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Carte WEALTH MANAGEMENT INC.

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KPW NEWSLETTER

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"The function of economic forecasting is to make astrology look respectable."- John Kenneth Galbraith

2024—A YEAR OF CAUTIOUS INVESTING

It should go without saying that when speaking about the markets we are always faced with the underlying caveat that "NO ONE KNOWS WILL HAPPEN". That being said, it is encouraging when the first quarter of the year produces positive results. I believe 2024 is going to add some meat to those caveat bones. Not only do we not know what will happen, but what we do know should add an abundance of caution to any pre-conceived investment themes.

The Way I See It.

As we continue to move further into the year there are several themes that can and likely will influence our capital markets. Before I get into these, let's recap what has happened over the last year. The broad shoulders of the U.S. economy held strong and rebounded beautifully while inflation declined. Unfortunately, this was not the case in Europe and several emerging markets countries as they struggled to get their economies moving. As inflation eased throughout the year, so did the US Federal Reserve's hawkishness, and towards the end of the year there was even contemplation about reducing interest rates in the near future. However, the European Central Bank and the Bank of England seemed less interested in taking this path and easing seems less likely any time soon.

For me, the big surprise of 2023 was the resiliency of the markets and how well they performed, ending the year considerably higher than I anticipated. That being said, these great gains did not come without some periods of considerable consternation. For example, one year ago the US experienced a regional banking crisis that had the makings of creating a major rout in the markets, but the Fed quickly stepped in and established a bank funding program that took the banks' liquidity issues away. It was an immediate and effective response that allowed the central bank to prevent a potential catastrophe and still continue to keep interest rates elevated. I give Fed Chair Jerome Powell a lot of credit for this action as it allowed the bank to address the crisis while continuing its war on inflation.

Across the pond, as dedicated as the Central Banks were to battle inflation by keeping rates elevated, the global equities markets, as measured by the MSCI AC World Index, rose more than 20% while core fixed income, as measured by the Bloomberg Barclays Global Aggregate Index, finally posting positive returns after two consecutive years of losses.

I recall how enthusiasm began to grow within our client base and this feeling was shared by many investors across the world, especially as the promise of Artificial Intelligence was thrown into the mix. By mid-year 2023 AI was sweeping over the equity markets and the major US tech companies referred to as the "Magnificent Seven" took the bull by the horns, so to speak, and painted a remarkably positive image of things to come. And this is where I see us taking the first of our ***"Cautious Investing"*** approaches.

I can still vividly recall the panic and chaos during the "Dot-Com Bubble" of the late 1990s – early 2000s. It was not pretty and many investors lost a large chunk of hard earned portfolios. I am not predicting that this situation will occur during this tech boom, only that history tells us that not all companies are created equal and that the companies we see in front during the beginning of a tech boom may not be the companies that are still around once that boom matures. This is a time to put our faith in great fund managers who have the means to properly analyze each underlying company in any subset prior to adding it to their portfolios. This will be critical as the AI sector evolves and the investment environment becomes more challenging.

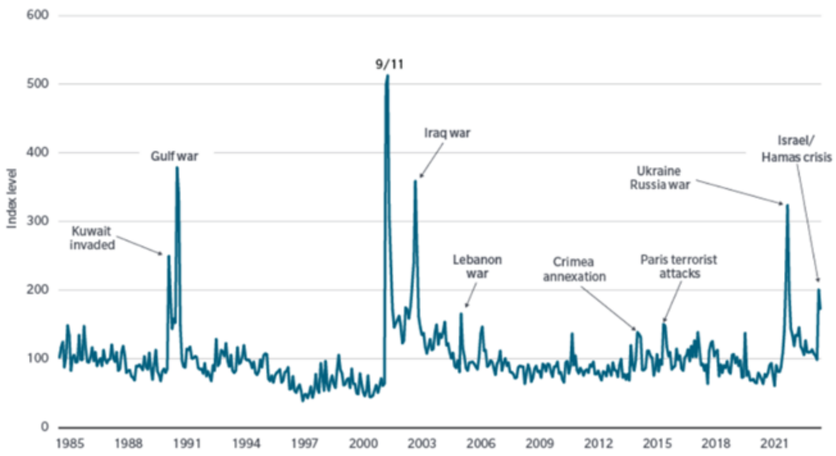
I do not envy fund managers these days as they navigate through some of the most challenging geo-political events we have experienced in many decades. And this is only the backdrop as they also are confronted with elevated sovereign debt levels, higher borrowing costs and disrupted global supply chains. Right now, research is critical and research is king.

2024—A Year Of Cautious Investing - Continued

If an individual investor does not have the resources to dig deep into a potential investment, then my advice is to let the experts do it. A management fee is a small price to pay to have their resources available. It doesn't mean they always get it right, but the probabilities are higher that they will more often than they don't.

Geopolitical risks have risen dramatically and I believe they are becoming more difficult to navigate. Dario Caldara and Matteo Iacoviello have constructed a well followed index that measures the adverse geopolitical events and associated risks based on a tally of newspaper articles covering geopolitical tensions. They have examined and back tested its evolution and economic effects since 1900. The reason I emphasize this is that higher geopolitical risk foreshadows lower investment, stock prices, and employment. It is also associated with a higher probability of economic disasters and creates a larger downward risk to the global economy.

EXHIBIT 2: MONITORING THE INTENSITY OF GEOPOLITICAL RISKS



Source: Geopolitical Risk (GPR) Index (matteoiacoviello.com). 28 Feb 1985 through 30 Nov 2023. Monthly data.

According to this Index, risks have risen substantially since Russia invaded Ukraine, especially when compared to the period from 2004-2021. I do not see a resolution any time soon. When we add the deterioration of relations between China and the U.S., increasing nuclear capabilities in Iran, and a renewed instability in North Korea, I can only assume that international tensions will increase. To add a little more fuel to the fire, as the world becomes more polarized, 2024 is a year when half the worlds population will be asked to vote for new leaders.

I advise caution because geopolitical risks are extremely unpredictable and almost impossible to protect an investment portfolio from. Let's face it, the timing, magnitude, duration and investor response to any crisis is always unpredictable. With this in mind, I suggest that building a portfolio with the primary objective of protecting against geo-political risk is a waste of time as it is impossible to predict the unexpected.

So, should we just ignore portfolio allocation? **No!** There are always strategies that investors can use to optimize their risk/return management.

In my opinion, the key to successful investing in this economic environment is to be well diversified by fund manager, asset class, geography and sector. I urge investors to seek non-correlated investments to add to their portfolios. At KPW Financial, we have been focused on introducing more non-correlated investments to our clients.

Investment portfolios should maintain a high level of liquidity. One of the biggest problems investors have during trying times is that they are over-weighted in investments they can't get out of when the markets turn on them. 2024 is a year to be ***"portfolio nimble."***

I am not suggesting, by any means, that markets will be hit hard in 2024. On the contrary, I believe this could be a very good year for our portfolios. I am only suggesting that we do not take anything for granted and that we spend more time evaluating and managing potential threats to our portfolios.

2024 has the makings of being a banner year, especially with falling inflation and expected falling interest rates. I only suggest that we apply a little caution to our underlying portfolio selections and construction.

HOLDING MY MORTGAGE IN MY RRSP

Imagine being able to be the mortgage holder of your own residential mortgage where you would be the one collecting the interest payments on the mortgage instead of some financial institution earning those interest payments. It is possible but is it practical?

The Income Tax Act contains rules and stipulations that specify the kinds of properties that qualify to be held in an RRSP or RRIF. The Act states that a debt obligation secured by a mortgage on real or immoveable property located in Canada is considered a qualified investment.

This is where it begins to get a little complicated and questionable. The Act states that the mortgage must be administered by an approved lender under the National Housing Act, and it must be insured by the Canada Mortgage and Housing Corporation (CMHC), or by an approved private insurer of mortgages. The interest rate and other terms of the mortgage must be derived from an arm's length transaction. That is, they must reflect normal commercial practice and the mortgage must be administered in the same manner as would any other arm's length mortgage transaction.

What this means is that you become a bystander in this transaction. Even though you are essentially paying yourself, you can't give yourself the deal of a lifetime in interest rates. You must pay market interest rates and you cannot miss a payment. If you default on the mortgage, the RRSP trustee is obligated to collect and even foreclose on you.

If I haven't yet dissuaded you, let's see how the strategy would work.

To begin with, you must have the available cash within your RRSP or RRIF to even contemplate the transaction. Ultimately, the cash within the structure will be converted to an investment. Unfortunately, this is not a simple straightforward transaction. There are fees and administrative transactions involved, but ultimately you will end up paying your principal and interest payments to your RRSP or RRIF instead of a financial institution, so that you are the one benefiting from those payments.

Keep in mind that those payments you make to the RRSP/RRIF are not considered deductible contributions. The payments are simply a repayment of the mortgage principal and interest. You can liken it to any fixed income investment like Bonds or Guaranteed Interest Certificates.

The big question you must ask yourself before venturing into this area is: "Does it make sense?" The first point you will want to consider is whether holding the Mortgage is more advantageous than holding another type of investment. Remember to view this investment with total impartiality because that is the way any other entity looking at this transaction will view it. The answer can usually be determined by considering which investment would give you the greatest returns. For example, if the mortgage interest, less any fees, is greater than an alternative investment option with similar risk, then you should consider holding your mortgage in your RRSP. Conversely if the return is less then you should consider holding your mortgage outside your RRSP and the alternative investment within your RRSP. This is obviously an oversimplification which doesn't consider other factors like; the size of the mortgage, the diversification verses over-concentration factors, and the time horizon to name a few.

