Counsellor Quarterly

Spring 2023

Wealth Management
PH&N Investment Counsel

President's message

The economy has so far remained remarkably resilient in the face of sharply higher interest rates. However, it is this very strength, combined with inflationary pressures, that has pushed central banks to aggressively tighten monetary policy over the past year. While the central banks appear to be winning the inflation war – February's Canadian reading was 5%, a huge improvement from the February 2022 peak of 8.2% – it still remains stubbornly high given the Bank of Canada's 2% target rate. Stronger-than-expected employment and GDP numbers also suggest that it will take some time to cool the economy sufficiently.

Despite the economy's strength, we continue to forecast that a recession is on the horizon, likely in the second or third quarter of this year, and that inflation will fall faster than the market anticipates, thus making the need for any further central bank tightening increasingly unnecessary. Looking forward, it makes sense that a structurally low interest-rate environment gradually reasserts itself given elevated global debt levels, demographics, and a low "speed limit" for economic growth.

The market's recent performance has certainly been challenging, testing investors' resolve to remain on track with their investment plans. With both bond and equity prices falling substantially, the last year has been highly unusual, and sharply higher interest rates have recently even rattled the global banking system.

Despite these many challenges, we continue to see this as a period of notable transition, as we move from the low inflation and interest rate environment that has developed over the last 40-plus years, to one that reflects historically normal – and higher – levels for both. Importantly, periods of transition often represent excellent investment opportunities for those who take a long-term view and remain patient and composed through volatility. As stewards of your wealth, we remain vigilant as the economy and markets go through this period of transition, while also maintaining our cautiously optimistic outlook.

Happy spring!

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

Resilient economic and job growth continues to keep the Bank of Canada (BoC) on its toes as it tries to gauge the need for more monetary policy tightening to ensure inflation remains on a downward trend. While inflation remains too elevated at 5% given the BoC's target of 2%, moderating wage pressure and increasing signs that consumer demand may be petering out suggest that interest rate increases are at or nearing an end. Recent U.S. and Swiss banking troubles are souring the positive tone towards equities that kicked off the year, with markets becoming increasingly cautious given the negative outlooks of companies across various sectors. With a recession likely in the months ahead, bond markets have rallied, providing an important bright spot for weary investors.

United States

The U.S. Federal Reserve's (Fed's) laser focus on bringing down decades-high inflation continued unabated, as the central bank raised its benchmark rate for a ninth time in a row in March, despite concerns that its increasingly hawkish monetary policy was causing substantial liquidity challenges in the banking system. The collapse of Silicon Valley Bank and Signature Bank sent a ripple of fear through markets. But the swift response of the Fed, the U.S. Treasury Department, regulators and other banks worked to shore up confidence in the sector and allayed worries that a broader crisis might unfold. While the economy and employment continued to defy the odds and show considerable strength, leading indicators suggest that the country is likely headed into recession in the second or third quarter of this year.

Europe

Despite fears that the region would be devastated by the loss of oil and natural gas supplies from Russia, Europe managed to navigate the worst months of winter and find new sources of supply. While the region continues to enjoy a resurgence in travel and tourism as COVID-19 worries fade, the region continues to adjust to sharply higher interest rates as central banks try to combat double-digit inflation. Offsetting the cloudier outlook and buoying financial markets are easing supply constraints, which allowed companies to work through order backlogs built during the pandemic. Banks' balance-sheet strength, as well as the firm backing of the European Central Bank and key governments, should prevent another Credit Suisse-type bank collapse.

Emerging Markets

Emerging Markets (EM) rebounded from a poor 2022 to start the year, as optimism rose around the outlook for the global economy. China's lifting of its stringent COVID-19 restrictions and continued strength in the U.S. economy buoyed sentiment. But equity markets quickly surrendered their gains over worries that the Fed would need to rely on further interest rate hikes to quell persistent inflation. Despite the worries, Chinese markets outperformed thanks to surging domestic consumption, while India fell back on concerns that rising rates would dampen global growth. An important trend favouring EM stocks in the months ahead is the expected depreciation of the U.S. dollar, which is strongly associated with EM outperformance.

