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Review

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Seeking a new path onward

By Jim Allworth

Several important shifts occurred on the global economic and financial landscape over the first half of the year. Here are the most important.

First the Fed and the Bank of Canada swung from being tolerant of higher inflation to being decidedly intolerant. Rate hikes have not only begun they've become more aggressive in the past 60 days as has the rhetoric about future hikes.

Central banks are no longer suppressing bond yields through quantitative easing, producing a pronounced upward shift in long bond rates.

While most forecasters (ourselves included) expected last year's gradual build up in inflation to turn into a price surge in the first half of this year, they underestimated the extent of that spike. The Ukraine/Russia conflict intensified the upward pressure on prices for oil, natural gas, and most agricultural commodities.

Supply chain disruptions have resolved much more slowly than expected, exacerbated by renewed China shutdowns.

As consumers shift spending from goods to services, inventories of unsold goods are building in the U.S. and new orders are weakening, suggesting manufacturing may be heading for a slowdown in the second half.

Meanwhile, ongoing labour shortages are affecting the reopening of the services side of the economy.

Market impact

The surge in inflation and bond yields has pressured valuations lower in the stock market by lowering the discounted present value of future earnings. (Moving bond yields higher from 2% to 3% reduces the present value of a dollar of earnings earned 10 years down the road by 9%.)

This has had the largest impact on the high P/E, mega-cap growth stocks of which the six largest comprised more than 25% of the value of the S&P 500 at the peak of the market in early January. Their performance was not helped by the fact that three of the biggest – Amazon, Meta (Facebook), and Alphabet (Google) – reported declines in first quarter earnings.

This magnified downward effect of a handful of very large capitalisation stocks helps to explain why Canada's TSX (down 14%), which contain none of these six stocks, fared better than the U.S. index (down 22%).

In the U.S. continuing supply chain issues, together with bloated inventories and labour shortages, have driven corporate confidence down to

Continued on page 2

Onward... Continued from page 1

much-reduced levels, taking investor confidence down at the same time. So far earnings estimates for 2022 and 2023 have not come down, however, if second quarter earnings guidance proves more cautious then some downward earnings estimate revisions are likely.

Is there a plausible path to new highs?

Measures of investor sentiment have been hugely negative of late. Such unanimous pessimism does not occur at market tops but frequently appears at or near tradable lows. However, even were markets to turn higher from here, views about how far they rally and for how long are decidedly downbeat. "Bear market rally" is the consensus interpretation among U.S. market observers.

Perhaps but not necessarily. It is useful to look at potential market outcomes through the lens of the two prevailing schools of thought on the likely trajectory of inflation over the coming year or two.

One view has inflation becoming a bigger and more intransigent problem than central banks or the market have yet recognised. The inflation expectations of U.S. consumers have recently jumped above the longstanding 2%-4.5% range that has prevailed for more than two decades to 5.5%. Reining in those expectations, so this view argues, will require the Fed to raise rates markedly higher than currently envisioned and keep them there for longer.

This would greatly increase the odds that the fed funds rate eventually overshoots producing the kind of tight credit conditions that would make recession inevitable. A recession would undoubtedly be bad for corporate earnings and share prices, and has typically been associated with a bear market for equities.

However, under this scenario, before that painful economic/market retrenchment arrived, the U.S. economy would likely traverse an extended period during which the Fed chased an overheated economy higher for much longer-than-expected – perhaps through 2023 and into 2024. That prolonged stretch might well see inflation-boosted sales and earnings grow faster than expected. It would be unusual for new highs in sales and earnings not to be accompanied by new highs in share prices.

But how much of a new high? A bit of history might be instructive. From the beginning of 1977 until the end of 1979, the Fed did just that – i.e., chase an overheating economy higher, raising the fed funds rate from 5% to 15% in the process. The economy was growing and S&P 500 earnings per share advanced by a very satisfactory 40% over the three years. But the index itself flatlined, starting and finishing at about 100. Bond yields rose from 7% to almost 11% over the same interval, compressing P/E multiples and limiting index investors to no better than dividend returns.

