The Financial Corner with Joanne Vesprini

Piedmont, Italy

A quarterly newsletter filled with practical wealth management advice.

Summer 2021

- Tax-Free Savings Account
- Will the Inflation Surge Impact Equity Markets?

My thoughts,

With economies reopening there is now strong growth, surging corporate profits and elevated investor confidence which has helped extend the bull market and boost global equities to record highs. So what can we expect for the next quarter?

- *We will continue to hear daily commentary on the number of new COVID-19 cases, the progress of the Delta variant, the percentage of the population fully vaccinated and digital vaccination certificates for cross-border travel. Coverage of the pandemic will remain in our lives for many, many more months;*
- *More commentary and analysis on the impact of high commodity prices, the shortage of shipping containers and computer chips on rising inflation to determine if it is structural or only transitory;*
- *The Olympics and Paralympic games between July and September*
- *Talk on whether the US dollar bear market will persist;*
- *The impact of more people returning to working from offices rather than home*
- *Fans returning to sporting events, concerts and the arts;*
- *Further insight into whether the surging economy lifts revenues and earnings leading to a durable earnings expansion that could last several years;*
- *A return to squash clubs, yoga classes and mid-size indoor events*

I hope most of us will start to feel a return to the life we had pre-pandemic over the course of the next couple of months. Hopefully this will mean seeing more of our family and friends, enjoying our summer and possibly even some travel.

Enjoy the summer!

Joanne

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TAX-FREE SAVINGS ACCOUNT

How the TFSA can help you reach your financial goals

The Tax-Free Savings Account (TFSA) is a flexible savings vehicle. Investment income earned in this account is tax-free, which may help you reach your financial goals more quickly.

WHAT IS A TFSA?

The TFSA was introduced in 2009 as a way for individuals to save and grow their savings in a tax-free manner.
Here are some key details:

- Any income (including capital gains) earned in a TFSA is exempt from tax. For this reason, any interest paid on money borrowed to contribute to a TFSA is not tax-deductible since the borrowing is not for the purpose of earning taxable income.
- Contributions to a TFSA are not tax-deductible.
- If capital losses are realized in a TFSA, they can't be used to offset capital gains realized outside a TFSA.
- Any withdrawal made (whether from capital or income) is tax-free and is added to an individual's contribution room in the following year.
- If someone contributes less than their annual contribution limit, they can carry forward any unused contribution room indefinitely.

OPENING YOUR TFSA

There are three different types of TFSAs: a deposit; an annuity contract; and a trust agreement

If your TFSA is a trust arrangement, it can be self-directed. This allows you to develop and manage your own portfolio. The other differences between the types of TFSAs are more pronounced upon death. For more details on the tax implications of TFSAs at death, please ask an RBC advisor for the article on this topic.

If you're a Canadian resident, have reached the age of majority in your province or territory of residence and have a valid social insurance number, you are eligible to open a TFSA. In the year you turn 18, you'll accrue the full TFSA dollar limit for that year. Note that certain provinces and territories, including Newfoundland and Labrador, New Brunswick, Nova Scotia, British Columbia, Northwest Territories, Yukon and Nunavut have set the age of majority to 19 years of age. If the age of majority is over 18 years of age in your province or territory of residence, you will still accumulate contribution room for the year you turned 18 and be able to carry it forward to any future year.

CONTRIBUTIONS

Your contribution room

The maximum amount you can contribute is limited to your TFSA contribution room. The total TFSA contribution limit from 2009 to 2021 is $75,500. The annual contribution limit is indexed to inflation and rounded to the nearest $500.

You automatically accumulate contribution room each year (starting in 2009) if you were a resident of Canada at any time during the year and you were at least 18 years of age. You actually don't have to open a TFSA or file an income tax return to earn contribution room. Your income level also has no bearing on your contribution room. Although the Canada Revenue Agency (CRA) will track your contribution room, you should also maintain your own records to keep track of your TFSA transactions.

Keep in mind that your contribution room decreases with any contributions you make, including re-contributions of funds you have withdrawn in previous years. Any investment income earned within your TFSA or the value of your investments held within your TFSA will not affect your contribution room.

If there's a situation where you don't use your contribution room in a particular year, you can carry forward the unused room throughout your lifetime to any future year. An attractive feature of the TFSA is that there is no age limit that restricts your ability to continue making contributions. There's also no lifetime limit on the amount you can contribute.

TO BE CONTINUED…

If you would like to receive this entire article, please contact Joanne at joanne.vesprini@rbc.com.

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"An important key to investing is to remember that stocks are not lottery tickets"
Peter Lynch

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WILL THE INFLATION SURGE IMPACT EQUITY MARKETS?

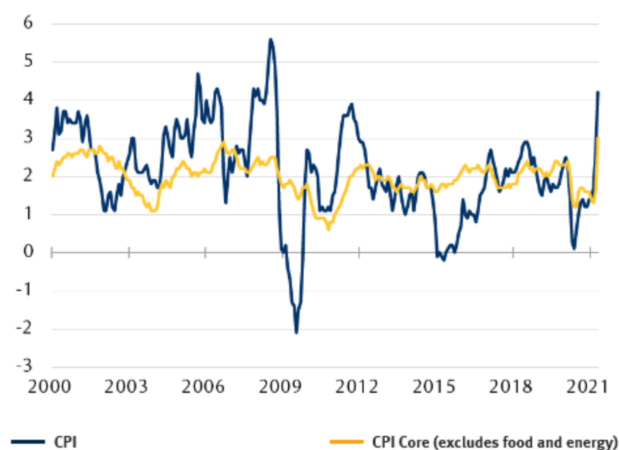
The rapid acceleration in inflation has investor fears heating up. We look at what this spike means for equity performance and portfolio positioning.

