Serber Speaking

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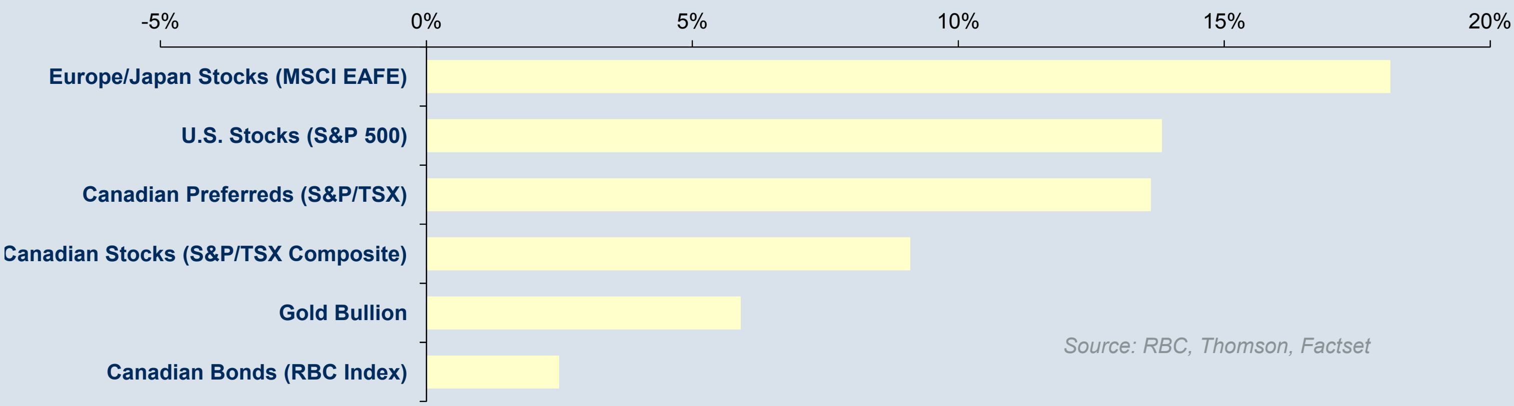
Commentary for the quarter ended Dec. 31, 2017

Many Happy Returns

The final numbers are in, and it is clear that 2017 was a good year, indeed, for investors. Equity markets were on a tear. As seen on the chart below, the U.S. stock market and global developed markets chalked up mid-to-high teens' percentage growth, while the S&P/TSX came in with a solid, albeit relatively weaker, return of about nine percent. Our typical client's managed portfolio invests about one-third of its equity allocation in Canada and two-thirds globally, so the higher performance of foreign markets was a nice added plus.

Performance by Asset Class: Jan. 1 to Dec. 31, 2017 (in Canadian $)



In fixed income, Canadian bonds produced very little return, around 2.5 percent, which is what one would expect, given the low overall level of interest rates. Canadian preferred shares, on the other hand, boasted a robust 14.5 percent return for the year. Our clients' portfolios are overweight in preferreds within the fixed-income section of their portfolios, also providing a nice tailwind for 2017. Gold tacked on a gain of about six percent, which also helped.

Market Conditions -- Perfect, for now...

The global economy and investment markets have been on a positive trajectory since early 2016, with global stock markets (MSCI All Country Index, in CAD$) gaining roughly 33 percent over that period. The key positive contributors have been: 1) easy monetary conditions (i.e., low interest rates); 2) low inflation and 3) solid business-profit growth.

So far, so good. The problem is that too much of a good thing eventually turns into a bad thing. Strong economic conditions mean that many economies are starting to grow faster than their long-term "potential" growth rates. Potential growth rate is a concept economists spend a lot of time thinking about. They attempt to gauge how fast an economy can grow, based on its capital base, demographics, etc., without causing inflation. The chart on the next page shows the average difference between actual GDP

