Serber Speaking

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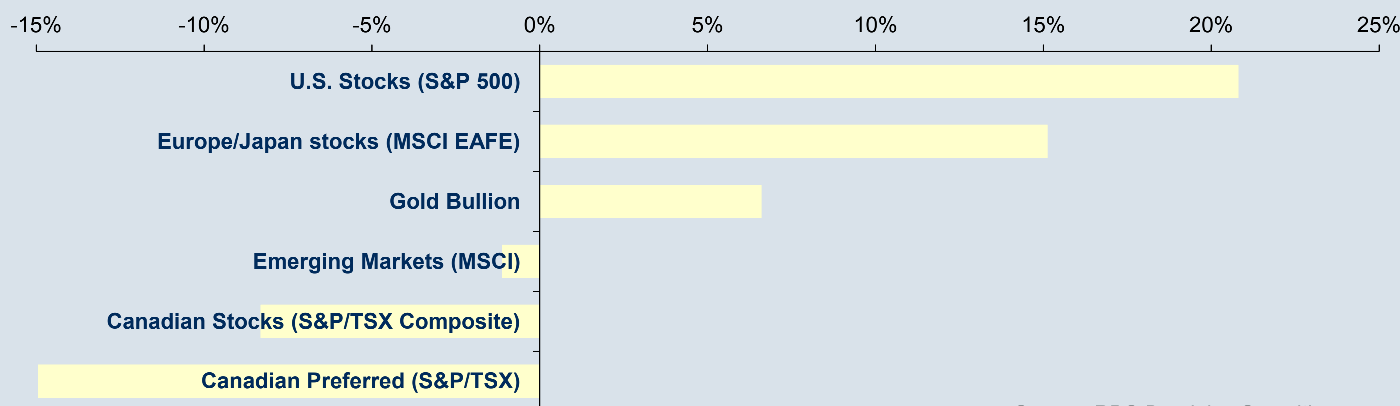
Commentary for the quarter ending December 31, 2015

A Tale of Two Currencies

Investment results for 2015 were largely determined by how much of your portfolio was invested outside Canada. The simple answer was “the more, the better.” The Canadian dollar fell against most major currencies, with the U.S. dollar gaining some 19 percent against the loonie. To wit, the top categories for 2015, as seen on the asset class chart below, were U.S. and foreign stocks, thanks to the strong tailwind from currency appreciation. Those who favoured the Canadian market not only missed the currency play, but also faced an eight-percent drop in the S&P/TSX Composite’s total return index and a 15-percent average loss in the preferred share market. Precious metals were a bit of a bright spot, as gold gained six percent—again, thanks to the Canadian dollar’s plunge. Our average client’s Managed Account holds about one-third of the equity portion in Canadian stocks and two-thirds in U.S. and foreign markets. This degree of global diversification worked in our favour last year.

Performance by Asset Class: January 1 to December 31, 2015 (in Canadian $)



Source: RBC Dominion Securities

So, what’s the problem with Canada? In a word, oil. From 2011 to 2014, the price of oil averaged around US$100 per barrel. During this boom period, a significant portion of Canada’s GDP growth came from investment in the oil patch and from income generated by oil exports. Oil is now trading around US$34 per barrel, and the energy sector has turned negative. In the first half of 2015, Canada had negative GDP growth—technically, a recession. In an open economy like Canada’s, a trade shock such as this is offset by a drop in currency value.

On a positive note, the lower loonie makes other export industries, such as manufacturing, more competitive globally. Growth in these sectors can counteract the loss in the energy sector. The problem is that the drop in the energy sector is rather immediate, whereas the recovery in other sectors takes time. This means there are two keys to a Canadian economic recovery, markets and currency—an upward move in the oil price or, failing that, the passage of time to allow the cheapened currency to have its desired effect.

The oil price itself is driven by forces of global supply and demand. Back in the 2000s, when fear of “peak oil” was prominent, some economists predicted it would soon surpass US$200 per barrel. I argued at the time in my book, *Inflation, China and Oil,* that high oil prices would provide economic incentive to develop new technology in the energy sector to satisfy demand. This turned out to be accurate, and the subsequent U.S. “fracking revolution” has caused an increase in global oil supplies.

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At the same time, the largest driver for oil-demand growth, China, has seen its economy stall. Since supply capacity is not going to disappear any time soon, the main way for oil prices to rise would be acceleration in demand. I expect this will happen over the next year or so, assuming China gets its economy back on track. Also, a lower cost for energy will stimulate increased oil demand (people will buy gas guzzlers, drive more miles, turn up the thermostat, etc.). On balance, it appears oil is stuck in the US$30-US$50 range for 2016 and around US$40 to US$60 in 2017—a bit higher than it is now, but not enough to avoid some further pain in the Canadian economy and, perhaps, an even slightly lower dollar in the year ahead.

Elsewhere on the planet

The global economy is in a long-term transition or "pause" period. For most of the post-Second World War era, whenever the economy slowed down, policymakers would revive growth by lowering interest rates. That prompted consumers and businesses to resume borrowing, spending and investment. After each such episode, the total amount of debt grew higher, like rising peaks in a mountain range. BCA Research dubbed this trend the "Debt Supercycle" and has long pointed out that it could not go on indefinitely. At some point, the amount of debt reaches a maximum, though it is not known in advance where that maximum is. This point was definitely reached with the Financial Crisis of 2008, which marked the end of the debt supercycle.

