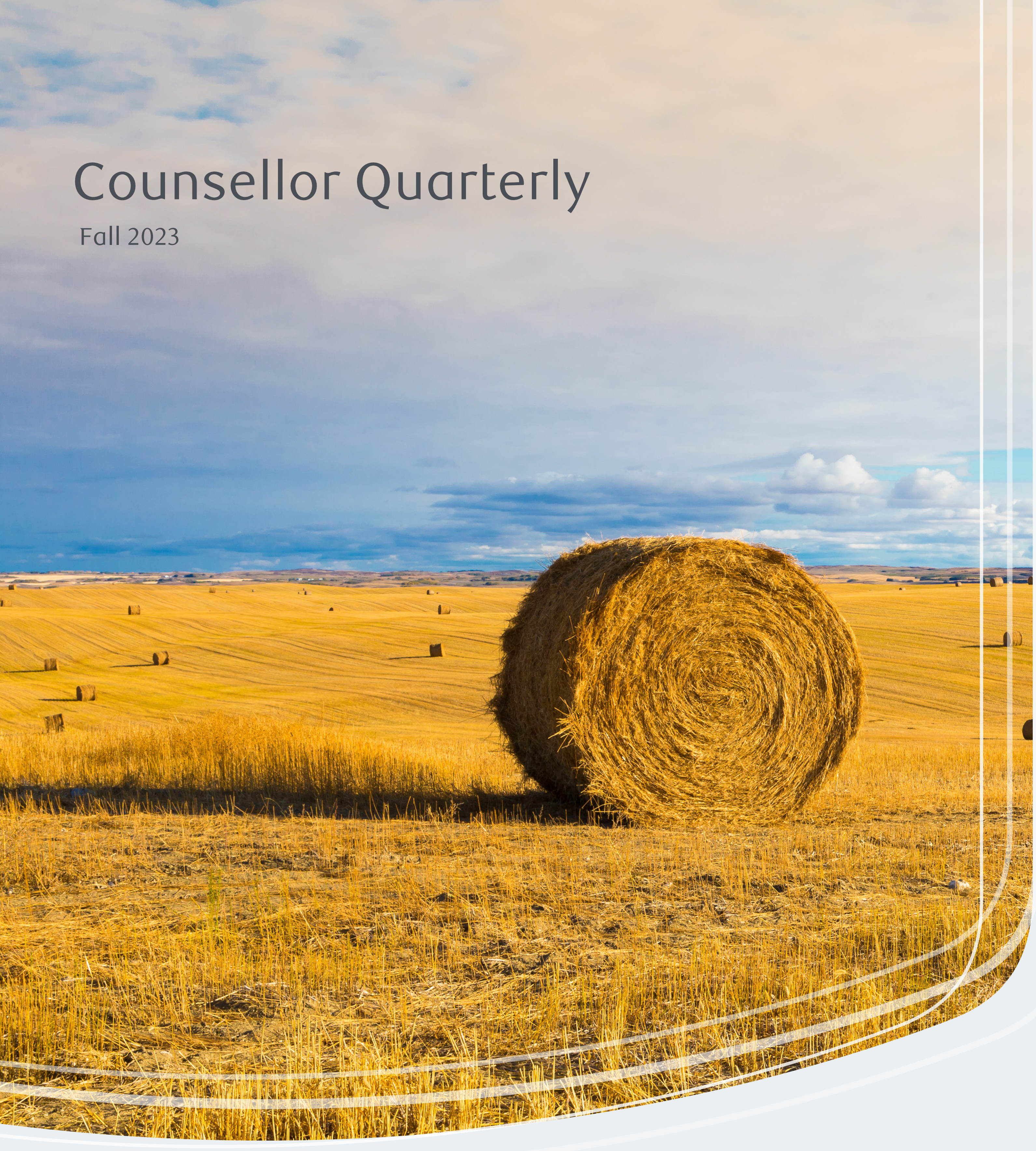
Counsellor Quarterly

Fall 2023



Wealth Management
PH&N Investment Counsel

President's message

The global economy has been resilient and a variety of challenges stemming from the pandemic have become less severe. Most major economies have continued to expand so far this year and some of the key risks to growth have diminished. Inflation has moderated from an extreme, and the stress in the U.S. regional-banking system has eased. But offsetting the positives is the fact that the most critical headwinds have intensified, as China's economic rebound from late last year is fizzling, and short-term interest rates have risen even further than previously anticipated in the developed world – and are now at decidedly restrictive levels not experienced in over two decades.

