

Dahms Wealth Management Group Newsletter



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In this edition

Managing Through Uncertainty.....	1
Tax Planning Before Year End: Gain from Your Losses	2
Inflation & Interest Rates: Has Inflation Peaked?	2
How Does a Recession Impact My Portfolio?	3
Bull & Bear Markets: A Closer Look	4

Managing Through Uncertainty

With continued moves by the central banks in raising rates to fight inflation, many have pointed to the current outlook for the economy and financial markets as being uncertain: Is a full-blown recession imminent? Will a soft landing be possible?

It is therefore not surprising that the markets have been extremely volatile. Uncertainties tend to raise fears, which can be a driving factor of short-term market behaviour. Today, fear appears to be the dominant emotion governing prices in equity markets. One study has shown that investor risk aversion is responsible for almost 75 percent of short-term market variations.¹ This is because we often underestimate our ability to adapt.

Whether or not we avoid a recession remains to be seen, but it's worthwhile to remember that downturns are a normal part of the economic cycle. Moreover, the stock market and the economy don't always move the same way at the same time, and predicting how the markets react to recessions is difficult, if not impossible. A recent study looked back at recessions in the U.S. since 1945, suggesting that the S&P 500 Index actually rose an average of one percent across all recessionary periods. And, in almost every recession, the markets began their climb well before its end.²

Over the summer, there were promising signs that inflation was slowing here at home. However, the bearish forecasters continue to warn of the consequences from the central banks' hard stance against inflation: ongoing rate hikes will further slow economies, put downside risk on equity markets and avert a soft landing. It's no wonder that many of us feel as though we are already in recession³ – the current narrative, alongside increasing household expenditures, a higher cost of borrowing and stock market declines, certainly hasn't helped to support optimism.

Yet, uncertainties will always be with us and some of the most successful long-term investors are adept at separating their emotions from investment decisions. This is not easy to do, but there are techniques and products available that can help. Systematic investing can limit the urge to otherwise succumb to market timing. Some look to managed products to put buy-sell decisions on the regular watch of others. We also manage risks to help cope with the unavoidable volatility. Diversification continues to be a proven way to increase stability and lower risk by spreading assets across different securities, sectors and asset classes, among others. Those who consider high-quality investments will also worry less about enduring values during uncertain times, secure in the knowledge that any price setbacks should be temporary.

While the current period of economic uncertainty is expected to continue, let's not forget that economies and modern capital markets have always adjusted and progressed over time. This time is no different. The investing journey is a long one, filled with both ups and downs, and there may be merit in never underestimating our ability to continue moving forward, despite the uncertainties.

1. www.nber.org/papers/w19818; 2. www.forbes.com/sites/sergeiklebnikov/2022/06/02/heres-how-the-stock-market-performs-during-economic-recessions/; 3. <https://leger360.com/surveys/legers-north-american-tracker-july-12-2022/>

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Tax Planning Before Year End: Gain from Your Losses

With the arrival of cooler weather, the end of 2022 is already in sight. This may be a time to consider tax-planning strategies before year end. If you are thinking of making portfolio adjustments, there may be an opportunity to gain from your losses through tax-loss selling.

What is Tax-Loss Selling?

Generally, an investment held in a non-registered account that is sold for less than its original cost will result in a capital loss. For tax purposes, 50 percent of the capital loss can be used to offset any taxable capital gains realized during the year to reduce your current tax liability. If you do not have sufficient taxable capital gains to offset the losses, the net capital loss can be carried back to any of the previous three taxation years to offset realized capital gains, or carried forward to use against future realized capital gains.

Be aware of the “superficial loss” rules, which deny the capital loss if you or an affiliated entity (such as a spouse, RRSP, TFSA) acquires the same security either 30 days before/after the date of the loss transaction. In this case, you will not be allowed to use the capital loss in the current tax year to offset capital gains. Instead, the capital loss will be added to the adjusted cost base of the identical property.

