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Quarterly Commentary

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"We can complain because rose bushes have thorns,
or rejoice because thorn bushes have roses."
- Abraham Lincoln

A good portfolio manager when building a portfolio firstly determines the objectives and the accepted risk tolerance. When that is determined, the task of asset allocation and individual security selection is the challenge. The skill of individual security selection is in the accumulation of great value that entails not following the current favourite as that is where demand has driven up prices. The goal is to acquire those "thorn bushes" that are about to bloom before they become popular.

In order to "lead the market", it's important to understand where we are in the economic or business cycle. The Sir John Templeton quote "bull markets are born on despair, grow on skepticism, mature on optimism and die on euphoria" gives us a guideline of what to look for.

The Toronto Stock Market is down 2.58 per cent since December 31, 2021. The S&P 500 is similarly down over that same time frame and the Canadian Aggregate Bond ETF managed by BMO is down 10.59 per cent over the last two years. In Canada, we also recently reported our second quarter of zero per cent GDP growth, which may be an indicator of a pending if not a current recession.

Therefore, from a business cycle perspective, we are somewhere near despair and scepticism. The perfect time to look for those thorn bushes about to bloom.

The culprit for slowing our economy and creating negative returns in capital markets has been rising interest rates brought on to control inflation.

Recent financial data seems to be foreshadowing declining inflation, which is creating optimism that interest rates have peaked. The bond markets and the stock markets have started to show some signs of life, as investors sense the beginning of the next business cycle is not far off. Keep in mind markets are leading indicators and anticipate future events, so investing early will achieve the best value and greater returns.

Bond prices go up as interest rates decline as do stock markets, particularly stocks that produce growing dividends.

We think it is a good time to review objectives, rebalance asset allocation, extend maturities in bonds and accumulate those stocks with a track record of growth and dividends.

The stimulus (fertilizer) to encourage these thorn bushes to bloom will be the decline of interest rates over the next few years.

“Today people who hold cash equivalents feel comfortable. They shouldn’t. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value.”
- Warren Buffett

“Calm is a superpower”
The future of interest rates

The undisputed leader in financial news over the last two years has been high inflation, and the corresponding increase in interest rates by central banks around the world to attempt to combat this. Inflation in Canada peaked at 8.1 per cent in mid-2022, and the Bank of Canada has consistently raised rates to their current levels. While causing pain for Canadians, especially in the mortgage and housing markets, the higher rates have worked – inflation levels have come down significantly, with the October numbers coming out at 3.0 per cent year-over-year, arriving at the high end of the Bank of Canada’s target range of 1-3 per cent.

This means that the Bank of Canada is highly unlikely to raise rates again, unless something significantly changes in the inflation picture. Indeed, institutional fixed income markets are expecting rates to come down into the second half of 2024. While we are unlikely to see rates go back to the extremely low rates of three to five years ago, the rate environment levelling off and easing provides some tailwinds for equity and bond prices.

For equity and growth investors, easing rates means more stable economic conditions, allowing for growth in activity and earnings moving forward.

For the more conservative investment portfolios, high interest savings accounts have been an extremely attractive choice for the last 18 months. Going in to 2021, high interest funds were paying 1 to 1.5 per cent, whereas today they’re paying close to five per cent. While this means earning a real positive return on the cash portion of a portfolio, the issue is that these rates are unlikely to stay at these levels for much longer.

We’re already starting to see the impact of peaking rates in the bond markets, with total yields coming down slightly. For the conservative portion of a portfolio, it is an attractive time to look at rolling existing high interest savings, which are a daily interest tool, into bonds or GICs of a longer duration. Even an investment grade bond ladder of one to three years until maturity will lead to a higher net return that the high interest funds, with the current high-rate environment captured and locked in until maturity.

There are additional tax benefits to a bond portfolio in a non-registered or corporate environment as well. A bond’s total return is comprised of two aspects: the coupon (interest) payment, which is taxed as earned investment income, and the appreciation in price from purchase to maturity. As bonds mature at $100, a bond purchased at a discount to maturity price means that the appreciation to maturity is taxed as a capital gain, with 50 per cent of the taxable implication. This can lead to a significant net benefit for fixed income investors.

There are a number of investment grade short-term bonds in Canadian banks and similar companies with an annualized equivalent total yield (interest plus growth) of five per cent – comparable to GICs and current high interest savings rates. But due to the tax advantaged return, in order to realize the same after-tax rate of return as the bonds, a GIC/high interest fund would have to pay over 6.5 per cent. This leads to a meaningful net positive benefit.

If you have cash currently in high interest funds, or even cash sitting in the bank, and would like to look at potential alternatives to lock in high rates and higher after-tax returns, please let us know.
Thank you!

Andrew

Dates and numbers to remember!

As we come to the end of the year, maximizing tax savings is only one part of an overall financial strategy, but can significantly impact wealth building in the current tax year and the years to follow. With deadlines fast approaching, now is the time to take advantage of tax-deferred growth opportunities, tax-advantaged investment strategies, and charitable-giving opportunities, among others, to maximize deductions and credits for your tax situation.

Coming up to the end of the year, there are a number of specific dates to remember:

- **Dec 27:** Last day to sell securities on the Canadian and U.S. markets to realize a gain or loss for the 2023 tax year.
- **Dec 31:** Last day to make charitable contributions for 2023. Note: this should be done before the holidays to ensure that charities are able to properly receive funds and issue receipts.
- **Jan 1:** TFSA contributions – for 2024, the new TFSA contribution room available is $7,000, in addition to any unused or re-earned prior year contribution room.
- **Feb 29:** Final day to contribute to an RRSP for 2023 tax deductions.

We will be reaching out early in the new year to discuss TFSA contributions and other market updates, but if you have any questions, or if there's anything else we can do, please do not hesitate to contact us.

Finally, a quick note on parking for office visits. There are visitor parking spots in our parking lot for every business' use and, therefore, finding a vacant spot can be difficult. We have two spots at the rear of the office allocated to our use, and Graham generally straddles both spots. If you give us some notice, we will move Graham's vehicle to one side and place a reserved orange cone in one spot for your use. In the event every spot is in use, there are usually spaces in Vaughan Avenue, and on the east-bound side of Clement Avenue, but please be very careful crossing Clement, as traffic is busy and usually moving fast. You're always welcome for a branch visit. Sorry that there isn't an abundance of parking for all.

Thank you all, and have a safe and enjoyable holiday season.

Regards,

Your Clearwater Wealth Management team (Graham, Andrew, and Rachelle).