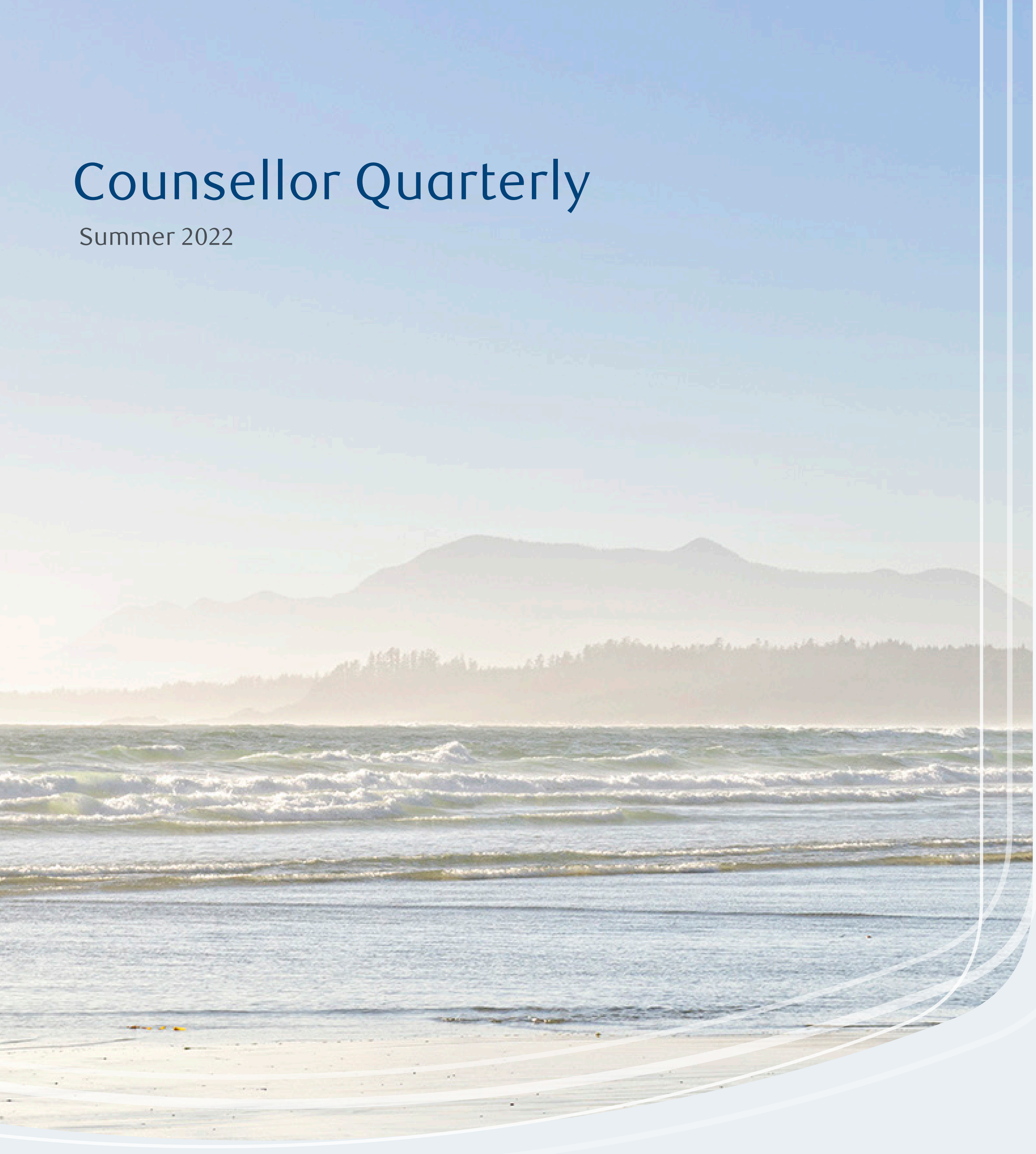
Counsellor Quarterly

Summer 2022



Wealth Management
PH&N Investment Counsel

President's message

Inflation pressures continued to mount over the first half of the year, with Canada's Consumer Price Index (CPI) rising almost 8% year-over-year in May. Led by surging gas and food prices, the ever-increasing cost of living is hitting consumers hard. When combined with continuing supply chain issues across the globe, and the added strain put on oil and food supplies by the war in Ukraine, the strong upward momentum in prices is driving key central banks to aggressively raise interest rates to stem demand. Since the beginning of 2022, the U.S. Federal Reserve has raised its benchmark interest rate by 1.50%, including a historically large increase of 0.75% in June. The Bank of Canada is expected to match the increase in July.

