Serber Speaking

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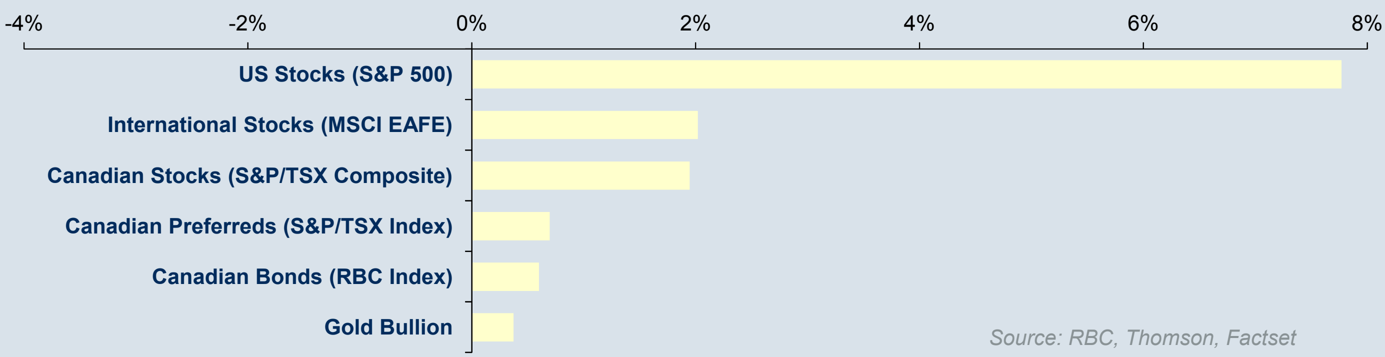
Commentary for the quarter ended June 30, 2018

Much Ado about Nothing

If you follow the financial media, you may be under the impression that 2018 is shaping up to be a year full of turmoil and volatility for financial markets. Trump, trade wars, North Korea, etc., etc. The fact is, at this year's mid-way point, nothing much has actually changed in the markets, one way or the other. Yes, there have been big one-day and one-week moves, up and down, but over the six-month period, there has been little overall movement. Thankfully, what little movement there has been, has been in a positive direction as can be seen on the chart below.

Performance by Asset Class: January 1 to June 30, 2018 (in Canadian $)



The outsized gain for US stocks is mostly due to a fall in the value of the Canadian dollar versus its US counterpart. Five percent of the S&P 500's gain is attributable to currency movement, while the actual US stock market, in US dollars, was up a less-impressive three percent over the six-month period.

Consolidation after a period of strong gains

This largely sideways movement of financial markets is normal after a period of strong gains. After major upward moves in 2013 and 2014, markets went nowhere in 2015. Likewise, after very good years in 2016 and 2017, it is reasonable to expect that markets this year will move mostly sideways. In this environment, there are three important priorities for portfolios:

1) **Collect current income**. Make money, whether markets go up or down.

2) **Be selective**. If there is no tide to lift all boats, you need to understand what you are invested in, what a good buy price is and when to sell.

3) **Buy the dips**. Have cash available so you can buy if securities go on sale. Conversely, sell the rallies.

How the top ETF holdings in my Managed Portfolios have done YTD

Total Return in CAD $

iShares Core S&P 500	8%
Hamilton Capital Global Banks	3%
iShares Core U.S. Aggregate Bond	3%
iShares MSCI EAFE - Small-Cap	2%
Vanguard FTSE Developed Mkts	1%
Horizons Active Preferred	1%
iShares Strategic Fixed Income	-1%
BMO MSCI EAFE Hedged to CAD	-1%
iShares China	-3%

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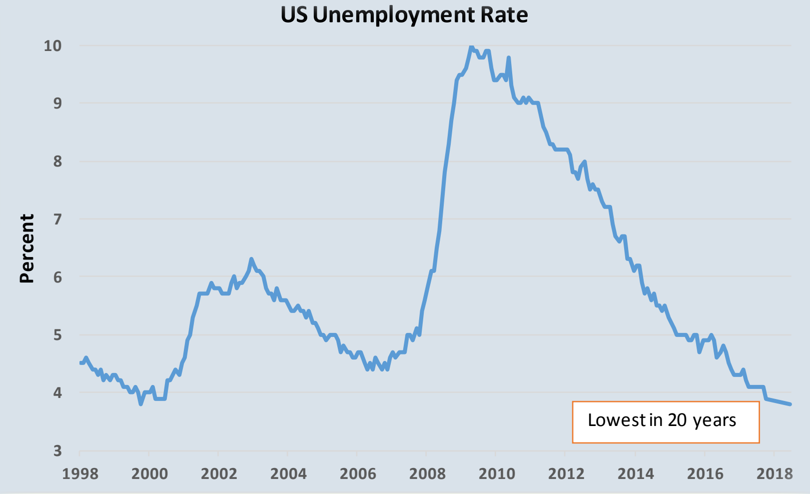
The Economy

Investment markets follow the path of the economy -- not every day, week or month, but over time. The economy is a huge complex system that behaves like a mammoth oil tanker going at 20 knots -- which is to say it has a lot of momentum and takes a very long time to change direction. Right now, the global economy is doing well. Unemployment is falling, incomes are rising and corporate profits are growing. And, because there was quite a bit of spare production capacity available globally over the past decade, all this has been happening without sparking inflation. So far so good.

