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Wealth Management
Review

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History lessons

By Jim Allworth

The impact of disruptive geopolitical events on equity markets is usually short – measured in days – and the ground lost is regained fairly quickly. However, the deepest and most drawn out have been those which produced a sustained rise in energy prices.

As a result, the Russia/Ukraine war is going to have a debilitating effect on developed economies, some more than others. Higher fuel prices can act like consumption taxes, reducing the amount of disposable income available to spend on other goods and services, many having a bigger multiplier effect on overall GDP growth.

This is coming at a time when the U.S., Canada and several other developed economies were in the process of shifting from goods-driven expenditure to services-driven. Work-from-home and the unavailability of dining out, travel and other services resulted in heavier-than-normal spending on goods, pulling a considerable portion of future demand forward and leaving a weaker outlook for goods producers as spending swings toward the re-opened services sector.

Weak manufacturing new orders are likely to be one result. This is sure to provoke debate about whether something worse than a slowdown is in the offing. We don't think it is, despite the prospect of further central bank tightening. But with long-held estimates of above-trend GDP growth for 2022 now being revised lower as the impact of sanctions on already tight energy markets and inflation are factored in, there could be room for further volatility in equity markets over the coming months.

Despite this darker outlook, all seven of our leading indicators of U.S. recession continue to indicate no such downturn is in sight.

It's worth remembering why getting the economy right is "Job One" for an investor. And the chart on page 2 paints the picture clearly.

The black line traces the path of the S&P 500 Index from the end of 1945 until today. It is plotted annually – that is, there is only one data point per year, eliminating all the volatility that goes on between each Jan. 1 and Dec. 31. While there are plenty of ups and downs, the rising trend of stock prices is clearly evident over the 76-year time span.

One can easily spot some of the most challenging bear markets:

- 1973-1974 when a recession turned much of industrial America into the "Rust Belt"
- The "tech wreck" from 2000 to 2003
- The financial crisis of 2008-2009

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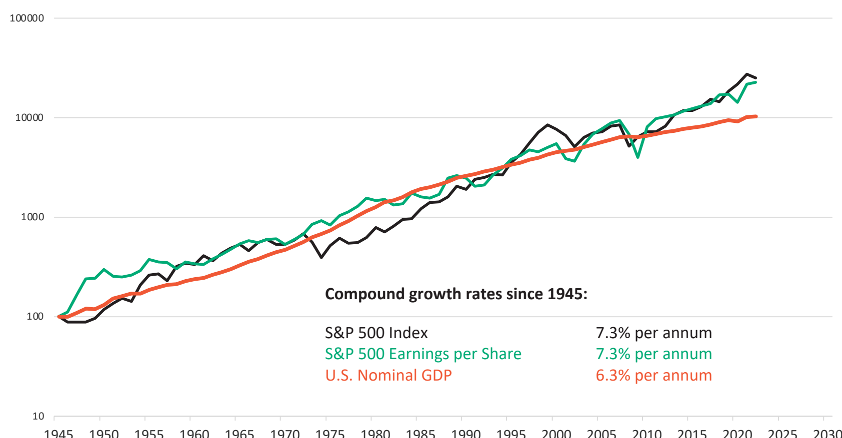
The march of history



But it is surprising how many of the other bear markets over that stretch (there were nine), not to mention other memorable market-shaking events, are hard to see when looked at this way. Here's a partial list:

- The Korean War from mid-1950 to mid-1953
- The Cuban Missile Crisis in 1962
- The collapse of oil prices and much of the heavily indebted oil and gas sector together with the Latin American debt bailout the mid-1980s
- The 1987 market crash
- The massive government bailout in the early '90s of the savings & loan industry, the largest source of mortgage lending in the U.S.
- The Mexican government debt bailout of 1995
- The emerging market currency crisis in 1997
- The Russian debt default and the collapse/bailout of Long-Term Capital Management
- The European sovereign debt crisis in 2011-2012
- The COVID-19 pandemic

All of these are largely or entirely invisible on this 76-year chart of the S&P 500.

