ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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What's With Negative Interest Rates?

Jyske Bank, Denmark's third largest, made history in August by offering the world's first negative interest rate mortgage. For a 10-year term, Danish homeowners can borrow at -0.5% per year.

With a negative interest rate, borrowers still make monthly payments as usual. However, the sum of the monthly payments over the term of the mortgage equates to less than the principal amount borrowed. For example, a million-dollar mortgage at -0.50% would require 120 monthly payments of $8,125 totaling $975,000 over the 10-year term. The borrower is essentially paid $25,000 to borrow the funds.

How is that possible? How can a bank afford to pay a borrower? How does the economy function properly with negative interest rates? These are good questions, and they boggle the mind!

The mortgage is possible because Jyske Bank is able to borrow from institutional investors at negative rates. The bank is simply passing this good fortune on to its customers – if you can call it good fortune.

At the time Jyske Bank launched its negative interest rate mortgage, more than $17 trillion of the world's debt was trading with a negative yield to maturity. Most of this is issued by governments in Europe and Japan, although there are some corporate bonds with negative yields as well. Even Greek three-month treasury bills recently traded at a negative yield!

Bonds in Europe and Japan have negative yields because their central banks helped push them there with extremely accommodative monetary policies. Interest rates on short-term bonds have fallen because the administered rates set by the European Central Bank and the Bank of Japan have been reduced to negative territory. Meanwhile, interest rates on long-term bonds have dropped below zero because these institutions continue to execute big bond-buying programs (quantitative easing); bond-buying pushes prices up and yields down. The hope, of course, has been that ultra-low interest rates would stimulate the European and Japanese economies, and yet growth remains sluggish.

Some think it is only a matter of time before we have negative interest rates in North America. While we are not sure if that will occur during the current economic cycle, we are definitely pondering the possibility. What does it mean when interest rates are negative, and why would someone want to buy a bond with a negative yield? We can think of five possible reasons:

1) Fear – Investors accept a small loss on the bond because they believe stocks, real estate and other assets will perform worse.

2) Price Speculation – Investors believe the economic outlook will deteriorate and interest rates will go even more negative, which would push up the price of already negative-yielding debt.

3) Currency Speculation – Investors believe the currency of the bond will appreciate enough to create a gain that will more than offset the loss from the negative interest rate.

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4) Purchasing Power Protection – Investors believe the general level of prices will fall and that they will receive a positive "real" return after inflation. A bond with a -1% interest rate would be a good investment if there is annual deflation of 5%. An investor's purchasing power would increase by 4% per year.

5) Forced Buying – Institutional investors have to accept prices (and yields) as offered because they are mandated to allocate money to the bond market.

None of the foregoing explanations is comforting. Rather, if investors are pricing bonds correctly, the outlook is downright depressing. That was certainly our interpretation until we read Richard Koo's book titled *The Other Half of Macroeconomics and the Fate of Globalization.*

Mr. Koo, a respected economist and expert on balance sheet recessions, argues that monetary policy loses its potency after bubbles burst and the private sector (consumers and businesses) has to repair its balance sheets. In his opinion, interest rates are extremely low today due to an absence of private-sector borrowers.

After bubbles burst, the private sector tends to focus on saving – paying down debt and repairing balance sheets. In Japan, the private sector has been a net saver of funds since the country's twin real estate and stock market bubbles burst in 1990. Similarly, the German private sector has been in saving mode since the bursting of the dot-com bubble in 2000, while most of the private sectors in the rest of the major western economies shifted from borrowing to saving following the 2008/09 Financial Crisis. Interestingly, Canada is a rare exception; our private sector appetite for leverage has continued unabated.

Mr. Koo believes a country's government needs to borrow and spend when its private sector is saving and repairing its balance sheets. If governments don't offset private sector savings with borrowing, economies will contract. In a leveraged world, shrinking economies are deadly, as they can lead to a self-feeding deflationary spiral.