With monetary policy expected to keep tightening over the coming months, speculation is rising that this may induce a recession within the next year, and this in turn has driven bond prices down and equity markets into either bear-market or correction territory.

The global economy is facing substantial challenges over the coming months, including slower economic growth. Combatting the negative economic effects of the pandemic required extraordinary fiscal and monetary policies, and these policies in turn created extraordinary but unsustainable economic and market conditions. Though painful, much of what we are now experiencing is how we return to more normal and sustainable conditions. Importantly, history has shown that perseverance through crisis creates opportunity. As a result, we continue to hold fast to our time-tested and proven investment strategies to ensure we are taking advantage of opportunities that may arise in a time of fear and panic.

We understand that unsettling periods can challenge investors to stay true to their investment plans, especially when both bond and equity markets are under pressure simultaneously. Please speak to us if you have questions or concerns about recent developments, or if anything has changed for you or your family. As stewards of your wealth, we are here to help you see the path forward to your goals.

Regards,

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

Economic and capital markets forecast

Around the world in 80 seconds

Canada

Rising costs have begun to nibble into Canada's economic growth, and inflation expectations are starting to change the purchasing behaviours of consumers and businesses. This is an important development, as reining in but not completely stifling the post-pandemic spending splurge on at first goods, and more recently services, such as travel and leisure, are likely to help corral price pressures over time. The Bank of Canada has moved emphatically to a tightening bias, rapidly reducing the extraordinary monetary policy stimulus that it implemented to combat the pandemic-induced economic downturn. Despite the mostly negative news and increasingly poor consumer confidence, employment and spending remain strong, defying – for now – rising calls for a recession in the not-to-distant future.

United States

With few tailwinds to sustain it, the post-COVID-19 economic surge in the world's largest economy is beginning to show signs of petering out, while the cost of living, especially for gas, shelter and food, continues to rise at an alarming rate. Inflation rose almost 9% year-over-year in May, the fastest rate in over 40 years. This has led to a rapid pivot in U.S. monetary policy, as the U.S. Federal Reserve tries to stem inflation while avoiding a "hard landing" for the economy. The central bank is likely to continue to increase rates aggressively over the coming months. Bond yields have soared and stock prices have fallen, with the S&P 500 Index recently following the NASDAQ Index into bear-market territory.

Europe

Sharply rising inflation is rapidly reversing the economic bounce the region was experiencing as it emerged from the COVID-19 pandemic. The war in Ukraine is having a particularly painful impact on Europe, with an increasingly-embargoed Russia, the dominant oil and natural gas supplier in the region, threatening to cut off supply to NATO-member nations such as Germany, Poland and France, resulting in surging energy costs. The European Central Bank, faced with sharply rising bond yields and inflation, is threading a precarious path to avoid stagflation, as the economic picture dims and growth falls. To help counter the impact of energy-price inflation and rising interest rates, the EU is ramping up fiscal support, and it is likely that investments in defense and energy independence will rise.

Emerging Markets

Emerging market (EM) equities have traded largely in line with those in developed markets, as EM were supported by stronger corporate cash flows, resilient currencies and attractive valuations. Excluding Russia, China was the weakest-performing emerging market, while commodity-exporting EM countries posted positive results. Asian equities pulled back over the quarter, with a significant divergence in performance among markets. We expect Chinese growth to keep decelerating until the fourth quarter of this year, while across Asia, an export downturn is likely starting, as the impact of the Russia-Ukraine war has weakened global demand. Inflation is likely to rise further in the region.

ToMorrow's Insights

Where do we go from here?