It is important to evaluate the size of the mortgage against the fees incurred to implement it. In this case, size does matter. Although it may be extremely appealing to be able to pay yourself, it may not make sense.

The size of your RRSP tends to be negatively correlated with the size of your mortgage. Let me explain. People generally begin contributing to their RRSP around the same time they purchase their first home with the accompanying mortgage. At this time, your RRSP will likely be at the lowest amount while your mortgage is likely to be at its highest amount. As the RRSP grows, the mortgage diminishes. By the time your RRSP is large enough to invest in a mortgage, your mortgage may be too small to make it economically feasible as the fees cannot be justified.

HOLDING MY MORTGAGE IN MY RRSP—Continued

Before applying this concept in your RRSP you may want to consider the reasons why you are doing it. Holding a mortgage in an RRSP should really be a consideration if it is meant to replace the fixed income component that already exists there. Investing all or a great majority of your RRSP in a mortgage will take away any benefits of diversification. Every investor should understand the weakness of an investment strategy that literally puts “all your eggs in one basket”.

Recently, high interest rates have been very appealing to investors looking to invest in fixed income vehicles like mortgages. In fact, the five-year rates have seen guarantees in the mid-single digits. The key word being guaranteed. The risk you run in locking up your money in a five-year guaranteed rate mortgage is that your funds are locked up and if you change your mind because better opportunities present themselves down the road, you are subject to the same fees any financial institution would require from a mortgagee intent on breaking the terms of the agreement. Remember, it is an arms-length transaction that is controlled by an outside administrator, not you. You have only provided the funds.

Here is another conundrum faced by people wanting to hold their mortgage within their RRSP. There is an inherent conflict of intertest. When you borrow money from a financial institution you strive to obtain the lowest rate possible and yet when you hold your own mortgage within your RRSP you will want to pay the highest interest rate possible for the longest term possible to maximize the RRSP’s return. To make matters worse, eventually the RRSP will be converted to a RRIF and the higher payments will likely turn into higher income which means higher income tax.

You may have been better off holding your mortgage outside your RRSP at a lower interest rate and for a shorter term, and contributing the savings to your TFSA which grows tax-free as are the withdrawals.

I have been saving the best part for last. As with any conventional mortgage, you will have to qualify to hold your own mortgage, following the approved administrators usual credit application process. You will likely have to provide information to satisfy their income verification and cashflow requirements. There will be a credit bureau check, appraisal on the property at your cost, and satisfying any other requirements for mortgage approval. How ironic that you will need to be approved to borrow your own money.

Some of the costs you will incur include: Appraisal fees, application and set up fees, mortgage administrative charges, legal fees and mortgage insurance costs. According to a CIBC report on RRSPs published in 2023, the mortgage insurance premium would range from 0.6% to 4% of the amount of the mortgage.

When you compare the total fees of holding a mortgage in your RRSP to the fees of another comparable investment, you might just reconsider the viability of this option.

Of course, there may be times when this does become the best solution. The way to determine this is to meet with your financial advisor and review your personal situation.

WELLNESS AND FINANCIAL PLANNING

Nearly 15 years ago when I completed my Bachelor of Arts, Honours degree in Psychology, little did I know I would find myself as a woman in wealth management. Although there has never been a doubt in my mind that my career choice was right for me, I can see why my educational background may lead to confusion when considering where I stand today.

The journey and the process have evolved over time, and the link between my psychological background and what I do now is becoming evidently more valid.

Mental and emotional well-being has always been the deep-rooted inspiration for what I do. It was the driving force behind my choice in post-secondary studies and has kept me well vested in the financial services industry alike.

In our shift to holistic lifestyle financial planning, we can see the relaxing effect that it has on our clients. This makes perfect sense given that some of our greatest stressors are linked to our finances, regardless of our degree of wealth. The path may have been long and winding, but we've arrived at a place in our process where all the pieces have finally come together.

In my quest to contribute to people's wellness, my career aspirations included being a doctor, a therapist or a clinical researcher. Although fundamentally different there certainly are similarities and aspects that overlap, to me in a more meaningful way. There is an uncanny overlap between mental health initiatives and my role as a lifestyle financial planner.

Active listening and asking the right questions are key to checking on clients' sense of well-being. Regardless of the scope of concerns, walking clients through what should work along with the uncertainties lays the groundwork, and in doing so relieves great tension for our clients.

Clients' net worth and concerns may vary, but the process seems to have a universal effect, one of calming, reassurance, and optimism. It doesn't necessarily need to be favorable, but knowing what the issues are and where the work needs to be put in has a positive impact, people just need to know.

I continue to be inspired by the emerging research surrounding mental and financial well-being. The mind-calming effect of having a financial plan has been noted in recent research by the Canadian Mental Health Association and Bridgehouse Asset Managers, whose studies have shown that 90% of investors who have a financial plan say their mental wellbeing ranges from good to excellent.

They also report that ***"advisors are in a unique position to impact the mental health of their clients, helping them feel hopeful about their financial futures and confident that long-term goals are achievable."*** This study showed the same positive effect impacts on sleep, as sleep issues are often a potential indicator that there are significant stressors affecting mental well-being. They demonstrated that simply having a financial plan is a big factor in how well an investor sleeps; ***"of those with financial plans, three quarters say they sleep well at night."***

I can attest to the fact that we as planners must often dig deep into client's affairs, and it is not always easy to get the full picture, especially when there are feelings of shame present.

In our role, active listening shows that we care about what's important to the client.

It is prudent to be aware of emotional and physical cues. With this said, while making space for tough conversations about peace of mind with clients, we also need to know where to draw the line; distinguishing what is within our expertise and staying in our own lane is critical.

Referring outwards is a key role of a prudent financial planner, understanding where our expertise ends and enlisting the help of other professionals and resources.

WELLNESS AND FINANCIAL PLANNING —Continued

My ‘why’ has always been there, but now there is a name to our process that links it all, and ongoing research to support and inspire.

There is increasing evidence to support the fact that our quest for wellness should incorporate financial planning as a high priority for promoting mental health. We continue to contribute through our role as **lifestyle financial planners** by listening and providing clarity and straddling the emotional and the technical.

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PROTECTING YOUR LIFESTYLE BY KPW

MACKENZIE Investments

Quick reference guide

2024 tax planning

Provincial/territorial income tax rates[1]

(current to January 2024)

British Columbia	
First $47,937	5.06%
$47,938 – $95,875	7.70%
$95,876 – $110,076	10.50%
$110,077 – $133,664	12.29%
$133,665 – $181,232	14.70%
$181,233 – $252,752	16.80%
$252,753 and over	20.50%

Alberta	
First $148,269	10.00%
$148,270 – $177,922	12.00%
$177,923 – $237,230	13.00%
$237,231 – $355,845	14.00%
$355,846 and over	15.00%

Saskatchewan	
First $52,057	10.50%
$52,058 – $148,734	12.50%
$148,735 and over	14.50%

Manitoba	
First $47,000	10.80%
$47,001 – $100,000	12.75%
$100,001 and over	17.40%

Ontario	
First $51,446	5.05%
$51,447 – $102,894	9.15%
$102,895 – $150,000	11.16%
$150,001 – 220,000	12.16%
$220,001 and over	13.16%

Quebec	
First $51,780	14.00%
$51,781 – $103,545	19.00%
$103,546 – $126,000	24.00%
$126,001 and over	25.75%

New Brunswick	
First $49,958	9.40%
$49,959 – $99,916	14.00%
$99,917 – $185,064	16.00%
$185,065 and over	19.50%

Nova Scotia	
First $29,590	8.79%
$29,591 – $59,180	14.95%
$59,181 – $93,000	16.67%
$93,001 – $150,000	17.50%
$150,001 and over	21.00%

Prince Edward Island	
First $32,656	9.65%
$32,657 – $64,313	13.63%
$64,314 $105,000	16.65%
$105,001 $140,000	18.00%
$140,001 and over	18.75%

Newfoundland & Labrador	
First $43,198	8.70%
$43,199 – $86,395	14.50%
$86,396 – $154,244	15.80%
$154,245 – $215,943	17.80%
$215,944 – $275,870	19.80%
$275,871 – $551,739	20.80%
$551,740 – $1,103,478	21.30%
$1,103,479 and over	21.80%

Yukon	
First $55,867	6.40%
$55,868 – $111,733	9.00%
$111,734 – $173,205	10.90%
$173,206 – $500,000	12.80%
$500,001 and over	15.00%

Northwest Territories	
First $50,597	5.90%
$50,598 – $101,198	8.60%
$101,199 – $164,525	12.20%
$164,526 and over	14.05%

Nunavut	
First $53,268	4.00%
$53,269 – $106,537	7.00%
$106,538 – $173,205	9.00%
$173,206 and over	11.50%

2024 top marginal tax rates

(Federal & provincial rates combined)[2]

	Interest	Capital gains[3]	Eligible dividends	Non-eligible dividends
British Columbia	53.50%	26.75%	36.54%	48.89%
Alberta	48.00%	24.00%	34.31%	42.31%
Saskatchewan	47.50%	23.75%	29.64%	40.87%
Manitoba	50.40%	25.20%	37.78%	46.68%
Ontario	53.53%	26.77%	39.34%	47.74%
Quebec	53.30%	26.65%	40.11%	48.70%
New Brunswick	52.50%	26.25%	32.40%	46.84%
Nova Scotia	54.00%	27.00%	41.58%	48.28%
PEI	51.75%	25.88%	36.20%	47.63%
Newfoundland	54.80%	27.40%	46.20%	48.96%
Yukon	48.00%	24.00%	28.92%	44.04%
NWT	47.05%	23.52%	28.33%	36.83%
Nunavut	44.50%	22.25%	33.08%	37.80%