Market insights: Update on and outlook for global fixed income markets

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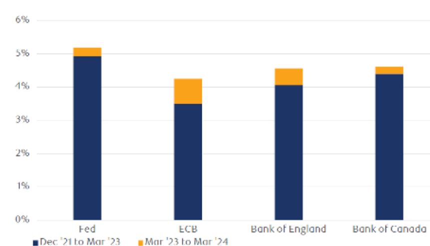
After a bright start to the year, government bonds have been coming under pressure from rising yields, as economic growth and inflation are proving much more resilient than expected. In response, central banks are likely to continue hiking interest rates through at least the middle of this year to cool still-too-high inflation and a remarkably strong labour market. That said, we expect central banks to hike policy rates much less than they did in 2022. The economy has shifted down a gear, and price rises are less rapid. We expect that inflation will slow towards 2% through the medium term and therefore believe that yields today compensate investors generously. Even with further increases in policy rates and a string of recent U.S. bank failures, we expect mid-single digit returns from government bonds over the next 12 months, as the highest yields in over a decade should provide a buffer against losses.

The U.S. recently experienced its largest bank run since 2008 – with Silicon Valley Bank (SVB) entering receivership. In response, investors flocked to the relative safety of government bonds, driving down yields. We do not believe that SVB's failure portends a system-wide crisis as policymakers responded quickly to avoid contagion risks. Moreover, the nature of the events so far differ considerably from the catastrophic losses of 2008, when the major concern was the quality of the banking industry's assets. In SVB's case, the problems were rooted in U.S. government bonds – assets of the highest quality whose values were hit by rising interest rates rather than any real risk that the debts wouldn't be repaid.

We are reasonably confident that 2023 will not mark a third straight year of negative returns for bonds. One reason is that yields are much higher. Last year's fixed-income returns were particularly poor due in part to the rapid and unexpected rise in interest rates that could not be offset by low starting yields.

Exhibit 1: Policymakers are expected to hike only a bit more – Historical and expected changes in central bank interest rate



Note: As of March 2, 2023 and based on historical changes and overnight-indexed swap rates. Source: RBC GAM

The effect of higher yields is particularly notable on short-maturity bonds: investors in a newly issued 2-year Treasury bond would experience losses over a one-year holding period only if the yield on the security more than doubled to 10.0% from the current 4.8%.

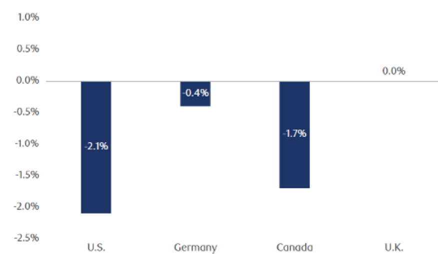
The market expects 50 to 75 basis points of hikes over the next 12 months from most central banks, a stark contrast to the hundreds of basis points of tightening delivered last year (Exhibit 1). While the year-over-year pace of inflation is still far above target in most countries, increases in prices have slowed markedly over the past six months. In the U.S., prices have been rising by a paltry 1% per year after excluding hikes in residential rents. Over the next year, we expect rent inflation to cool significantly. The impact of last year's rapid climb in energy prices due to Russia's invasion of Ukraine and supply-chain disruptions from the pandemic will also fade.

In addition to falling price pressures, economic activity has clearly downshifted. By our calculations, inflation-adjusted policy rates are as restrictive as they have been since before the global financial crisis (Exhibit 2). We also believe the full effect of the massive amount of tightening is yet to be felt in the economy. Traditional harbingers of economic downturns are signaling agreement with our assessment, as short-term bond yields have significantly exceeded those on longer-term bonds since the middle of last year. This inversion of the yield curve historically portends a recession some time over the ensuing two years, and we expect most of the world to fall into a mild recession by late 2023 or early 2024 – suggesting support for bond prices.

