Serber Speaking

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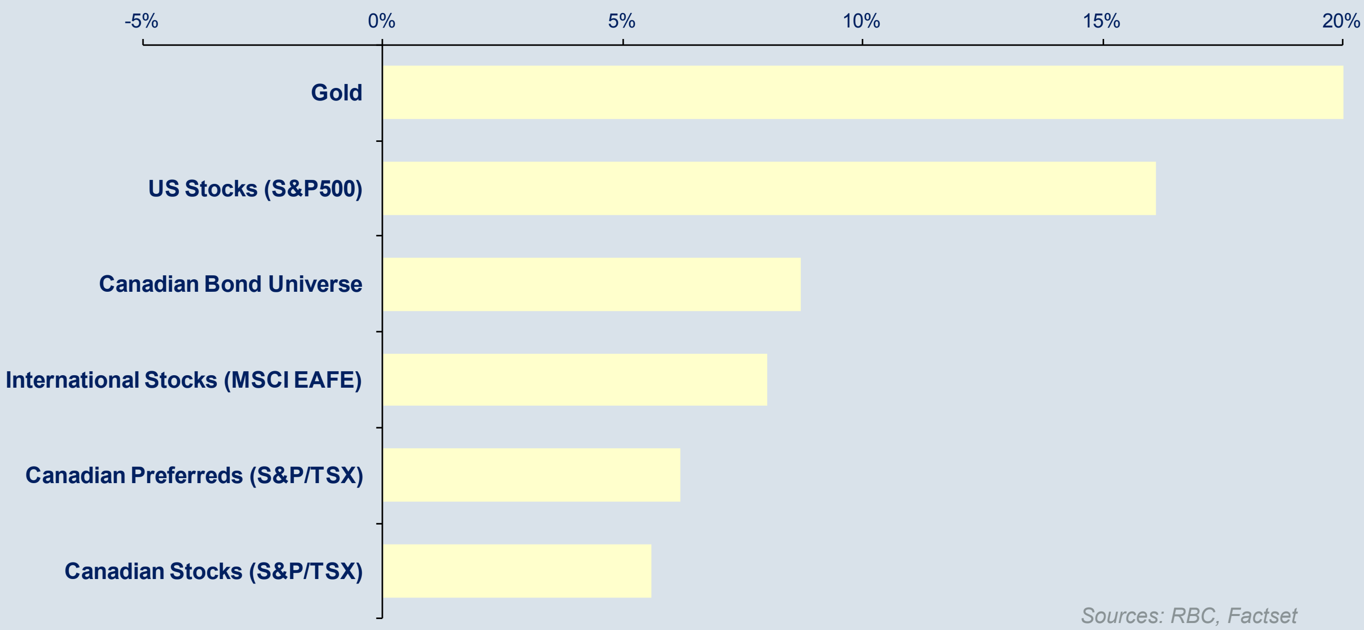
Commentary for the quarter ended December 31, 2020

Annus Horribilis, Annus Mirabilis

For most of us, 2020 will be remembered as perhaps the most unusual year of our lives.

Yet, despite the damage to lives and to businesses caused in the wake of COVID-19, a look at the chart below shows that all the asset classes we follow posted positive investment returns for the year. Most people I talk to are somewhat mystified by this state of affairs, and rightly so. It is very difficult to see how it makes any sense.

Performance by Asset Class: January 1 to December 31, 2020 (in Canadian $)



So let's break it down. It is perhaps easiest to understand why gold did well. After all, in a time of crisis that has seen massive money printing by central banks, gold seems like a tempting option to preserve capital and to provide protection from possible inflation. Positive returns for bonds also makes sense -- when the authorities respond to a recession or financial crisis by lowering interest rates, bond prices generally go up.

What is more difficult to understand is why stocks fared as well as they did. I will list a few of the possible factors at play:

1. Main street bias. It is easy for the average person to see how local stores and restaurants are struggling under COVID-19 restrictions. It is much harder to grasp that many companies are in fact thriving. An obvious example is Amazon. Its revenue of US$380 billion in 2020 was up about 10 percent over 2019 and is expected to climb to US$600 billion by 2023. I am not addressing here whether this is a good or bad thing - rather I am pointing out that all the local stores and restaurants that are suffering, and even going out of business, are not represented in the stock market. Amazon is.

2. Lower interest rates make a big difference. I have written previously how the value of a stock can be seen as the present value of projected future profits (see June 30, 2020 issue). The present-value formula includes an interest-rate assumption, and lowering this assumption increases the present value of the future profit stream. So, other factors holding constant, if interest rates fall, investors are willing to pay a higher price for a stock and still expect a decent return compared to fixed-income investments like bonds or GICs.

Low interest rates also benefit stock prices by increasing demand. When investors see their savings in bank accounts or GICs are earning less than one percent, they are tempted to take on more risk in search of better returns. Would I rather make less than one percent on a bank GIC or a five-percent dividend on a bank stock? Many have moved, or will consider moving, some of their money out of GICs and into stocks. This overall increase in demand tends to push stock prices higher.