RRSP/TFSA contribution limits

18% of previous year's earned income to a maximum of	**2024** – $31,560 **2025** – $32,490
TFSA contribution limit	$7,000
Accumulated TFSA contribution limit[4]	$95,000

2024 federal income tax rates

First – $55,867	15.00%
$55,868 – $111,733	20.50%
$111,734 – $173,205	26.00%
$173,206 – $246,752	29.00%
$246,753 and over	33.00%
Basic personal exemption	$15,705[5]

Withholding tax rates for RRSP/RRIF withdrawals

	Quebec	All other provinces
Up to $5,000	19%	10%
$5,001 – $15,000	24%	20%
Over $15,001	29%	30%

2024 Average tax rates

(Federal & Provincial Rates Combined. Includes any applicable provincial surtaxes and basic personal exemption)

Province/territory	$50,000	$100,000	$150,000	$200,000	$300,000	$500,000	$1,000,000
British Columbia	14.18%	20.98%	26.47%	30.67%	37.05%	43.63%	48.57%
Alberta	15.91%	22.88%	26.85%	30.19%	35.10%	40.15%	44.07%
Saskatchewan	16.91%	24.59%	28.81%	32.18%	36.71%	41.03%	44.26%
Manitoba	17.80%	25.20%	30.84%	34.42%	39.17%	43.66%	47.03%
Ontario	14.09%	21.66%	28.25%	32.88%	39.08%	44.86%	49.20%
Quebec	17.54%	26.47%	32.68%	36.75%	41.79%	46.40%	49.85%
New Brunswick	17.24%	25.55%	30.60%	34.16%	39.70%	44.82%	48.66%
Nova Scotia	19.84%	28.21%	32.88%	36.85%	41.99%	46.80%	50.40%
PEI	18.71%	27.18%	32.36%	35.90%	40.61%	45.07%	48.41%
Newfoundland	17.90%	26.30%	31.04%	34.63%	40.09%	45.57%	49.91%
Yukon	14.68%	21.61%	26.13%	29.54%	34.41%	38.96%	43.48%
NWT	14.14%	21.28%	26.46%	30.17%	35.22%	39.95%	43.50%
Nunavut	12.79%	19.72%	24.30%	27.75%	32.76%	37.46%	40.98%
Average	**16.29%**	**23.97%**	**29.05%**	**32.78%**	**37.98%**	**42.95%**	**46.79%**

2024 Employment Insurance (EI) premiums

	All provinces/territories except Quebec	Quebec
Maximum yearly insurable earnings	$63,200	$63,200
Employee's premium rate	1.66%	1.32%
Employer's premium rate	2.32%	1.85%
Maximum yearly employee premium	$1,049.12	$834.24
Maximum yearly employer premium	$1,468.77	$1,167.94

2024 Canada Pension Plan (CPP) premiums

	All provinces/territories except Quebec	Quebec
Maximum pensionable earnings	$68,500	$68,500
Basic exemption	$3,500	$3,500
Maximum contributory earnings	$65,000	$65,000
Employee and employer rate	5.95%	6.40%
Maximum employee/employer contribution	$3,867.50	$4,160.00
Maximum self-employed contribution	$7,735.00	$8,320.00

RRIF minimum withdrawals

Age	Withdrawal	Age	Withdrawal
60	3.33%	78	6.36%
61	3.45%	79	6.58%
62	3.57%	80	6.82%
63	3.70%	81	7.08%
64	3.85%	82	7.38%
65	4.00%	83	7.71%
66	4.17%	84	8.08%
67	4.35%	85	8.51%
68	4.55%	86	8.99%
69	4.76%	87	9.55%
70	5.00%	88	10.21%
71	5.28%	89	10.99%
72	5.40%	90	11.92%
73	5.53%	91	13.06%
74	5.67%	92	14.49%
75	5.82%	93	16.34%
76	5.98%	94	18.79%
77	6.17%	95+	20.00%

2024 CPP and QPP retirement benefit.

CPP maximum monthly benefit (assuming payments begin at age 65): **$1,364.60**
QPP maximum monthly benefit (assuming payments begin at age 65): **$1,364.60**

2024 Old Age Security (OAS) payment rates

(January to March)

Maximum monthly benefit
Age 65 - 74: **$713.34**
Age 75 and over: **$784.67**

Maximum annual income
For the 2024 tax year, pensioners with net income of $90,997 or more are subject to OAS clawback. Clawback rate is 15% for each dollar beyond $90,997. OAS is fully eliminated once net income reaches $148,065 (age 65 to 74) and $153,771 (for age 75 and over). Applicable to payments made from July 2025 to June 2026.

Marginal versus effective tax rates – what's the difference?

Marginal tax rate
Tax rate applicable to an additional dollar of income earned. Does not consider deductions and credits available to taxpayer.

Effective tax rate
Actual rate of tax paid by taxpayer. Considers deductions, credits and graduated tax brackets.

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UNDERSTANDING KEY CHALLENGES IMPACTING REAL ESTATE IN 2024

In the year ahead, many of the key challenges that defined Canadian real estate in 2023 can be expected to continue to drive headwinds for the industry at large. Interest rates, entrenched inflation costs, a construction labour shortage, and wavering housing-market sentiment have consequently led to softening growth and returns among many property types.

Office, commercial, and retail property values and profits are strongly correlated with the Canadian economy, which entered the new year exhibiting virtually flat growth. Interest-rate sensitive single-family resale home prices, which can be equally driven by mass psychology and speculation, saw a moderate but clear correction with the national Home Price Index softening for a third consecutive month in November 2023.

Understandably, a focus on these stalling real estate assets can lead to cooling investor sentiment around Canadian real estate at large. However, it is important that investors rightly observant of these economic trends fully understand their impacts, as they do not affect every facet of the real estate market equally. Indeed, it is in this economic environment that multi-family apartment assets are viewed by some as a strong opportunity for investors seeking alternative exposure in 2024.

Interest Rates

After raising interest rates 10 times since March 2022, the Bank of Canada's (BoC) aggressive campaign against inflation finally moderated into a dovish hold at its current 5% benchmark rate. Rates are widely expected not to climb any further in 2024, but the question of potential cuts – when and how much – has divided rate watchers.

As the effects of the Bank's hiking cycle continue to work their way through real estate markets, raising investment capital for acquisition and development can prove more challenging for firms. Retail investors dealing with the personal impacts of a slowing economy have less liquidity to invest. Along with fewer investor funds, a higher cost of capital can slow firms' ability to obtain leverage for construction. Meanwhile, REITs holding mortgages maturing within a high-interest period face the possibility of significant interest-cost increases. As a result, investors will see slower, more conservative markets and downward pressure on the value of some property types.

A study of multi-residential apartment assets' relative strengths will find them well-positioned to mitigate the effects of high interest rates. Investors will note that cap rates, a measure of potential profitability partially driven by interest rates, have been unfavourably rising across most major Canadian property types. From Q4 2021 to Q3 2023, and through the BoC's rate-hiking cycle, softer-than-expected real estate activity saw national average cap rates increase for major property types; however, multi-family cap rates remained at the low end of all major property types, buoyed by expectations of rent growth and investor demand. Canadian institutional investors, which have been net sellers of real estate since the pandemic, have continued to make multi-billion-dollar investments in multi-family properties.

Investors interested in the multi-residential space should continue to look to private REITs displaying strong fiscal governance through interest-risk mitigation strategies, such as staggered mortgages. With less-prepared buyers sidelined or struggling in the current economic environment, financially healthy firms can take advantage of the weakness in the market to purchase assets at discounted or distressed pricing levels and grow their portfolios efficiently.

Entrenched Inflation Costs

According to the BoC's 2023 Monetary Policy Report, core inflation has dropped from 2022 highs to just below 4%. Excluding shelter costs — the sole component of the BoC's inflation measure that has not experienced a decrease — inflation currently rests just shy of 2%. Although inflation growth remains muted in the wake of the BoC's rate-hiking cycle, like shelter costs, many of the attendant increases remain entrenched. For example, residential building construction costs across 11 major Canadian metros rose 6% year over year in Q3 2023, driven by increases in material costs and construction wages. Property owners are faced with higher operating, utility, tax, and maintenance costs.

Stable rental income from multi-residential apartments provides a welcome buffer against possible property-value fluctuations, offering firms another way to reward patient investors. Rental income is considered an effective hedge against inflation in the current environment with asking rents hitting new highs across Canada. However, like owners of other property types, multi-residential apartment owners face increased expenses in categories ranging from insurance to payroll.

For this reason, REITs best positioned to weather inflationary cost increases include those with an active approach to property management. Firms who manage properties directly versus outsourcing their management to third parties are better able to tap into economies of scale through vendor partnerships, create operational efficiencies, and act on opportunities to create cost savings. Likewise, portfolios with a substantial gap-to-market benefit from a greater ability to absorb or mitigate costs.

Construction Labour Shortage

A severe construction worker shortage continues to fuel Canada's chronic inability to meet skilled employment demand on job sites across all major property types. This serious imbalance results in longer construction timelines and stalled projects and poses greater risk for investors.

By mid-2023, the industry had erased a surge in post-pandemic hiring from September 2022 to January 2023. A partial rebound in October and November 2023 did little to advance the situation for housing and infrastructure labour demand, resulting in a net loss of 15,000 jobs since year-start.