Exhibit 2: Expected real policy rates are very restrictive – Expected peak in inflation-adjusted U.S. policy rates

Note: As of March 2, 2023. Source: Bloomberg, University of Michigan and RBC GAM calculations

Exhibit 3: Inflation is falling in most markets
6-month decline in annual inflation rates, selected markets



Note: From July 2022 to January 2023. Source: Bloomberg

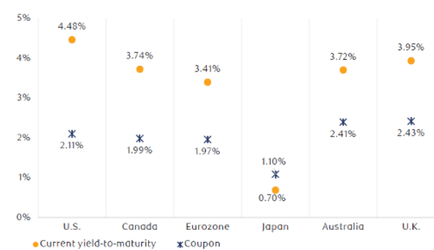
In the meantime, resilient economic activity could keep policy rates and yields higher for longer than many investors had expected even just a few months ago, as many thought the economy would be well on its way to recession by now. The economic tailwinds include remarkably strong U.S. consumer spending in the face of steeply rising borrowing costs, the positive impact on Europeans' wallets of a warm winter and energy subsidies representing more than 5% of GDP, and China's earlier-than-expected abandonment of the economy limiting zero-COVID policy. While disinflation has gripped most of the world in the past six months (Exhibit 3), worries about inflation becoming entrenched well above target are very real. The vast majority of the inflation slowdown is due to falling energy prices and the partial unclogging of supply chains – over which policymakers have little control. Meanwhile, the effects of the expansive fiscal and monetary response to the pandemic are taking longer to relinquish their inflationary impact. Labour markets have shown little response to aggressive central-bank policy actions over the past year. Wage inflation is near 5% in most economies, which is above levels consistent with 2% inflation over the long term. In Europe and Japan, workers are set to bank their best pay raises in decades. A re-acceleration of price pressures amid a still-strong job market would present a troubling scenario for bonds as it would indicate that more rate hikes are needed than is currently expected.

Bond investors are also grappling with questions over the sustainability of government finances in the presence of much higher yields. For more than a decade, central banks have supported government-debt markets by both cutting interest rates and purchasing vast amounts of bonds. But those measures are being forcefully reversed.

Central banks are now reducing their massive balance sheets. For Europe, this year marks the largest increase in bonds outstanding, excluding central-bank purchases, since the launch of the single currency in the early 2000s. In the U.S., burgeoning tax receipts have reduced the need to issue new debt, but worries about how future deficits will be financed are intensifying. These concerns are not restricted to the U.S. Fiscally weak members of the euro area such as Italy and Spain are facing higher levels of investor scrutiny.

In most fixed-income markets, the average coupon on existing debt is still much lower than prevailing yields (Exhibit 4). As outstanding debt matures and new bonds are issued, government coupon payments will rise significantly. This process will happen faster in some markets than others.

Exhibit 4: Government bond yields are much higher than coupons – Current coupon rate versus prevailing market yields



Note: As of March 2, 2023. Source: Bloomberg, RBC GAM calculations

In the U.S. and Canada, for example, about 25% of the countries' outstanding debt will roll over by the end of 2024 since their governments have relatively more short-term debt.

In Japan and the U.K., by contrast, that figure is barely above 10%, giving those countries a much longer period to adjust to higher financing costs. Under current policy, the share of the U.S. federal government's annual expenditures taken up by interest payments could double over the next decade to 12% from 6% now, according to the Congressional Budget Office. While borrowing costs are also expected to climb in Canada, the relatively healthy fiscal picture means that debt-to-GDP ratios are projected to decline even in fairly negative economic scenarios. Towards the end of the summer, the U.S. Congress approaches another budget showdown over the debt ceiling. We are fairly sanguine regarding the odds of a government shutdown, but the event could bring attention to just how poor the long-run fiscal position of the U.S. government is.

Overall, we expect that a combination of strengthening economic activity, a resilient labour market and modest disinflation will prompt central bankers to continue hiking interest rates through the middle of this year, and then pause. In our view, policy rates in most markets are already high enough to dampen growth, and with price pressures easing, the risks to overtightening versus letting inflation become entrenched are more finely balanced than they were in 2022. Growth and inflation are already much slower than a year ago, and we expect that most economies will eventually slip into recession. As investors shift their attention from inflation and aggressive tightening to flagging growth, bonds should do well.

Article originally appeared in the Global Investment Outlook, published by RBC Global Asset Management (Spring, 2023).

Recession-proof your portfolio with the three Rs

What do you do with your investment portfolio when you hear the infamous "R" word – recession? It's easy. Just follow the three Rs: Review, rebalance and relax.