However, much of that spare capacity has now been put to work, which means any further growth in demand relative to production capacity will be inflationary. Take the labour market, for example: When unemployment was high after the 2008 Great Recession (see chart), there was plenty of surplus labour available. With unemployment in the US now below four percent, there is no longer any spare labour capacity. This means any further increase in demand will spark wage inflation. And we expect increased demand in the US over the coming year, as fiscal stimulus, consisting of tax cuts and new spending, kicks in.



Source: Factset

But low unemployment is good, right? So what's the problem?

The problem is that central banks will take steps to stop inflation from rising too high above their target level of around two percent. As it becomes clear that inflation is moving above two percent and heading toward three, the US Federal Reserve will increasingly hit the brakes on the economy, which is to say, raise interest rates. Higher interest rates have at least four negative impacts on stock prices: 1) increased interest expenses for corporations decrease profits, other factors holding constant; 2) higher interest rates decrease the present value of future profits, lowering stock valuations; 3) higher interest rates discourage borrowing and spending, reducing corporate revenue and 4) higher available rates on bonds and GICs encourage worried investors to move money out of stocks and into safer alternatives.

At some point, the negative influence of higher rates becomes too much to bear, and the economy tilts into recession. Of course, investors are aware of this pattern and attempt to anticipate the turning point in advance. Thus, if a recession is in the cards for 2020, the peak of the current bull market in stocks will likely occur sometime in 2019.

As we know, however, investment markets do not move from A to B in a straight line. Between now and the expected peak next year, we may see a good-sized correction at some point, as investors fret over the impact of higher interest rates. In preparation for this, I have reduced equity exposure over the past several months and increased cash holdings. If and when the correction arrives, I will put some of this cash back to work.

Then, if all goes according to plan, sometime next year I will start moving to a more cautious stance, minimizing equity exposure in favour of recession-proof assets such as government bonds, within the context of your portfolio's Investment Policy and Asset Mix Guidelines.

For the 2020s, after markets bottom in the next recession in say, 2021 or 2022, the investment themes will likely be tied to higher inflation, slow economic growth in the developed economies and rising interest rates. As such, several long-term themes I am preparing for are: underweight bonds (inflation and rising rates are bad for bonds), overweight gold and silver and overweight emerging markets.

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From The Estate Planning Notebook

Multiple Wills

When you pass away, your executor may be required to obtain a grant of probate in order to fully administer your estate. Probate is an administrative procedure to validate a Will and confirm the authority of the executor named in the Will to act on behalf of the estate.

Third parties, such as a bank, may require probate in order to release your assets to your executor or change the legal ownership of property, such as securities or real estate. Probate offers these third parties protection against legal liability. For example, probate protects third parties from claims that assets were distributed to the wrong person. This is the case even if probate was granted in error and is subsequently revoked.

Most provinces charge a tax when your Will is probated. Probate taxes range from a nominal or low flat fee in some provinces to a percentage of the fair market value of the estate assets. In Ontario, probate tax amounts to approximately 1.5 percent of the estate's value.

In an effort to reduce or avoid probate taxes, some estate planners advocate the use of multiple Wills.

A multiple Wills strategy involves segregating your assets so that different assets are subject to different Wills. For example, a "primary" Will might deal with assets that require probate, such as bank accounts, investment portfolios and real estate. A "secondary" Will may hold the remaining assets that do not require probate, such as privately held shares or personal effects, such as antiques, art and jewelry.

Where this strategy is available, your executor has the choice to probate any of your Wills, and probate taxes would apply only to the assets included in the Will being probated. By separating assets that may require probate from those that do not, you may avoid paying probate on those assets that do not require probate.

Multiple Wills may also be structured based upon jurisdiction to take advantage of lower or nominal probate taxes in different jurisdictions, such as Quebec and Alberta. For example, an Ontario resident who wishes to take advantage of the multiple Wills strategy may have an "Ontario" Will to deal with real property located in Ontario and a "Quebec" Will to deal with other property situated in Quebec. As well, multiple Wills may be used to simplify estate administration when assets are held in multiple jurisdictions.

In the right circumstances, multiple Wills can significantly reduce the probate taxes that the estate would otherwise pay. Whether or not multiple Wills should be used depends upon your intentions, the nature of the assets held, where they are held, the value of the assets and the corresponding anticipated savings in probate taxes that follow from the implementation of this strategy. If you are interested in a Will and Estate plan review, just let us know!

The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your individual circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified lawyer and/or accountant, as applicable, before acting on any of the information in this article.

Until next time, best regards,

David Serber

Feel free to forward ***Serber Speaking*** to anyone you think would find it of interest.