In our view, the same dynamic would probably yield similar results if the Fed-hikes-faster-for-longer scenario were to play out over the next couple of years. So, it's possible the averages could get back to old highs, perhaps even exceed them, but it seems likely the appreciation potential would be heavily dampened by rising bond yields.

As was the case in the 1977-1979 experience referred to above, the S&P/TSX should do better than its U.S. counterparts given its heavier commodity exposure. But forestry, metals and mining are all much smaller components of the economy and market than they were in 1977. Energy, meanwhile, despite enjoying higher prices, continues to be bedeviled by an inability to get product to market, which is unlikely to be materially improved for a year or more.

The other prevailing view out there – and one we subscribe to – has inflation subsiding somewhat over the second half and retreating further next year. As the stay-at-home spending boom on goods wanes, with household budgets squeezed by rising costs for food and fuel, the goods side of the economy will need to pare back bloated inventories of unsold goods. This should produce some price weakness for non-essential goods, allowing the core rate of inflation to recede somewhat, the headline rate to peak and inflation momentum to turn lower.

That, together with a continuing slowdown in the goods-producing side of the economy, might induce the Fed to rethink how far rates need to rise and how fast. Any sign the Fed was backing away from further tightening would bring back into play the possibility of a "soft landing" for the U.S. economy, which would support an outlook for stronger earnings growth and higher share prices.

However, turning the equity market decisively higher, where an advance to new highs becomes plausible, usually requires the arrival of some catalyst that re-ignites investor optimism – perhaps a Fed rate cut, a marked downturn in energy prices, or a couple of much softer-than-expected inflation reports. None of these looks likely at the moment.

On the other hand, current readings of unusually deep investor pessimism suggest limited downside from here. We expect the most likely path for equity prices through the remainder of this year will be a mostly sideways one until some set of circumstances re-invigorates the case for sustained economic and corporate earnings growth or conversely reveals that that a recession is rapidly approaching.

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.

Health care planning is part of investment planning in pandemic era

David Agnew discusses the importance of including health care planning as part of long-term financial goals.

By Clare O'Hara, *The Globe & Mail*

More than two years into the pandemic, Canadians are beginning to realize the sudden impact a major health crisis could have on their retirement and financial planning, and it's not just concern about COVID-19, says David Agnew, chief executive officer at RBC Wealth Management Canada.

Financial advisers are now incorporating health care planning into the conversations they are having with clients as part of their long-term financial goals. RBC Wealth, through several partnerships, has taken it a step further by launching information seminars with medical professionals to discuss various health care risks such as dementia, advanced care plans and specific women's health issues.

"COVID has been a wake-up call for all Canadians to prepare or update their financial affairs, but also beyond the pandemic, people are now living longer," Mr. Agnew said in an interview. "Clients are much more concerned about what health issues they could be facing, as well as who will take care of them if they can no longer be at home."

Mr. Agnew has spent the past 12 years overseeing RBC's wealth management businesses in Canada including the bank's brokerage RBC Dominion Securities, RBC PH&N Investment Counsel, RBC Royal Trust, RBC family office services and RBC Wealth Management Financial Services Inc.

That includes one of the country's largest full-service securities brokerages with 1,900 securities advisers and 110 investment counsellors who oversee about $510-billion in assets, as of March 30, for high-net-worth and ultra-high-net-worth families in Canada.

Throughout Mr. Agnew's 37-year career with the bank, he has navigated his fair share of recessions and market meltdowns. Mr. Agnew joined RBC in 1985 as an investment adviser in Montreal. In 2003, the same year the SARS virus hit Toronto, he was named national director of RBC Dominion Securities, and then chief executive officer of the brokerage in 2008, at the height of the global financial crisis.