The green line plots S&P 500 earnings per share over the same 76 years. Since 1945, the S&P 500 has appreciated almost exactly as fast as the earnings per share of the index – both at close to 7.3% per annum. (Of course, shareholders did better than that collecting dividends along the way equal to about 2% per annum on top of the appreciation return.)

It would seem the best guide as to where the S&P 500 might be headed over the next few years would be a reliable forecast of earnings per share over that period.

It's no mystery

Earnings rise at a rate mostly consistent with the growth rate of the economy. The red line plots the value of U.S. GDP produced in that same year. (This is the so-called "nominal" value, that is, with the effect of consumer price increases left in.)

This GDP plot is incredibly smooth. Despite the fact there were 12 recessions over the last 76 years, fewer than half show up as no more than faint ripples in this steadily rising line. The rest can't be seen at all.

The paths followed by earnings and share prices are much bumpier, but for the most part hug the trend traced out by the economy. However, they have opened up a growth gap over GDP in the years following the financial crisis. Part of this gap stems from the big U.S. corporate tax cut in 2017, which boosted index earnings by an estimated 12%. But more importantly over the past decade, foreign earnings have surged for the biggest capitalisation weights in the S&P 500, notably large-cap tech and tech-related. This has boosted index earnings per share but not U.S. GDP to the same degree.

The valuation question

Is the S&P 500 overvalued? Since the end of the financial crisis in 2009 to the end of last year the S&P 500 appreciated at a rate of 12% per annum while the earnings per share of the index grew by a startling 15.5% per annum. So if anything, it has been earnings that have been the over-achievers here more so than average share prices.

No big "value gap" has opened between share prices and index earnings as happened at the peak of the tech bubble. At its highs in December, the S&P 500 was trading at 21.3x the forward 12-month consensus earnings per share estimate. The pullback at the low brought that down to 17.6x forward earnings of $234 versus the 30-year average forward P/E of 17.4x.

Canada's S&P/TSX Composite Index at 14.1x forward earnings estimates is below its historical average of 14.8x and at one of the deepest P/E discounts relative to the U.S. in history. European, UK and Japanese markets are trading at comparably low multiples.

In our view, valuations do not pose a large risk to investors as things stand. It would take a serious deterioration in the earnings outlook to push the market into a state of overvalued vulnerability. Such a deterioration would likely show up ahead of time in the leading indicators of recession. Our U.S. "recession scorecard" is showing no such weakness.

For a more detailed discussion of our outlook for financial markets, ask for a copy of our current issue of *Global Insight*.

Jim Allworth is co-chair of the RBC Global Portfolio Advisory Committee.

Five tips to reduce your taxes in retirement

With people living longer – and the cost of living continuing to rise – it can be a challenge to make your retirement savings last as long as you need. What's more, the major sources of retirement income are often taxed at the highest marginal rate. Here are five tips to reduce taxes – and maximize your retirement "paycheque":

1. Consider how different types of investment income are taxed

Your investment income is taxed in different ways within a regular, non-registered account:

- **Interest income from bonds or GICs** is taxed at higher rates than dividend income or capital gains from stocks. Therefore, by selling investments that generate interest income (as opposed to selling investments that generate dividend income or capital gains), you're depleting the capital which earns the higher taxed income.
- **Preferentially taxed income like Canadian-source dividends** can be a good source to draw from, as you're already paying tax on it regardless. And if you are only using the income, you will not be drawing down on your capital, which may preserve future growth.
- **Capital gains** are taxed most favourably. As such, triggering gains in order to fund lifestyle expenses will allow you to have more after-tax income for spending.

2. Think about the order you draw from your income sources

What are (or will be) your retirement income sources? When – and in what order – should you start drawing income from them? You often have a choice, or at least a choice within certain parameters. And timing is important when it comes to maximizing your after-tax retirement income.