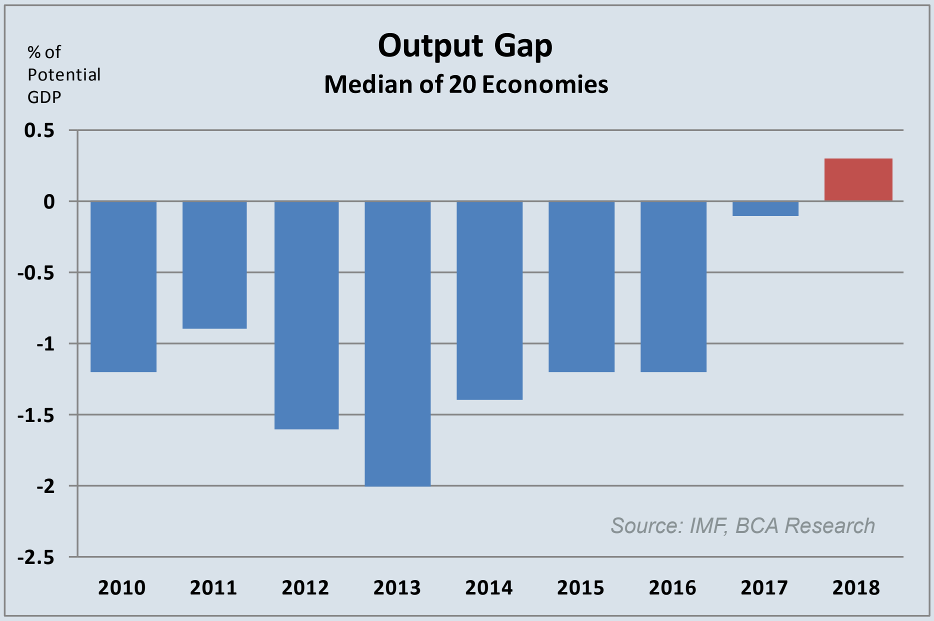
How the top ETF holdings in my Managed Portfolios did in 2017

Total Return in CAD $

iShares China	27%
iShares MSCI EAFE - Small-Cap	24%
Vanguard FTSE Developed Mkts	18%
BMO MSCI EAFE Hedged to CAD	16%
Horizons Active Preferred	16%
iShares Core S&P 500	14%
Hamilton Capital Global Banks	11%
iShares Strategic Fixed Income	4%
iShares Core U.S. Aggregate Bond	-3%

growth and potential GDP growth, known as the output gap, for 20 leading global economies. When the output gap is negative, economies are performing below potential and inflationary pressure will be muted. If economies grow faster than potential growth, economic theory says that, over time, inflation will ensue, as demand will outstrip the economy's potential to supply. Higher demand relative to supply means higher prices, leading to inflation.

Note that in 2017 the output gap almost disappeared and is expected to go positive in 2018. We can see evidence of this trend in labour markets. The U.S. unemployment rate is now 4.1 percent and will almost certainly drop below the four-percent level in the coming year. Canada's unemployment rate dropped to 5.7 percent in December, a four-decade low, as the economy added 422,500 jobs in Q4 -- the fastest clip since 2002. While low unemployment is a positive, if it gets too low, below what economists call the NAIRU (non-accelerating inflation rate of unemployment), wage inflation becomes more likely.



The price of oil is another example of higher demand relative to supply. Two years ago, global growth, and hence demand for oil, was weak, and oil prices dropped to the US$30 range. Recently, demand growth has picked up relative to supply, and the oil price is now above US$60 per barrel for the first time since 2014.

If, as expected, demand grows faster than supply in other market segments, we will likely see signs of inflation later this year. This will encourage the U.S. Federal Reserve, and potentially other central bankers, to continue tightening monetary conditions, primarily by raising interest rates. If so, and depending how far they are willing to go to slow down an "overheating" economy, the central bankers are liable to change the economy's trajectory from up to down, whether intentionally or inadvertently.

A slowing economy leads to slower income growth, reduced spending and lower business investment. A downward feedback loop ensues, which typically ends in some kind of recession. If the economy gets dramatically worse, governments seek to avoid a too-severe recession through hyper-stimulative policies, and the cycle begins again.

What to do?

If the above base-case scenario plays out, 2018 should be a good year for the global economy (barring any shocks), with interest rates still low-ish, inflation still low-ish and solid corporate profitability. However, by sometime in 2019 the economy may start to gasp under the increased pressure of higher interest rates and tilt into recession. Stock markets typically peak and roll over three to 12 months prior to the onset of recession. If so, we should expect them to peak sometime later this year. At that point, by definition, interest rates on government bonds will be higher than they are now. For example, Canadian 10-year bonds closed out 2017 yielding about two percent. This figure should look more like three percent by the end of 2018.

