# ELAINE'S NEWS & VIEWS
## JUL 2018

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**Global Economic Outlook**

As I am writing this newsletter, the Canadian stock market is about flat for 2018 – no gains. The American market, as measured by the Dow Jones Industrial Index is down for 2018 but as measured by the broader S&P 500 and the Nasdaq indices is up for 2018. Europe and the Emerging Markets stock markets are up even more. U.S. stocks in the historically defensive sectors, like telecom, utilities and real estate dropped, as expected, as bond interest rates rose in the U.S. Similarly in Canada, BCE (Bell Canada) is down about 15% this year as interest rates headed up. It was exactly in anticipation of this that we worried that dividend focused funds in Canada that had so many utilities and interest sensitive stocks were overpriced and we shied away from them.

It has been a much bumpier ride in the stock market this spring than it has been for the last couple of years. We can **expect that higher volatility to continue**. And we can expect interest rates to continue higher as the central banks of Canada and the U.S. continue to normalize interest rates.

The Canadian economy is being driven by consumer spending and housing investment more so than at any time since at least 1981, while business investment as a % of GDP is at a near low for the last 37 yrs. This is not good, because the Canadian consumer debt level is dangerously high. Consumers can't keep spending so much, as their ability to borrow more gets more and more limited. And as interest rates rise (another small rise is expected in Canada in July), consumers will have to curtail their spending even more as they face higher costs to carry their debt/mortgages. So who is going to keep fuelling the Canadian economy?

Some people are hoping for a commodity boom. With cheaper oil production increasing in the rest of the world and Chinese growth slower than in 2009 and 2010, there doesn't appear to be any strong driver of demand for Canadian resources. That isn't good for the Canadian dollar. A substantially lower Canadian dollar could fuel some manufacturing demand though. More on that below.

Trump's U.S. corporate tax cut is expected to boost U.S. corporate earnings. Already between the U.S. stock market drop in the last few months and corporate earnings growth, U.S. stocks that last year appeared too highly valued, now appear reasonably valued – not cheap on average, but not expensive. Some of our U.S. and global fund managers still hold a lot of cash though as they wait for bargain prices to buy more stocks, but the fear of a stock bubble seems to be gone for now.

Emerging markets (like Thailand, Brazil, South Korea etc) and Europe are not as far along in the economic cycle and have more room left for potential growth. More on that further down.

As an aside, it's interesting how much of the world economy various regions of the world represent, as measure by Gross Domestic Product (GDP), compared to how much of the world stock market value they represent. Japan and Europe's GDP and % of world markets are within a couple per cent or each other. By contrast, Emerging Markets (including China) represent 11.8% of the world's stock market but represents 38.1% of the world's economy. That is a growth sector not to be missed from an investment point of view. On the other hand, the U.S. is only 26% of world GDP but is 52% of world stock markets. What does all this tell you about the future economic powerhouse area in the world?

(Source: The Capital Group June 2018 Insight)

Also on a positive note for markets going forward, the % of the Manufacturing Purchasing Manager's Index ratings that are above 50 is huge. That is one of the best predictors of continued market growth, and when the index goes below 50 it indicates a recession may be near.

In January 2018 when Jordan and I heard the chief economists of Canada's 5 biggest banks speak, they all predicted a recession and market downturn in 2019. Now Royal Bank is saying there is only a 30% chance of a downturn next year. So **more and more economists and analysts are suggesting positive returns for this year and next for stock markets, especially non-Canadian stock markets**.

**Will the Canadian Dollar Plunge?**

I love charts. Fidelity Investments recently sent me a chart from the Bank of Canada which shows how correlated the Canadian dollar is to the cumulative gap between Canadian consumption (including housing investment) and net exports and non-residential expenditure. The chart shows almost perfect correlation with some time lag, because our exchange rate is what David Tulk of Fidelity calls a "rebalancing mechanism". When we have more trade, our dollar is up and when resource exports and other exports drop, the dollar sinks. The economic imbalance indication is expected to increase significantly in the next 3 yrs and that would take the **Canadian dollar into the 62 cent range**! The imbalance (and therefore Canadian dollar value) is predicted to be the worst since the chart started in 1986. I expect some of the tariffs the U.S. is levying will contribute to even lower exports and the weakening of demand for the Canadian dollar.

The one bright side to this is that a lower Canadian dollar would make your foreign investments worth more in terms of Canadian dollars.

**Rising Interest Rates**

Many expect the Bank of Canada to raise interest rates in Canada again in July, while others think the next raise might not be till Sept because of increased worry about the impact of Trump's trade tariffs, but a raise is surely coming. The raises of last year had a measureable impact on the housing market, definitely slowing sales. As mentioned above, interest sensitive stocks like Bell Canada (BCE) were negatively impacted as investors who had sought the big dividends of BCE may have left those stocks to go to bonds, which are starting to yield more as rates have risen. Of course the rise in bond yields has resulted in a loss in market value for bonds. So people who sought the "safety" of bonds and high dividend paying stocks may finally be waking up to the fact that more volatile stock or equity investments may well have been a less risky place to invest than bonds and dividend focused stocks.