The full effect of tightening monetary conditions – intended to curb inflation – typically slows the economy with a significant lag. That means the window for a recession may just now be starting to open. As a result, we continue to expect a recession in most of the developed world over the year ahead, though it should be mild in depth and short in duration.

Global equity markets continue to adjust to rapidly evolving economic and monetary policy conditions, the latter of which represents a seismic change after almost 14 years of cheap and easy money. The volatility gripping markets over the latter part of the summer and early fall will likely continue, challenging investors' patience until uncertainty gives way to a clearer path forward.

Despite the still-many challenges ahead for markets to navigate, we remain focused on the future and never idle, choosing instead to see past today's turmoil to tomorrow's opportunities. As such, we continue to work with our suite of investment management partners, RBC Global Asset Management and select external managers, to expand our array of solutions in areas such as alternative investments. This helps ensure that we continue to meet the evolving challenges and opportunities of the marketplace, as well as the evolving needs of our clients and their goals.

I wish you and your families a very happy and healthy fall and holiday season ahead.

Regards,

Vijay Parmar

Vijay Parmar, CPA, CA
President
RBC PH&N Investment Counsel

Economic and capital markets forecast

Around the world in 80 seconds

Canada

Led by a surprising 0.2% contraction in second-quarter GDP, the Canadian economy is showing signs of mounting weakness. Once-resilient Canadian consumers have at long last run down their extraordinary savings amassed during the pandemic – one of the primary sources of the outsized purchases of goods and services that fueled the highest inflation in decades – while the labour market has begun to strain under the weight of rapidly slowing demand. Interest rate increases by the Bank of Canada are weighing heavily on consumers and businesses, reducing spending and investment further. With the global economy also showing signs of weakness, the probability that the country has entered into a sharply lower economic growth phase or even an outright recession (or will in the coming months) has risen significantly, and equity markets have pulled back over the late summer and early fall in response.

United States

The U.S. Federal Reserve's (the Fed's) aggressive interest rate increases since the spring of 2022 have begun to create cracks in what has been an otherwise remarkably resilient U.S. economy over 2023. While the labour market remains solid, job openings have begun to fall sharply while jobless claims have begun to rise. With housing also taking a negative turn, the country appears poised to begin its march towards an economic slowdown or outright recession in early to mid-2024. Markets have turned downwards and volatile in the face of uncertainty over the Fed's intentions to further increase rates, with bond yields soaring to levels not seen since 2007, and even the much-vaunted Technology sector is beginning to show signs of weakness.

Europe

The region continues to strain under the combined impact of high inflation, which has substantially exceeded that of North America, and the sharply higher interest rates delivered by central banks designed to combat that inflation. The area's economic behemoth, Germany, has already slipped into recessionary territory, making it highly likely that the rest of the continent will soon do the same. Soaring heat this summer scorched much of Europe, killing over 70,000 people and hurting spending and economic activity. While the region's bourses have performed well over the summer, concerns that central bankers will be forced to extend interest-rate hikes to combat slowing, but still-troublesome inflation has pushed prices down more recently, and leading indicators are painting a bleak picture for the months ahead.

Emerging Markets

A surging U.S. dollar and rising interest rates are taking a toll on Emerging Market nations, driving up borrowing costs while stifling growth. China's troubled real estate sector and limp economic growth has hit equity values, while sending a chill through developed markets as well. While we expect earnings growth in Emerging Markets to rise faster than in developed markets over the next two years, patience over the coming months will be required as capital flows adjust to the changing monetary regimes across the world, and a more stable market is reestablished following China's sharp equity market downturn.

Global fixed income markets – Fall 2023

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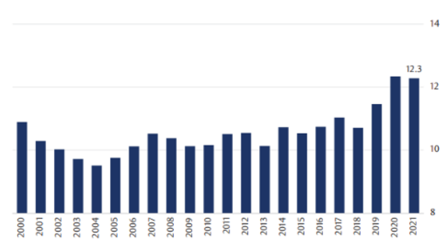
The outlook for bond investors appears to be improving, with the highest yields in 15 years forming a positive backdrop for fixed-income returns over the year ahead.

