Serber Speaking

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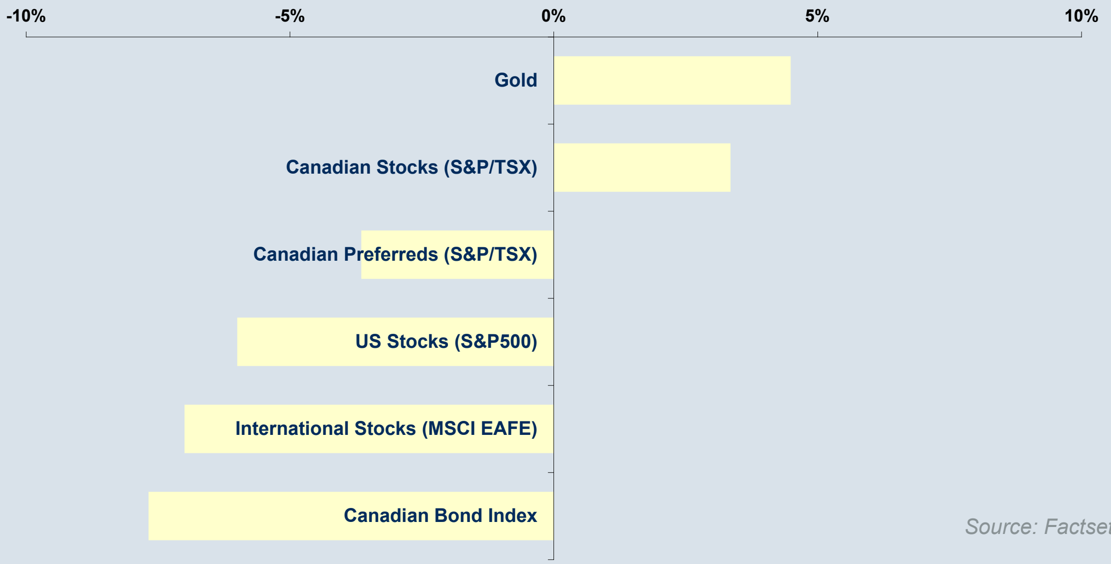
Commentary for the quarter ended March 31, 2022

Invasion, Inflation, Inversion ... Oh my!

The first quarter of 2022 delivered a host of unprecedented dramatic negative shocks to the global economy and financial markets. Chief among these was the Russian invasion of Ukraine on February 24. The long-term economic implications of renewed war on European soil are still uncertain. What is clear in the short term, however, is that a return to the much hoped-for and anticipated normalization of global trade and supply chains, post-COVID-19, has been delayed for an undetermined period. Russia is a major provider of commodities such as oil, natural gas, iron, steel, fertilizer and wheat. The economic war of sanctions is escalating, and supply shocks have rippled through the global economy sending prices for many of these commodities higher by 20-to-50 percent.

In addition to the humanitarian nightmare, the war in Ukraine and its byproducts are, of course, terrible economic news. As can be seen on the chart below, most markets are down so far in 2022. The exceptions are gold, which makes sense as it is a "go-to" safe harbour, and Canadian stocks. Our market has done better than others because of its high exposure to oil and gas companies, which benefit from currently elevated prices.

Performance by Asset Class: January 1 to March 31, 2022 (in Canadian $)



Source: Factset

Higher prices for commodities are also fuelling upward pressure on prices in general, i.e., inflation. Absent the Russian invasion of Ukraine, it was widely believed that last year's bout of inflation would moderate this year. That expectation has also been deferred.

To combat this inflation, which now looks like it's not going away any time soon, central banks have begun to tighten monetary conditions - a fancy way to say they are raising interest rates. On March 16 the US Federal Reserve, by far the most important central bank on the planet, raised its "Fed Funds" reference rate by 0.25 percentage points - the first increase since lowering the rate to near zero in the Spring of 2020 amid the first wave of COVID-19.

The Fed's rather hawkish recent inflation commentary has caused investors to expect a rapid increase in rates this year. So much so that short-term (two-year) rates briefly exceeded long-term (10-year) rates in early April. Historically, it can be seen that when short-term rates move higher than longer-term rates, known as a "yield curve inversion," a recession often occurs thereafter. But not always...

The Neutral Rate of Interest

Prices are a function of supply and demand. When central banks fear that inflation may be accelerating, they increase interest rates to reduce aggregate demand. If central banks had the power to prompt a relatively rapid increase in supply, that would be another (and possibly better) way they could tackle inflation. But they don't. The only power they have to address inflation is by raising interest rates to cause a decrease in demand. This works by making borrowing more expensive, reducing the effective spending capacity of consumers and firms, thereby lowering effective demand.

The trick is to raise rates enough to reduce inflation, but not enough to cause unemployment to rise, or even worse, a recession. This is sometimes referred to as engineering a soft landing.

