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April Market Analysis

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The Markets

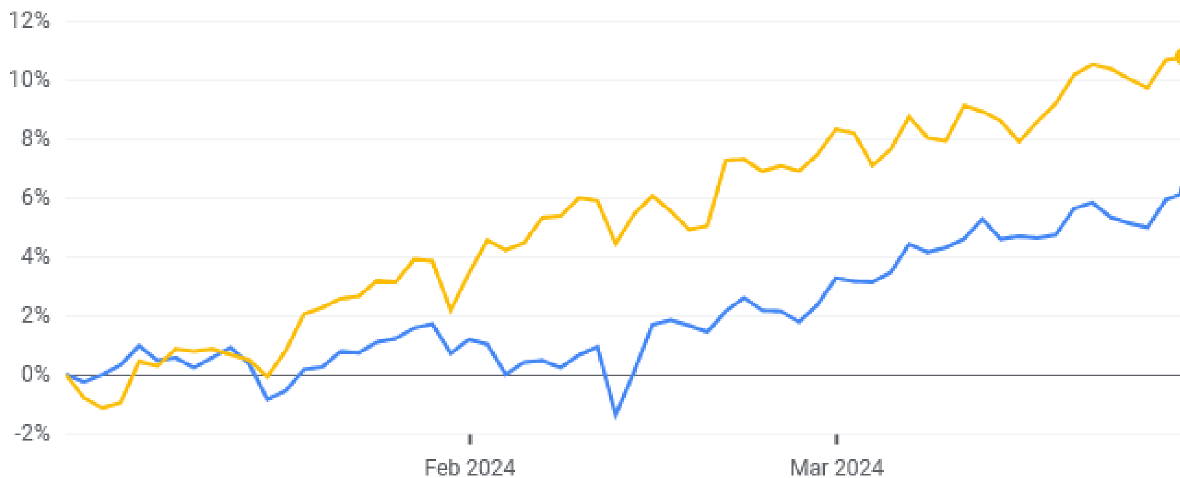
	April	Change in Month	Year –To-Date
S&P TSX	21714	−2.0%	3.6%
S&P 500	5035	−4.2%	5.6%
Dow 30	37815	−5.0%	0.3%
Oil	$81.54	−1.9%	13.8%
Gold	$2299	2.0%	11.0%

It was the best of times; it was the worst of times. In the middle of April, the S&P 500 had its worst week year-to-date with stocks such as NVIDIA declining 14%. As the month came to a close the S&P 500 had its best week year-to-date as stocks such as NVIDIA rallied 15%. We were told technology stocks had rallied too far too fast and were due for a correction. The companies released their earnings for the first quarter and stocks rallied. Even Telsa, that had disappointing earnings, rallied on the hope they would have self-driving taxis and a new lower cost model. The US economy continues to be resilient so hopes for interest rate cuts have been deferred until later this year. The market was weak as the likelihood of interest rates staying higher for longer became a generally accepted tenet. Not that long ago investors expected 6 interest rate declines but today expect the Federal Reserve to begin cutting rates in the late third quarter for one time for the year.

It was a good month for commodity stocks. Strength in the price of gold and copper led to a 5.9% rally in the Materials sector. The Gold subsector rose almost 7%. The prospect of continued growth combined with the chance of interest rate decreases kept the price of gold strong. Some analysts indicate foreign central bank purchases supported the price of gold. Despite weaker oil prices the Energy sector was the second strongest performer in the month. Small capitalization stocks on the Venture exchange also had strong performance. At the other end of the spectrum were the interest sensitive stocks. The prospect of higher for longer interest rates led to a 7% decline in the Real Estate sector. Income trusts, that are essentially a yield vehicle, were the weakest group and declined more than 8% in April. The Banks declined by more than 5% as investors became concerned that higher interest rates could put pressure on real estate loans and other borrowers. After a year of strength, the Information Technology gave up some of their gains and finished the month down 5.4%.

The graph below presents the performance of the S&P 500 and the S&P TSX for year-to-date.

