Serber Speaking

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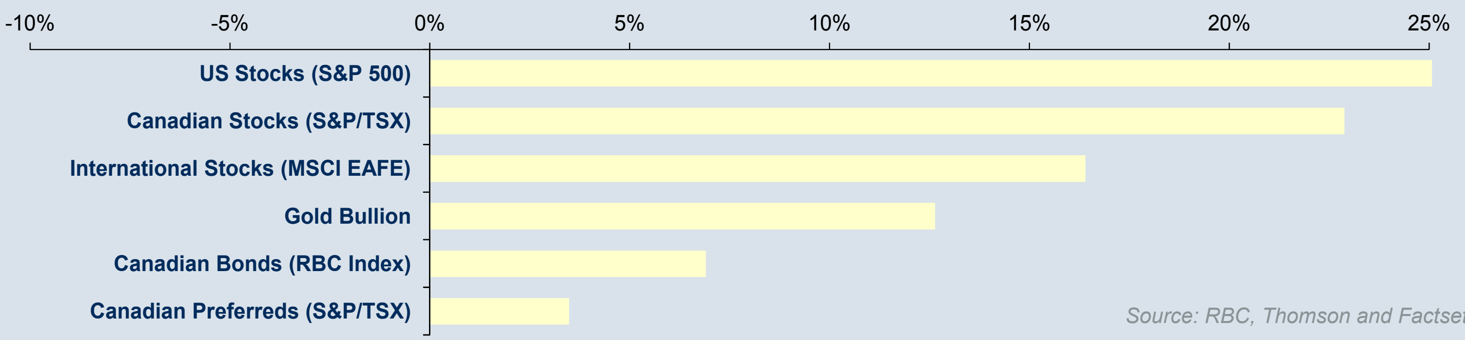
Commentary for the quarter ended December 31, 2019

Recovery and Expansion on Track

In stark contrast to the end of 2018, when global markets were in meltdown mode, the final months of 2019 were positive for investment markets. Global equities rallied six percent in the fourth quarter (MSCI World Index, in CAD$), capping a stellar year overall. As seen on the chart below, the US market was the top performer with a 25-percent gain for the year, followed closely by Canada's TSX index at 23 percent. International equity markets, gold and bonds all pitched in decent results as well. Preferred shares, which were underwater for most of the year, eked out a positive return of about 3.5 percent for 2019 after bouncing up eight percent since their lows at the end of August.

Performance by Asset Class: January 1 to December 31, 2019 (in Canadian $)



The question on investors' minds now is whether the good times will continue through 2020, or are markets now overvalued and setting up for a fall? While nobody has a crystal ball, it appears to me that the former is more likely than the latter. Here are my reasons for relative optimism:

1) Global growth should accelerate in 2020 in response to monetary stimulus. The last move on interest rates, by 18 of the world's top central banks, was a rate cut. This level of monetary easing is typically followed by a rebound in economic activity, in particular manufacturing, with a six-to-12-month lag.

2) Easing of US-China Trade War. With the announcement of a Phase One deal between the US and China, which President Trump is to sign on January 15, the trade war jitters that haunted markets in 2019 will likely fade into the background. While many of the issues remain unresolved, and tensions will inevitably flare up again, it would appear to be in both China's and the US administration's interests to maintain a trade truce for the time being.

3) Europe will make a positive contribution. Europe was a drag on growth in 2019, with particular weakness in Germany and Italy. As an export-based economy, Germany should benefit from general global GDP growth in 2020, while Italy should enjoy a tailwind from lower interest rates, as the Italian 10-year bond yield has dropped from 3.7% to 1.2% over the past 15 months. The reduction in Brexit uncertainty should remove some of the doubt that has plagued business confidence for several years. Also, European establishment governments will be more likely to approve debt-financed fiscal stimulus going forward as a way to forestall populism, providing further tailwind to growth. Finally, European stocks are better value than other markets, such as in the US, and may be surprise leaders for gains in 2020.