U.S. government bonds returned just over 3.0% over the past 10 months, a period in which 10-year bond yields were essentially unchanged. Over the next 12 months, we expect returns in the mid-to-high single digits as yields are augmented by rising bond prices in an environment where inflation continues to slow and central bankers appear set to begin cutting interest rates. Our view is that the threat of a recession, whether or not one materializes, will lead central banks to reduce interest rates within the next year. Moreover, inflation is already falling back toward central bankers' 2% target, bolstering the case for lower policy rates. While we have been predicting a recession since late 2022, it hasn't materialized due to much-better-than-expected U.S. growth, which buoyed equity markets and kept central banks raising interest rates, even after a brief pause during the spring.

Why has growth been so resilient?

The first reason is that we underestimated the full effect of fiscal stimulus and the impact of the pandemic-related savings accumulated in most of the developed world. Fiscal stimulus has been pared, but spending incentives related to the U.S. Inflation Reduction Act and energy subsidies in the eurozone have bolstered growth much more than we anticipated. Governments were also much slower to curtail pandemic-related expenditures and consumers much more eager to spend their savings stashes. Typically, consumers would raise their savings rates for a period after a serious economic downturn – reflecting a more cautious outlook on the world. Instead, households have spent their savings, and more. Governments, for their part, have made little effort to scale back their own spending and budget deficits remain remarkably high.

Exhibit 1: Firms issued exceptionally long-maturity debt when yields were low



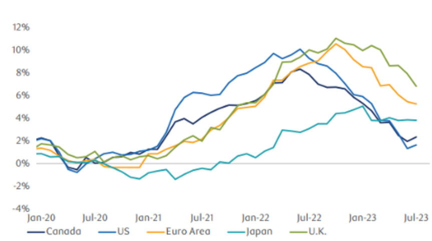
Note: Data as of December 31, 2021. Bonds, weighted average time to maturity (years). Source: Bloomberg Barclays U.S. Corporate Bond Index

Another reason that a recession has so far been avoided is that the economy seems less sensitive to rising interest rates than has historically been the case. In the U.S., corporations took advantage of low yields to lock in borrowing costs for exceptionally long periods (Exhibit 1), and households typically have very long-maturity borrowings related to mortgages. Even terms on car loans are much longer and now stretch as long as 10 years.

This means that borrowing costs for businesses and households rise much more slowly because a smaller portion of their debt is renewed every year. The impact of interest-rate hikes is therefore spread over a longer period and their effect dulled by earnings growth (for businesses) and income growth (for households). The forbearance of lenders has also been surprising. In Canada, major banks have permitted some mortgage borrowers to extend amortization periods by decades in order to keep payments manageable.

Quantitative easing also reduced the sensitivity of the economy to rate hikes by reducing banks' bond holdings and therefore their exposure to losses linked to rising interest rates. Smaller bond holdings have enabled banks to sustain lending better than if their bond holdings had been more significant. To be sure, the failure of several important U.S. banks indicates that the decline in bond portfolios still had an impact this time around, but absent quantitative easing it would have been much worse. We still think that the rapid pace and huge scale of interest-rate hikes over the past year and a half will be sufficient to bring inflation back to 2% alongside a cooling of economic activity. We already see signs that the economy is softening. Inflation has eased substantially, and the risks of overtightening (i.e., raising rates excessively) are much higher now.

Exhibit 2: Inflation has slowed

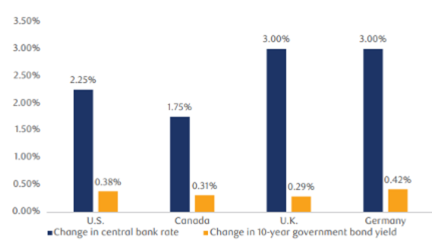


Note: Data as of August 30, 2023. Adjusted for country-level differences in inflation calculation methods. Source: National statistical offices

While inflation still exceeds 2%, the pace is down from mid-2022, when prices were rising at the fastest pace since the 1980s (Exhibit 2). Labour-market strength – which central banks have identified as a key contributor to the risk of sustained too-high inflation – has also eased. Consumers and businesses, for their part, are also set to feel the pinch of rate hikes more fully. Payments for Canadian mortgage holders could rise 20% or even more as they renew their loans.