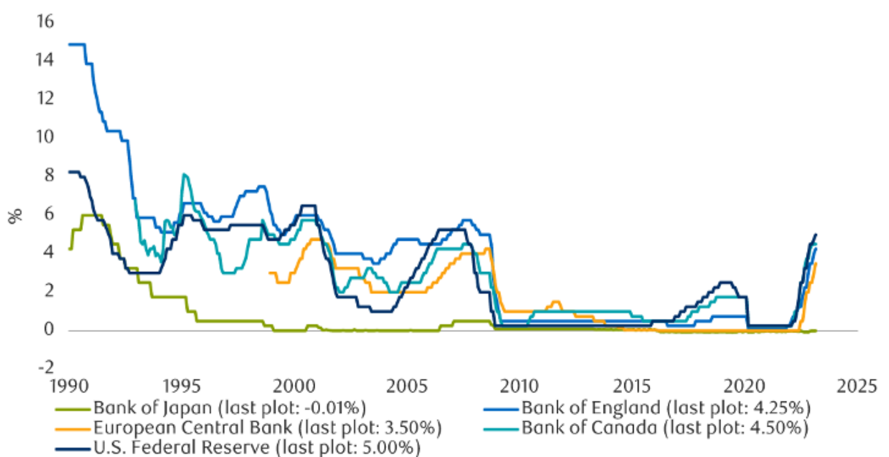
Recession: A nasty nine-letter word

The strong post-pandemic economic boom – combined with global supply chain issues and massive increases in energy prices – has caused a surge in inflation over the last year-and-a-half to levels not seen since the 1980s. In response, almost every major central bank the world over has scrambled to increase interest rates to tamp down demand and regain control over prices. So much so, in fact, that the Governor of the Bank of Canada (BoC) recently stated that it was better for our long-term economic well-being to use restrictive monetary policy to induce a recession – where the economy ceases to grow or even contracts for two consecutive quarters or more – than risk allowing inflation to continue to ravage consumers, government and businesses.

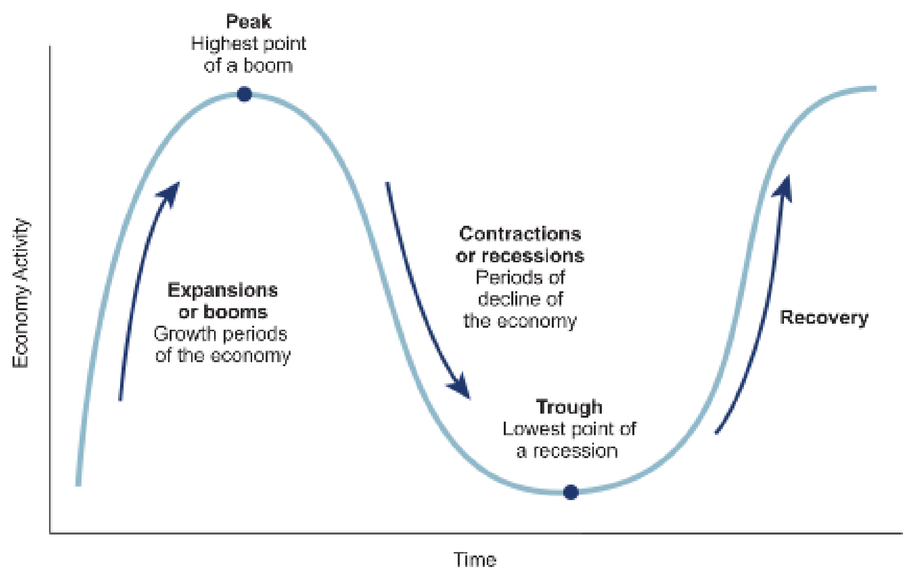
To fight inflation, the BoC has raised its benchmark rate eight times, lifting it from 0.25% back in the spring of last year to 4.5% today. While the rise has been sharp and rapid, it appears that recent economic conditions have weakened enough to allow the BoC to pause, or perhaps even end, its tightening course.

However, unfortunately most economists now agree that sharply higher rates, while working to bring down inflation from its peak of over 8% in February 2022 to today's 5% level, a recession is likely to be inevitable. Whether that recession is mild or severe is still open to debate, but increasingly the consensus appears to be that a "soft landing" – where the economy slows but doesn't enter a recession – has become increasing unlikely.*

Central bank key lending rates



Note: As of March 24, 2023. Source: Bloomberg, RBC GAM



"R"-proofing your portfolio

Already suffering from rising interest rates, and now anticipating a recession, both bond and equity markets turned negative and volatile in 2022, reflecting the uncertain and bumpy road ahead. While 2023 started off on a positive footing, equity markets have largely given back this year's gains (fortunately, bond markets have done better as interest rate increases have stabilized).