My plan is to keep a vigilant eye on these developments throughout the year and, at the appropriate time, reduce exposure to equities in favour of government bonds, which should, as noted above, yield something like three percent. While three percent doesn't sound like much, it will look awfully good if stock markets suffer any kind of significant drop.

Separately, gold may play an important role for performance over the next five or 10 years. If inflation picks up and were to become an issue, I could see the value of gold climbing nicely in the 2020s. It is a bit early to get too excited about this idea, but it's on my radar. Stay tuned!

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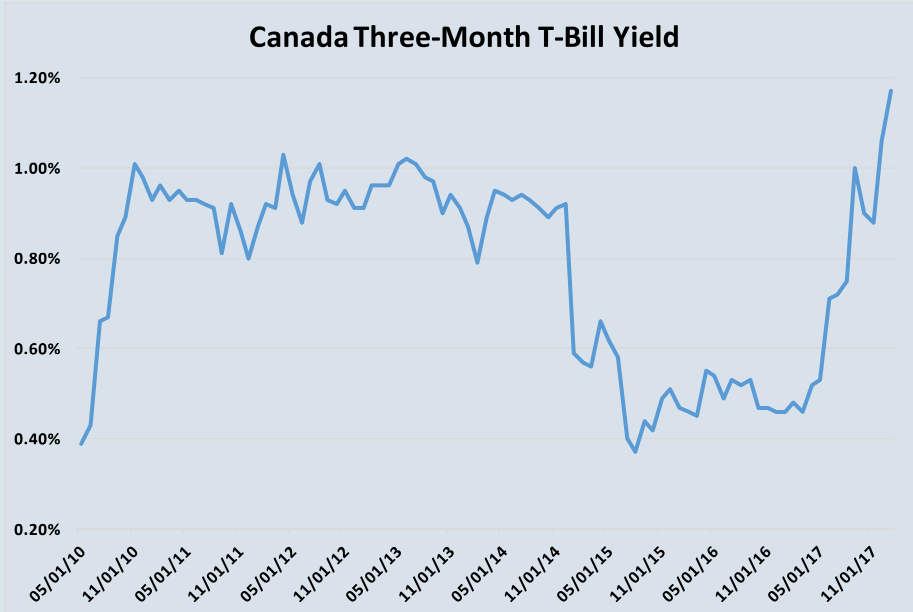
The Wealth Management Notebook

URGENT -- Now is the time to act if you are in a position to split investment income



Investment theory says that the only way to increase your investment rate of return is to increase your portfolio's exposure to risk. While this idea contains much truth, there is an important exception. There is one sure way to increase your portfolio's rate of return that does not increase portfolio risk—organizing your affairs to reduce taxes payable on investment income.

One of the key principles of tax planning is to split income among family members, where possible, so that each family member earns some income at the low tax rates payable on the first $40,000 or so of annual income.

For example, let's say Ralph has a $1 million investment portfolio generating $50,000 per year of taxable income. Since Ralph also has other sources of income, he pays tax at the top marginal rate on the investment income of 53.5%, or $26,750. To reduce taxes, using a strategy allowed by the CRA, Ralph loans his $1 million to his wife Sue who has little or no income. Sue pays Ralph interest at the lowest rate permitted by the CRA, called the Prescribed Rate, which is currently one percent.

At the end of the year, Sue pays Ralph $10,000 interest, on which he pays $5,350 tax, and she reports $40,000 in income, on which she pays about $5,000. Going forward, Ralph and Sue will save about $16,000 in taxes annually. In the end, this investment income splitting idea has the effect of meaningfully boosting their after-tax rate of return, without adding any portfolio risk.

Unfortunately this happy math is all about to change. The Prescribed Rate is based on the yield on Canada three-month T-Bills. As can be seen on the chart above, this rate has recently moved up strongly and is now well above one percent. Given how the Prescribed Rate is determined, it is now almost certain that it will be raised to two percent starting on April 1. However, the key thing is this: once the loan is advanced at the current prescribed rate, that rate stays the same for the life on the loan. So, for families that may be able to use this strategy, locking in a spousal income-splitting loan now at one percent is both urgent and important.

Until next time, best regards,

David Serber

My team and I are experienced Prescribed Rate Loan strategy experts. We can get accounts up and running and documented usually within a few days. Please call or email right away if you think this strategy might make sense for you or someone you know.

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