Year-to-Date Performance S&P 500 and TSX



TSX, S&P 500 source google.com/finance

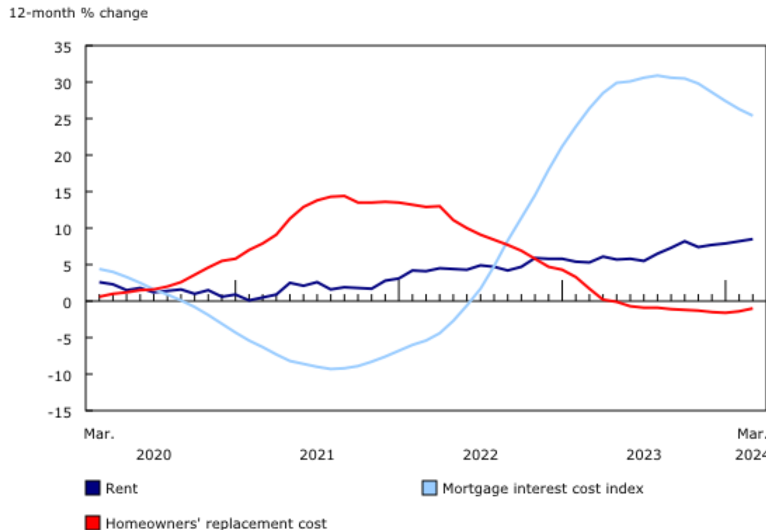
Economic Indicators

1. Consumer Price Index - Inflation

Will he or won't he? Everyone is focused on the Bank of Canada to see if they will lower interest rates. Two key factors in the Bank's decision are the strength of the economy and inflation. In this section we will discuss inflation as measured by the Consumer Price Index.

The Bank of Canada target rate for inflation is 2%. The Consumer Price Index (CPI) rose 2.9% in March. This might cause the Bank to delay any rate decrease. The devil is in the details they say.

Gasoline prices are extremely volatile and had a significant impact on the reported level of inflation. If you exclude gasoline prices, the rate of inflation is 0.1% lower than reported in March but when they are included the rate of inflation increased by a further 0.1% versus the previous month. One problem facing the Bank of Canada is the Bank is part of the problem. Higher interest rates used to reduce inflation add to the cost of mortgages which is in itself inflationary. Shelter prices rose 6.5% over the past year. Mortgage costs were 25% higher than a year ago. Immigration combined with fewer people moving from rental properties to home purchases created an 8.5% increase in rents. The chart below shows the changes in rent and mortgage interest cost. One side note is that inflation is the rate of change in prices. If the Bank holds interest rates steady, houses will not be more affordable but mortgage interest costs will not change so will have a zero rate of inflation in a few months.



Source: Statistics Canada

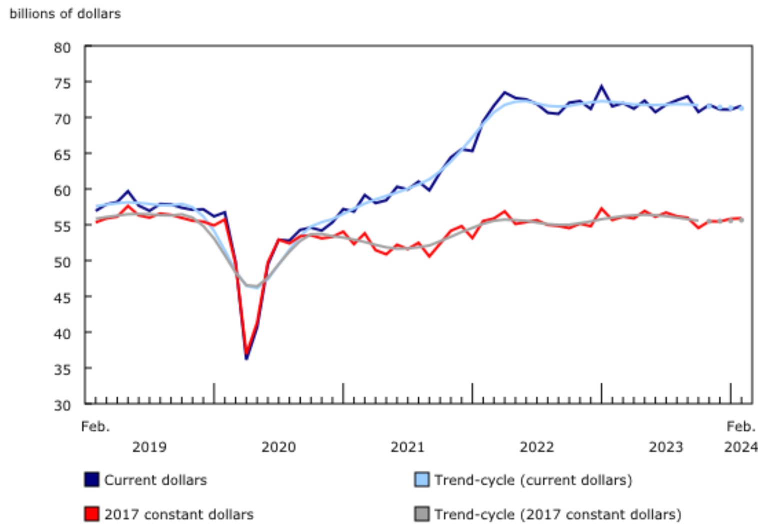
The Bank is concerned as much about the rate of inflation as the direction of inflation. For instance, in November CPI ran at a 3.9% annual rate, in February the rate dropped to 3.1% and now in March it is 2.9%. They say the trend is your friend. Based on this trend the Bank can consider lowering interest rates.

There are many ways to measure inflation and the Bank looks at all of them. Some analysts prefer to look at core inflation rate that removes volatile food and energy. Others argue that you can't live without heat and food. Removing short-term volatility has its benefits. The Bank preferred definition of inflation is CPI trim. CPI trim removes the largest moves up and down in a factor. For example, if gasoline was up 10% and Services declined 10%, the bank would exclude both outliers in its calculation of CPI trim. As you might expect CPI trim is less volatile. The trend is similar to the broader definition of inflation. CPI trim declined from 3.6% in December to 3.2% in February to 3.1% in March.