Overall, we believe that the window for continued economic resilience and very high policy rates will close in 2024, and this view is in line with bond-market indicators. The inverted yield curve reflects investors' conviction that an economic downturn is nigh and that high policy rates are unlikely to persist. The extremeness of the inversion is reflected in the fact that, while central banks have raised interest rates by several percentage points over the past year, longer-term bond yields are effectively unchanged (Exhibit 3).

Exhibit 3: Government bond yields have not risen with policy rates – Respective changes since October 2022



Note: Data as of August 30, 2023. Source: Bloomberg

Yield-curve inversions, where long-term bond yields are lower than short-term yields, have presaged every U.S. recession since 1945, and it's unlikely that this time will be different. Typically, the yield curve inverts between six months and two years before a recession starts. The yield curve has been inverted since last July, just six months after the first rate hike by the U.S. Federal Reserve. Based on history, a recession is mostly likely to occur sometime over the next year.

Our view is that we have likely seen the final few rate hikes from most central banks. We think slower price rises and a more balanced labour market will give policymakers the confidence to reduce policy rates from very restrictive levels, bolstering bond returns. Over the next year, the dominant theme in the bond market will likely be peak policy rates and peak bond yields. Bonds are cheap according to most of our valuation metrics, and we expect that returns over the next year will be well supported by coupon income and price gains as central banks start to cut policy rates.

Some investors are legitimately concerned that the long-run impact of poor government finances will be negative for bonds – and that investors will demand higher yields in exchange for higher risk of non-payment. As mentioned above, government deficits remain very large in most countries.

We have been writing about this risk for some time. The fiscal situation in many places looks particularly poor compared to history. In the U.S., for example, government debt relative to the size of the economy is expected to grow quickly through the middle of this century. This trend might prompt investors to draw comparisons to the European debt crisis of the early 2010s. Our view is that the U.S. situation is quite different. The U.S. tax burden is very low, and unlike European countries that faced huge interest costs and were already highly taxed, the U.S. has substantial room to raise revenues and "right-size" its tax base to reflect an expanded government footprint.

Overall, we think that concerns about government deficits in the developed world are overblown. While government debt and deficits are concerning, bond yields are more likely to be affected over the next year by slower inflation and growth than long-run concerns over fiscal probity.

*Reprinted from the Global Investment Outlook – Fall 2023 (Author: the RBC GAM Investment Strategy Committee; date published: September 15, 2023).

Talking with Tas

Introducing RBC PH&N Investment Counsel's new Chief Investment Strategist, Tasneem Azim-Khan

RBC PH&N Investment Counsel is delighted to welcome Tasneem Azim-Khan to the role of Chief Investment Strategist. Tasneem joined RBC in 2013 and has over 15 years of experience in equity analysis and portfolio management. Tasneem began her career as an Equity Research Associate at UBS Securities Canada in 2006, shortly after graduating with an MBA from the Richard Ivey School of Business. She later became the lead analyst responsible for providing research coverage of the Industrials & Transportation sectors. This experience was formative and allowed her to develop the skills to become a subject matter expert, speak to different types of institutional investors, and build lasting client relationships.

Immediately prior to joining RBC PH&N Investment Counsel, Tasneem spent close to a decade with RBC Dominion Securities' Portfolio Advisory Group as a U.S. Equity Advisor. In this capacity, she was a critical partner to advisors on portfolio construction and stock selection for their high-net worth clients. In addition, Tasneem sat on the investment committee as a Portfolio Manager for several U.S. and North American portfolios closely followed by advisors.

"I'm very much a people person," Tasneem says. "The fact that this was a role where I would be forging new relationships with clients through daily interactions on the markets and stocks really appealed to me."

She was also drawn to RBC's solid corporate culture – an aspect that became increasingly important to Tasneem as she progressed through her career.

In 2021, Tasneem was promoted to team lead for the U.S. Equities desk, taking on additional responsibilities related to the launch of new products for clients, including spearheading the launch of a U.S. equity total-return mandate in 2022.

"My time on the desk afforded me the opportunity to speak to a diverse group of clients, understand what is important to them, how they perceive risk, and tailor my advice accordingly," says Tasneem.

After 10 years with RBC Dominion Securities, Tasneem is excited to join the RBC PH&N Investment Counsel team as Chief Investment Strategist where she will build relationships with a new set of clients and continue to grow in the business.