3. Fiscal spending makes a big difference. In response to the economic crisis caused by the pandemic, governments around the world embarked on a massive spending binge, more than US$10 trillion so far -- more than three times the amount spent in response to the Global Financial Crisis of 2008/09 (Source: www.mckinsey.com). Much of this spending has been in the form of direct support to individuals and businesses to replace lost income. As a result, the demand side of the economy has not collapsed and incomes overall remain healthy. Indeed, in the US, personal income is materially higher now than it was before COVID-19 (Source: www.bea.gov).

So, as long as the government hands out free money, everything will be OK - but how long can the government hand out free money? To understand this question, we need to consider Modern Monetary Theory (MMT), an approach that has become increasingly popular in economic circles. According to MMT, governments can spend as much money as they want, and use the printing press to finance that spending, so long as the economy does not exhibit inflation. If there is unused productive capacity, in the form of high unemployment and/or idle factories, MMT claims that government spending simply puts this idle capacity to work, growing the economy without causing inflation. However, if and when the economy reaches full capacity, the fiscal spending has to be scaled back. Otherwise, the result will be inflation.

Whether this theory is correct, and the policies it recommends are viable or not, what is important for investors is that more and more economic decision-makers are warming to its logic. This makes it easier for politicians to propose and approve large government spending plans, and that is exactly what they are doing. Since politicians are rewarded for positive economic growth and punished for economic decline, it is fair to predict that the fiscal spending spree will continue until it is forced to stop.

By its own logic, inflation is what will stop an MMT-induced spending binge. This is not unlike what happened in the 1960s. Excess post-war production capacity in the 50s and 60s allowed government spending to grow rapidly without causing inflation. Indeed, from 1960 to 1965, inflation was less than two percent - just like it is today. However, it then began to climb sharply, and by 1970 was more than six percent. Inflation was a major economic issue of the 1970s and was solved only by aggressive changes in economic policies starting in 1980.

Is inflation an immediate threat? Probably not, since capacity utilization is still low. However, it is reasonable to forecast that inflation will start to become a problem within the next three to five years, and investors need to plan ahead. One idea is to hold some gold in portfolios as an inflation hedge. In the 1970s, stocks, bonds and cash all generated about six-percent annual returns, which sounds nice, except inflation averaged about seven percent, which means that real returns for the decade were actually negative. Gold and silver returns, on the other hand, averaged 25-to-30 percent annually over the decade. Other tangible assets, such as real estate, also did well.

4. New vaccines are a game changer. The concerted global effort to develop vaccines for COVD-19 has resulted in approvals for two vaccines which are based on a new biotechnology called mRNA. This approach allows faster vaccine development and easier production than with traditional vaccines. There are studies underway to use this mRNA technology to treat or prevent other infectious diseases and even certain cancers. It is possible that one long-term COVID-19 legacy is that it provided the impetus to develop mRNA vaccines that, over time, save many millions of lives from a wide array of diseases. Let's hope so.

Looking ahead to 2021, the combination of vaccine rollouts plus continued monetary and fiscal largesse from governments will keep the economy well supported. This means company profits should remain solid and that stock returns will beat those on cash, bonds or GICs. At the margin, I would take the bank stock with the five-percent dividend over the GIC at one percent.

Important Financial Information for 2021

- Interest payments for prescribed-rate loans made to family members for income-splitting purposes must be paid on or before January 30.

- Deadline for 2020 RRSP contributions is March 1, 2021. Allowed contribution is 18 percent of earned income to a maximum of $27,230. Maximum for 2021 is $27,830.

- Tax-free savings account (TFSA) contribution amount for 2020 is $6,000. The cumulative contribution allowed, for someone who does not yet have a TFSA, is $75,500.

- Maximum CPP amounts for payments beginning at age:

  60 = $770.40/month,

  65 = $1,203.75/month,

  70 = $1,709.33/month.

2021 Tax Rates (Ontario, simplified)

First $45,000	20%
$45,000 - $49,000	24%
$49,000 - $79,500	30%
$79,500 - $90,000	31%
$90,000 - $93,500	34%
$93,500 - $98,000	38%
$98,000 - $150,000	43%
$152,000 - $216,500	48%
More than $220,000	54%

- Old Age Security (OAS) benefit for 2021 is $615.37/month. Clawback of OAS begins at income level of $79,845 and is fully clawed back if income exceeds $129,079.

- Useful phone numbers: CRA General Inquiries: 800-959-8281; CPP and OAS: 800-277-9914.

- Many COVID-19-related benefits paid out in 2020 are taxable but did not have tax withheld at source by the government. If you have received government benefits related to COVID-19, you may have taxes to pay this spring, so be prepared!

If you would like to discuss any wealth management topics in more detail, I am happy to oblige and can be reached at david.serber@rbc.com. In any event, please ensure you consult tax and legal experts before implementing any tax or estate strategies.

Until next time, best regards,

David Serber

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