Gifting to Adult Children

Gifting investments that have declined in value to an adult child can put subsequent capital gains/income in the hands of someone in a lower tax bracket, resulting in less taxes payable for the family unit. This will also trigger a capital loss in your hands, which can help to offset realized capital gains. For estate planning, transferring assets to your children while alive can reduce the value of your estate and the eventual taxes or probate fees (where applicable) on your estate at death.

Year-End Tax Planning By Donating Securities

Year-end tax planning often involves charitable giving. Donating publicly-traded securities “in kind” that have appreciated in value will eliminate the tax liability on the capital gains triggered and allow for a donation tax credit for the fair market value of the securities. However, for securities that have declined in value, you may wish to simply sell the securities to claim the capital loss and donate cash, which will entitle you to a donation tax credit. Unlike appreciated securities, where the additional tax benefit (that eliminates the tax liability on the capital gains) will only occur if you donate shares “in kind,” you will still be able to claim the capital loss. Remember to make charitable donations in advance of the December 31, 2022 deadline to count towards your 2022 taxes. Please seek the support of tax planning professionals for your situation.

Consider These Year-End Tax Planning Opportunities:

- › **Charitable Donations:** See above story for tax benefits.
- › **Tax-Loss Selling:** Consider realizing capital losses to offset realized capital gains.
- › **RRSP Contributions:** While you have until March 1, 2023, consider contributing before year end to benefit 2022 taxes.
- › **RESP Contributions:** This won't affect 2022 taxes, but you may potentially benefit from the CESG grants in 2022.
- › **Turned 71 in 2022?** Your RRSP will mature by year end, so please call the office to discuss the options available.
- › **Income Splitting:** This may include paying reasonable salaries to family members for services provided to your business or electing to split eligible pension income with a spouse on a tax return. Get in touch for more ideas.

Inflation & Interest Rates: Has Inflation Peaked?

We are in one of the most aggressive tightening cycles in more than 40 years. Are higher rates helping to curb inflation? At the time of writing, there have been positive disinflationary signals as commodities prices, notably energy, have moderated and certain pricing pressures appear to be easing.

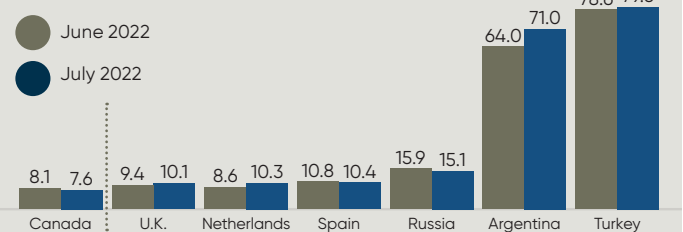
While higher inflation rates continue to put a strain on many, consider that we aren't alone. Most of the world has been troubled by inflation; countries like Turkey and Argentina have had unprecedented rates, in excess of 70 percent! Only a handful of nations, such as South Sudan and Bolivia, have been able to escape inflation. Canada continues to be in a comparatively favourable position due to our vast domestic resources production and as a net exporter of both food and energy. Many European countries suffer from high energy and food prices due to their dependence on imports, and there are concerns about a worsening energy crisis over the winter months.

For investors, talk of slowing inflation is welcome because this may slow the pace of future rate hikes. Rising interest rates have been a key driver of the volatile markets in 2022. For fixed income, the inverse relationship between bond prices and interest rates meant a significant decline in the bond

markets this year. For equities, valuations often go down as the future value of cash flows is lower when a higher discount rate is used. Company profitability may also be hampered by slower economic growth.

Inflationary pressures are expected to continue, so it's too soon to say if the central banks will ease their approach. Yet, our monetary policy practices appear relatively benign when compared to others: In August, Argentina raised its key interest rate to a whopping 69.5 percent!

G20 Countries with Highest Inflation, as of August 2022



Canada shown for comparative purposes. <https://tradingeconomics.com/country-list/inflation-rate>

How Does a Recession Impact My Portfolio?

