Serber Speaking

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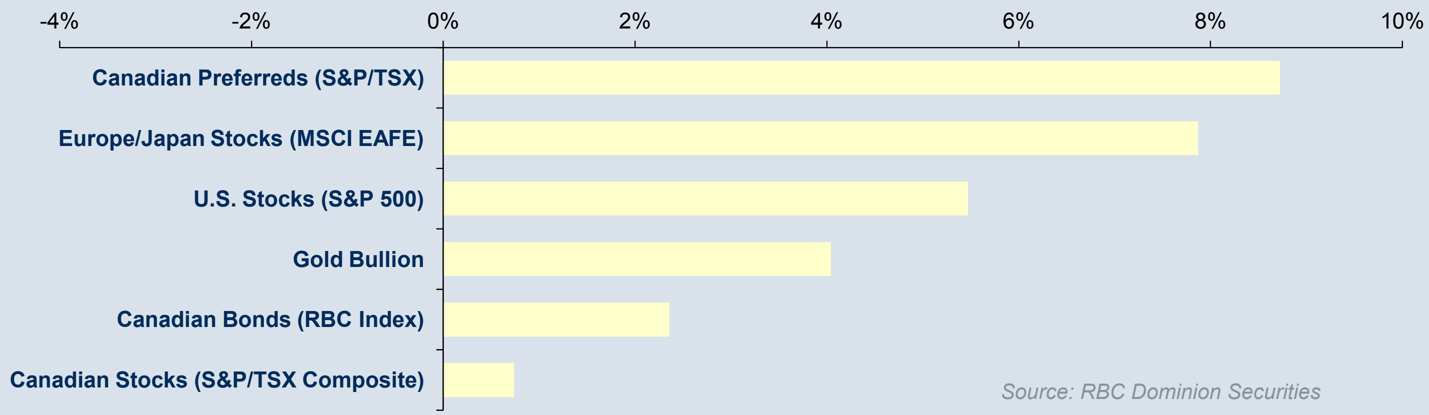
Commentary for the quarter ended June 30, 2017

It's Complicated...

The first half of 2017 delivered positive investment returns across the board. The global economy is growing, and corporate profits are rising. As can be seen on the chart, all investment categories that we track generated positive results so far this year. Does that mean all is well and we can relax and enjoy the ride, or is something about to go wrong? The answer is, you guessed it, "It's complicated."

Performance by Asset Class: Jan.1 to June 30, 2017 (in Canadian $)



Source: RBC Dominion Securities

Improving Economy

Clearly, the global economy has emerged from its post-financial-crisis prolonged slump. The U.S. economy, in particular, is performing very well, indeed. Unemployment there currently stands at 4.3 percent, and is set to trend lower over the coming year, towards four percent or even lower -- a level of full employment not seen since 2000. In Canada, the unemployment rate recently hit 6.5 percent, the lowest level since October 2008. Overseas, growth in Europe, Japan and elsewhere is positive and stable for the first time in years.

The employment numbers are both good news and bad news. The good news is that a high level of employment leads to growth in aggregate income and more spending. Since consumer spending is the largest component of GDP, high employment provides a tailwind to growth. Higher spending and GDP growth will also support profit increases for corporations, helping stock prices to move higher. Strong corporate profitability also reduces the risk of defaults, which makes the greater yield on instruments like high-yield bonds and preferred shares appealing. The strong investment performance we have seen in the first half of 2017 is testament to this positive economic backdrop.

Now for the potential bad news. A typical economic cycle unfolds something like this: After a recession, governments implement stimulative fiscal and monetary policies to encourage a recovery. This eventually leads to a virtuous cycle of higher employment, higher incomes, higher growth, higher profits and happy times. Eventually, when unemployment gets very low, inflation begins to heat up. To fight inflation, central banks raise interest rates and otherwise tighten conditions, to slow things down and avoid a more serious inflation outbreak. This tightening slows down spending, leading to falling corporate profits and layoffs. This, in turn, produces increased unemployment, lower income growth and lower spending. The downward trend culminates in a recession, and the cycle begins again.

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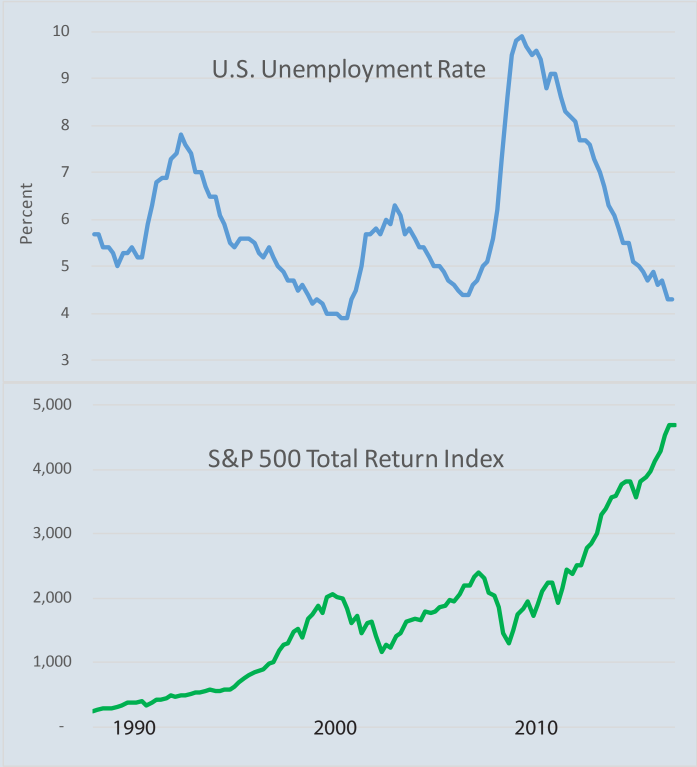
Of course, this is an oversimplification, and there are many other variables impacting the economy's path. However, it is a reasonably useful model, and it may help us plan investment strategy over the next year or two.