Japan has avoided a deflationary disaster and maintained a reasonably healthy economy since its bubbles burst, largely because its government has run large budget deficits. On the other hand, many countries in the European Union are struggling because they are bound by a law that forbids deficits greater than 3% of GDP. That's not enough when private sector saving is a greater percentage of an economy.

The good news is that there seems to be a growing appreciation by thought leaders that governments have a larger role to play in nursing economies back to a healthier state. Mr. Koo believes governments should take advantage of the large pool of private sector savings and ultra-low interest rates to fund infrastructure and other socially desirable projects that will provide attractive returns. These projects will stimulate economic growth and accelerate the pace of private sector balance sheet repair.

Once balance sheets are mended and the private sector shifts back to being a net borrower, interest rates will likely rise as individuals and corporations once again compete with governments for funds. Indeed, if central bank bond-buying programs aren't sufficiently reversed by that time and government deficits aren't simultaneously reduced, interest rates could rise significantly.

It's impossible to know whether central banks and governments will do what's needed or whether they will make mistakes. Given the level of social unrest in the world today, and the associated polarization of politics, it is not unreasonable to worry.

The bottom line is it is really hard to predict the future of interest rates. There is a risk of deflation, which could send interest rates even lower, and there are inflationary possibilities, which could cause interest rates to soar.

Because the world has never experienced negative interest rates before, we can't look to history for guidance. Instead, we take seriously the negative economic outlook implied by the bond market. Consequently, we continue to advise a high-quality approach to investing. We want to own the securities of the best companies and the strongest institutions and governments in this uncertain time. Now is not the time to speculate on higher-risk investments.

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St. Paul's Foundation – Lights of Hope Community Celebration November 14, 2019 Vancouver, BC

Since 1998, St. Paul's Foundation has illuminated the streets with a breathtaking display of Christmas lights in support of Lights of Hope. This year's display will also contribute to the future of St. Paul's at the Jim Pattison Medical Centre.

For 17 years, Odlum Brown has proudly been a corporate sponsor, supporting the life-saving work being done at St. Paul's and other Providence Health Care sites throughout British Columbia.

The Community Celebration, open to the public, will see this year's display of over 100,000 light bulbs switched on for the first time. For more information, visit lightsofhope.com.

Not All Assets Are Created Equal: Death and Taxes

Not all assets nor accounts are treated equally when it comes to income tax – in life or after death. This month, we highlight some of the income tax implications that can arise from holding various account types and real estate at the time of death.

Non-Registered Accounts

General Rule: ***Deemed disposition at fair market value***

- Even if no securities are actually sold, the Income Tax Act considers (or deems) all securities in a non-registered account to be sold and immediately reacquired at fair market value on the date of death. Any resulting taxable capital gains (50% of capital gains) are added to income in the year of death.
- Any resulting capital losses must first be deducted against capital gains reported in the year of death. Remaining net capital losses may then be used to reduce taxable capital gains and/or other income in the current and previous years, subject to a number of rules and limitations.

Exception: ***Spousal rollover***

- When the deceased's capital property passes to their surviving spouse or common-law partner[1] under the terms of a will or by virtue of the asset being owned jointly with right of survivorship, the transfer, by default, takes place at cost, effectively deferring any capital gains or losses. This is known as a "rollover."
- Alternatively, the executor can elect the transfer to occur at fair market value on a property-by-property basis to trigger desired capital gains or losses for tax planning purposes.

Other: ***Private corporation shares***

- In addition to a deemed disposition at fair market value (unless a spousal rollover is available), holding shares of a private corporation at the time of death may result in a number of negative consequences and generally requires specialized tax planning.

Registered Retirement Accounts (RRSPs and RRIFs)

General Rule: ***Included in income at fair market value***

- The fair market value of all registered retirement accounts on the date of death is added to the deceased's income on his or her final income tax return.

Exceptions: ***Rollover to spouse, dependent child or grandchild***

- Registered funds can be transferred to a spouse designated as "successor annuitant" on a fully tax-deferred basis.
- Amounts not passing under the successor annuitant rules can be paid to a qualifying survivor, including a spouse or dependent children or grandchildren, to reduce the deceased's taxable income. Any increases in plan value after December 31 of the year after death, until distribution, are taxable to the beneficiaries.
- Specific rollover provisions exist for beneficiaries who are financially dependent children or grandchildren under the age of 18.
- A rollover to a Registered Disability Savings Plan (RDSP) for a financially dependent infirm child or grandchild may also be available.