How do central banks know how much of an interest rate increase is just enough for a soft landing, but not enough to cause a recession? They don't. What they use as a guide is a theoretical framework called the neutral rate of interest. The neutral rate is a hypothetical interest rate that neither tends to speed up nor slow down the economy. If the central bank sets interest rates below this hypothetical neutral rate, the economy will speed up, and vice-versa.

The Fed currently estimates that the US economy's neutral rate is between 2.0 and 2.5 percent. This is an educated guess. Highly educated, mind you, but still a guess. Their setting of interest rates well below this level since the onset of COVID-19 was appropriate to provide economic stimulus. However, it is now time to remove this stimulus. The evidence that rates are below the neutral rate is above-trend GDP growth and rising inflation. As such, the Fed plans to raise rates, to two percent or a bit more, by the end of this year. If they are right about the neutral rate, this should lead to a soft landing -- a slowdown sufficient to stop inflation from rising, but not enough to cause a recession.

But what if they're wrong? If it turns out that the neutral rate is lower than two percent, then raising rates above that level will likely lead to recession. This is possible, but not likely. The highly respected strategists I follow at BCA Research believe the neutral rate is actually higher than the Fed believes - more like three percent or even a bit more. If they are correct, then raising rates to two percent or so will not significantly slow down the economy. This is good news in the short term but bad news in the medium term. Good news in the short term because it means corporate sales and profits will continue to grow, supporting higher stock prices over the next year or so. Bad news in the medium term because it would mean that the Fed may find it needs to initiate a more punitive round of rate increases in 2023-2024 to finally slay the inflation dragon, which may wind up triggering a bear market and recession.

Investment Implications

Using the above scenario as our base case, the appropriate investment strategy would be to maintain "normal" exposure to risk assets such as stocks, preferred shares and corporate bonds over the next 12 months. Sometime after that, it will make sense to reduce risk exposure. Around that time, interest rates will be hitting a cyclical peak (around four percent or so?), and at that point increasing investments in government bonds or GICs will make sense.

Having said that - the most important thing is to have a well-balanced and diversified portfolio that reflects your personal investment comfort zone. Yes, the portfolio can be tweaked based on predictions for the path of interest rates, or the timing of the next recession, which I certainly do -- but these are only tweaks. Each of my clients decides what portion of their total portfolio they are comfortable investing in equities (risk) over the long term, which we define as a minimum-maximum range. This range generally doesn't change much, if at all, over time. What does change is where within that range their portfolio sits at any given time.

From the Planning Notebook - Testamentary Trusts

A testamentary trust is an alternative to a direct or outright distribution of estate assets and is generally created through your Will. It allows you to control the distribution of assets to your beneficiaries over time. Your Will can identify, among other things, the amount of money or property to be held in the trust, the beneficiaries of the trust, the trustees and their powers, the duration of the trust, and when and how distributions are to be made.

Testamentary trusts can provide significant estate planning opportunities. They are not used as tax-planning vehicles in general, but can be considered for reasons other than taxation. Here are some examples:

* A testamentary trust allows you to set aside funds for a disabled child and name a trusted party to take care of their financial needs. If your child would otherwise qualify for provincial disability support, you may be able to leave significant funds in a so-called Henson trust and still allow your beneficiary with a disability to qualify for provincial support. If you would like more information on Henson trusts, ask me for our article on that topic.

* Funds left outright to a minor child cannot be paid directly to the minor child, as they do not have the legal capacity to manage those funds. The solution is to establish a testamentary trust in your Will for the benefit of your minor children. You may specify in your Will what the trust funds are to be used for and when they can be used.

* For an adult child, or other person you wish to benefit, who may not be good at handling money, a testamentary trust may allow you to ensure the beneficiary does not exhaust the trust assets too quickly or irresponsibly.

* A trust can be created for a specific purpose, such as to fund the educational expenses of children or grandchildren.

* If you're married and have children from a previous relationship, a testamentary trust may be a suitable vehicle. For example, you can create a trust that provides for your spouse during their lifetime and, on the spouse's death, distributes the trust assets to your children from a previous marriage or relationship.

* If your family owns a cottage, you may consider establishing a testamentary trust to hold the property, instead of leaving it outright to your children. The concept of holding a cottage or other vacation property in a trust is discussed in our article on succession planning for your Canadian vacation property. If you are interested, ask me for a copy.

A trust company, like RBC Royal Trust, can help by acting as the trustee, co-trustee or as an agent for the named trustee. If you would like to learn more about using Royal Trust as a trustee, let me know.

Until next time, best regards,

David Serber

If you would like to discuss your personal situation please feel free to contact me. Also, feel free to forward this copy of ***Serber Speaking*** to anyone you think would find it of interest.