In June, 2020, only several months into the pandemic, Mr. Agnew reached out to Samir Sinha, the director of health policy research at the National Institute on Ageing (NIA), and the director of geriatrics at Sinai Health System and the University Health Network in Toronto.

"The pandemic has put Canada's entire health care system under enormous strain, exposing gaps that are expected to widen as the baby boomer generation continues to age," Mr. Agnew adds. "I asked him where he saw the greatest need and what we could do, as a firm, to help. He was quick to identify two areas – financial education and fraud protection for older Canadians."

The conversation was the start of a partnership between RBC Wealth Management and the NIA, a think tank at Toronto Metropolitan University (formerly known as Ryerson University), to help older Canadians prepare for numerous financial scenarios that may occur later in life when age-related medical conditions may arise and advanced care may be required.

The number of Canadians over the age of 85 is expected to reach 2.6 million by 2050, up from around 844,000 in 2021, according to research conducted by the NIA. The organization also estimates that long-term care costs will more than triple to $71-billion by 2050 from $22-billion in 2019.

"Part of the challenge, both within government circles and in the broader society, is that health and finances are often treated as separate domains

Continued on page 4

Health care planning ... Continued from page 3

working in separate silos," Michael Nicin, executive director of the NIA, said in an interview with The Globe. "But in the face of an aging population we really need to help bridge the gap between financial planning – whether it's fiscal policy at the government level or individual retirement planning – and health issues, including how individual Canadians can prepare to live longer."

"People need to know where they're going to age, where they're going to receive care, what the health care system is able to do for them, and what they have to do on their own – including the cost of private health care."

A power-of-attorney document is one of the more common legal forms brought up during conversations around wills and estate planning. A recent RBC Wealth Management survey reported that about 71 per cent of Canadian adults do not have a signed power-of-attorney document, which authorizes a trusted individual in case of a personal emergency or other circumstances that may require someone to make decisions on their behalf.

"COVID-19 has only added urgency to the need to plan for these situations," Mr. Agnew said.

In 2020, the NIA began to track how prepared Canadians are when it comes to unexpected health issues. It found that 80 per cent of Canadians had no written plan about their wishes should they become incapable of consenting to or refusing treatment for medical purposes, and fewer than 50 per cent have had a conversation with a trusted family member or friend about preferred health care treatments should they become incapacitated.

As a result, Mr. Agnew has begun to incorporate more health care planning into the discussions his advisers are having with clients. Conversations can touch upon advance care planning, incapacity and having a trusted person of contact in case there are signs of cognitive decline, as well as how to detect signs of potential financial abuse in those who are vulnerable.

"Health and wellness has been a huge focus for us – and not just during the first year of COVID but it has been ongoing," Mr. Agnew said. "It strengthens our relationship with clients and they begin to trust us with more of their financial needs."

And those conversations could be contributing to growth. Assets for the entire Canadian wealth management division have jumped to $534-billion, as of March, 2022, up from $425-billion in assets for the same period in 2020.

Along with the NIA, RBC Wealth has also partnered with care-management company Elder Caring Inc. and Women's Brain Health Initiative, a charitable foundation that conducts research on brain aging disorders that disproportionately affect women. The partnerships include a series of in-person and online seminars for clients

that feature medical professionals discussing various health care risks they may face in the future and how they can prepare ahead of time.

More than 6,500 clients across the country have attended four separate health-related discussions virtually on topics such as the early signs of dementia, long-term care and women's brain health.

"Our relationship with clients is well beyond just investment management and that has just accelerated even more during the pandemic," Mr. Agnew said.

"We saw what happened in long-term care homes during COVID-19, and now people are paying much closer attention to where they want to live in retirement, who will be taking care of them – and how to ensure they can afford that kind of care."

This article was originally published in The Globe & Mail at https://www.theglobeandmail.com/business/article-health-care-planning-is-part-of-investment-planning-in-pandemic-era/

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