Tasneem will play a critical role in driving the strategic direction of the investment platform while also remaining close to portfolio risk management. She hopes to approach her new responsibilities with a fresh mindset, seeking to enhance innovation across the product offering, ensuring that Investment Counsellors have the products to fulfill their clients' financial goals, and building solutions that drive efficiency and enable growth through the business. She looks forward to the opportunity to engage with clients in the days and months ahead.

"Wealth is deeply personal and inherently emotional, so the trust our clients place in us is a privilege that has to be earned continually," says Tasneem. "RBC PH&N Investment Counsel's Investment Counsellors understand this implicitly. I have already seen first-hand how they go above and beyond to put their clients first and strive to maintain a standard of excellence. I look forward to collaborating with, and learning from, my new colleagues."

Outside of work, Tasneem is passionate about travelling, having grown up in the Middle East, pursuing a Bachelor's degree in London, England, and spending holidays visiting her grandparents in Bangladesh. While she is now settled in Canada with her husband and two children, her wanderlust lives on as she continues to check new destinations off her bucket list.

"My travels and upbringing outside of North America has exposed me to so many different cultures and shaped my curiosity around unexplored parts of the world," Tasneem says. "I'd also like to think that it helps me understand people better."

Cold comfort: The real cost and risk of cash

As investment markets melted under the heat of sharp and seemingly relentless central bank interest rate increases over the last year, investors have taken shelter under the relative protection of cash and short-term investments. And while these instruments can be appropriate for an investor in the short term, for the long term, investor cash often provides poor net returns, while also creating the risk of lost opportunity as markets turn higher.

Cash is king in the land of the blind(sided)

There is a general truism in investing that when markets are on the downswing and volatility is causing investors headaches, cash is king – or, in short, cash is the best place to take refuge until markets regain their footing.

As central banks have jacked up interest rates far beyond expectations in an effort to combat persistent inflation, the interest rates paid on cash deposits and short-term cash-equivalent instruments like T-bills, High Interest Savings Accounts (HISAs) and Money Market funds have soared to the 4%-5% range, providing a decent return for volatility-scarred and jittery investors.

It's all about the net, not the netting

When we consider our returns on an investment, it is important to note that your return is more than what an asset has generated for you over a certain period. Your return is all about what you net **after inflation and taxes** – in short, what you net, not just what you seemingly netted or earned.

Real after-tax return = Nominal return - taxes - inflation

Assuming an investor is earning a nominal annualized return of 5% in their cash or cash-equivalent investments these days, if we then subtract the annualized inflation rate that stood in the month of April 2023 of 4.4%, the net annualized return would be 0.6% (5% - 4.4%).

Even worse, assuming the funds are held outside a tax-sheltered savings account such as an RRSP or a TFSA, that means paying taxes at the investor's top marginal tax rate on your nominal return (interest income is taxed at your top marginal tax rate). This would cut down your 5% nominal return by as much as half, meaning an after-tax return of 2.5%; and, then accounting for inflation's impact, your return actually turns to a negative 1.9% (5% - 2.5% - 4.4%). Hardly a comforting return when you consider all these factors.

It's cold on the sidelines – staying on track to your investment plan

For a long-term, risk-appropriate investor whose investment plan's success is predicated on them remaining invested through all market conditions, another downside of moving to cash during volatile and difficult periods in the market is the danger of missing out when markets rebound and regain their forward momentum. Based on history, markets have always risen over time, so to move to the sidelines is to risk losing important potential returns.

This is particularly true these days. Interest rates have begun to peak, so it's important to note the historical reaction from markets and the impact on investors in the months that follow a peak in central bank hikes, as illustrated here:

		S&P 500 total return post final rate hike					
	Fed funds rate	3 months	6 months	12 months	18 months	24 months	36 months
05/01/74	11.3%	-11.2%	-16.2%	1.4%	5.6%	22.9%	24.0%
03/03/80	17.2%	-0.3%	15.3%	22.2%	16.4%	9.5%	60.2%
05/08/81	18.5%	1.3%	-4.3%	-4.1%	16.1%	40.6%	42.0%
01/04/82	13.2%	-4.8%	-9.6%	22.0%	49.0%	50.4%	54.7%
08/21/84	11.6%	-0.9%	9.8%	17.8%	42.7%	61.4%	124.1%
02/24/89	9.4%	12.2%	24.5%	16.8%	14.2%	36.5%	58.8%
02/01/95	5.9%	10.0%	20.5%	39.2%	43.3%	75.1%	122.2%
05/16/00	6.3%	1.2%	-5.9%	-11.3%	-20.9%	-23.2%	-32.7%
06/29/06	5.0%	5.4%	12.5%	20.3%	19.6%	4.5%	-22.2%
12/19/18	2.3%	13.6%	17.9%	30.4%	27.3%	53.7%	94.2%
Average		*2.7%*	*6.5%*	*15.5%*	*21.3%*	*33.1%*	*52.5%*
Median		*1.3%*	*11.2%*	*19.0%*	*18.0%*	*38.5%*	*56.7%*

