Wealth for Life

Wealth Management
Dominion Securities

September 2022

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The third quarter opened on an optimistic note notwithstanding central bank interest rate increases.

Hawkish overtones by central banks about further aggressive interest rate increases quickly ignited an increase in 10-year bond yields (interest rates) from 2.6% in July to 4% by late September in the U.S. Equity indexes reacted negatively to increasing interest rates, pricing in future recessionary risks.

The prospect of rising interest rates in the U.S. attracted global investors to higher short-term returns from bonds and the relative safety of the U.S. dollar.

The U.S. dollar not surprisingly spiked to 20-year highs, resulting in price declines of most commodities and, by extension, the Canadian dollar. Oil tumbled from over $120/bbl in June to $78/bbl in September. Gasoline prices also tumbled offering consumers a reprieve from peak energy prices. The decline in commodity prices offered many optimism that inflation was abating.

Although anecdotal evidence is building that inflation looks to be turning, traditional measures like the consumer price index (CPI) and “core CPI” have resisted any meaningful declines.

Recently, the U.S. September CPI and core CPI were stubbornly high yet lower than in July. Housing and wage growth remain elevated and big contributors to inflation. The debate in financial markets is focused on the backward and lagging nature of both housing costs and wage growth. Some argue that housing prices have declined and rents are starting to weaken, while layoffs are growing and will soon affect wage expectations. In fact, U.S. job openings declined by 1.1 million, down to 10.1 million, on the last day of August, reflecting a more cautious stance by employers.

Along with lower commodity prices, evidence that supply bottlenecks are easing can be seen in many areas.

Container freight rates have plummeted, retail inventories have recovered, and new car inventories are recovering, but still below pre-pandemic levels for light vehicle sales. At the time of writing, U.S. September retail sales were reported as flat compared with August, and expectations are for an increase of 0.3%.

Although the U.S. consumer has pulled back on purchasing goods, consumer savings in the U.S. are still strong, owing to the windfalls during COVID-19, as illustrated below. With wage growth still meaningful, the question becomes, will the consumer continue their spending momentum? The consumer seems to have migrated from purchasing goods to purchasing services – leisure, entertainment and travel. Big ticket purchases like homes and autos have clearly been affected by the meteoric rise in financing costs

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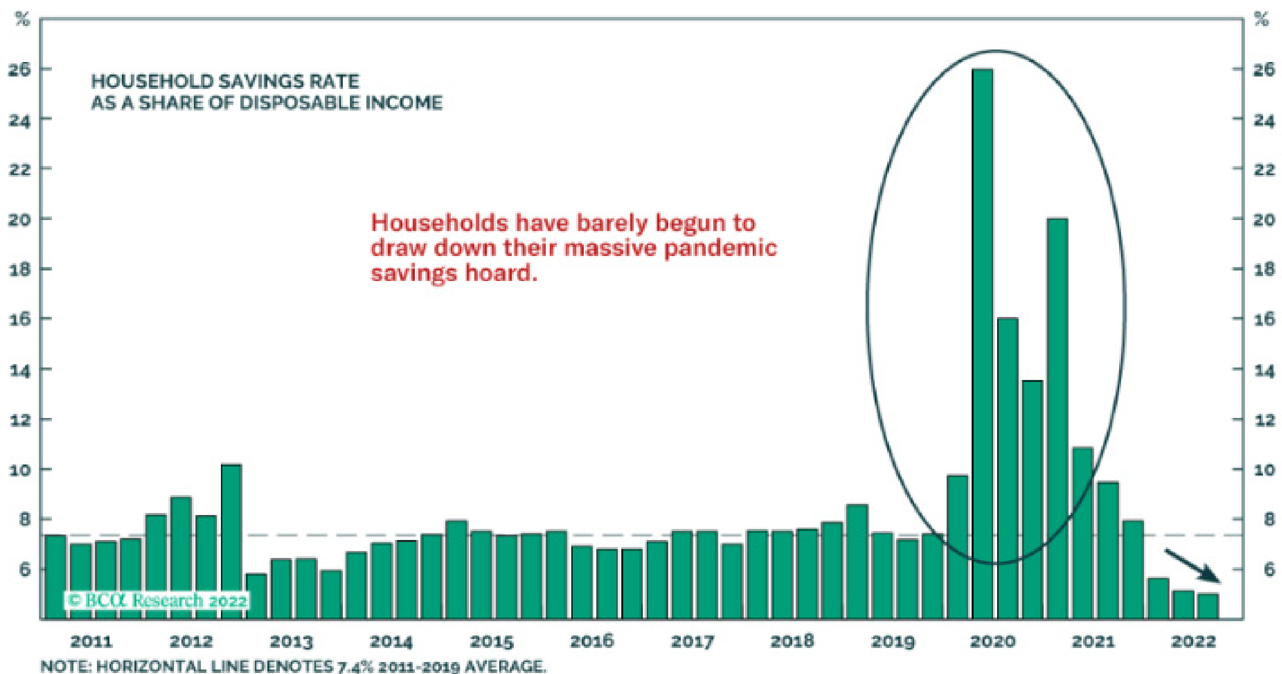
An extended period of dis-saving is sustainable