2. Canadian Manufacturing

The second factor considered by the Bank of Canada is economic strength. Manufacturing activity is a great measure of economic activity.

Manufacturing sales were strong in February with growth evident in 13 of 21 sectors. Manufacturing sales grew 0.7% in February alone. Two primary contributors to growth were petroleum & coal and electrical equipment that grew 4.3% and 12.6%, respectively. This more than offset weakness in the chemicals sector. The gains in petroleum were due almost entirely to higher pricing and not higher volume.



Source: Statistics Canada

There are some positives for the manufacturing sector. Inventories declined by 0.7% in February. This is the third consecutive month of lower inventories. If companies draw down inventories, they are likely to need to make more goods to meet future sales. Just think of the local grocery store. When the shelves are full the store does not need to reorder, a couple of busy days and the store still has enough inventory. A very busy couple of days will cause them to have empty shelves, so lower inventories will lead to more orders and more goods manufactured. One key measure is the inventory-to-sale ratio. This ratio compares inventories to monthly sales, the higher the number the more inventory is on hand relative to sales. A lower number means it is more likely that future sales will require new production. The inventory to sales ratio declined last month. This is supported by the increase in the level of unfilled orders.

Reflection

Taxes, not as bad as you might think

I cannot turn on the TV without hearing how the change in the capital gains tax is going to wreck havoc on the economy. Some of the math and logic is faulty. The problem with this issue is it has become a political hot button and it is easy to get lost in the math.

The facts are the recent federal budget increased the amount of the capital gain that is taxable from 50% to 66% for the gains in excess of $250,000. Those supporting the new tax state that only 0.13% of people filing tax returns have gains in excess of $250,000. Therefore, it is a tax the rich measure. Others disagree. Investors have a few months to avoid the new tax level as the new rules do not take effect until June 25th. One key point to note is the change in rate is a change in the percentage that is taxable NOT the tax rate on the gain. No one will pay 66% tax on a gain, just as no one pays 50% tax on a gain.

The rate that is changing is the percentage of the gain that is taxable, not the tax rate on the gain. For instance, if you are at the top tax bracket you pay 53.5% of the next dollar you earn from interest or wages. Based on a 50% inclusion rate you pay 26.8% tax on the next dollar of capital gains. At a 66.6% inclusion rate you would pay 35.3%. The headlines scare the crap out of people. You hear 66.6% tax and you mind drifts to the question why would anyone invest if their income is taxed at 66.6%? This is not the case. Some argue there should be no capital gains tax as you had to pay tax on the funds you invest. I am not going to get into the moral issues of taxation.

One hot button is the sale of a family cottage. A real estate agent was on the news and said prices of cottages might drop by 5% to 10% due to the change in the capital gains rate. He indicated people would sell to lock in the gain. First the math then the logic test. If you assume the cottage has been in the family for decades and cost almost nothing. Then assume it is now worth $1 million. At the existing rates only half the gain would be taxable or $500,000. Under the new rules the first $250,000 gain remains as 50% taxable ($250K * 50% = $125K). Sixty-six percent of the remaining gain of $750K is taxable ($750K * 66.6% = $499K). The amount gain that would be taxable would be $629,000 ($125K + 499K). The difference between the amount to be included in your taxes as income is $129,000 ($629K - $500K). At the top tax rate of 53%, you would pay $68,000 in additional taxes. Sixty-eight thousand as a percentage of the one-million-dollar gain is 6.8%. It is totally illogical for people to pay 5% to a real estate agent to save 6.8% in taxes. Plus, the agent forecast a 5% to 10% decline in cottage prices. It would be ludicrous to sell your summer vacation home to save $18,000. It would cost you more to take a vacation somewhere else.

There are some other problems with the sell your cottage to avoid the tax increase story. One, if the price declines by 6.6% you have given up the entire tax savings. One benefit of RRSPs is they defer the tax you have to pay; they do not eliminate the tax. The same logic applies to your cottage. Why pay tax today by selling when you can continue to enjoy your cottage and worry about the tax years or decades later. Some argue it is a family cottage that has been in the family for years and it would be unfair to tax them when their parents die. This is true no matter what the tax rate. The same is true for death taxes politely called probate fees. However, some of the gain could be sheltered. If the person who owns the cottage does not own another property, they can designate the cottage as their principal residence and any change in value while designated as a principal residence would not be subject to capital gains tax. A senior in a retirement home could designate the family cottage as their principal residence and reduce the tax burden on their family.