Stuart Morrow, CFA

Vice-President, Head of Investments
RBC PH&N Investment Counsel

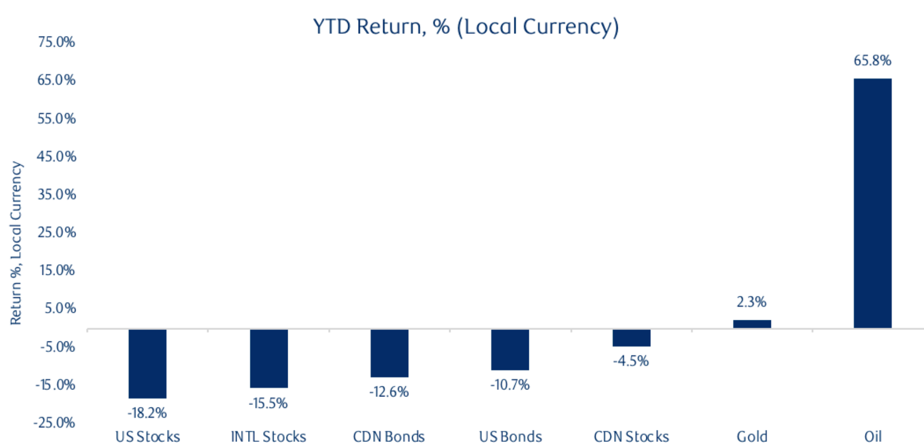
Coming into this unusual start to the year, higher inflation was very much the dominant risk investors were focused on. In fact, in our 2022 outlook, we highlighted that inflation variability would be a prominent threat to investors through the year and into next year as well. Inflation fears only escalated in February when Russia invaded Ukraine and oil hit $120 per barrel. Recently, however, the focus has shifted decisively toward slowing growth, with every major asset class pricing in an economic slowdown, and that inflation is likely to stick around for a little while longer. Market-based measures of volatility have been on the rise since the start of the year, with rather large swings in prices - both higher and lower.

Few places to hide from the bear

Adding to the woes so far this year have been bond prices, which have moved lower. Investors haven't seen this in some time – simultaneous declines in both bond and stock values. Usually there is some degree of offset between the two, but this has been a rather unusual first half of the year. While some pundits have questioned the role of bonds in a portfolio today based on a short time period, we believe the portfolio diversification benefits of bonds remain important. Historically, as inflation volatility declines, the low correlation between bonds and stocks tends to return. We expect that this time won't be any different.

There have really been no places for investors to hide year-to-date. As shown in the chart below, the

YTD Return of U.S., Canadian Bonds and Equities, International Equities, Oil, and Gold



Sources: Bloomberg; Bond indices used: U.S. Investment Grade Bond Aggregate (LBUSTRDH), Bloomberg Canada Aggregate TR Investment Grade (I05486CA); Equity indices used: S&P/TSX Composite (SPTSX), S&P 500 (SPX), MSCI AWCI Excluding United States (MXWDU). Commodities indices used: WTI Active Contract (CLA CMDTY), Gold/United States Dollar Spot Exchange Rate (XAU BGN CRNCY). Daily index levels. All data is in local currency; non-annualized. December 31, 2021 until June 10, 2022. The returns shown are gross of fees, transaction costs or taxes. Past performance is not a guarantee of future performance.

You cannot invest directly in an index.

unrealized losses across U.S., international and Canadian stocks and bonds have been material. The only positive nominal returns so far this year have been in commodities. In the chart, we show the unrealized gains for gold and oil (two good proxies for commodities).

Entering an official bear market

In mid-June, the leading barometer for equities, the S&P 500 Index, entered official bear market territory. A bear market is defined as a market correction from the prior high of at least -20%. The average bear market over the last 100+ years has lasted just over 2.5 years and the median peak-to-trough decline over that period was just over 35%. Each bear market and correction is different, so these are just goalposts to keep in mind so you can be financially and psychologically ready for what may come next. But there is no secret sauce to timing the market tops and bottoms, so we don't promote such strategies at RBC PH&N Investment Counsel.