Worker loss due to retirement is the primary contributor. According to forecasts, Canada will see more than 245,000 construction workers retire by 2032, roughly 20% of the 2022 labour force. Meanwhile, demand growth is expected to reach almost 300,000 workers. The widening gap has already sent labour costs soaring with construction wages increasing nearly double the pace of other industries in 2022. Economic conditions have slowed the pace of construction as firms trim headcount, resulting in 67% of home builders and developers reporting plans to build fewer units.

Though November 2023 posted a decline in rental housing starts, they remain at multi-decade highs in both absolute and per-capita terms, underscoring expectations that starts in the category will remain elevated through 2024. This strength can be attributed partly to past and newly implemented government programs which reduce the impacts of construction-related challenges. The complete removal of harmonized sales tax on purpose-built rental projects in many provinces provides an immediate reprieve from mounting construction costs, while initiatives like the federal government's recently announced express entry status for immigrants skilled in the trades suggests sustained political will on the issue. Organizations, such as the Canadian Chamber of Commerce's Housing and Development Strategy Council*, help to ensure federal housing and development policies around labour reflect industry realities.

*Equiton is a member of the Housing and Development Strategy Council.

Housing-Market Sentiment and Policy Risk

Despite the country's diverse real estate offerings, a wide-ranging media focus on Canada's housing supply crisis has in many ways soured investor sentiment and spurred some governments to enact policy in this area. While not expected to have a significant impact on housing supply or pricing, foreign purchase bans, vacant-home taxes, and the application of taxes to newly constructed and substantially renovated residential housing instead create new sources of apprehension for investors hoping to enter the single-family home market. Less directly, interest-rate increases have taken hold in the form of softening residential resale prices and stymied growth.

In this complex environment of fluctuating home values and heightened policy risk, investors are reminded that single-family homes, although a major component of Canadian real estate, do not represent the sector at large and that the demographic shifts informing Canada's housing policy response may represent opportunities for other property types.

The federal government expects to welcome 500,000 new immigrants annually by 2025, creating further demand for housing which is widely expected to be unmet. Low housing supply and affordability has pushed more Canadians into the rental market and limited existing renters' ability to transition to homeownership. That said, more Canadians within the younger and senior tranches of the population are actively choosing to rent, seeking a more affordable, urban-oriented lifestyle free of property upkeep. Rentership growth is more than double the rate of homeownership and highest among the financially stable baby boomer generation, which numbered more than 9 million in 2021.

REITs that focus their development and acquisition strategy on high-growth regions in Southern and Western Ontario, as well as growing metros in Alberta, British Columbia, and Quebec, will have an advantage as immigrants settle into populous but underserved markets. Additionally, property owners catering to Canadians' advancing preference for rental living through condo-like amenities and community-building will be rewarded with high-quality residents and the ability to right-price rents to the market's currently higher levels.

Mitigating Risk with Multi-Residential Apartments

Sophisticated investors who understand these challenges and how different categories of real estate are impacted can more clearly see and take advantage of investment opportunities in Canadian real estate while other investors shy away. With the moderation of cost increases attributed to inflation and the resolution of rapid shifts in monetary policy, Canadian housing and multi-residential apartments should continue to yield rewards for investors over the coming years.

PRIVATE WEALTH

INFORMATION AND SOLUTIONS FOR HIGH NET WORTH INVESTORS

FIDUCIARY TRUST

USING THE HOTCHPOT CLAUSE TO SOLVE LIFE'S STEW

By Thomas E. Junkin, Sr. VP, Personal Trust Services


Thomas E. Junkin, TEP, Senior Vice President, Personal Trust Services

One wonderful thing about family life is the variety of parent, child and sibling relationships and the ties that bind. When it comes to estate planning, those same relationships—complicated by realities such as blended families, children's varying financial circumstances, higher needs dependants, divorce, personal injury, or simply bad luck—can present the greatest challenges. It's also worth noting parents' increasing support of adult offspring—for instance, in 2021, Canadian parents gave more than $10 billion in down-payment help (for first-home purchases) to their children.[1]

Over time, for various reasons, there's often a mix of unequal gifting of assets or loans to children. As a result, parents often ask: How do I make things fair to all my children when I'm gone?

Enter the hotchpot clause. The more familiar word, hodgepodge, is a sometimes recognized synonym. Hotchpot's roots include the Anglo-Norman and Middle French hochepot meal, featuring a mix of meat and vegetables—a stew. The original English word, hotchpot, introduced prior to 1381, eventually morphed to metaphorically mean a medley or jumble. Then came the rhyming version, hotchpotch, covering both the stew and jumble definitions.2 As laws develop to reflect life, it was a natural progression for hotchpot to assume an ongoing legal meaning. Merriam-Webster, for instance, defines it as "the combining of properties into a common lot to ensure equality of division among heirs.3"

From our vantage point, a hotchpot clause in a will means that when the executor is calculating a beneficiary's share of the estate distribution, they add any lifetime gifts or advances the beneficiary received to "the pot." The executor then reduces the beneficiary's share of the estate by the amount gifted or loaned. To ensure the hotchpot clause fulfils its role in equalizing things among beneficiaries, the will also includes a provision releasing or cancelling any debt owed by a beneficiary.

Let's look at a hotchpot clause in action. Consider Ralph, a 65-year-old widower with three adult children, Debbie, David and Don. Ten years ago, Ralph and his wife loaned Debbie $150,000 for a down payment on her first house. She's been repaying the loan, but still owes $125,000 and might not fully repay it during Ralph's lifetime. Five years ago, David, injured in a car accident, needed to renovate his home, making it wheelchair accessible. So, Ralph gifted David $200,000 to cover those costs. Ralph hasn't provided any lifetime gifts or loans to Don. Ralph's current will states any debts his children owe to Ralph should be forgiven (i.e., cancelled)4 and his $2-million estate is to be divided equally among his children. The document doesn't include a hotchpot clause.

Example 1 shows how, under the current will, Ralph's lifetime wealth will be divided among his children (no tax taken into consideration).

Example 1	Debbie	David	Don
Balance Of Loan/Amount Of Lifetime Gift	$125,000	$200,000	-
One-Third Of $2-Million Estate	$666,667	$666,667	$666,667
Total Received	$791,667	$866,667	$666,667

Using The Hotchpot Clause To Solve Life's Stew - Continued

Ralph knows this distribution may seem unfair, especially from Don's point of view. Ralph loves all his children and doesn't want his will to create hard feelings among the siblings. However, expecting to live many years, Ralph needs to conserve his $2-million estate as financial security in case expenses increase substantially as he ages. Ralph's dilemma: how to treat his children equally, knowing he can't afford to make any further lifetime gifts.

Working with an experienced estate lawyer, Ralph's advisor suggests adding a hotchpot clause to his will. The clause doesn't need to include the word hotchpot, but often does. As discussed earlier, the hotchpot clause instructs Ralph's executor to bring the value of any outstanding loans or gifts into account when calculating the amount each child receives under the will terms. Like the original will, and to ensure the hotchpot clause works effectively, the instructions forgive any debts the children owe Ralph.

Example 2 illustrates how funds will be distributed should he leave a $2-million estate, using a will that includes hotchpot and release clauses (no tax taken into consideration).

Example 2		Debbie	David	Don
Balance Of Loan/Amount Of Lifetime Gift		$125,000	$200,000	-
	Hotchpot			
Value Of Frank's Estate	**$2,000,000**			
Add: Balance Of Debbie's Loan	**$125,000**			
Add: David's Gift	**$200,000**			
Hotchpot Amount	**$2,325,000**			
Equal Distribution Of Hotchpot Amount		$775,000	$775,000	$775,000
Less Lifetime Gifts Received		($125,000)	($200,000)	
Fair Distribution Of $2-Million Estate	$2,000,000	$650,000	$575,000	$775,000

In this example, Debbie, David and Don each receive a total of $775,000 from their father, through a combination of loan cancellation, gifts and inheritance.

One of the nice things about a hotchpot clause is the clarity it brings to the situation. It shows Ralph wants his children to share equally the total amount passed on to them. The hotchpot and accompanying release clause will probably end any doubts about whether Ralph forgave Debbie's loan, or any argument by David that his father did not intend to account for the gift he received.

Another benefit of a hotchpot clause is that it can be written to include any loans or gifts made after the will has been signed. For example, while Ralph at age 65 is uncomfortable making additional gifts to his children, at age 80 with the $2-million estate intact, he might feel more comfortable giving Don or Debbie large gifts, aligning the amount of money they receive with the total amount originally given to David. If Ralph makes a future gift, he won't need a new will; the hotchpot clause will take care of making things fair.

However, what happens if the amount advanced to one child is greater than their equal share of hotchpot? For example, what if David needs a lot of money from his father while he's alive, depleting Ralph's estate and resulting in David's advances totaling more than his share of the remaining estate? Generally, David wouldn't be compelled to repay the shortfall to his father's estate. Instead, Debbie and Don might share the estate, with David receiving nothing.

Clarity is Key

As with other wealth transfer tools, the thought and structuring of the will including a hotchpot clause is important and we recommend working with an estate lawyer with experience in this specific area. In addition, using Ralph's situation as an example, he should carefully:

1. Document the loan to Debbie and record any repayments so his executor will know how much is still owing.
2. Document his gift to David in writing.
3. Document any further loans or gifts made after he has signed the will.
4. Keep these records with other important papers so the executor can easily find them.

It’s critical to:

Clearly define what’s to be taken into the hotchpot clause and document any or all relevant advances, whether money, jewelry and/or real property.

Assess the value of any advance or gift when it’s made, as that will affect hotchpot clause calculations.

The more well-defined the hotchpot clause, the better the opportunity to do its job and help equalize the unequal among siblings. It will also help avoid any unintended consequences.