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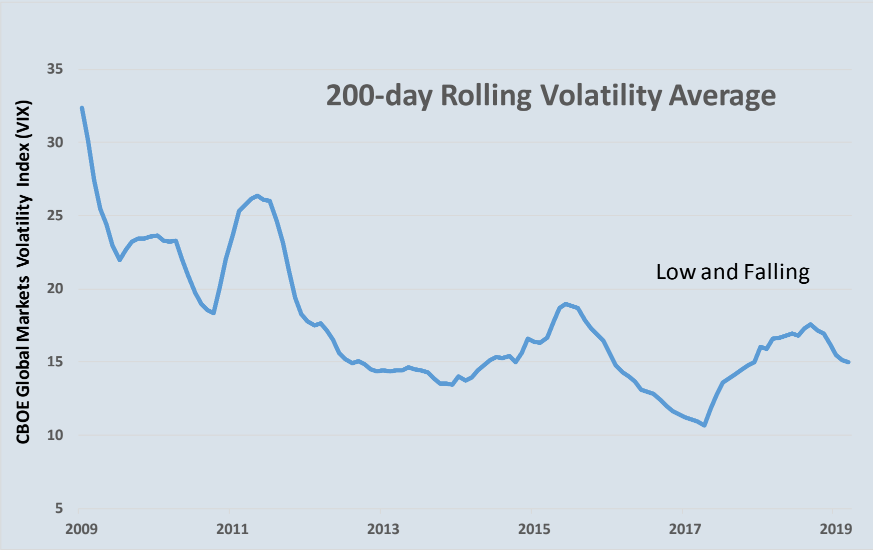
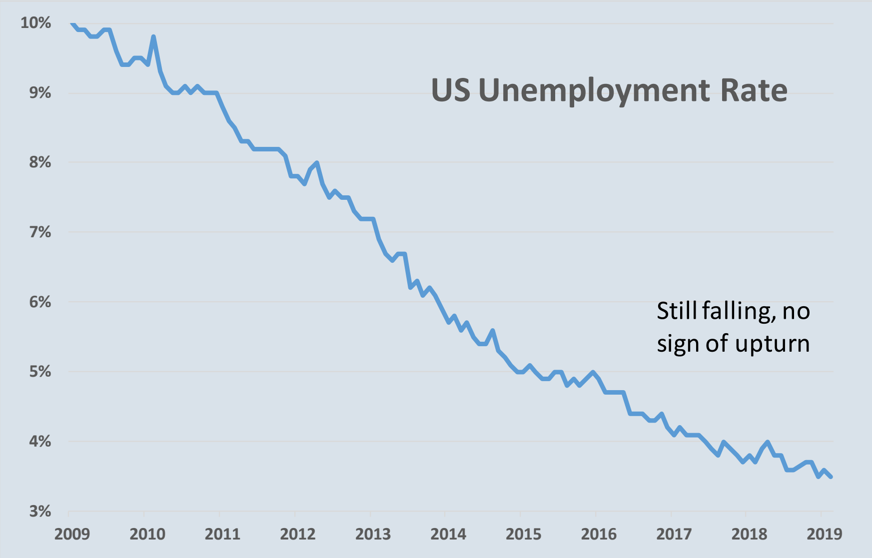
That said, here are some things I worry about...

1. US Stocks are overvalued. The S&P 500 Index of US stocks has generated returns of 370 percent over the past 10 years, versus about 180 percent for the rest of the world's developed markets over the same period. As a result, US stocks are somewhat overvalued. To wit, S&P 500 stocks on average are trading at 2.3 times their sales revenues -- an historic record, higher than the previous dot-com bubble peak in 2000. This does not mean that US stocks will fall in 2020. But it does mean that one should probably be tilting away from the US markets and toward more undervalued markets such as in Europe. High valuation in the US also increases downside risk in the event of an unexpected shock, as there is less margin of safety from a value perspective. As a result, I will be shifting some US exposure to Europe this quarter.