Over the summer, the U.S. reported its second successive quarter of declining GDP, which commonly defines a recession. Yet, the U.S. government pointed to economic data that suggested otherwise: strong jobs growth, robust corporate earnings and continued consumer spending. However, it prompted considerable debate about whether the U.S. had entered a recession, and if Canada would follow. Semantics aside, there is little doubt that we have entered a slowing economic period, largely due to continuing efforts by the central banks to aggressively raise rates to curb inflation.

How Do Rising Rates Affect Economies and the Markets?

Higher rates raise the cost of borrowing, which can lead consumers to spend less. While decreased demand for goods and services eases inflation, it can also impact a business' profitability. Rising rates also increase the cost for companies to borrow money, along with the cost of debt. Sometimes companies pass these costs along to consumers. However, if they cannot, it can potentially impact earnings and lower stock prices. As well, valuations often go down because the future value of cashflows is lower when a higher discount rate is used. With fixed income markets, as interest rates rise, bond prices generally fall. This is why we have seen both stock and bond markets struggle in 2022 as the central banks raised rates.

Is a "Soft Landing" Still Possible?

Renowned economist John Kenneth Galbraith once said, "The only function of economic forecasting is to make astrology look respectable." Although likely said in jest, the point is to suggest that nobody knows with certainty how economies will perform over the near term. Economic slowdowns will occur from time to time and recessions, when they do occur, can be quite different in their length and intensity.

At the time of writing, labour markets continue to be relatively strong, with low unemployment and job vacancies. While unemployment is expected to rise as the economy slows, higher savings rates among many Canadian households may act as a buffer. Productivity has also been stable, and our economy has benefitted by being a net exporter of resources. As such, some believe that Canada may avoid a full-blown recession.

What About My Portfolio?

The potential for a recession should never be a reason to consider curtailing investment programs. Portfolios have been positioned to weather the inevitable down periods, with a focus on quality investments, which can be expected to regain their values when better times arrive, as well as diversification and asset allocation to help reduce portfolio risk.



Consider also that the stock market and the economy don't always move the same way at the same time. History has shown that markets can begin their upward climb when economic conditions are at their worst. A look back at the last seven U.S. recessions reminds us that the S&P 500 Index has, as often as not, started its climb during the depths of a recession (chart).

S&P 500 Returns During Recession, One and Three Years After End

Recession	During Recession	One Year After	Three Years After
Nov. '73 to Mar. '75	-17.90%	28.32%	21.99%
Jan. '80 to Jul. '80	16.14%	12.92%	55.89%
Jul. '81 to Nov. '82	14.66%	25.40%	67.24%
Jul. '90 to Mar. '91	7.64%	11.04%	29.84%
Mar. '01 to Nov. '01	-7.18%	-16.51%	8.44%
Dec. '07 to Jun. '09	-35.46%	14.43%	57.70%
Mar. '20 to Apr. '20	-1.12%	45.98%	TBD

Sources: NBER, Returns 2.0, awealthofcommonsense.com/2022/06/timing-a-recession-vs-timing-the-stock-market/

A Pullback, Then More Growth

History also reminds us that periods of retrenchment have always been followed by new growth, economic expansion and improved equity values. There is little reason to expect otherwise in this cycle. Moreover, even during the most challenging times, things can quickly change, so continue to look forward. As always, we remain here to provide support.

Bull & Bear Markets: A Closer Look

In the first half of 2022, the S&P 500 Index entered into a bear market prompting some to ask: are the Canadian markets next? As a reminder, a bear market is often defined as a period in which stocks have declined by 20 percent from a previous peak over a period of usually two months or more.