In today’s world, as parents increasingly support their children one way or another and face the reality that they’ve been uneven with their gifting and/or loans, we expect the ancient hotchpot clause will be called upon more often to help solve the rich stew of family life.

NOTES:

1.Rob Carrick, “Parents gave their adult kids more than $10 billion to buy houses in the past year,” Globe and Mail, October 24, 2021, https://www.theglobeandmail.com.

2. Ben Yagoda, “Hotchpotch,” Not One-Off Britishisms, July 18, 2019, https://notoneoffbritishisms.com.

3.“Hotchpot,” Merriam-Webster Online Dictionary, https://www.merriam-webster.com/dictionary/hotchpot.

4. Debra L. Stephens, “Hotchpot Clauses,” May 3, 2018, https://welpartners.com/resources/WELL-six-minute-estates-lawyer-hotchpot-clauses-2018.pdf. (accessed March 29,2023). “Failing to include both the hotchpot and release clauses in the will could create unintended prejudice for some beneficiaries and a windfall for others. The hotchpot clause in and of itself does not operate to release the beneficiaries from the obligation to repay any debts owed by them to the testator’s estate.”

BEHAVIORAL FINANCE BY KPW

RULES TARGETING ACTIVE BUSINESSES THAT INVEST PASSIVELY

When a private corporation earns too much passive (that is, investment) income, the owner may not be able to access lower tax rates on active business income up to the $500,000 annual small business limit (SBL).

When passive income, (specifically the adjusted aggregate investment income [AAII] of a corporation) exceeds $50,000 in a tax year, each dollar of AAII over the threshold will reduce the SBL by $5. Therefore, the SBL may be fully eliminated when AAII reaches $150,000.

The AAII earned in the 2023 tax year will be used to calculate the SBL for the 2024 tax year. A reduction in the SBL means that your corporation may lose some or all of the ability to pay tax at the lower tax rate. Instead, it may be subject to tax at the higher general corporate tax rate on the active income that exceeds the available SBL. Tax-efficient investment strategies will be critical in helping to reduce the annual AAII for purposes of lowering the overall corporate tax liability, as well as protecting the SBL. Speak to your financial advisor about specific strategies that suit your situation

Business Owners Donating In-Kind Securities

If an appreciated security is donated in-kind to a charity, the capital gain is not taxable. Therefore, 100% of the capital gain (as opposed to 50%) will be added to the corporation's capital dividend account (CDA), which can be paid tax-free to shareholders. The corporation will also receive a charitable donation receipt equal to the value of the security donated, which can be used to reduce income for taxation purposes from all sources. Consider the Mackenzie Charitable Giving Program if you are looking to create a legacy.

Defer your income

Consider delaying income you expect to receive this year until 2024. For example, bonuses are deductible by the corporation provided they are paid within 180 days after the business year-end. This means a bonus payable in 2023 could be paid in 2024, which would mean a tax deferral.

Pay salaries and/or dividends to family members

Income splitting among family members is a strategy available to many incorporated business owners and professionals.

Consider paying family members (that is, your spouse or children) a reasonable salary or wage for services provided to the corporation this year. This can shift income into the hands of family members who pay lower tax rates. This provides an opportunity for children to start building RRSP contribution room. If your spouse, common-law partner or adult children are in a lower tax bracket than you, the payment of dividends can result in tax savings for the family. Be aware, however, that taxable dividends paid to adult family members may also be subject to top rate taxation, unless the adult family members meet certain tests or exclusions set out in the Income Tax Act.

For example, if you turned 65 this year, dividends may be paid to your spouse or common-law partner under a specific exclusion to benefit from income splitting. Paying dividends to adult family members is still available, however you should obtain appropriate tax advice to ensure you are onside with the new rules.

Determine your compensation mix

Your compensation mix can affect your taxes. As a shareholder, you could be compensated by your corporation either in the form of a salary, eligible, non-eligible or capital dividends.

The optimal compensation mix can only be determined after considering your financial and tax position and that of your corporation.

Speak with your corporate accountant about determining what compensation mix is most appropriate in your situation for this year

Purchase a vehicle from your company

Consider purchasing the vehicle that the company has provided to you, if it has depreciated in value. Otherwise, the taxable standby charge will continue to be calculated using the original cost rather than the depreciated value. Purchasing the vehicle will potentially allow you to avoid the annual taxable benefits and begin receiving a tax-free car allowance from the corporation for business use of your vehicle.

Claim an ABIL

An allowable business investment loss (ABIL) may be available to you if you lent money to, or invested in shares of, a small business corporation that has become insolvent or bankrupt. The ABIL is equal to 50% of the loss, offsets capital gains and can be applied against any other type of income.

Shareholder loans

To your company

Consider reclassifying payments made to you by your corporation as a repayment of a shareholder loan owing to you. Shareholder loan payments are a very tax-efficient way of drawing money out of the corporation with excess cash.

From your company

If you have borrowed money from your corporation in the prior taxation year, you should consider repaying the loan in full before the corporate year-end. Otherwise, you will face an income inclusion on your personal tax return for the value of the outstanding loan

Transfer your business to child’s corporation before year end

Under Bill C-208, shareholders of private corporations can transfer shares of a qualified small business, family farm, or fishing corporation to a corporation controlled by their child or grandchild and benefit from the same capital gains tax treatment as would be available in the case of a third-party sale. Prior to these rules, the income from the sale was taxed as a dividend resulting in higher tax liability. The 2023 Federal Budget introduced several parameters and criteria to qualify for the preferred tax treatment, which will apply to transactions after 2023.

Shareholders of private corporations planning a sale to their child(ren) may consider selling their business before year end under the less restrictive rules. Speak to a qualified tax professional regarding the application of these rules to you and your business.

Make a gift or award to an employee

Large gifts to employees are taxable. As an employer, you are entitled to provide unlimited non-cash gifts or awards annually to employees. However, the aggregate cost of the gifts, including HST/GST cannot exceed $500

SECOND VERSE, SAME AS THE FIRST

BMO Global Asset Management

Brittany Baumann, Vice President, Investment Strategist

Trends from 2023 continue into 2024, with expectations of interest rate cuts from the U.S. Federal Reserve (Fed) getting pushed back further. Meanwhile, the Canadian economy continues to cool and China's growth struggles persist.

U.S. Outlook

U.S. markets continue to cope with seasonality in the data; January and February jobs were strong and inflation numbers have been higher than expected, similar to what happened in January 2023. It is possible that this trend will continue into the Q1 data, which would likely pare back interest rate cut expectations even further, but we would not take that as a signal that the economy is necessarily reheating. Rather, we're looking further out into the second half of the year—we think there's a good chance inflation will be lower by then, helped by a further loosening of the labour market. That would give the Fed the justification to lower rates at least a few times before year-end.

Canada Outlook

Canada's outlook remains largely the same as recent months. Weak growth continues, with Q4 gross domestic product (GDP) growth clocking in at a subpar 1%. Private sector job growth has also disappointed in recent months. At the same time, a technical recession has been avoided, and growth is tracking positive for Q1. This likely reflects Canada's economic linkages to the U.S.—a resilient U.S. economy is underpinning Canadian growth. Inflation is still elevated, but the latest report was much more constructive than previous months. We think weak growth and a loosening labour market are important reasons why the Bank of Canada (BoC) will likely cut rates this year. In the near term, however, they're likely to stay on the sidelines and take their cues from the Fed. If they were to cut before their American counterparts, it would probably be the result of especially ugly growth numbers or bearish developments in the labour market.

International Outlook

In general, we're seeing early signs that global growth is bottoming, including a greater share of Purchasing Managers' Indexes (PMIs) rising above 50 (indicating expansion rather than contraction) and trade flows picking up. In particular, leading indicators in the Eurozone and U.K. continue to improve, with both regions also primed for rate cuts given that inflation data is likely to show more meaningful progress beginning in the second quarter.

Weak Chinese growth continues to weigh on the outlook for Emerging Markets (EM). On the macro side, China's economic outlook remains dour, particularly because there are not yet any signs that its housing market is bottoming. That's particularly concerning given that stimulus aimed at stemming the bleeding has already been deployed.

Key Risks	BMO GAM House View
Inflation	• Stronger U.S. growth means a slower path to the Fed's 2% target and maybe even a small reacceleration of inflation, but not at the level of 2022
Interest rates	• Resilient U.S. growth likely means slower, shallower cuts from the Fed
Recession	• Delayed, but the bears refuse to fold • Fear of a recession could roll into 2025
Consumer	• The U.S. consumer and Canadian consumer are two different species at present • The U.S. consumer is fully employed and doesn't have to worry about higher rates unless they're buying a new car or home • For Canadian consumers, mortgage refinancing is the big pain point
Housing	• The market has come off the lows in both Canada and the U.S. • No longer a drag on the outlook, but delayed rate cuts mean delayed recovery
Geopolitics	• For the U.S. administration, the goal is to avoid an inflationary escalation • Such an escalation should be considered a low-probability, high-consequence risk
Energy	• Oil prices are likely the most important part of inflation risk • If there's another surge in commodity prices driven by geopolitical conflict, that could drive inflation a leg higher

Kleinburg PRIVATE WEALTH

Carte WEALTH MANAGEMENT INC.

SPECIAL REPORT!

UNDERSTANDING BITCOIN

DOES BITCOIN BELONG IN ASSET ALLOCATION CONSIDERATION

By Jurrien Timmer, Director of Global Macro, Fidelity Management & Research Company

About bitcoin: Prospects, prospectors, and portfolio managers

Among many portfolio managers, bitcoin seems to be gaining legitimacy as an asset class. But the digital-asset space is rather technical, and the learning curve can be very steep. Getting on board with bitcoin takes serious commitment. I intend this paper as a brief plain-English primer, but also to assess, in a meaningful way, the value proposition of bitcoin as it relates to asset allocation. Of course, what follows pertains to my own learning and, thus, represents just one opinion among many.