However, it's still important to keep in mind that despite the year-to-date unrealized losses, corrections and bear markets are quite normal through time. In fact, the U.S. equity market, which is the most widely followed, has averaged at least one sizeable decline (i.e., 10% or more) every year since 1975, with the average fall being nearly 20%. Yet, the U.S. equity market still managed to generate a positive annual return three quarters of the time over the last 50+ years. In other words, dealing with market volatility is part of the investing experience.

Important reminders for bear markets

Mentally, it's never easy to get through a bear market. Here are some important reminders about staying invested in bear markets:

- **They are inevitable:** Bear markets are an ingrained aspect of investing. We know that they will happen; we just cannot know when or why. Expect to see one every six to seven years.
- **Nobody can call the bottom (or the top):** Market timing is impossible, and this fact does not change during a bear market.
- **Lower prices are good for long-term savers:** For younger investors saving for the long term, lower market prices are attractive and beneficial to long-run outcomes. (It just won't feel like it at the time!)
- **Emotions will run high:** Our ability to make intelligent, long-term decisions during a bear market is severely compromised. Rational thought will be overcome by the emotional strains we are likely to feel – what happens if things keep getting worse and I didn't do anything about it? It is during such times that systematic decision-making – such as rebalancing and regular savings –are important.
- **Bear market rallies:** Once a market declines 20% or more and is officially noted as a bear market, there could be periods of time where the market rallies higher before exceeding prior peak prices and ending the bear market. These rallies are unofficially termed "bear market rallies" and can be quite common during bear markets. During the previous six S&P 500 Index bear markets, there were 29 such bear market rallies which took place before the bear market was deemed to be over. The average bear market rally lasted about 43 days and the market rose by an average of 12.2%. During these periods there was a growing sense of optimism that the bear market could be over, only to see further price declines. Investors should be aware that during any bear market, there could be bear market rallies which may not mark the end of the bear market itself.
- **Our risk tolerance will be examined:** Bear markets are the worst possible time to find out about our tolerance for risk. Everyone becomes risk averse when they are losing money. The problem for investors is that living through a significant loss (even if it is only on paper) is a far different proposition to seeing it presented as a hypothetical scenario. If possible, avoid reassessing your appetite for risk during tough periods.
- **Each bear market will be different:** Each bear market is unhappy in its own way. They can be shorter or longer than in the past, and unrealized losses could be higher as well.

Bottom line – sticking to your wealth plan is the way to go

Try your best to avoid the noise of daily market fluctuations, reduce the urge to check your portfolio frequently and make rash, short-term decisions. And as always, if you have any questions about your investment portfolio, please reach out to your Investment Counsellor at any time.

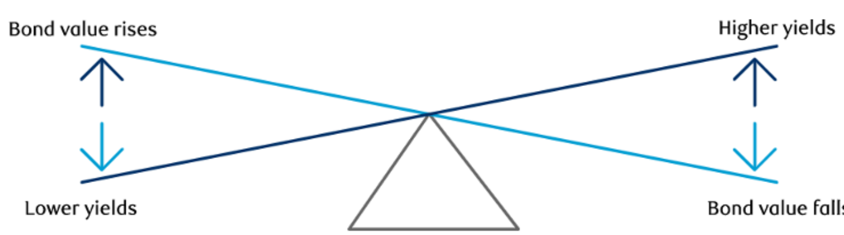
Portfolio Management

Three reasons why bonds remain important for investors – even with today's rising yields

As they represent a bond owner's theoretical return, bond yields rising should be good news for investors, right? In fact, when bond yields rise, the market price of existing bonds goes down. Given the present-day rising rate environment, some investors might think it's time to sell their bonds. But there are important reasons to stay invested – including wealth protection and predictable income.

How it works: The bond teeter-totter

When a bond's yield falls, its price rises; conversely, when a bond's yield rises, its price falls. When interest rates rise, they often raise yields with them. In turn, rising yields can trigger a short-term drop in the value of existing bonds. That's because investors will want to buy the bonds that offer a higher yield. As demand drops for the bonds with lower yields, the value of those bonds will likely drop too. However, this near-term view overlooks the longer-term payback of higher yields. Capital losses in the short term can set the stage for higher future returns.