Source: BCA Research

and the increasing costs of services may trigger a similar consumer retrenchment as their savings are depleted. We note that household savings have tipped below average since the last half of 2021 in the U.S.

As central banks raised interest rates, equity markets sold off during the last half of the third quarter.

Equities seemed to take their cue from U.S. 10-year bond yields that roared to 4%, levels not seen since 2008. Equity indexes reached the low levels of mid-June, a "technically" important level, then went marginally lower. The volatility and levels of stock prices seem to indicate markets were grappling with uncertainties – what a future recession could look like. The contradictions between the strength of the consumer and job market, weakness in housing and commodity prices, and central bank commentary on future interest rate increases, left many company share prices at recessionary levels.

By quarter end, the TSX had returned (11.1%) year-to-date (YTD) while the U.S. equity market, S&P 500, returned (23.9%) YTD. The U.S. tech-heavy NASDAQ returned (32.4%). U.S. equity markets had clearly entered "bear market" territory. The dramatic increase in interest rates caused similar losses on a YTD basis for bonds across the yield curve, with average bond returns – 11.1% and 14.4%, in Canada and the U.S., respectively. Consequently, asset safety havens for investments were scarce.

As the quarter ended, financial markets were bracing for corporate earnings.

Announcements in October and November. Many investors and market participants are anxious to hear how earnings are doing. More importantly, everyone will be listening to what corporate CEOs have to say about their businesses and future outlook. Key talking points will include how companies are dealing with rising costs, how business activity is or will affect staffing and hiring plans, and their view of recessionary expectations. Everyone is trying to handicap if and how low earnings may decline in 2023 given the diversity of recessionary expectations. All this is to gauge where markets are today in the cycle of the bear market: At the bottom and bottoming? Lower yet to go? Recovery under way?

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Of course we have been there before.

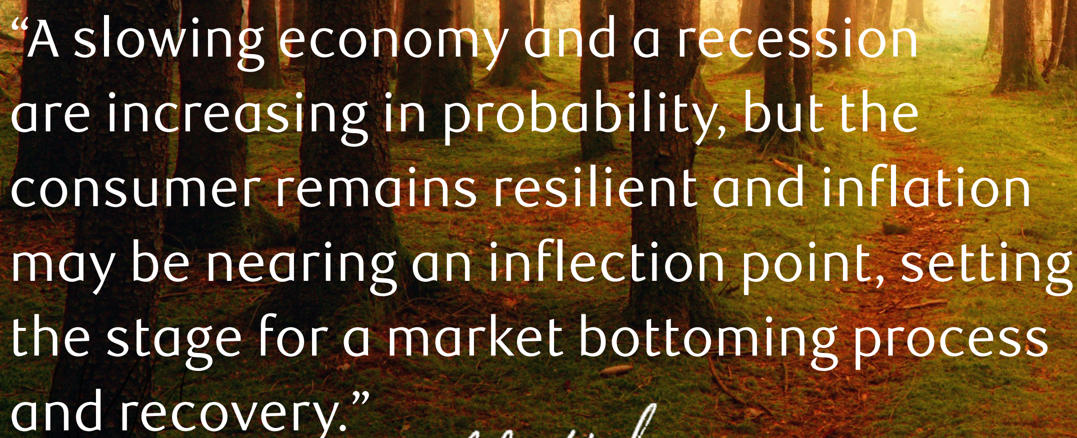
Financial markets, like the economy, cycles through growth with bull markets, then retrenches to digest the growth in capacity that appears as bear markets. As the economy grows into the excess capacity, we get a recovery, and the cycle continues. Equity valuations have declined significantly from the highs of 2021/22, and the future recovery will be contingent on better visibility on future earnings. Markets are keen to learn when central banks might be nearing a pause in their track for interest rate increases. The key to central bank increases will be inflationary sign posts that show a meaningful decline in inflation.