Surging consumer inflation has spooked the equity market, and has fueled a debate among economists and market participants: Is this higher inflation transitory? And if it is, how long will "transitory" inflation last?

The Consumer Price Index (CPI) jumped 4.2 percent in April compared to the level one year ago. This is the highest consumer inflation rate since 2008, and is well beyond the 3.6 percent consensus forecast of economists. When viewed against consumer prices just one month prior, the CPI jumped 0.8 percent, the biggest monthly gain since 2009.

The core rate, which strips out volatile food and energy prices, also rose dramatically compared to March of this year. At 0.9 percent, the increase was three times higher than economists had expected and the sharpest monthly increase since 1982.

We think much of the inflation spike is a short-term phenomenon. The annual inflation rate plunged to almost zero percent at this time last year when the economy was shut down, and has rebounded sharply this year as businesses have reopened. Once we are past the April, May, and June period when prices last year were falling, the year-over-year comparisons should be less extreme.



The question of how long "transitory" inflation will last is more difficult to gauge. The longer it lingers, the greater the risk that the Federal Reserve will shift away from its uber-accommodative monetary policies. We think this will take some quarters to convincingly sort out. This could keep equity market volatility and pullback risks elevated for the time being.

RBC Global Asset Management Inc. Chief Economist Eric Lascelles does not see runaway 1970s-style inflation as a threat. Lascelles wrote, "Yes, inflation will be quite high over the next few months and then slightly elevated over the next few years. But, from a structural standpoint, it is far from obvious that inflation has to be high over the next several decades. If anything, the long-term forces still argue for deflationary pressures to dominate." The long-term forces he's referring to are demographic headwinds, deflation in key segments of the economy (including technology), declining unionization, and maturing emerging market economies.

The Fed has already signaled that the hot April inflation data will not in and of itself change the course of its highly accommodative policies, and we think the Fed has reasons to stand firm even if inflation remains elevated in the near term.

INFLATION'S SWAY

For equity investors, there are two main issues to consider: The impact of inflation on the U.S. market as a whole, and the impact on sectors within the market, both of which influence portfolio positioning.

For the S&P 500 overall, profit margins usually rise when inflation and expectations of future inflation push up from a low level—as long as wages aren't the major factor for the inflation boost. Most companies have pricing power, as they are typically able to pass some or all of the inflation in input costs along to their customers, maintaining or increasing profit margins. We saw this pattern in Q1 earnings reports, and expect to see it again during the Q2 reporting season. Furthermore, when commodity prices rise, this often provides a broad range of industries with added pricing power—even some non-commodity producers.

Throughout this expansion period and in others in recent decades, the public's expectations about the direction of future inflation and the broader stock market have been positively correlated. As households' inflation expectations have risen, the market has worked its way higher.

But when it comes to sectors within the market, inflation doesn't necessarily treat them equally. According to an RBC Capital Markets study going back to 2004, some of the most economically-sensitive value sectors (those that are highly cyclical) outperformed when inflation expectations rose, such as Energy, Materials, and Financials. In contrast, the Technology, Health Care, and Communication

Services sectors were underperformers. This track record supports our ongoing recommendation to tilt U.S. equity holdings toward "value" stocks instead of "growth" for 2021, at least.

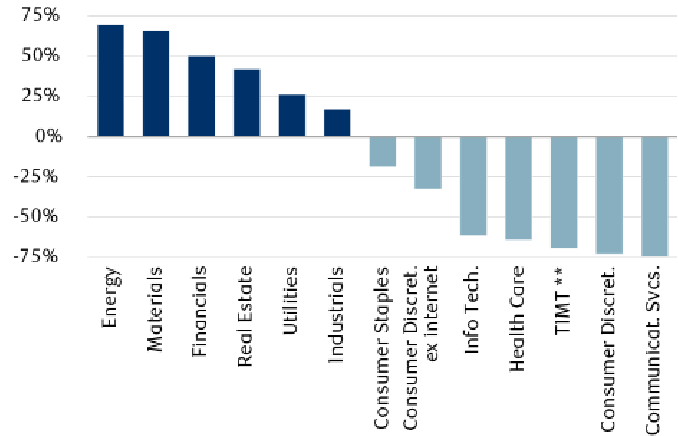
But the challenge for the overall U.S. equity market is that the inflation-vulnerable and valuation-stretched Tech sector represents a much bigger share of the market than it used to: 26 percent of the S&P 500 today versus 17 percent in 2010. As long as inflation jitters are front and center, institutional investors may be inclined to ratchet down their Tech exposure, at least temporarily. To us, this means more adjustment time for the market as a whole, which could include additional volatility and rotation between sectors.

A HURDLE, NOT A ROADBLOCK

It's still early in the business cycle, and the tight credit conditions necessary to produce the next recession, an accompanying decline in corporate profits, and an equity bear market appear to be a long way off. We think long-term investors should look through the latest inflation disruption and continue to moderately Overweight equities in portfolios. But we think heightened inflation risks underscore the need to tilt U.S. exposure more toward "value" stocks than "growth" stocks.

Energy, Materials, and Financials tend to outperform the S&P 500 the most when inflation expectations rise

Correlations of relative S&P 500 sector performance with inflation expectations since 2004*



* The S&P 500 sector performances are measured relative to the S&P 500 Index as a whole. Inflation expectations are measured by the University of Michigan Inflation Expectations Surveys of Consumers, which presents the median expected growth of prices of goods and services over the next five years ** TIMT stands for Technology, Internet, Media, and Telecommunications

Source - RBC Capital Markets U.S. Equity Strategy, Haver, S&P Capital IQ/ClariFi; data from 2004 through March 2021

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