While the Canadian markets have been more resilient to date, consider that bear markets are a normal part of the investing cycle. Since 1970, the S&P/TSX Composite Index has had an average annual return of over six percent (not including dividends reinvested) but this hasn't come without an abundance of ups and downs. There have been nine bull markets, lasting 61 months (on average), leading to an average gain of 151 percent.* This compares to eight bear markets, which lasted 10 months (on average), resulting in an average decline of 32 percent.* The upturns, on balance, lasted longer than the downturns and took prices to much higher than their former peaks.

While declining asset values during bear market times may feel uncomfortable, it shouldn't be a time for investors to run and hide. This is because the biggest up and down days often occur during down markets.¹ Since 1928, the S&P 500 Index has had 350 trading days when the index fell by three percent or worse and 290 days when it surged by three percent or more in a single day. More than 90 percent of both volatile days have taken place during market corrections of 10 percent or worse and more than 80 percent have taken place during a bear market drawdown of 20 percent or worse.

By making rash decisions such as exiting the markets during a market drop, you're likely to miss significant upward moves.

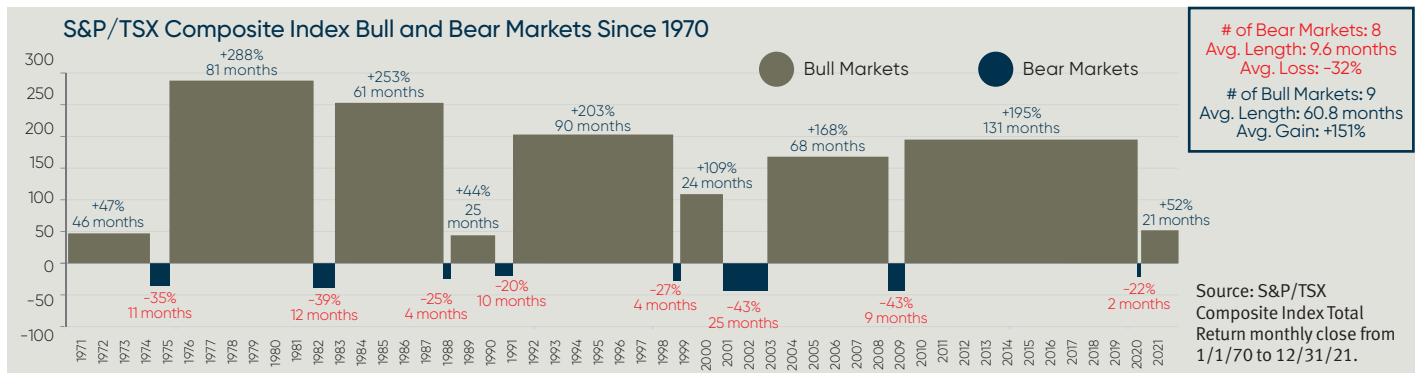
Consider also what happens after a bear market. It isn't uncommon to see significant gains. Here are the worst bear markets for the S&P 500 Index since 1970 (chart), along with their ensuing one, three and five-year forward returns. While the timing is uncertain, we know that equity values eventually recover their positive tone in the same way as the cycle swings back towards more optimism.

S&P 500 Index Returns After a Bear Market

Drawdown	Peak	Trough	1 Year	3 Years	5 Years
-56.8%	10/9/07	3/9/09	53.6%	97.9%	181.6%
-49.1%	3/24/00	10/9/02	24.4%	59.0%	105.1%
-48.2%	1/11/73	10/3/74	38.1%	72.7%	117.5%
-33.5%	8/25/87	12/4/87	23.2%	55.5%	121.7%
-31.9%	2/19/20	3/20/20	69.8%	TBD	TBD

Equities continue to be one of the best asset classes in which to grow wealth, but this is not without market fluctuations. This period of volatility and economic uncertainty will eventually pass. Longer-term investors should remember that portfolios have been positioned with the expectation that the equity markets will experience both ups and downs – this is a normal part of the investing journey. Continue to look forward to better days ahead.

1. <https://awealthofcommonsense.com/2022/08/when-is-a-bear-market-over/>.
*Including reinvested dividends.



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