Other Considerations

- Depending on the amount of income expected on the deceased's final income tax return, the estate representative and beneficiaries may jointly elect, for tax purposes, to report a portion of the account balance on the deceased's tax return, rather than rolling over the entire amount.

Tax-Free Savings Accounts (TFSAs)

General Rule: ***Tax-free***

- The death of a TFSA holder does not trigger any immediate income tax consequences.

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Protecting You

As the old adage goes, "an ounce of prevention is worth a pound of cure." At Odlum Brown Limited, we are committed to taking every precaution to safeguard your personal and confidential information against unauthorized access and use, such as identify theft or fraud.

The level of sophistication in cyberattacks is astounding, and hackers' methods continue to become more complex.

Odlum Brown follows a strict identity authentication process. We will never ask you to provide your username or password over the phone or by email, nor do we accept trades or transfer requests by email.

Our business is about building long-term relationships, and part of these relationships is speaking with our clients regularly. Verbal authentication not only provides a secure method of confirmation, but also allows us to continue building the relationships we value.

If you suspect that any of your personal or account information has been compromised, please let us know immediately.

With a healthy ounce of caution, awareness and discussion, we can combat fraud together.

Other TFSA Considerations

- At Odlum Brown, the default and only beneficiary designation available for a spouse named in a TFSA contract is "successor holder." As successor holder, the surviving spouse automatically becomes the new account holder and keeps the tax-exempt status of the TFSA without affecting their own contribution room.
- If the surviving spouse is named as a beneficiary rather than successor holder, the proceeds can be used to make an "exempt" contribution to the spouse's TFSA that does not affect the survivor's TFSA contribution room. However, any increase in value between the date of death and transfer would be taxable to the surviving spouse.[2]
- If the beneficiary is someone other than a spouse, payments will only be taxable to the extent that they include income or capital gains earned after the holder's death. Such beneficiaries can contribute any of the amounts they receive to their own TFSA as long as they have unused TFSA contribution room.

Real Estate

General Rule: *Deemed disposition at fair market value*

- Real estate is deemed to be sold at fair market value on the date of death. Any resulting taxable capital gains (50% of capital gains) are added to income in the year of death.
- If capital cost allowance (CCA) – depreciation for tax purposes – has been claimed (for example, on a rental property), any past CCA deductions claimed in excess of the final market value of the building will be "recaptured" and added to income in the year of death.
- Any resulting capital losses on non-personal-use property must first be deducted against capital gains reported in the year of death. Remaining net capital losses may then be used to reduce taxable capital gains and/or other income in the current and previous years, subject to a number of rules and limitations.
- Any resulting capital losses on personal-use property are limited to offset capital gains on personal-use property, if available.

Exception: *Spousal rollover*

- A spousal rollover is available on the transfer of real estate between spouses, similar to non-registered accounts, as described above.

Exception: *Principal residence*

- If a property qualifies as your principal residence, your executor can designate it as such on your final tax return and claim the principal residence capital gains exemption to eliminate any capital gains. Seek professional tax advice on whether a property qualifies for all or part of the exemption, especially when holding more than one property that may qualify.

A Note on Probate

The probate process and associated fees on an estate are governed differently by each province and territory and are separate and distinct from the income tax rules described in this article, which are administered by the Canada Revenue Agency (CRA).

To learn more about the potential tax and probate implications that could affect your estate or for more information about the products and services offered by Odlum Brown Financial Services Limited, contact us through your Odlum Brown Investment Advisor or Portfolio Manager.

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Vice President, Director
Odlum Brown Financial Services Limited

[1] All references to a "spouse" in this article also apply to a common-law partner.
[2] The contribution must be made before the end of the year following the holder's death and designated as an exempt contribution on the survivor's income tax return.

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