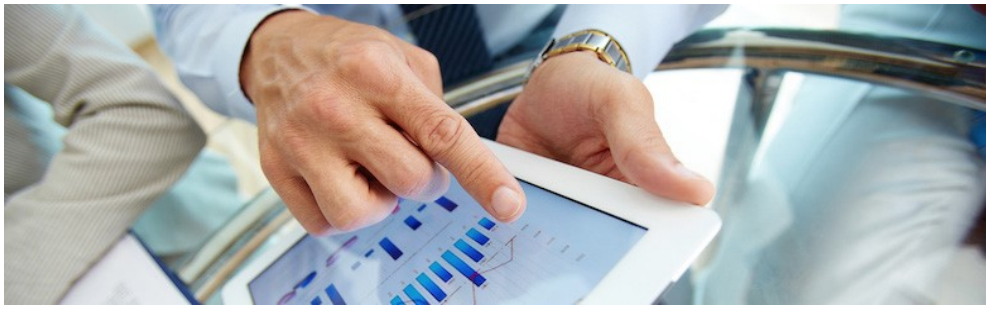
THE GREG UPSON WEALTH MANAGEMENT TEAM | RBC DOMINION SECURITIES

UPSON'S UPDATE

SUMMER 2022

STAGFLATION AND FOUR WAYS TO MITIGATE ITS IMPACT

As inflation soars and economic growth stalls, the growing threat of "stagflation" is hitting the economy and investment markets hard. The term stagflation combines "stagnant" with "inflation" – and here's what you need to know about it.



As the pandemic has wound down, demand for goods and services has skyrocketed. In the wake of reopening economies across the globe, the pull of surging demand has strained global supply chains, and geopolitical events have exacerbated the issue. In response, inflation has soared, forcing central banks to raise interest rates to slow demand, increasing the threat of an economic slowdown – or even recession. Increasing stagflationary conditions impact investors too: rising interest rates ripple into rising bond yields, hitting bond prices (bond prices and yields move inversely). Stocks fall as well, as investors increasingly anticipate companies will struggle to generate sustained profits in these challenging conditions.

Sticking the landing: Aiming for soft, bracing for hard

Unfortunately, the accepted remedy to tame inflation often only adds to the pain, at least in the short run. In response to rising prices, central banks must raise interest rates, in turn increasing borrowing costs for businesses and consumers, and further crimping their dwindling resources. While this can stifle demand and gradually inflation, it can also stifle economic growth. If the central banks cause a recession, especially a painful one, that's called a "hard landing." If they manage to finesse a slowdown but it doesn't result in a recession – or at least a prolonged and nasty one – that's called a "soft landing." Fortunately, there is still time for central bankers to engineer a soft landing and avoid a hard one, and a recession, especially a painful one, is not a forgone conclusion.

Stagflation mitigation

Here are four things to consider in light of the increasingly stagflationary environment:

- **Debt:** If borrowing costs are rising, it can be timely to review your debt service costs, and to consider reducing debt or

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SPECIAL POINTS OF INTEREST:

- *In a stagflationary environment, there are four important things to consider: debt, investment portfolio, quality, and fixed income.*
- *The three-bucket approach is a straight-forward strategy to help retired and cash-flow focused investors sustain their investment income and preserve their wealth through all market conditions.*
- *Welcome Avinash Haswani, our team's new Associate. Please find Avinash's information and contact details on page 4.*

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deferring purchases that may increase it.

- **Investment portfolio:** The market's negative response to it can provide a "stress test" and an opportunity to review your portfolio with Greg to determine whether it requires any rebalancing. Taking advantage of lower asset prices can also be a smart strategy when markets are stressed.

- **Quality:** In times of economic and market stress, certain types of assets tend to perform better – or "less worse" – than others. A focus on assets that are considered high quality because they can consistently perform through challenging economic circumstances can help reduce volatility.

- **Fixed income:** When interest rates rise, the bond market typically sees yields soar and prices fall. On the positive side, fixed-interest-rate investments (e.g., GICs) tend to see their returns rise, while newly higher yields on bonds offer the opportunity to "reset" coupon payments at higher levels, creating the opportunity to enhance fixed-income returns over the longer term. Two-year GICs are now over 4%.

If you have questions about your portfolio and investment plan, speak to us today.