2. Projected returns for the next 10 years are low. Given the above high valuations for US stocks, and low interest rates on bonds, returns for a balanced portfolio from the current starting point are not looking great. BCA Research projects that a global balanced portfolio with a 40-percent weight in US stocks would hypothetically generate about 4.4 percent per year over the coming decade. Adjusting their models for the asset allocation of our typical client, I project something closer to 4.9 percent. Not bad, I suppose, but nothing to write home about. Potential returns will look much better starting at the bottom of the next bear market -- see Point Three below.

3. When will the next bear market begin? Anyone who has been investing for more than a decade or two knows that bear markets are no fun. If we knew when the next one was coming, we would of course sell everything and hold our money in cash and government bonds while waiting for the dust to settle. Unfortunately, nobody knows for sure because the future is unpredictable. That said, there are a few things worth keeping an eye on: Bear markets usually begin when the economy is going well -- too well, in fact. Central banks start raising interest rates to prevent inflation. Then, because of these increases, which slow economic growth, the unemployment rate stops heading down and begins going up. Also, stock market volatility moves higher in a sustained way. None of these three indicators are currently flashing red (see charts), so it would seem that the coast is clear for now. That said, anything can happen. The best advice is to hold only as much in risk assets (such as stocks) as you are prepared to ride through the next bear market with.





Source: Factset

4. US Election. If Trump's approval rating falls as 2020 progresses, or if economic leading indicators slip, his re-election chances could drop significantly. If things start moving in this direction, markets might sell off, as investors start worrying about a "socialist" president like Bernie Sanders or Elizabeth Warren. In addition, if the risk of losing the election increases beyond a certain point, Trump may launch more foreign adventures, for example against Iran, in a bid to focus voters' attention on his America First platform and to benefit from the "rally to the flag" effect. This is of course fanciful conjecture, but I am watching this political situation closely, and will keep you posted.

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From the Planning Notebook

Recent changes to tax rates

To help individuals cover their basic needs, the federal government offers non-refundable tax credits that reduce a person's tax liability. One such credit is the basic personal tax credit. This credit, which increases annually with inflation, is calculated by multiplying the Basic Personal Amount (BPA) by 15 percent. In 2020, the BPA will be $12,298, which will result in a tax credit of $1,845.

On Dec. 9, 2019, Finance Minister Bill Morneau tabled a motion in the House of Commons that proposes to increase the BPA to $15,000, phased in over four years, starting in 2020. The Liberal minority government will need support from another party in order to get the proposal enacted. If fully implemented, single individuals could save close to a further $300 in taxes every year, and families could save close to $600.

The bad news is that the government plans to phase out the benefits of the increased BPA for higher income earners. The benefit will be clawed back starting for those with a net income above $150,000, and the benefit will be zero for those with incomes above $214,000 (the top federal tax bracket. That said, for households with both high- and low-income earners, this tax cut increases the incentive to look at implementing income-splitting strategies. **I am experienced with these strategies, so feel free to call or email me with any questions.**

Raising tax rates on capital gains -- Will they or won't they?

As mentioned above, the Trudeau minority government is reliant on support from others in order to implement its election platform. The support may come from the New Democratic Party (NDP), whose ideology, particularly its social agenda, is similar to the Liberals. In their election platform, the NDP proposed to increase the capital gains inclusion rate to 75 percent from the current 50 percent. This has Canadians speculating, again, if a hike to the capital gains inclusion rate may occur in the coming federal budget, expected some time in the spring.

If you would like to plan for a potential increase in the inclusion rate, you may wish to consider certain strategies along with your qualified tax advisor. For a short article detailing some of these strategies, please call or email and we will be happy to send it to you.

As always, please consult tax and legal experts before implementing any tax strategies.

Until next time, best regards,

David Serber

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