Also, if the U.S. continues to raise interest rates at a faster rate than Canada, more investors will buy U.S. bonds over Canadian bonds and further lessen demand for our currency. The U.S. is expected to have 3 more interest rate rises this year and Canada to have only 2.

So if you have high debt, it is getting increasingly crucial to pay down the debt as much and as quickly as you can. Your interest payments are going to be increasingly difficult to cover over the next year and years.

And we continue to like investments outside of Canada not only because our economy is not expected to do as well as global economies and but also because our currency may weaken more, and foreign investments would make money on their currency.

**Why Women Need to Save More for Retirement (and Longevity Averages for Men and Women)**

The simple reason why women need to have more savings when they retire than men need is because women live longer. Here is the latest longevity numbers I have seen. They are from the May 19, 2018 Globe and Mail's Report on Business who attribute the numbers to Statistics Canada.

| If you are this age: | Your life expectancy is: | |
|---|---|---|
| | Males | Females |
| 50 | 82 | 85 |
| 55 | 83 | 86 |
| 60 | 83 | 86 |
| 65 | 84 | 87 |
| 70 | 85 | 88 |
| 75 | 87 | 89 |
| 80 | 89 | 91 |
| 85 | 91 | 93 |
| 90 | 94 | 95 |
| 95 | 98 | 99 |
| 100 | 102 | 102 |

Sadly the same Globe and Mail article said that **women who just finished university and started working will need to save 18% of their income to be in as good a position by retirement as new male**

**grads who only save 10% each year**, because women typically have fewer years in the workforce, get fewer raises and have longer life expectancy.

And married couples need to make sure that their family has enough saved, so that the longest living spouse has enough savings left to support them for the rest of their life.

And just think of how seriously children being born these days will have to save. We heard on 680 News recently that **children who were born in 2017 have an average life expectancy of 104 yrs**. If that's the average, lots of people should be living past 2010. If they retired at age 65, that would be 45 years to support themselves in retirement.

**Soundbite from Buffett on Bitcoin and Stock Prices**

The Globe & Mail quoted Warren Buffett on May 8, 2018 as saying **Bitcoin is like "rat poison squared**". Buffett's partner, Charlie Munger, calls Bitcoin "artificial gold" and said it was like what Oscar Wilde called fox hunting, "the pursuit of the uneatable by the unspeakable". Buffett has been warning about Bitcoin for some time now. It's interesting to note that it hit $17,550 on Dec 11 (in USD) and 6 months later was down to $6,133. Bitcoin is a speculative security (if we use the work security loosely), not to be confused with an investment.

Buffett also said that U.S. stocks are not in a bubble (price-wise), although he has $108 Billion in cash at Berkshire Hathaway that he can't find enough bargain companies to spend it on. He has a problem that we don't have, in that he can't even consider buying anything for less than $1 Billion. Enviable problem!

**Who is Shouldering the Tax Burden in Canada?**

The Canadian Taxpayers Federation released data that shows that the people who make (and declare) more than $100,000/yr constitute **9.4% of all taxpayers but they pay 73% of all the income tax collected** in Canada. So each high income earner makes it possible for 8 other earners to pay no tax, or for 16 other taxpayers to only pay half as much as the cost of expenses for the services that the average Canadian receive from the federal and provincial governments etc. And of course there are lots of people who only declare a fraction of their income and thus put even more tax burden on those who report all their income.

The Globe & Mail Report on Business Jun 5, 2018

**Why Invest in Emerging Markets Now?**

First let's look at what the biggest emerging markets are (in contrast to the developed markets or North America and Western Europe): China, India, Brazil, Indonesia, Mexico, Russia and Turkey. Emerging Markets account for 75% of the world's Gross Domestic Product (GDP). Canada accounts for only 3-4% of world GDP. And the growth rate in those emerging markets is expected to continue to exceed the Canadian growth rate for 2 big reasons. First **over 90% of the world's population under age 30 live in the Emerging Markets. That's where the world's future work force and future consumers will be. Secondly, those countries have increasing access to capital for growth, because in Asian countries the average worker saves 35% of their income**. People are not living at the standard of living they could be, let alone living above their means! Many of the Emerging Market companies have strong growth rates, like their banks, or have emerged as global players, like Samsung, Hyundai and Embraer (Bombardier's biggest competitor). Many countries, like Pakistan are considered Frontier Markets, because they are not developed enough to be Emerging Markets yet.