I'll also mention that bitcoin has many competitors, and not just in the private sphere: The relatively new acronym CBDC expands back into “central bank digital currency,” and its exploration as a government-issued (or controlled) legal tender extends to Russia, China, Japan, and even the United States. My focus here, though, is on bitcoin as the first and inarguably most successful digital currency to date. This status, of course, is subject to change, which poses some non-quantifiable risk to bitcoin.

In progressing from novice to initiate, I still view bitcoin through the lens of a global macro strategist. Cryptocurrency has many dimensions, and I am gratified that the path to understanding such a futuristic asset cuts a wide swath through market history.

We can start by asking: What is bitcoin (BTC)?1 Is it an asset class? Should we invest in it? If so, what is bitcoin worth? Is it digital gold—or digital tulip bulbs? For most investors, it comes down to these few questions.

Price axiomatically resides at the intersection of supply and demand, and as I see it, bitcoin has both a unique supply and a unique demand dimension. Let's start with the former.

A scarce asset

The first so-called cryptocurrency—bitcoin—emerged in 2009, the brainchild of a mysterious individual (or group) using the name Satoshi Nakamoto. One of bitcoin's key features was a built-in scarcity factor: Total supply is limited to no more than 21 million bitcoins, and as more get mined (computationally created), the incentive to mine more goes down. Miners (electronic auditors) receive a reward—fresh bitcoins—for each new block of ledger data generated, accepted, and added to the chain of bitcoin transactions. This reward undergoes a “halving” every 210,000 blocks, or roughly every four years (Exhibit 1). As of May 2020, the reward was down to 6.25 bitcoins (roughly $200,000 as of this writing, but the bitcoin price is nothing if not volatile). This creates an asymptotic supply curve and, therefore, scarcity.

Today, about 18.6 million of the total 21 million bitcoins have been created, but it still will take many more years (120, give or take) before the mines are depleted.

BTC S2F

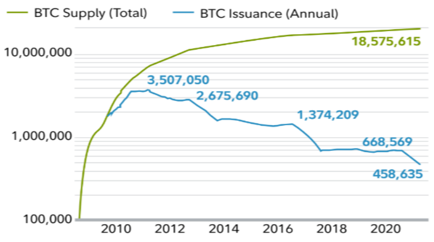
This declining supply-growth curve is what makes bitcoin a scarce asset—unlike, say, fiat money, which it seems to me central banks are prepared to print ad infinitum. We will return to this in a moment, but let's look first at the bitcoin Stock-to-Flow (S2F) pricing model. S2F is a popular valuation approach among bitcoin's most vocal proponents. The model simply measures the number of years (flow) needed to replace the current supply (stock). A high S2F is deemed bullish, as it indicates scarcity, and vice versa.

A web search for “bitcoin stock to flow” will inevitably call up papers written by the model's architect, a pseudonymous Dutch institutional investor operating under the Twitter handle @PlanB. These papers lay out a complex regression analysis that projects ever-higher prices driven by ever-slowing (indeed, finite) supply growth. The math is complicated, but fortunately it's not needed to get a sense of the mechanics.

Understanding Bitcoin—Continued

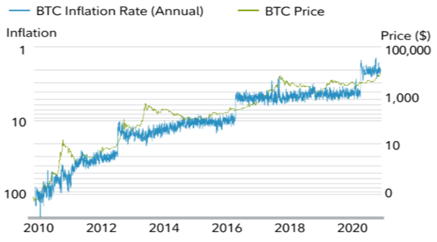
All we really need is to flip the incremental supply curve upside down and regress it against price (Exhibit 2).

EXHIBIT 1: Growth in bitcoin supply is flattening.
Bitcoin Annual Issuance and Aggregate Supply



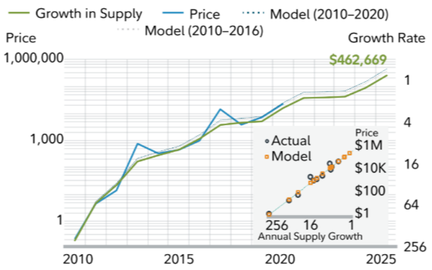
Source: Coinmetrics; daily data, 2009–2020.

EXHIBIT 2: "Supply and demand" is usually the answer.
Bitcoin Stock and Flow



Source: Coinmetrics; daily data, 2010–2020.

EXHIBIT 3: Is the BTC S2F on to something?
Bitcoin Annual Supply Growth Versus Price



Past performance is no guarantee of future results. Price scale is logarithmic.
Source: Bloomberg Finance L.P., Fidelity Investments; annual data, 2010–2020.

So, under the law of supply, higher prices elicit higher quantities, all else equal; that is, price drives supply. The inverse, on the other hand, tells us how changes (here, restrictions) in quantity affect price. Exhibit 3 (above) shows a fairly tight fit between the inverse supply curve and the bitcoin price. Now, regressing (curve fitting) two lines that appear corelated presents many pitfalls, and our industry is littered with perfect regressions that fell apart as soon as they went from in-sample (historical) to real-time data.

Further—and I cannot stress this enough—past performance is no guarantee of future results. Plus, these are just models: Who knows what really lies ahead for bitcoin?

With these warnings in mind, the chart above shows the two simple regression models I created for this exercise. Each one takes the historical and future supply growth and regresses it against price. The incremental supply of bitcoins is known well in advance, so this allows us to project future prices using the S2F model.

My first iteration takes the entire history of bitcoin (2010–2020) and regresses it against its price. This model extrapolates the future supply curve, applies the S2F model, and voilà! Price projections.

No fancy multivariate models here, just a simple power-regression function. (I say again: These are projections, not promises, purely hypothetical and merely mathematical.)

Wary of the aforementioned theory-to-practice peril, I built a second model that uses historical data only up through 2016, and then compared its projections with actual data from the years thereafter. Fortunately, my second iteration comes up with similar projections as the first, which gives me some comfort that the BTC S2F approach may be on to something.

And the S2F model's price projections are eye-popping. The model predicted the price of one bitcoin at $24k this year (done!) and $463k in 2025. One can see why bitcoiners are so excited.

But like any model, the BTC S2F approach has its limitations. Aside from the obvious dangers of curve-fitting two data streams and assuming that one causes the other ("correlation is not causation"), the S2F model is limited because it assumes that price is entirely a function of supply.

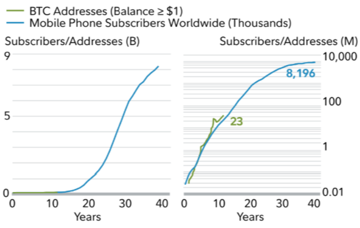
Where is the demand side of this equation? Think back to 2017 when bitcoin first reached $20k—exactly in line with the model—only to collapse down to $3k before eventually crawling back. What happened? Again, price lies at the intersection of demand and supply, and without the demand side kicking in, it doesn't really matter how scarce the supply is. Thus, I see S2F as a one-dimensional model in that regard.

Metcalfe's Law

Fortunately for bitcoin, an entire demand-side dynamic is at work—one described by Metcalfe's Law. In its simplest form, Metcalfe's Law holds that, as the number of its users grows linearly, a network's value (or, by inference, the bitcoin price) grows geometrically. In other words, bitcoin's utility (value) should grow much faster than does its network of buyers, sellers, exchanges, ATMs, and participating retailers—at this time including, directly or indirectly, AT&T, Wikimedia Foundation (donations), the Dallas Mavericks, a few insurers, many banks, and countless small businesses.

EXHIBIT 4: Metcalfe's Law may offer some S-curve perspective.

Growth Patterns of Bitcoin and Mobile Phone Accounts



Source: Worldbank, Coinmetrics; annual data.

We can get a practical sense of Metcalfe's Law by reviewing growth curves, also known as S-curves: flatter at each end, steeper in the middle. We see them everywhere, from mobile-phone penetration rates to broadband subscriptions to internet usage (Exhibit 4). On a linear scale, these indeed look like an S, but on a log scale the data describes a bending curve that starts out exponential and then turns asymptotic—flat—as the penetration rate approaches 100%.

Exhibit 4 charts the raw number of worldwide mobile-phone subscribers overlaid against the raw number of bitcoin addresses. The S-curve on the left is set to a linear scale; the one on the right, to a log scale.

Penetration rates are not a perfect analogy to the growing number of bitcoin digital addresses. For instance, some of the increase in network activity may be running through existing wallets (e.g., PayPal), and a single user can self-custody multiple addresses (in a "hardware wallet," perhaps). But despite certain limits to what we can infer, this may be the best we have at this point.

With the caveat that we are comparing two different data series, it appears the bitcoin growth curve may still be in its early, exponential phase—and could remain so for a number of years. That suggests to me that the demand side of the equation also could continue to grow exponentially.

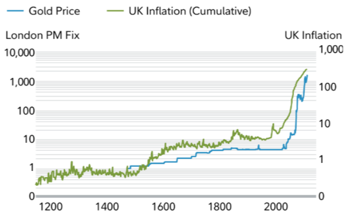
Thus the bullish case for bitcoin: Price is at the intersection of supply and demand, and demand is growing exponentially while supply (per BTC S2F) approaches its limit. Bitcoin can act as a store of value because of its scarcity, but it's also an integral part of a technological revolution (blockchain encryption) with potentially explosive demand growth.