Consumers and businesses, in aggregate, are no longer interested in increasing their debt level to finance spending and investment. Interest rates are close to zero in most developed economies and, yet, growth in borrowing is tepid at best. When you borrow to buy a car or a house or anything else, you are spending not only your current savings, but also your future income: you are bringing your future spending power forward, into the present. If society does this as a whole, it is great for a while as GDP grows faster than it otherwise would. The problem occurs once everyone has mostly used up their future spending power. Then, there is no way to stimulate demand by bringing future spending into the present. In fact, the opposite is probably more accurate—people start spending less than their current incomes as they look to save more and/or reduce debt.

This means the developed world is in slow-growth mode. Slow growth isn't a disaster in and of itself, but it creates some issues. One is that asset returns will be relatively low going forward. A reasonable expectation over the next five or 10 years for a balanced portfolio is about four-to-five percent per year.

Another issue is a higher risk of recession. If the economy is cruising at four percent growth and you have a three percent slowdown, you are still at plus one percent. If, however, economic growth is coasting along at closer to two percent, as it is these days, and you have a three percent slowdown, you are in a recession.

Emerging markets are not in a position to make much of an immediate contribution. Many so-called developing economies squandered the good years of high oil prices and have little to show for it (Russia, Middle East, Brazil, etc.). Currently, I have little exposure to emerging market stocks or bonds, except for a position in large-cap Chinese stocks (ETF symbol: FXI), which I expect will stage a strong recovery at some point.

Since consumers and businesses are no longer willing or able to borrow and spend, it will likely fall on governments to do so. This idea runs counter to the current trend in most developed countries, which favours austerity and the idea of balanced budgets. However, going forward, politicians will figure out that a promise to spend money on infrastructure to create jobs will be a winning strategy. With a platform that promised a ramp-up in infrastructure spending, the landslide victory of the Liberals in Canada is a sign of things to come.

What is the investment plan?

There are elevated risks right now, especially for economies like Canada's, battling against the trade shock from a falling oil price. On the other hand, the S&P/TSX Composite Index is down 20 percent from its recent peak in April 2015, so the negative outlook may already be discounted. Indeed, buying opportunities arise when the mood is negative, and I plan to start buying Canadian stocks on any further material weakness. In fixed income, I continue to add to preferreds at current depressed prices, offering attractive yields in the 5.5-percent range, compared to bonds and GICs, which are in the 2.5-percent range.

I wrote last January that, "Portfolio returns in the four-percent to five-percent range for the year ahead seems like a reasonable expectation." In the end, this forecast proved optimistic. A generic Canadian Balanced portfolio generated gains in the zero-to-one-percent range in 2015. I will reiterate my 2015 estimate and call for returns in the four-percent to five-percent range for 2016, although I have to admit the scenarios I can envision vary widely, from negative returns on the one hand to gains of 10 percent or more, depending on how the world unfolds.

Advanced Wealth Management & Estate Planning

Mention that you sell life insurance and whoever you're talking to will nod their head and simultaneously look around the room to see if there's an unobstructed path to the nearest exit.

This is unfortunate, since life insurance in general, and permanent life insurance in particular, can be an extremely useful investment tool and a very tax-efficient component of effective estate-planning.

Permanent Insurance

Generic Example of "Joint-last" Insurance

Husband's age	59
Wife's age	58
Death Benefit	$1,000,000
Total Premiums paid in	$ 344,000
Investment gain	$ 656,000
Tax on investment gain	$ 0

Term for Risk Management, Permanent for long-term growth

On its most basic level, life insurance is a risk management tool just like home or auto insurance. You pay an annual premium, which is an expense, to protect you and/or your family in case something bad happens. The cheapest way to buy risk protection against untimely demise is term life insurance, which usually runs for 10 or 20 years. Most people buy term life when they have young families. They pay the premiums and, in return, they have peace of mind, knowing their families are protected. The vast majority of term policies never pay out the death benefit, because holders of these policies by and large outlive the term of the contract.

There is a major difference, however, between life insurance and other forms of insurance. Whereas we cannot know when or if a particular house may burn down, we know with 100 percent certainty that everyone will die. This leads us to the other, more sophisticated product—permanent life insurance. As the name implies, permanent life insurance does not expire. So long as the premiums are paid, we know with certainty that the death benefit will become payable at some point in the future. In this way, permanent insurance is similar to a bond or a GIC—we know exactly the amount that will be paid on the maturity date. But, whereas a bond or GIC has a specific maturity date, a permanent life policy has an uncertain maturity date, being the date of death of the insured.

The extra and all-important twist is this: the federal government long ago decided that the proceeds of a life insurance policy are received by the beneficiary tax free. This allows for long-term, tax-free compounding, which for most people is the best way to create long-term inter-generational wealth. See the table above for an example of how a tax-free gain of $656,000 would be generated in a typical policy.

Tax Planning Tip: Maximize the use of tax-sheltered investment vehicles whenever possible. For the benefit of your family, children or grandchildren, explore permanent life insurance. Call me to discuss.

Until next time, best regards,

David Serber

RBC Wealth Management
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