Volatile markets often generate strong emotional reactions in investors, sometimes prompting them to veer off course from their investment plans. This can lead to common pitfalls like taking inappropriate and ill-advised risks, buying high and selling low, and moving to "the sidelines" (i.e. cash) to avoid losses, thereby missing out when markets recover.

Similarly, reacting to the "R" by altering your investment plan is rarely the right move. Instead, investors would be well served to follow the three Rs:

- **Review:** Volatility can spur some difficult-to-manage emotions, and to questioning one's goals and the plan to achieve them. Does your investment plan still align with your goals? Is your risk profile still accurate? These are important questions and concerns to review with your Investment Counsellor if your financial or personal circumstances have changed.
- **Rebalance:** Your portfolio should be balanced in a way that maximizes your investing efforts to help achieve your goals, while reflecting your appropriate risk profile.
- **Relax:** Once you've reviewed and rebalanced, if and as necessary, you can relax with confidence that you are on the right track to your goals.

It's important to keep in mind that recessions are usually short-lived events, and that your portfolio is designed to achieve long-term goals – like retirement – that are in the future and that stretch over many years. So changing your long-term plan as a result of short-term challenges is rarely advisable.

* Canadian economy unlikely to dodge a downturn despite early-2023 resilience. RBC Economics (March 15, 2023).

Three ways to leave a legacy through charitable giving

Take a proactive approach to make the most of your family's charitable legacy

As Canadians, we support causes important to us in many ways, whether it's by giving our time, expertise, or money. But charitable giving is something that we often leave until the last minute, or that we do only when asked. By taking a more thoughtful approach, you can support causes important to you and your family, maximize tax incentives, and create an enduring legacy.

Here are three ways to take a more planned approach to charitable giving:

1. Make giving part of your life through regular cash donations or donations of non-registered securities

Cash donations are the most common way to make an impact on the communities you care about, and it has never been easier. Many employers offer automatic payroll deductions and charitable organizations can set up pre-authorized debit options through your bank account or credit card. Not only does pre-planned giving help charities do their work; it also helps you plan your own monthly budget. And don't forget, when donating to a registered charity, you will receive a tax donation receipt which can be claimed on your tax return as a credit.

Here's another idea: If you are holding publicly traded securities (such as stocks) which have appreciated in value in your non-registered account (e.g., not held in an RRSP or RRIF) consider donating them "in-kind" to a charity. In return, you'll get a tax receipt equal to the fair market value (FMV) of the securities donated, and you will not be taxed on the capital gains accrued on those securities, as you would if you sold the securities during your lifetime.

How it can cost less to donate securities instead of cash

	Sell shares and donate cash	Donate shares directly
FMV of donation (a)	$50,000	$50,000
Adjusted cost base	$10,000	$10,000
Capital gain	$40,000	$40,000
Taxable capital gain	$20,000	$0
Tax on capital gain @46% (b)	$9,200	$0
Tax savings from donation tax credit (c)	$23,000	$23,000
Total cost of donation = (a) + (b) – (c)	$36,200	$27,000

2. Arrange future gifts through your estate planning

Deciding how to distribute your estate in advance helps ensure your loved ones or important charities will be taken care of after your passing. There are many ways to achieve this goal, including:

- You can leave a set cash legacy, direct specific assets (publicly traded shares or land, for example) or bequeath a share of the residue of your estate to a charity or charities of your choosing. Outlining your charitable wishes through your Will has benefits. You can enjoy the use of your assets while you are alive, knowing that charities that are important to you will benefit in your Will.

- Your estate will also receive an enhanced donation tax credit. Generally, you cannot claim a credit for donations exceeding 75% of the net income reported on your federal tax return in any particular year. However, in the year of death and the preceding year, you may claim donations of up to 100% of your net income.

- Another way to provide a future gift, while benefiting from your assets during your lifetime, is by establishing a charitable remainder trust. You receive an immediate donation tax credit plus income from the trust throughout your lifetime. Upon your passing, the remainder of the assets in the trust will pass directly to the charity you name as the beneficiary (bypassing probate fees).