Gold and bitcoin as a store of value

Gold has a long and well-nigh undisputed history as a store of value and source of protection against inflation (Exhibit 5). Part of gold's historical stability derived from its status. Gold was used as money long before King Croesus coined it, and gold served as the backbone of global commerce for millennia. As for us, the United States has been on and off a gold standard since its founding: Gold was money here until 1944, then it became the reserve asset backing our money. But since 1971, after then-President Richard Nixon abandoned the Bretton Woods agreements—and even the pretense of a gold standard—we have been living in a "fiat money" era, with gold reserves making up less and less of the world's monetary system.2 In 1970, the ratio of global reserve assets (money) to reserve gold stood at roughly 2-to-1; currently, the ratio is more like 10-to-1.

EXHIBIT 5: It's not "the gold standard" for nothing.

Gold as an Inflation Hedge, 1200–2020



Source: Worldbank, Coinmetrics; annual data.

This divergence has widened sharply in recent years. Starting with the global financial crisis of 2007–08, world central banks began expanding their balance sheets at an unprecedented pace, and then accelerated mightily in 2020 to offset some of the economic effects of the COVID-19 pandemic. Recent measures put the Federal Reserve's balance sheet at roughly 35% of GDP—far ahead of the previous spikes following the Civil War and World War II. The monetary base, at roughly 24% of GDP as of December 2020, also stands at its highest level in U.S. history.

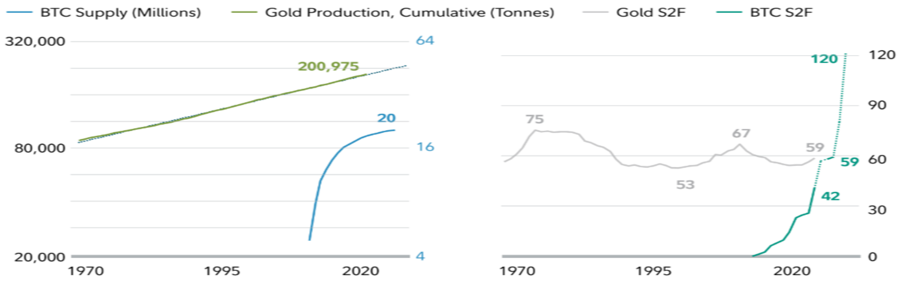
So, in this fiat era we have less gold backing up the monetary system at a time when money is being printed at breathtaking speed. For some, this has made gold more appealing as an asset class, and lately bitcoin has joined the conversation as, potentially, a form of digital gold.

Which is better then: gold or bitcoin? Like gold, bitcoin is scarce, but unlike gold, bitcoin cannot be touched, seen, or felt. Moreover, bitcoin is a brand-new asset that may be at risk of future regulation; indeed, both the U.S. Treasury and the IRS paying more attention lately. Uncertainty regarding policy-driven restrictions could affect demand. Trusting that something conceptual and unproven can compete with a tangible rarity treasured for millennia takes somewhat of a leap of faith, in my view.

But bitcoin may have a unique advantage over gold: Bitcoin supply, by design, is finite. The left-hand chart of Exhibit 6, below, shows gold's supply curve (i.e., cumulative global gold production since 1970) versus bitcoin's supply curve. We know that bitcoin's supply growth is flattening. Note how the production of gold has been quite steady throughout the years: No asymptote here!

The right-hand chart shows my S2F calculation for each asset, or how long it takes to replace existing supply. The stock-to-flow for gold has been fairly stable at around 60 years, meaning it would take about 60 years of production to replace the current stock. In other words, gold is scarce but not getting any scarcer.

EXHIBIT 6: Bitcoin and gold have (at least) one major difference.
Gold and Bitcoin Production over Time



Right-hand chart: Dotted line represents a forward projection of the bitcoin stock-to-flow calculation. Source: Bloomberg Financial, L.P., Global Financial Data, Fidelity Investments; annual data, 1970–2020.

At 42 years, bitcoin's S2F is lower, but it is rising rapidly and likely will draw abreast of gold in a few years. So, according to the S2F model, bitcoin will eventually be much scarcer than gold. One could think of it as a more convex form of gold.

Valuation

This raises the issue of valuation. Neither gold nor bitcoin produces a yield, making them impossible to value via traditional discounted cash flow models. Fortunately, global bond yields are close to zero, with Bloomberg reporting some $18 trillion of negative-yielding debt around the world (as of December 2020). We see it even here in the United States: The Federal Reserve has been reporting a cycle of negative short- and medium-term real rates since mid-2019. Thus, the opportunity cost of holding a zero-yielding asset is much lower now than when bond yields were positive. This is not a "detail" but rather a major takeaway: Gold and bitcoin are competitive to bonds at today's low levels of interest rates. In a 60/40 stock/bond world, gold and bitcoin are poised, in my view, as potential disruptors to the 40 side of the allocation—but not so much to the 60. More on this later.

Thinking about the relative size of various asset categories: The market value of investable financial assets (stocks, bonds) is around $160 trillion (as of December 2020); the value of all above-ground gold bullion is estimated at $11 trillion; and the market value of bitcoin exceeds $800 billion (as of February 15, 2021). Although bitcoin is catching up fast, as of now it remains only a fraction of gold's value.

I should reiterate that, so far, bitcoin has proven highly volatile. While the models I am using may indicate a rising bitcoin price over time, I expect the ride to be rather bumpy, even dismaying at times. Bitcoin's volatility could have a consequential impact on a portfolio's short-term results. Past performance is no guarantee of future results.

Given the foregoing—supply, demand, growth—how should gold and bitcoin be valued relative to one another, and relative to financial assets in general? My sense is that no one knows with any certainty, but I think both the gold bulls and the bitcoin bulls would surely say, "More than it is now." To better understand the relative valuation dynamic, we will look first at equities over time and under special circumstances, and then add bonds and gold.

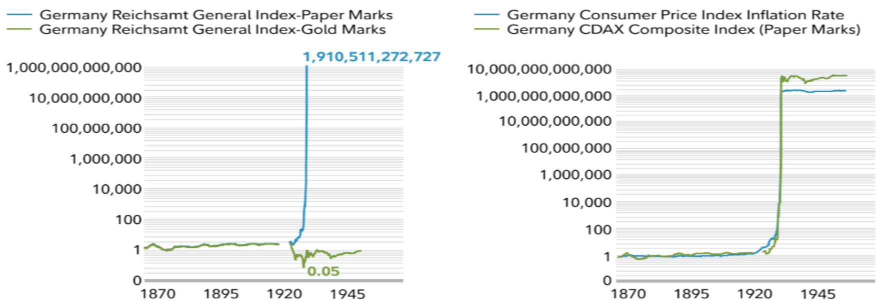
Equities as an inflation hedge

Equities historically have offered an effective hedge against inflation. We can see this most plainly by examining periods of hyperinflation. Brazil in the 1980s and '90s comes to mind and, of course, Weimar Germany.

Understanding Bitcoin—Continued

EXHIBIT 7: Gold was a safe haven in Weimar Germany.

German Papiermarks (Fiat Currency) Versus Goldmarks



Source: Bloomberg Financial, L.P., Global Financial Data, Fidelity Investments; annual data, 1970–2020.

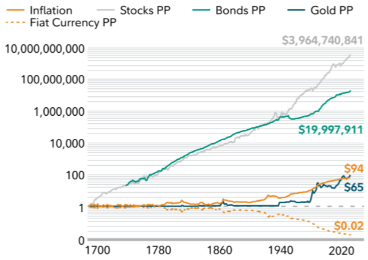
At the start of 1919, one U.S. dollar could purchase nine German papiermarks; by November 1923, that same dollar could purchase 4.2 trillion marks. Charting these changes shows both German CPI and the German stock market heading essentially to infinity (Exhibit 7, right side), which in context means that stocks offered a measure of inflation protection. But with the mark losing all value, highly priced German shares didn't go very far in other currencies. And this is where gold comes in as perhaps the ultimate store of value during a hyperinflationary episode.

Germany abandoned the gold standard in 1914, but following its defeat in World War I, the country was forced to make reparations in gold-backed currency. The left-hand section of Exhibit 7 shows the German stock market priced in its fiat currency, i.e., paper marks (blue), and also priced in money backed by gold (green). Whereas the German stock market of the early 1920s soared in nominal terms, the real experience for most investors was one of substantial loss. This disparity highlights that, against inflation, equities have been a good hedge, but against hyperinflation, the yellow metal has proven even better.

But what about during more normal conditions, i.e., most of the time? Here, equities have a distinct advantage over gold: the magic of compounding—the reinvestment of cashflows. With gold (or bitcoin) there is simply nothing to compound, whereas equity returns can compound incrementally, with the potential, over time, to produce dramatic results.

EXHIBIT 8: What might a dollar of money from 1700 be worth today?

Purchasing Power of Various Assets over Time



PP: purchasing power. Source: Global Financial Data (GFD),[3] Fidelity Investments; annual data, 1700–2020.

Asset classes over time

Comparing the purchasing power of stocks, bonds, gold, and money over various stretches of time is, I think, always instructive. In Exhibit 8, above, the orange lines indicate inflation in two different ways. The solid line represents cumulative inflation over time, and the dashed line represents inflation's inverse, i.e., the erosion of purchasing power. Looking back to 1700, we can see that the gold price has moved roughly in line with inflation. I think the compounding effects of stocks and bonds speak for themselves.

One U.S. dollar of money in 1700 would, adjusted for inflation, be worth $65 today, and one dollar's worth of gold in 1700 would be worth $94 today. But, had it been possible, a dollar's worth of stocks purchased in 1700 would today be valued at roughly $4 billion, which shows the magic of an inflation hedge that also compounds. In many ways, a long-term allocation to stocks has delivered the best of both worlds, i.e., inflation protection plus a positive real return that can snowball over time. For the most part, the story doesn't change whether one starts the clock at 1700, 1800, or even 1900.