For example, if you're in a high tax bracket, it generally makes sense to draw on your least taxed income sources first, where possible. For example, income from your RRIF is fully taxable at your marginal rate, whereas all income withdrawn from your TFSA is completely tax free. As a result, it can make sense to start drawing from your TFSA before withdrawing excess income from your RRIF.

And while you can't completely control the timing of your RRIF income, you do have some flexibility. For example, you can wait to start receiving RRIF payments until the year in which you turn 71 – and then only take the minimum required amount. Choosing the minimum payment has the added benefit of leaving more of your assets to continue growing within your RRIF on a tax-deferred basis (you only pay tax when you withdraw from your RRIF).

Key retirement income sources

- ☐ Canada Pension Plan (CPP) / Quebec Pension Plan (QPP)
- ☐ Old Age Security (OAS)
- ☐ Guaranteed Income Supplement (GIS)
- ☐ Registered Retirement Savings Plan (RRSP) / Registered Retirement Income Fund (RRIF)
- ☐ Employer-sponsored Registered Pension Plan (RPP)
- ☐ Locked-in account (LIF/LRIF/PRIF)
- ☐ Non-registered account
- ☐ Tax-Free Savings Account (TFSA)
- ☐ Annuity

The optimal order to draw on your retirement income sources depends on your individual circumstances. Ask your Investment Advisor for more information.

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3. Maximize your registered plans

Registered plans such as your RRSP and RRIF offer some unique tax advantages. As mentioned, you can choose to wait to convert your RRSP into a RRIF until the year you turn 71. By doing so, you can give your RRSP assets more time to continue growing on a tax-deferred basis. Then, once you do convert your RRSP into a RRIF, consider taking only the minimum required RRIF payment. Again, that leaves more of your RRIF assets within the tax-deferred environment to continue accumulating.

And there are other ways to make the most of your registered plans. For example, interest income is fully taxable when earned within your regular, non-registered account. Consider allocating more of your interest-bearing investments such as bonds and GICs to your registered accounts instead. Then, allocate more of your tax-efficient investments such as dividend-paying stocks to your non-registered account. You're able to claim a tax credit on eligible dividends, and only 50% of any capital gain realized on the sale of a stock is taxable – when earned in a regular, non-registered account.

And if it makes sense in your situation, consider maximizing your available RRSP contribution room as soon as possible, before you convert your RRSP into a retirement income source, such as a RRIF. In addition to being able to claim a deduction on your tax return, you also give those contributions that much more time to benefit from tax-deferred growth.

4. Split income with your spouse or common-law partner

Income splitting works best when you have one spouse in a higher tax bracket than the other. By allocating income to the lower-income spouse, they pay tax on that income at their lower rate. This effectively helps to reduce your combined taxes.

You and your spouse can split eligible pension income (which includes annuity and RRIF income, but not CPP/QPP) by making a joint election on Form T1032, Joint Election to Split Pension Income, when you file your annual tax returns.

Another way to split income is through a spousal RRSP. If you expect your retirement income to be higher than that of your spouse, consider contributing to a spousal RRSP in advance. The sooner you start, the more income you'll be able to shift to your lower-income spouse by the time you retire. You receive the RRSP contribution tax deduction as usual to reduce your current taxable income. However, the eventual retirement income is taxed at your spouse's lower tax rate.

Already retired? If you still have unused RRSP contribution room and your spouse has not yet reached the year in which they turn 72, you can continue to make spousal RRSP contributions even if you, yourself, are over age 71.

5. Maximize your TFSA

The TFSA is sometimes overlooked as a retirement planning tool. But it offers some great advantages, whether you're already retired or still working on it. Unlike an RRSP, you (and every Canadian resident 18+) automatically receive new TFSA contribution room every year – regardless of whether you have earned income. You can invest in all sorts of investments and earn tax-free investment income. You can also make tax-free withdrawals – which makes a TFSA a potential source of tax-free retirement income.

Ask your Investment Advisor for more information about maximizing after-tax retirement income.

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