Here's another tax-smart way to make a future gift to your chosen charity: Donate a life insurance policy. You can donate a new or existing policy to a charity during your lifetime and receive a tax credit you can use immediately. Alternatively, you can defer the donation until you pass away, in which case your estate receives the tax credit. Either way, your chosen charity receives the life insurance benefit directly on your passing. What's more, it bypasses probate, which can reduce costs and maintain your privacy if desired.

3. Create a lasting legacy with a donor-advised fund

If you want to establish an ongoing charitable legacy, consider a donor-advised fund. A donor-advised fund is administered by a public foundation, and provides many of the same advantages as a private foundation, without the upfront costs, complexity and ongoing administration responsibilities. With a donor-advised fund, you contribute a certain amount, receive a donation tax credit, invest your contribution, and then make grants to registered charities of your choice. You can also name a fund successor, such as one of your estate beneficiaries, who can continue your legacy after your passing. If you don't name a successor, the public foundation will continue to administer your fund and make grants consistent with your wishes.

So, whether you're giving a little or a lot, there are many ways you can make a meaningful difference to causes close to your heart. Plus, you can take advantage of tax incentives to maximize your giving. To learn more, please contact your Investment Counsellor.

The Last Word

The legacy of literacy

Investing in our children's financial knowledge can build a legacy that pays dividends for years to come

For many of us, our teenage years included "The Talk" with Mom, Dad or both. As awkward and uncomfortable as that conversation could be, there are likely few parents who would disagree that it was essential for the well-being of their children, ultimately helping them to avoid poor decisions and pitfalls that unfortunately plague so many young adults – and, frankly, older ones, too. As the receivers of "The Talk", we not only survived it, but if we were wise enough to heed our parents' thoughtful and informative words, we were likely the better for it, both then and throughout our lives.

"What's the difference between a stock and a bond?"

"The Talk" referred to is, of course, the one concerning financial literacy. Covering topics such as earning, budgeting, borrowing, spending, saving and investing, this critically important knowledge can help your children navigate the sometimes-tricky world of personal finance. Unfortunately, Canadians continue to struggle to achieve an adequate level of knowledge on these topics. According to a survey conducted by Abacus Data on behalf of the Canadian Bankers Association, when Canadians were asked five financial knowledge questions of varying degrees of difficulty, only 13% of respondents answered all five questions correctly, and over one in three got only two or fewer questions right. The long-standing issue is acute enough to have led the federal government's Financial Consumer Agency of Canada to renew its National Financial Literacy Strategy in 2021, a five-year plan to help Canadians build what they call "financial resilience" through knowledge and awareness.

Dollars and sense

For many wealthy Canadians, the concern can be more about how their children will manage the wealth they will receive throughout their lives, especially as beneficiaries of their parent's and/or family's wealth. Importantly, knowledge of financial topics can empower children to make smart decisions when building and growing their wealth as adults – and help them avoid costly mistakes, too. According to financial literacy experts at RBC Wealth Management, increased financial literacy has been shown to lead to greater resilience during predictable and unpredictable life events. Learning how to earn, spend, save and invest wisely contributes to overall well-being and stability.

Bringing his unique perspective as a youth himself to the topic, RBC Wealth Management-sponsored Canadian author Noah Booth has written a book aimed at helping teens learn about the value of money. As Booth points out in his A Rich Future: Essential Financial Concepts for Youth, not everyone successfully manages money. Financial literacy is the key to changing that dynamic.

"There is a knowledge gap among kids in the world," Booth says. "Some have access to information from parents, schools and other forms of financial literacy, while others do not. If you're financially literate and smart with your money, you have a huge advantage in life, right from the beginning."

He goes on to say that learning how to manage money well when you're young translates into greater stability as an adult. "Financial literacy is super important, as money is a part of everyone's lives. When you're older, you're going to have to pay for your food, housing, transportation. Everybody has to deal with money. I think it goes along with other key things that are taught, such as physical well-being and mental well-being."

Investing the time and effort in ensuring your children have the knowledge to navigate the financial decisions that will confront them through their lives can be essential to their long-term well-being and success. "The Talk" can work for many parents if they have the requisite knowledge themselves. But your Investment Counsellor can help too, bringing both their knowledge as well as important learning resources to assist. Please talk to us about building a strong legacy of financial literacy with your children, one that will pay dividends for years to come.

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.

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