Things do, however, get a bit more interesting around 1970, after the U.S. quit the Bretton Woods international monetary system that kept the U.S. dollar essentially, if not literally, "as good as gold."

Once fiat money replaced the gold standard, physical gold could trade freely (when such trade was legal, that is). Gold's "return" outstripped both bonds and inflation—and grew more competitive with stocks. For easier comparison, we can line up four periods starting from 1700, 1800, 1900, and 1970 (Exhibit 9). The chart's first four data groups show the nominal CAGR (compound annual growth rate) for stocks, gold, bonds, and inflation over these four different periods. Note the consistency of stock returns, regardless of the time frame.

Understanding Bitcoin—Continued

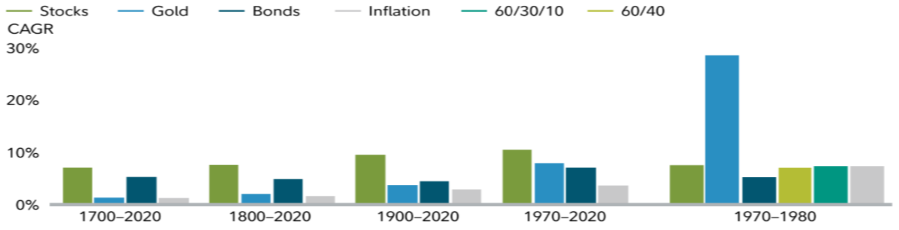
I believe historical evidence shows yet again why equities should form the foundation of any investment strategy. Equities offer growth potential, a store of value, and some measure of protection against inflation, not to mention the magic of compounding. Bonds have proven valuable as well, consistently having produced a CAGR of around 5% nominal. Interestingly, though, as we move from left to right—closer to the present—we can see gold becoming more competitive as inflation creeps up.

The rightmost data group shows the asset class CAGRs for just the 1970s, a decade that, as we all know, was marred by slow growth and high inflation (stagflation). Equity valuations tend to move inversely to inflation, and the 1970s started with a price-to-earnings (P/E) multiple of 20 and ended with a P/E of 7. During this period, gold outshone all other asset classes under discussion.

For reference, the chart also includes a traditional 60/40 stock/bond portfolio as well as a 60/30/10 mix (with the 10% being gold). Both of these portfolios kept pace with inflation, as did equities, but none of them produced a positive real return. During the 1970s, a 60/30/10 portfolio generated only an extra 20 basis points of CAGR versus a standard 60/40. The difference isn't large, indicating that gold tranche, at 10%, was not sufficient to move the needle.

EXHIBIT 9: Which assets have delivered the best investment returns over different time horizons?

Asset Class Returns for Various Horizons



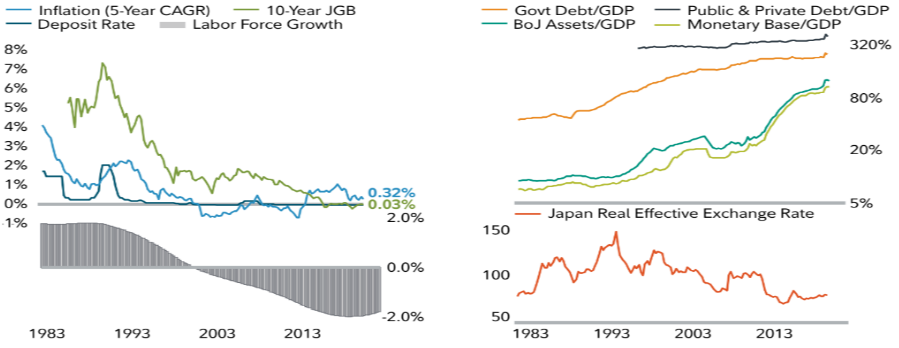
Source: Bloomberg Finance L.P., Global Financial Data, Fidelity Investments; annual data, 1700–2020.

Of course, whether the present era of fiat money will meet with inflation or a crashing dollar remains to be seen. After all, Japan has been down this path already—yet the Japanese economy has experienced essentially zero inflation and the yen remains a stable currency (Exhibit 10).

The Bank of Japan (BoJ) has gone much further than the U.S. Federal Reserve, with the BoJ balance sheet at 128% of GDP (the Fed is at a mere 36%). Since 2008, Japan's debt-to-GDP ratio has risen about 100 percentage points, all of which was monetized by its central bank, yet its five-year annualized inflation rate has not budged and the yen has not collapsed.

EXHIBIT 10: Even amid massive efforts, inflation is not a given.

Vital Statistics: Japan



JGB: Japanese government bond. Source: Bloomberg Finance L.P., Haver Analytics, Fidelity Investments; quarterly data, 1983–2020.

One of the lessons here may be that, during normal times, investors may want to limit that portion of their portfolios dedicated to inflation hedges (like gold), given the high opportunity cost of reduced investment in assets that compound over time. One should want to be long, but not irresponsibly so.

But when conditions go extreme—meaning high inflation or hyperinflation—no matter how big one's hedge is, it will seem not nearly enough, at least in my experience. At such times, we might wish we had been "irresponsibly" long. This dilemma, investors have always faced. We cannot predict the future with any certainty.

Conclusions

After dipping heavily into some of the data, what are the takeaways?

In my view, bitcoin has gone mainstream, already considered a legitimate asset class by more and more investors. I think bitcoin has both a compelling supply dynamic (S2F) and demand dynamic (Metcalfe's Law). At close to $900 billion, bitcoin is still just a fraction of gold's total global value of roughly $11 trillion, not to mention total global financial assets of $160 trillion.

With interest rates close to zero—or negative—and central banks printing money like there's no tomorrow, is it any wonder that bitcoin seems to be having its day? The global monetary debasement story has a new protagonist, as well as fresh catalyst, in the form of COVID stimulus.

As far as I can see, the current economic situation need not end in tears. The Japan riddle is an important counterargument to consider when using monetary debasement to argue the case for owning either gold or digital assets (or both).

Either way, bitcoin is gaining credibility, and as a digital analog of gold but with greater convexity, my guess is that bitcoin will, over time, take more market share from gold.

Before the days of fiat money—when the price of gold was mostly fixed—gold was money and little more (exclusive of jewelry, medicine, electronics, and other commercial uses). Without the ability to compound, gold did not stand a chance against equities except during periods of high inflation or, more so, hyperinflation. But that changed during the 1970s when the gold price was allowed to float freely and reflect monetary conditions around the world. Whereas in the old days bonds beat gold 2-to-1, since 1970, gold and bonds have been neck-and-neck in terms of returns.

Which brings me to the 60/40 paradigm. If gold is now competitive with bonds, and bond yields are near zero (or negative), could it make sense to replace some of a portfolio's nominal bond exposure with gold and assets that behave like gold? Many have already done so, whether via inflation-protected Treasuries, low-duration bank loans, or commodities—and opportunity cost of such a shift has become less and less. In my view, the only question may be, how much?

If bitcoin is a legitimate store of value, is scarcer than gold, and comes complete with a potentially exponential demand dynamic, then is it now worth considering for inclusion in a portfolio (at some prudent level and at least alongside other alternatives, such as real estate, commodities, and certain index-linked securities)? Despite the many risks discussed—including such factors as volatility, competitors, and policy intervention—for some the answer may well be "yes," at least insofar as that "yes" applies only to components on the 40 side of 60/40. For those investors, the question of bitcoin may no longer be "whether" but "how much?"

Endnotes

[1] CoinDesk, creator of the first price reference (2013)—Bitcoin Price Index—puts it this way: "Bitcoin was the first cryptocurrency to successfully record transactions on a secure, decentralized blockchain-based network. Launched in early 2009 by its pseudonymous creator Satoshi Nakamoto, Bitcoin is the largest cryptocurrency measured by market capitalization and amount of data stored on its blockchain. ... Only approximately 21 million bitcoins will ever be created. New coins are minted every 10 minutes by bitcoin miners who help to maintain the network by adding new transaction data to the blockchain." Bitcoin.org, originally registered and owned by bitcoin's first two developers, has this to say: "Bitcoin is a consensus network that enables a new payment system and a completely digital money. It is the first decentralized peer-to-peer payment network that is powered by its users with no central authority or middlemen. From a user perspective, Bitcoin is pretty much like cash for the internet. Bitcoin can also be seen as the most prominent triple-entry bookkeeping system in existence." For more information, see fidelitydigitalassets.com.

[2] The United States, in its early days, entertained various gold standards but in 1900 fixed the price of a dollar at "twenty-five and eight-tenths grains of gold nine-tenths fine." This set the gold price at $20.67 per troy ounce (480 grains). The Gold Reserve Act of 1933 revoked the gold standard and nationalized gold ownership; subsequently, Congress raised the statutory gold price to $35 per ounce (an early form of quantitative easing). From 1946 to 1971, the Bretton Woods agreements kept 44 major countries' external exchange rates to within 1% of the U.S. gold price. But since 1971, after Richard Nixon effectively abandoned the Bretton Woods gold standard, the United States has issued only fiat money, with currency backed by "the full faith and credit" of its issuing authority alone.

[3] Global Financial Data (GFD) has used proprietary research on global stock markets and individual securities to create the most extensive set of total return series for stocks, bonds, bills and commodities for all major countries. GFD's extensive historical database on hundreds of sovereign bonds has been used to create bond indices that begin in 1700. GFD data also has been used to create commodity indices that follow the path of energy, agricultural and non-agricultural commodities over the past millennium

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