Don't throw your bonds out with the bath water

Despite the sharp rise in yields, and the consequent downturn in prices, it is important to remember that bonds have long been a stalwart defender of wealth and income, providing three essential components that together help support their importance in a risk-appropriate portfolio:

1. **Income:** Bonds generate income through coupon payments, which are quarterly or semi-annual payments of interest from the issuer made throughout the lifetime of the bond. This provides a steady return to investors regardless of market conditions and the existing, day-to-day market value of the bond. This flow of income can be extremely important, especially for those, like retirees, who depend on the income generated from their portfolios to live on. Coupon payments can also be re-invested as they are paid out, something that can be advantageous when interest rates and yields are rising.

2. **Protection:** Generally speaking, when investment markets become volatile, usually as a result of uncertainty or crisis, bonds increase in value. This is based on two important aspects of their structure: one, they are a specific commitment on the part of the issuer to repay the face value of the bond, and on a certain date, unlike equities that exist in perpetuity and have no maturity value; and, two, when interest rates are cut or reduced as they often are in times of stress, this lowers yields and increases prices for bonds (see "How it works: The bond teeter-totter").

3. **Diversification:** A fundamental principle of successful, long-term portfolio management is diversification – the old adage "Don't put all of your eggs in one basket." As asset classes such as bonds and equities usually move in opposite directions from each other (they are "negatively correlated"), that means when things are going badly for equities, your bond portfolio will often perform much better, offsetting one for the other and smoothing out your portfolio returns over time.

Keep the faith

Despite their recent volatility, bonds have long been a critically important foundation for most investors' portfolios, offering important protection and income flows that offset periodic periods of price pressure. If you have questions about the important role that bonds play in a well-diversified portfolio, speak with your Investment Counsellor.

Financial Planning

Stagflation and five 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.

Long associated with the 1970s – snaking lineups of cars at gas stations during the OPEC embargo, workers striking for higher wages, massive government deficits – stagflation is the bane of economies worldwide. Combining the twin challenges of soaring inflation with low or even negative economic growth, stagflation is the worst of both worlds: governments, businesses and consumers require more to buy the same as before, but thanks to low or stagnant growth and high unemployment, they have less and less to do so.

Sticking the landing: Aiming for soft, bracing for hard

Today, governments, businesses and consumers are facing increasingly similar circumstances. 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. The war in Ukraine only exacerbated the issue, reducing supplies of oil, natural gas and food. Inflation, in turn, has soared.

Unfortunately, the accepted remedy to tame inflation often only adds to the pain, at least in the short run. In response to rising prices driven by pent-up demand, 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."

It's hard on investors, too: rising interest rates ripple into rising bond yields, hitting bond prices (bond prices and yields move inversely). Stocks usually fall in turn, as investors increasingly expect that:

- a slowing economy and higher wages will mean lower corporate profits
- the economic uncertainty reduces longer-term visibility, increasing volatility
- rising rates and yields reduce the relative attractiveness of stock dividends and distributions

Learning from the past

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. Governments and central banks better understand the lessons

“It is fascinating to note how differently consumers responded to inflation in the 1970s relative to today. In the 1970s, high inflation was viewed as a reason to pull spending forward, on the presumption that the cost of products would continue to rise rapidly, rendering them even less affordable in the future. In contrast, today, the dominant thinking by consumers is that it is now a bad time to buy things given that their cost has recently risen so substantially.”

of previous stagflation periods. It’s also encouraging to note that consumers and businesses are responding differently than they did in past periods, when the response to stagflation resulted in a vicious cycle of ever-worsening economic conditions. According to RBC Global Asset Management Chief Economist Eric Lascelles:

Stagflation mitigation

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

1 **Debt:** As inflation rises and central banks raise interest rates to combat it, borrowing costs also rise. As well, the slowing economy can negatively affect the value of assets such as stocks, bonds and real estate. In light of this, it can be timely to review your debt service costs and the effective net yield of any leveraged investment structures, especially if that return has been negatively inversed, i.e., your borrowing rate is higher than the yield or expected return of the associated underlying asset.