According to the International Monetary Fund (IMF) as quoted by Christine Tan of Sun Life

**Do You Own U.S. Stock or Property? You're Estate is Not Beyond the IRS' Reach**

Under a new law in the U.S., Americans don't have to pay estate or inheritance tax on the first $11.2 Million of their estates. For Canadians who hold American property (stocks or real estate, but not American mutual funds offered by Canadian mutual fund companies), their estates get a pro-rated exemption from American estate taxes. However to get that exemption, **your executor has to fill out a special form within 9 months of your death or face severe penalties**. You may want to alert your executor, if you have U.S. property or stocks, that they have to watch out for this IRS requirement. If you are an executor, make sure you get proper legal and tax advice. Being an executor has gotten much more complicated in many ways in the last 5 yrs.

The Globe & Mail Report on Business May 22, 2018

**Giving a Cottage to Your Kids more Tax Effectively**

If you transfer a cottage to anyone other than a spouse, for example to your children, you are deemed to have sold your cottage at Fair Market Value. That could trigger capital gains and a tax liability. Capital gains occur if there is appreciation on the cottage and if you aren't using your Principal Residence Tax Exemption on your cottage, but are saving that exemption for your regular home. If you have had your cottage for many years, the capital gains tax could be very significant.

One idea to make the tax burden easier to tolerate is **to spread the gains over up to 5 years, so that the taxable capital gains each year might not push you into as high a tax bracket and so that the taxes won't all be payable in the first year. This involves having a promissory note from your children that gives you the right to demand 1/5$^{th}$ of the Fair Market Value each year**. Of course you don't actually have to get paid the amount in the promissory note and you set the promissory note up to be forgiven on death.

Talk to a tax professional to make sure you minimize your tax burden if you decide to transfer a family cottage to your children. And you may want to consider making such a transfer happen before your death, since an estate might not have the same tax minimization options. Lastly think about whether your family dynamics allow for the sharing of a cottage and whether the sharing of the use, the maintenance and costs could lead to friction between your children. A shared cottage certainly isn't workable in many families.

The Globe & Mail Report on Business May 18, 2018

**The Cost of Retirement in One's Final Years**

We try to set up retirees' cash flow in retirement so that it doesn't deplete their capital. That way in their very final years if they run into health problems and the big expenses that can mean, they will have their investment capital, and often their home available to liquidate for health care expenses. **Retirement homes cost about $4,000-$5,000/mo**, and more for someone in a retirement home who is needing much medical attention or assistance and who is trying to avoid a long term care facility. Those wanting to **stay in their home might pay as much as $30,000/mo for round the clock care**. It sure can be expensive to live a long time, if one has health problems. And of course, **an increasing number of**

**drugs that seniors need are not covered by OHIP** and must be paid for out of pocket. I know of one that costs $120,000/yr and makes a huge difference in some people's quality of life.

The senior may not be the only one paying the price for the help they need. Many children have to help support their parents in retirement. Also, a 2017 CIBC report quoted in the Mar 16 Globe & Mail Report on Business, said that **30% of those with parents over 65 need to take time off work to help take care of them. On average they take off about 450 hours (11 wks) a year**. A lot of that time is surely unpaid absence and that much absence can seriously harm one's career.

So preserving your capital for use in your later years is a good strategy, so that you can be as independent and comfortable as money can make you in your later years, and so that you don't become a burden to your children.

**Mining and Financial Stocks Over the Long Term**

The long-term returns of the U.S. stock market as reported by Ryan Vlastelica on Marketwatch.com in June, were analyzed to see if there were certain market sectors which boosted returns more than other sectors over the long term. Looking at 1925-2017, 1957 – 2017 and 1989 – 2017 the results consistently showed that **not holding the Consumer Staples or Health Care sectors would have reduced long-term returns**. Not holding Materials (mining and forest product companies etc) and Financials would have increased long-term returns. Materials are commodities where there is no pricing power, so it's easy to see why there wouldn't be outsized profits or stock appreciation. U.S. Banks have gone through a lot of tough times and crises (thank goodness for better Canadian banking laws). Right now however, U.S. bank stocks still haven't recovered from the loss of confidence in 2008. So they may be in a temporary position of opportunity. There were no other sectors which have consistently underperformed or outperformed the U.S. stock market over the long-term.

The long-term results for the U.S. stock market for 28, 60 and 92 yrs were 9.71%, 10.28% and 11.53% respectively.

**Thank Goodness Canada has Immigration**

I often hear people criticizing the fact that Canada lets in as many immigrants as it does. I get it. If there were fewer immigrants in our country, there would be fewer changes in the country, fewer accents heard in the streets, fewer names we can't spell, etc. There would be more job openings for home-grown Canadians. (Maybe Canadians felt the same way in post WWII Canada when European immigrants flooded into Canada, but that turned out to enrich our country economically and culturally!) It is so important to see the other side of Canada's immigration policy. This newsletter isn't the place to look at issues like compassion, so let's only look at financial and self-interest issues.