- Greg

FORTIFYING YOUR RETIREMENT INCOME: THE THREE-BUCKET APPROACH

The three-bucket approach is a straight-forward strategy to help retired and cash-flow-focused investors sustain their investment income and preserve their wealth through all market conditions.

Market volatility often strikes fear into the hearts' of retirees and those that rely on their investment portfolios to meet or augment their cash flow needs. Pressure on asset prices during market downturns can sometimes result in negative outcomes for such investors, including:

- When the need arises to sell assets to generate cash flow or to meet spending needs, it may be at a loss or at a poor valuation level.

- Fixed income yields and rates can fall as central banks move to cut interest rates to spur economic growth, in turn reducing the income investors' can expect to generate through bond coupon payments and/or GIC interest.

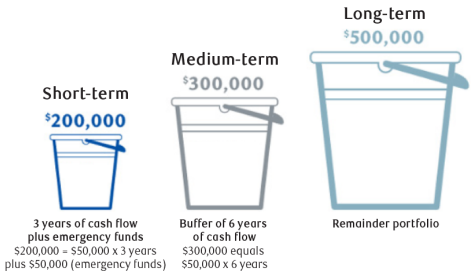
- Companies that pay dividends and distributions may need to reduce or suspend those payments in the face of challenging economic circumstances, putting income-focused investors' cash flow at further risk of reduction. In short, periods of heightened market volatility are an important reminder of the need to ensure that portfolios of cash-flow-focused investors are structured to meet the challenges of volatile or even extended bear markets. This can help prevent a need to change their lifestyles in the face of shrinking cash flow – or worse, face the ultimate risk of outliving their savings.

Shoring up your defences

Fortunately, there is a way to help ease income-focused investors' minds when faced with the twin threat of lower asset prices and portfolio cash-flow generation during volatile markets: the three-bucket approach. So long as it's aligned to their investment objectives and suitable given their risk profile, retirees and other cash-flow-focused investors may wish to leverage this approach to help ensure that they have enough income to provide for their short-term needs, while still growing their portfolio over the medium- and long-term:

Easy as 1-2-3:

An example of the three-bucket strategy using an initial investment of $1 million to generate required annual income of $50,000



Source: RBC Global Asset Management

The three buckets:

- Short term – Income (1-5 years): The short-term bucket holds cash and short-term investments for cash-flow withdrawals and emergency funds, while also helping to reduce the impact of short-term market volatility on the portfolio.
- Medium term – Buffer (6-10 years): Holds income-generating investments, including low-risk, low-volatility equities for stable capital gains. This bucket serves as a buffer between the cash bucket and the long-term growth bucket.
- Long term – Growth (10+ years): Holds growth-oriented equity funds, which are more volatile but offer higher potential for capital growth to sustain the portfolio for the later years of retirement.

The best defence is a good offence

Longer term, preserving your wealth benefits from a degree of growth in order to protect your portfolio from the impact of ongoing cash-flow demands, as well as the ravages of inflation. To do so, investors can use a well-structured and considered strategy that, if properly aligned to their investment objectives and risk profile, should help them ensure they meet their long-term cash-flow needs while still preserving their retirement nest egg.

Bob Farrell's 10 rules for investing

For decades, investing legend Bob Farrell was a top Wall Street strategist known for predicting changes in overall stock market direction.

Bob Farrell was a legend at Merrill Lynch & Co. for several decades. Farrell had a front-row seat to the go-go markets of the late 1960s, mid-1980s and late 1990s, the brutal bear market of 1973-74, and October 1987's crash.

He retired as chief stock market analyst at the end of 1992, but continued to occasionally publish.

10 years ago, Marketwatch gathered some of Farrell's more famous observations, and republished them as "*10 Market Rules to Remember.*" I think this piece is as timely today as it was 10 years ago.

Bob Farrell picture above during his time at Merrill Lynch & Co. Source: Business Insider

1. Markets tend to return to the mean over time

When stocks go too far in one direction, they come back. Euphoria and pessimism can cloud people's heads. It's easy to get caught up in the heat of the moment and lose perspective.

2. Excesses in one direction will lead to an opposite excess in the other direction

Think of the market baseline as attached to a rubber string. Any action to far in one direction not only brings you back to the baseline, but leads to an overshoot in the opposite direction.

3. There are no new eras — excesses are never permanent

Whatever the latest hot sector is, it eventually overheats, mean reverts, and then overshoots. Look at how far the emerging markets and BRIC nations ran over the past 6 years, only to get cut in half.