2 **Investment portfolio:** A crisis can be a sad thing to waste, as it may reveal the strengths and weaknesses of portfolios and investment plans. While stagflation is historically rare, the market’s negative response to it provides a “stress test” and an opportunity to review your portfolio with your Investment Counsellor to determine whether it requires any rebalancing.

3 **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, such as value stocks, can help reduce volatility, as these companies have the ability to consistently perform through challenging economic circumstances. As well, those investments that have an established history of growing their dividends or distributions over time can help mitigate the impact of inflation and an economic slowdown, while maintaining the cash flow generated from a portfolio.

4 **Fixed income:** When central banks raise rates to combat inflation, the bond market typically sees yields soar and prices fall. However, on the more 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” your coupon payments at higher levels, and can create the opportunity to enhance fixed-income returns over the longer term.

5 **Short-term goals:** If you are considering making a major life change, it may be opportune to reconsider and/or recalculate its impact on your financial circumstances. Anticipating the longer-term economic situation accurately is nearly impossible, so some plans may need a rethink if they could potentially have a negative impact on your longer-term financial well-being.

As always, if you have any questions about stagflation and its potential impact on your portfolio and wealth plan, your Investment Counsellor is available to help you navigate today’s challenging economic and market conditions.

The Last Word

Beyond the numbers

At the confluence of wealth, health and life is the well-being of you and your family – our pledge is to help you achieve it.

The last few years of the pandemic have led many of us to evaluate our lives and goals, and to prioritize the things that matter to us. For most, the primary objective is to secure the well-being of our family and loved ones. One of the ways we do that is to strive to achieve financial well-being, which is often understood as "having enough" to be "secure", however that is defined or envisioned by each of us. In broad terms, financial well-being means having enough assets to meet present needs, and then by extension, enough to securely meet planned, expected or hoped-for needs further down the road – from paying for a child's wedding or first home down payment, to having enough income to live how and where you choose in retirement.

Well-being lies beyond the numbers

Wealth is a critically important component of well-being, and our primary job as your Investment Counsellors is to help maintain and build it. As stewards of your wealth, we strive to understand your financial needs today, as well as your legacy and the needs of your family and beneficiaries for years – perhaps even decades – into the future. We have deep expertise and experience working with families to help them achieve their life goals, and we have specialized knowledge and experience in areas such as financial, business succession, tax, and will and estate planning.

But beyond those numbers and plans for managing, preserving and growing your wealth is what you do with that wealth – how you enjoy it and deploy it, how it helps you and your loved ones lead a happy and healthy life – that is something we care deeply about, because that's all about your well-being, the ultimate goal of a focused and trusted steward.

Health – both physical and mental – is another critically important component to one's well-being. Wealth means little without it. And while we are not health experts, we want to help ensure that your health – and where and when relevant, the health of your loved ones – is a key consideration when looking at your priorities and goals, and how those in turn drive your wealth plan and advice needs.

Family stewardship

Understanding your values and goals is an important priority for our Investment Counsellors. As a firm, we have evolved over the years to better understand that our focus is really family stewardship, a collaboration with our clients to build the wealth plans that will help them and their loved ones achieve the things that matter, and live a fulfilling and meaningful life. We can help by addressing those values and priorities with you, and then by guiding and coordinating the expertise to help you achieve your goals.

The last few years in particular have been tough, and at times even tragic, for many of our clients. Life is always unpredictable, and is sometimes precarious. As your family stewards, we care deeply about your well-being, and the pandemic has shown that we must continuously evolve to meet the ever-growing complexities of life, health and wealth. Our pledge is to continue that evolution to bring the care, expertise and stewardship that will guide and help you along your life journey – and it is our privilege to play a key part in helping you achieve the ultimate goal: you and your family's well-being.

Our commitment to you during the pandemic

While our offices are gradually reopening based on the direction and guidance of provincial health officials, we continue to provide the investment and wealth management services you need. We welcome you to contact us by phone or email.

Wealth Management
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