Source: Bloomberg LP. Returns are: for the S&P Index; in local currency; total return (include reinvested dividends); and cumulative. Please note that you cannot invest directly in an index, and past performance is no guarantee of future returns. Chart is for illustrative purposes only.

Note that in eight of the last ten circumstances such as the one we face today, markets were sharply higher one, two and three years after the final interest rate hike of a tightening cycle.

No better time than the present to get back on track – we can help

If you have sought the seeming comfort of cash but want to get back on track, talk to your Investment Counsellor today – they can help bring you and your portfolio back in from the cold.

The Last Word

The joy of collecting

Art and collectibles can bring passion, purpose and prosperity together to both grow wealth and create an important and lasting legacy. We can help.

From a paint-by-numbers canvas to a masterpiece by Van Gogh, from perusing a flea market to being immersed in one of the world's famous galleries, art is discovered and comes alive in our world in an almost endless number of ways and places. Art inhabits our lives, inspires us, moves us, disturbs us, challenges us – in short, it provokes broad and deep emotions, stirs our passions, and dazzles us in what can often seem an otherwise mundane world. And the same can be said of other passion collecting and investing, each of which offers its unique joys to the collector.

Kahlo or Kandinsky? Lafite Rothschild or a Romanée-Conti? Ruth or Hornsby?

Art and passion investing covers everything from classic cars, to wine, to baseball trading cards. It provides investors with an experience beyond that which a traditional portfolio of stocks, bonds, or mutual funds might. Collecting around our passions is often more a lifestyle, bringing a sense of pride, enjoyment, and personal expression.

But much like building an investment portfolio, collecting art and other passion investments requires a high level of specialized expertise and awareness of the market for that collectible. What's more, it often involves unique costs and considerations compared to investing in public securities like stocks and bonds.

Passion investing and managing a collection effectively also requires real expertise beyond that related to the type of passion investment itself. This includes expertise in such areas as protection (insurance), effective charitable giving, and estate planning, all of which can help ensure that a collector is preserving and maximizing the value of their collection over time, while leaving a legacy befitting them and their beneficiaries.

Supporting your passion in the arts

As stewards of your wealth, we have long understood and appreciated the importance of art and collectibles. To help you incorporate your passions into your overall wealth planning, we have wealth management experts who specialize in art and collectibles. They can advise you on how to preserve and protect your collections and provide guidance on your charitable giving and/or estate planning needs. Talk to your Investment Counsellor to learn more.

Our support of the arts also includes sponsoring artists, shows and galleries through our RBC Emerging Artists program and major events like Art Toronto, one of the nation's top exhibitions. Always a fun and fascinating experience, Art Toronto offers attendees a wide variety of artists and art forms, including everything from cutting-edge concept art to more traditional and established schools and styles.

Importantly for those who want to establish or build upon their existing knowledge, we also host two information-focused sessions at Art Toronto with our top wealth management art advisors. These sessions also feature experts from our partner RBC Royal Trust covering such important topics as estate planning relating to bequeathing a collection to your beneficiaries or passing it along to an institution or charity. If you're interested in attending future events we may host in your area, ask your Investment Counsellor for more information.

"Let's start the bidding at..."

Importantly, art and other collectibles bring together one's passion, even a sense of purpose, along with the benefit of building wealth over time. As your wealth managers, we strive to better understand you and your family, both in terms of your needs today as well as your desired legacy. Speak to us to see how we can help you start or preserve your passion investing journey.

KEEPING YOU INFORMED

Our offices have now fully reopened, and we are delighted to welcome you back to our RBC PH&N Investment Counsel offices. As always, you are more than welcome to contact us by phone or email, and we remain available at your convenience to meet with you virtually, depending upon your preference. We look forward to seeing you again soon.

Wealth Management
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