As the fever builds, a chorus of "this time it's different" will be heard, even if those exact words are never used. And of course, it — Human Nature — never is different.

4. Exponentially, rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways

Regardless of how hot a sector is, don't expect a plateau to work off the excesses. Profits are locked in by

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Sources: https://ritholtz.com/2008/08/bob-farrells-10-rules-for-investing/c
https://www.businessinsider.com/bob-farrells-10-rules-in-charts-2013-2
https://www.businessinsider.com/financial-advisor-insights-november-6-2013-11

selling, and that invariably leads to a significant correction — eventually.

5. The public buys the most at the top and the least at the bottom

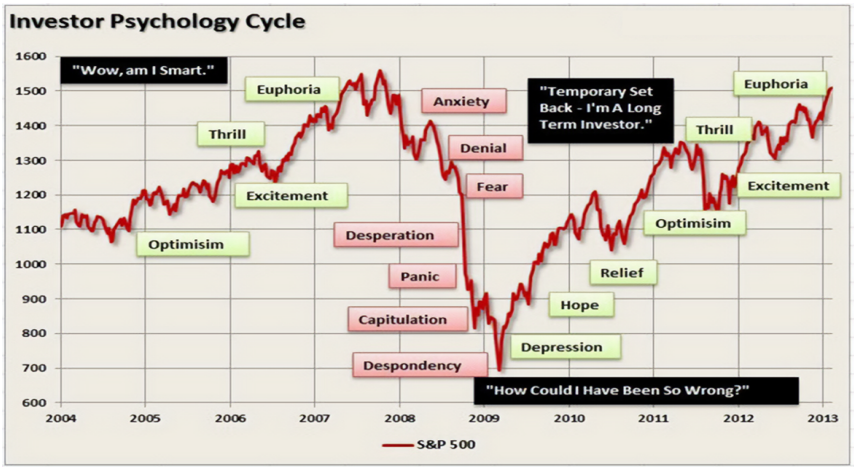
That's why contrarian-minded investors can make good money if they follow the sentiment indicators and have good timing.

6. Fear and greed are stronger than long-term resolve

Investors can be their own worst enemy, particularly when emotions take hold. Gains "*make us exuberant; they enhance well-being and promote optimism,*" says Santa Clara University finance professor Meir Statman. His studies of investor behavior show that "*Losses bring sadness, disgust, fear, regret. Fear increases the sense of risk and some react by shunning stocks.*"

7. Markets are strongest when they are broad and weakest when they narrow to a handful of names

Hence, why breadth and volume are so important. Think of it as strength in numbers. Broad momentum is hard to stop, Farrell observes. Watch for when momentum channels into a small number of stocks ("Nifty 50" stocks).



Source: Business Insider

8. Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend

As an example of this observation, Farrell suggested in August 2008 that the markets were on their third reflexive rebound—following the January 2008 rate cuts, the Bear Stearns low in March, and then the Fannie/ Freddie rescue lows of July.

At the time of Farrell's writing, he noted that even with the end of these sporadic rallies, he'd still yet to see the long drawn out fundamental portion of the Bear Market, which then followed and lasted into 2009.

9. When all the experts and forecasts agree — something else is going to happen

As Stovall, the S&P investment strategist, puts it: "If everybody's optimistic, who is left to buy? If everybody's pessimistic, who's left to sell?" Going against the herd as Farrell repeatedly suggests can be very profitable, especially for patient buyers who raise cash from frothy markets and reinvest it when sentiment is low.

10. Bull markets are more fun than bear markets

Especially if you are long only or mandated to be full invested. Those with more flexible charters might squeak out a smile here and there.

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CONTACT US

We are committed to providing you with the highest quality of service. If you have any questions, if there is anything we may assist you with, or if you would like to speak in greater detail about anything, please let us know.

Admin Note: Welcome Avinash Haswani! Avinash has taken over the role of Associate for our team. He is a graduate from the University of British Columbia, where he obtained a Bachelor of Science degree in Biochemistry. Avinash worked at an Accounting and Equity Research prior to joining RBC Dominion Securities. Avinash performs all administrative tasks for the team and you can reach him at 604-257-7653 or avinash.haswani@rbc.com.

Closing Quote:

"THE MOST IMPORTANT QUALITY FOR AN INVESTOR IS TEMPERAMENT, NOT INTELLECT."

- WARREN BUFFETT