According to this road map, riskier investments such as stocks and higher-yielding corporate bonds and preferreds should remain a profitable choice over the next 12 months or so. Given the recent bullish U.S. economic performance, we should expect inflationary pressures to start showing up there later this year. This will lead the Federal Reserve to tighten monetary conditions. Since there is a lag for changes in Fed policy to impact the economy, there may well be no signs of a slowdown until next summer. In Canada, a similar story is unfolding, with the Bank of Canada hinting that interest rates here may soon be moving higher.



Source: RBC Dominion Securities

One telltale signal to watch for is an uptick in the unemployment rate. According to BCA Research, every reversal* of the unemployment rate since the Second World War has been followed by recession. This pattern can clearly be seen on the accompanying chart. The U.S. unemployment-rate increases from very low levels in 2000 and in 2007 were followed by recession and significant bear markets. Currently, the unemployment rate is very low and falling. As time goes by, it will have nowhere to go but up. Once it does start moving up, a recession and a bear market will likely be not far behind.

If the U.S. economy were to tilt into a bear market and recession in 2019, other markets around the world, including Canada, would likely do the same, to a greater or lesser extent. While each economy follows its own dynamics, which may not be synchronized with the U.S. cycle, the U.S. economy and financial markets are so large that the rest of the world would almost certainly be impacted.

The severity of such a global scenario cannot be known in advance. It could be a mild recession or something more severe -- the system is simply too complex to predict with any accuracy. I will be following these developments very closely and, as always, will provide my commentary to you on a quarterly basis.

Investment Strategy

The strategy to follow for the above scenario goes like this:

1) **Maintain investments in risk assets for the next six to 12 months**. Current conditions are positive, and good returns are still likely for stocks, investment-grade corporate bonds and higher-yielding corporate bonds and preferreds.

2) **Avoid long-term government bonds**. Interest rates will likely be moving up over the next year or so as the Fed increases rates and inflation becomes more of an issue.

3) **Be prepared to reduce risk assets to minimum levels sometime next year**. One would ideally switch to secure investments once the tide begins to turn. Not too early, but not too late. Easier said than done. Err on the side of too early.

4) **Accumulate inflation assets such as gold at low prices over the next year.** Until investors believe there is a potential inflation problem, gold will underperform. Once inflation becomes a concern, gold will be a good asset to hold. If the enduring value of the immense amount of "paper" money created over the last decade by central banks becomes questionable, the gains for gold and silver over the next decade could be significant.

* Reversal is defined as an increase of more than one-third of a percentage point in the unemployment rate's three-month trailing average.

Financial Planning Checklist for Seniors

Preserving and growing your wealth means taking advantage of tax, investment and estate planning opportunities. While some strategies are available throughout your lifetime, others are available only after the age of 65. This checklist discusses financial planning considerations for seniors and offers an overview of commonly used strategies.

1. **Pension Income Splitting**: If your spouse has a lower marginal tax rate, consider splitting eligible pension income to reduce your family's overall tax bill. Eligible pension income includes life annuity payments from a registered pension plan and, when you are 65 years or older, includes withdrawals from your RRIF. (Withdrawals from your RRSP are not considered eligible pension income.) Generally, you can allocate up to 50 percent of your eligible pension income to your spouse.

2. **Forgotten RRSP Contribution**: If you are turning 71 this year and are still earning employment income, or have unused contribution room carried forward, consider making your final RRSP contribution before Dec. 31, 2017, and before converting to a RRIF. Although you will be subject to a one-percent overcontribution penalty for the month of December, the benefit of the tax deferral and compounding growth in the RRIF will outweigh the penalty.

3. **Inter-vivos Trusts**: Consider the benefits of setting up an inter-vivos trust, such as a family trust. An inter-vivos trust can be used to income split with your children or grandchildren, or simply provide ongoing financial support for your children or other family members. It can also be used as a discrete means of transferring assets to your beneficiaries outside of your estate. An inter-vivos trust may enable you to avoid probate taxes in most provinces when its assets are left to other beneficiaries on your death and do not go back to your estate.

If you are 65 or older, an alter ego trust or joint partner trust (for you and your spouse) may provide you with additional tax and estate planning opportunities. Speak to a qualified tax advisor to determine if these types of trusts are right for you.

4. **In-kind Donation of Publicly Traded Securities**: If you have philanthropic intentions, consider gifting your publicly traded securities to a qualified registered charity, either in your lifetime, or through your will. Any accrued capital gains on these securities should then be exempt from tax. You (or your estate) will also receive a donation tax credit equivalent to the fair market value of your in-kind security donation, which will reduce your overall tax bill.

As a professional Wealth Advisor, it is clear to me that families who prepare and plan for the future are better off than those who don't. If you would like to discuss your retirement and estate plan, please feel free to contact me.

Until next time, best regards,

David Serber

The above checklist is an excerpt from a longer article in RBC Wealth Management's *Navigator* series. If you'd like a copy of the full article, with more details and helpful tips, just let us know and we'll send it right out.

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