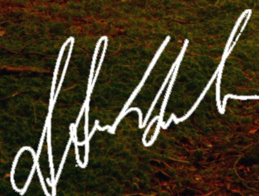
Looking forward, the risk of a recession is real.

Regardless of how "hard the landing is" (soft or deep recession), economic growth is slowing so everyone is watching how slow the economy might go. As never before, central banks have embarked on an unprecedented increase in interest rates coupled with quantitative tightening, so the risk to "over tightening" is high. Therefore, the risk of recession is also high and central banks are monitoring inflation sign posts intently.

As we try to assess the risks of recession and opportunities, the direction of inflation is critical.

Like the economy, equity earnings are cyclical – some more than others – and will recover with markets. Current valuations are discounting a very high probability of recession so, as the bottoming process unfolds, attractive valuations in great companies are evident. Higher interest rates on bonds provide better opportunities for stable investment returns than in the past. As in past down cycles, investor sentiment (fear) is at peak (bearish) levels, only rivaled by the great recession of 2008/9. Equity values could go lower or recover, supply bottlenecks are easing, commodity prices have declined, and central banks will eventually get a handle on inflation so investing in great companies will be more productive than trying to "time markets."





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Protecting your wealth with insurance

Like most Canadians, you want to be free of financial worry. That means knowing you will have enough money to live comfortably in retirement and potentially leave something for your family in your estate.

Unfortunately, without proper planning, the value of your assets could be reduced by a hefty tax bill. Your estate may not have enough liquid assets or cash on hand to pay this bill and your heirs may have to decide which assets to sell in order to fulfill the obligation.

Upon passing (if you are unable to roll over assets to your spouse), registered assets, as well as gains on non-registered investments and property (excluding your principal residence), will be included in your income in the year of death. While the tax bill may be relatively low today, it may increase over time as your assets increase in value, so your family is not only inheriting the assets, but also the tax bill.

An effective solution

There are strategies using life insurance to help your family when the time comes to settle your final tax bill. Once integrated into your overall financial plan, these strategies will help to protect the value of your assets and provide your heirs with the funds necessary to pay the taxes due when you pass away, all for just a fraction of the potential tax bill.

Traditionally, we view life insurance as a means to replace lost income or to provide money for final expenses like a funeral. However, permanent life insurance may be valuable as a financial planning tool in other ways, especially for families with more complex financial needs.

Three types of permanent insurance

- **Term To 100:** Basic insurance coverage that lasts your lifetime.
- **Universal Life (UL):** Combines the security of insurance coverage with the growth opportunity of a tax-sheltered investment account that is managed by the policyholder to achieve long-term estate growth.
- **Whole Life (WL):** Generates long-term growth by crediting policy dividends, which are largely created by the performance of a diversified investment portfolio managed by the insurer's professional money managers. It is a product intended to maximize estate values with the help of a managed investment approach.

The use of permanent life insurance provides the ability to manage your tax risk today and in the future.

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The insurance premiums relative to the benefit make it an extremely cost-efficient method of covering your future tax liability.

There are several differences in the mechanics of whole life and universal life insurance, but in the end, they may both be used for either personal or corporate planning needs. They may also offer a tax-deferred accumulation of wealth and a tax-free benefit payable to your heirs.

The use of permanent life insurance provides the ability to manage your tax risk today and in the future. It is important to keep in mind that you must medically qualify for coverage in order to purchase life insurance and implement this type of strategy.

The insurance premiums relative to the benefit make it an extremely cost-efficient method of covering your future tax liability.

Selecting the right insurance solution for you will depend on your objectives and investment style. Whether your needs are simple or complex, there is a solution for you. We will analyze your situation, determine your needs and implement a strategy that is right for you.

Please contact us if you are interested in getting more information on life insurance and how it fits within your overall wealth plan.

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