The next story on the news was the increased capital gains inclusion rate was going to exacerbate the doctor shortage in Ontario. Really? Many doctors have incorporated their practice. This allows them to tax effectively leave funds in the business to earn income at the lower small business tax rate versus the higher tax rate on individuals. The astute doctors keep their investments in their corporation. The gains on their investments will now be subject to the new tax rates the same as the rest of the wage earners except corporations do not get the benefit of the first $250,000 being subject to the lower tax rate. Now the doctors' income from practicing medicine remains taxed at the same rate so there is no incentive to retire as their working income remains taxed at the same rate. The gains they have in their corporations will not change whether they practice medicine or sit at home practicing the piano. There is no tax benefit of removing their services because their investments are taxed higher. You could argue a new doctor has much to consider. However, many new doctors have debt related to the cost of medical school so capital gains inclusion rate probably don't matter for many years or the stories on the news about indebted doctors is also not true. The other night a story on the news indicated doctors are working longer hours and earning less so the tax on their investment is likely the last thing that will cause them to retire. There were some other changes to the tax laws that were positive to small business, including the medical practices.

No one likes to pay tax. Higher taxes are never good. Let's take a second to review how unjust the new tax rate is for capital gains. Take a cottage acquired in 1988 or a medical practice that year, 46 years ago. In 1988 the tax inclusion rate was 66.6% on every dollar, not $250,000 exemption. You expected pay a capital gains tax on your property or gains in your corporation of 66.6% when you started. We did not have a shortage of doctors in the nineties, so a 66.6% inclusion rate should not cause them to close up shop. Let's fast forward to 1990, a whole 2 years, when the tax inclusion rate was 75%. Yes, that applied to cottages and investments in corporations. The rate did not decline to 50% until 2000. We had twelve years where the tax rate was on every dollar and for 10 years was in excess of the current rate. What if we went back and told people you knew the tax inclusion rate was 75% when you opened your medical practice or purchased your cottage so how can you expect to only have a 50% inclusion rate? Yes, this is a ridiculous argument but not far off the fact that we know tax rates change and they have been higher so it is hard to accept the world will end with this tax change.

Some other points

1. It was a Liberal government that lowered the inclusion rate to 50% from 75%
2. This is the biggest point to consider…. There is an election in less than 2 years. Who do you think will win. If it is the Conservatives, do you think they will keep the rate at 66.6%? Therefore, why trigger gains today when you can wait and defer paying tax until rates might drop in a couple of years. There is your tax planning tip.

Summary

"Nothing is certain but death and taxes." Ben Franklin.

This month we looked at the overstated risks to the economy of the new capital gains inclusion rate. The first point to note is the rate that changed is the percentage of the gain that is taxed not the tax rate on the gain. The 66.6% inclusion rate would mean a tax rate of approximately 33.3% at the top tax bracket which compares favorably to the 50% tax rate on wages and interest. Some forecast a rush to sell cottages to avoid the increase in taxes. The flaw in that logic is the commission on the sale would almost fully offset the taxes saved. Others indicate doctors will close up their practices if the gains rate increases. The tax on the doctors' income from their practices does not change with this budget. The gains they already have on their investments will be taxed at the new rate whether they practice medicine or not, so I think this is overstated. One factor most people forget is there is an election in a couple of years and the current government could be voted out, do you think the axe the tax party will keep capital gains taxes at the new higher level? The problem may solve itself with the passage of time.

What are we doing about this tax change and our view on the markets. We have an extremely low portfolio turnover which means we do not trade frequently. Active traders lock in capital gains and make it a taxable event. If you have a stock that has gone up and have not sold you continue to delay paying tax. Giving the government tax dollars earlier than you have to is not the best strategy. We continue to like dividend paying stocks. Dividends are taxed at a lower rate than wages and interest. We like the ability to use the cash from dividends to allow clients to meet their cash flow needs or allow us to rebalance the portfolio by deploying the cash in undervalued securities. In short, we have not changed our strategy.

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