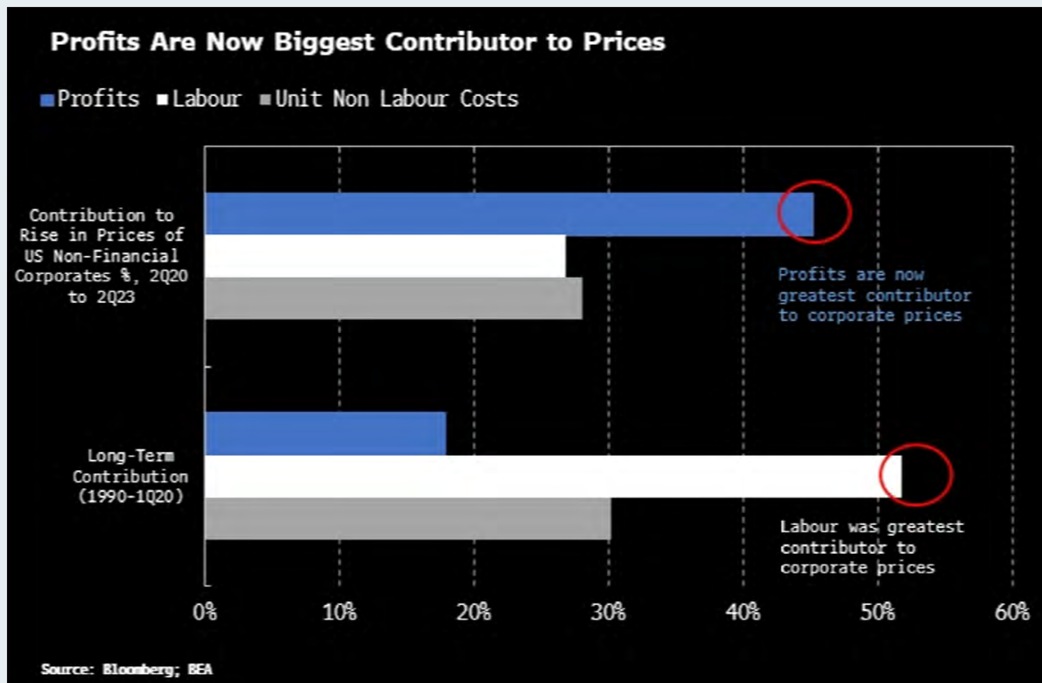
One final interesting note on the inflation story. Occasionally, you may hear a comment in the media that wage increases could spur a second round of inflation in the economy, known as a "wage-price spiral". This occurred in the 1970s when inflation was high, but the workforce was able to negotiate wage increases that more than made up for it (in large part due to the scale and power of unions at the time). For most of the past few decades, the higher wages paid by a corporation to their employees would be passed on to the consumer in the form of price increases. Those increases in price were mainly attributed to this additional cost of labour along with capital costs to run the business. The rest of the



price increase was simply additional profit to the company's bottom line.

Between 1990 and the start of COVID in 2020, these profits accounted for less than 20% of price increases.

Since COVID, that equation has changed entirely. **Corporate profits now account for 45% of price increases!** (see chart from Bloomberg). This is well over double the previous norm and has been the main driver for inflation remaining sticky. The pandemic and subsequent supply chain crisis from the Russia/Ukraine conflict provided an opportunity for companies to raise prices substantially in response to very real cost increases at the time. Consumers were understanding (if not annoyed) for a long time and remained willing and able to pay the higher prices with the influx of savings they accrued during the pandemic. **Pretty much any industry you looked at was raising prices and using their increased costs as the reason (which in hindsight appears to only be half the story – the other half was profit).** Now that many consumers have seen their savings dwindle, there is less ability (or desire) to withstand further price increases. The good news is companies clearly don't need to hike prices to cover costs in this environment. In the absence of that strong, price-insensitive consumer from recent years, they likely also can't. This setup should help to keep a lid on inflation, hopefully allowing the stock market to wind its way higher.



CAPITAL GAINS INCLUSION RATE - WHAT INVESTORS NEED TO KNOW:

Following the recent release of the federal budget on April 16th, 2024, which provided updates to the capital gains inclusion rate for individuals and corporations, our team at Ord Private Wealth Management aims to clarify how these changes could impact you and what steps we're taking to mitigate their effects on your portfolio. While there's a high likelihood that the proposed changes won't significantly impact your investment strategy with us at RBC Dominion Securities, it's important to stay informed.

Please take the time to read through how the proposed changes to the capital gains inclusion rate might affect individual non-registered investors; corporation owners and real estate investors.

Individual Non-Registered Investors

- If your only source of capital gains comes from your personal non-registered investment portfolio, nothing will change until you realize more than $250,000 in capital gains in a single year. Only at that level would the inclusion rate rise to 66.67% from 50% on additional gains.

****As part of our portfolio management service, we employ year-end tax-loss selling to minimize capital gains.** For clients with large, embedded capital gains, keeping realized amounts under $250,000 annually is achievable with proper planning.**

IMPORTANT NOTE: The "Capital gains inclusion rate" refers to the percentage of your realized capital gain considered as income, **not the tax rate you pay on gains.** It's added to all other income sources for tax calculation.

Investments Held in a Corporation or Trust

- If you have investments in a corporation or trust, then this proposed change is more of an immediate concern. There is no $250,000 buffer on the capital gains inclusion rate change for a corporation or trust.

After June 25th, the inclusion rate for ALL capital gains within a corporation or trust would be 66.67%. This would also mean going forward, the Capital Dividend Account (CDA) within a corporation would only be credited 33.33% (rather than the current 50%), reducing tax-free distributions to owners. **Owners of corporations are encouraged to consult their accountants to assess any tax implications and explore any possible tax efficient strategies.**

Real Estate Investors – Secondary Properties

- Owners of secondary properties should be mindful of the impact of the capital gains tax change. As only principal residences are covered by a capital gains exemption, additional properties are subject to capital gains tax upon sale.

If this gain exceeds $250,000, there could be additional tax consequences. Whether this changes your long-term planning depends on individual circumstances. Consultation with an accountant is recommended for tax advice on secondary properties.

RBC CONFERENCE

Most recently John attended an RBC conference in the Dominican Republic where ideas and strategies were discussed. John's partner Michelle joined him as well for an extended holiday after the conference.

AS ALWAYS, PLEASE REACH OUT TO US DIRECTLY IF YOU HAVE ANY QUESTIONS OR CONCERNS RELATED TO YOUR PORTFOLIO.

ORD PRIVATE WEALTH MANAGEMENT

Best regards, John, David, Tim, Mikail & Michael

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