Right now the country has more seniors over age 65 than children under age 15. In fewer than 20 yrs, over a quarter of our population will be over 65, generally retired and not contributing to our economy in terms of Gross Domestic Product (GDP). According to an on-line Globe & Mail article by Darren Calabrese called "Boom, Bust and Economic Headaches", "**the boomers' exit from the labour force will slow economic growth, eroding the tax base and eating into government revenues. Meanwhile, this growing bulge of seniors needs and demands more from their governments – most notably, health care and income support programs, such as Old Age Security**. Health care spending in particular increases significantly for people 65 and older. … younger workers are being saddled with the task of paying for rising spending needs, mainly in health care, which are eating nearly half of provincial budgets. …We built this government machine that takes tax revenues from everybody and gives them disproportionately to this growing population of older people"… The C.D. Howe Institute has gone a step further by tallying the present **<u>cost of maintaining demographically sensitive government programs, such as health care</u>**, over the next 50 years. The total "implicit liability" is nearly $4.3-trillion, or **<u>$120,000 per person across Canada [per year]</u>**, with most of the burden – $107,000 – falling on the provinces. ...there is the issue of pensions. The universal Old Age Security (OAS) benefit paid to all seniors, as well as the supplemental Guaranteed Income Security (GIS) plan for low-income seniors, are paid entirely from annual federal government tax revenue. Projections forecast federal OAS and GIS costs to rise from $47-billion in 2015 to more than $100-billion by 2031." How on earth could the government ever be able to pay out more than $120,000/yr per person just for seniors' OAS and health care costs out of annual taxes collected? The Canadian government won't be able to afford to continue these services, let along to offer more treatments or faster service. Our **<u>government and future taxpayers will NEVER be able to afford all the health care treatments that are being invented</u>**.

The Globe & Mail article cited above says, "But even with current levels of immigration, we're having trouble keeping up with even the first wave of retiring baby boomers. The number of new retirees in Canada has jumped from about 170,000 annually five years ago to nearly 250,000 today [twice the population growth from the birth rate, net of the mortality rate]. Within a few years, we face retirement rates closing in on 400,000 a year."

So besides having our GDP slow down as more workers retire and the resultant lower tax revenue, and needing more workers to care for baby boomers has they age at the same time as our workforce shrinks, the government will need far more to pay for the social programs (health care and Old Age Security) in place today for baby boomers.

Places like Britain and Japan, with greater ratios of older citizens to younger ones, are in even more trouble. And the U.S., which proportionately takes in only 5% as many immigrants as Canada does, will face an even greater challenge than Canada. Canada's immigration policy is helping lessen our future problem of underfunded social programs for Baby Boomers and lack of workers to fill caregiver positions. It still isn't enough. Aging seniors may face reduced services and have to rely on much more self-funding for health care. We all may face an increased tax burden. Our children's standard of living may well be compromised as they support more and more seniors.

Immigration won't solve all the problems of our aging population, but it's helpful to mitigate the problems we are going to face. So let's appreciate how much young immigrants to Canada will contribute to Canada's labour pool and tax base as more as more baby boomers retire and put a strain on the budget for the social programs so many retirees count on, like OAS and health care. And let's keep a little more aside in our own savings for retirement so we can self-fund what the government may not be able to afford to pay for us. And of course, let's all stay as healthy as we can for as long as we can.

**<u>The Canadian Securities Administrators (CSA) Announced Changes</u>**

At the end of June, the CSA announced many things after their years of studying the issues of how Canadians pay for investments and financial advice. The CSA has concluded that imbedded fees on mutual funds for ongoing advice can remain, but that discount brokerages which do not give investment or financial advice will not be able to continue to collect the full fees. The discount brokerages have for years been getting paid the same a full service dealerships, but that is coming to an end. That will be fairer to investors. Also, advisors and dealerships who charge more than the normal 1% trailer fee for ongoing advice will have to justify the extra charges. So my peers in other firms who charge 50% to more than 100% more than the 1% trailer fee that Manulife Securities Incorporated gets now will have to explain where the extra value is to their clients. And advisors who can only offer their own dealers' funds and cannot shop the market for their clients will be identified in some way to investors, so investors can know if the advisor is offering the best available option on the market or the best available option from a limited shelf of product. All of these things seem positive.

Unfortunately the implementation of some of the other CSA new requirements will mean everything we do will be more time consuming and involve more paperwork. I'm sorry. We will have to do what the law requires and we will try to make it as painless as possible as it is rolled out over the next months and years. It will mean however that we may no longer be able to take on small clients, even if they are related to existing clients. We will have to see how that plays out as more becomes known about the CSA requirements.

Have a great summer.

*Elaine*

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