TD Wealth

August 2017

Market Update

Important Topic: Inflation

When evaluating any investment it is always critical to consider the **after-tax** and **after-inflation** return. This is the true result. Last month I addressed taxation so let's take a look at inflation.

Simply put, inflation is a measure of how quickly the value of our money is decreasing. If inflation is 3% then a $100 item today will cost $103 next year. Therefore, next year, $100 will not be able to buy this item unless you get a return on investment that at least matches the rate of inflation. Consider a bond bought for $100 that will pay annual interest and then return your $100 in ten years' time. When the $100 is returned in ten years it will only buy 66% of what it could have bought today. We describe this as $100 in ten years' time will only be worth $66.

Therefore finding investments that will, at the very least, match inflation (after-tax) is critical. If not, the dollar value of the account may go up but the "value" (how much you can buy) is actually going down.

Expectations

Importantly, one's return expectations should rise and fall with inflation. With the inflation rate in Canada at 1.2%, significantly below the long term average, one should expect lower returns than average but understanding that one's net worth is still increasing at the same pace. In other words, a total return of 6% when inflation is 3% is the same as a total return of 4% when inflation is 1%. Our focus and expectations should be on the net return.

After Tax and Inflation

Consider the early 1980s when one could get 18% interest at the bank (and I have heard people pine for those days). Now consider the after tax and after inflation return! 18% interest was taxed at over 50% so you ended up with less than 9%. Rates were 18% only because inflation was at 12%. Getting an after tax return of 9% when inflation is 12% meant a REAL annual return of negative 3%.

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Today buying a 1.5% GIC with tax rates at 50% and inflation at 1.2% means that your REAL return is 1.5% * 50% = 0.75% - 1.2% = a negative annual 0.45%. Today's 1.5% GICs are better for you than the 18% return of the early 1980s.

Conclusion

Always remember to consider the effects of Inflation. It can have a significant effect on your net worth over time and therefore on your ability to meet your goals.

Market Update – August 2017:

August proved to be subdued month - subdued for the capital markets. The first half of the month saw the markets fall while the second half saw a recovery that regained all it lost in the US, and almost all in Canada.

Earnings continued to impress. Strong earnings justify higher prices and since prices did not rise, markets are trading at more reasonable levels. Markets are still not cheap and one must continue to be careful but the month proved more positive than the return figures reveal.

Note, importantly, that markets have not been volatile and in fact volatility measures are near all-time lows. We have become used to small movements – portfolios rising and falling less than 1%. Based on history, markets and valuation metrics we should expect higher, more normalized volatility levels. We should expect, we should always expect and be prepared for, movements of 5-10%. They are coming.

We will not like them but they are simply the cost (emotional) of investing in the markets. They are not a cause for concern. Markets will fluctuate and without an economic downturn or a recession these fluctuations reverse and mean very little.

Looking forward, the economy is performing just fine by many measures (no predictions of an economic downturn in the near future), political uncertainty has increased but market volatility remains at historic lows, and inflation remains benign. We hold our positions and continue to invest cautiously.

For the month the bond market was up 1.0%, the Canadian market was down 0.4%, the US market was up 0.3%, International markets were flat, the Emerging markets were up 2.5%.

Have a great month and let us know if there is anything we can do for you,
Meir