SPRING 2022

PERSPECTIVE

ARCA™ FINANCIAL GROUP

PEOPLE WHO CARE, PLANS THAT PERFORM

Awakening to inflation

Higher prices can chip away at your savings, so position your money to stay a step ahead.

Monetary inflation hasn't been much of a concern for so long that it may seem like a foreign concept to some people. Before the 1990s, wild swings in inflation were more common, but for the past 25 years annual rates have hovered close to two per cent, with few notable fluctuations. What a difference a year can make.

When widescale reaction to the global pandemic began in March 2020, the Canadian economy entered uncharted waters. Global stock markets experienced their biggest drop in years, unemployment and business closures began to rise and supply chain interruptions soon contributed to a downward trend for the inflation rate, which eventually reached 0.72 per cent. However, it didn't stay that low for long.

The Bank of Canada boosted the economy by injecting massive amounts of money into the financial system through the purchase of bonds and other assets (known as quantitative easing) and lowering long-term interest rates. In late 2020, vaccine development gained ground and a return to higher consumer spending appeared on the horizon, stoking confidence in an economic recovery. An upswing of activity drove Canada's inflation rate to 3.7 per cent in July 2021 – the highest level seen in a decade.[1]

What is inflation?

Inflation is the financial term that describes a rise in the Consumer Price Index (CPI), a measurement that reflects average changes in the cost of the typical goods and services purchased by households. The CPI is published monthly by the Bank of Canada.

When the economy gains strength, prices often go up. Today, as the pandemic recedes and the economy re-energizes, inflation is being pushed higher by a combination of factors. These include a return to brisk consumer spending, a recovering labour market and the loosening of many COVID-19 restrictions. However, they are driving up the price of everything from furniture to cars to coffee.

Effects of inflation

Popping into a grocery store, gas station or coffee shop today means paying higher prices than a year ago. And those aren't the only places where you'll face rising costs. You may also see them at the bank. This is due to the relationship between interest rates and inflation. When the Bank of Canada wants to reduce the rate of inflation, it raises interest rates, which raises the cost of borrowing money in the form of mortgages, loans, and lines of credit.

As economic conditions continue to improve, some economists speculate that regulators may be ready to raise interest rates sometime in 2022. When this occurs, Canadians can expect to make higher payments due to higher interest rates on their debts.

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This means households may have to look closely at reining in their spending and paying down high-interest debt. Here's some information that illustrates the effect interest rate hikes can have on a typical mortgage.

Handling inflation

It's debatable whether the economy has entered a temporary or a prolonged period of inflation. While the experts monitor and measure all the factors that affect inflation in one way or another, consumers can continue to stay focused on our long-term goals and re-examine what we can do to make up the shortfall in our purchasing power. If the average annual inflation rate is, for example, 2.5 per cent, a person needs to generate a return of at least 2.5 per cent on their money or risk losing some financial ground to rising prices. Since very few savings and other types of cash accounts, such as GIC's pay anywhere near this amount of interest these days, investing in a diversified portfolio with a balanced selection of stocks and bonds may offer the best protection against inflation.

Another option to consider is taking a gradual approach towards investments to benefit from dollar-cost averaging. Making regular investment purchases, buys more units when prices are low and fewer units when prices are high, effectively lowering the average cost and providing the potential for greater growth over the long term. Of course, this approach may be more beneficial to people with a longer investment timeline, as investment strategies for older investors and retirees may differ.

In any case, it's important to also recognize that most investments come with certain levels of risk – and to determine your own tolerance for risk with the help of an advisor and a few key questions.

Inflation and retirement

Retired people and those who are planning their retirement are likely keeping a close eye on inflation rates and what they may mean to their retirement savings. If higher rates persist for some time, not only would inflation affect retirees' ability to afford everyday expenses, but also some important necessities, such as medication or some health care procedures.

Creating a realistic retirement budget and reducing spending can help to limit the potential harm posed by rising prices, but the answer is the same in just about every scenario – to beat inflation, even when it comes to minor increases, look at leveraging your investments.

Consider this example: a typical balanced portfolio holds 60 per cent of its value in stocks and 40 per cent in bonds. Assume you earn a five per cent annual average return, and that when you enter retirement you initially withdraw four per cent of your portfolio, adjusted for inflation that averages two per cent annually. Over the next 25 years, the odds against running out of money are 85 per cent. But if inflation climbs another percentage point higher, to three per cent, those odds fall to 72 per cent. If inflation were to rise to a consistent four per cent, the odds then fall to about 50-50.

Realizing how a spike in inflation can draw value away from retirement savings and income should be a signal to contact your advisor and reassess your investment strategy to ensure that you have enough assets to continue to support your standard of living. On the other hand, retirees should know that some programs are automatically cost-adjusted for inflation, including Old Age Security and some defined benefit pension plans.

What might the future hold?

It's logical to expect that the post-pandemic Canadian economy will continue to strengthen through rising spending, investment, trade, and employment. Meanwhile, influential economists and investment strategists believe that over the next year or two, inflation will trend higher than we've seen in the last 10 years.

Investing in advice

Cash has a hard time keeping up with inflation, so it's important to be aware of how easily it can turn savings into a loss by weakening purchasing power. Rather than relying on traditional savings accounts, exposing your money to the markets could earn better returns that keep pace with or, possibly, outperform the negative effects of inflation.

Investment choices have broadened over the past decade, providing more flexibility to build a portfolio with growth potential that remains safely within your tolerance for risk. Speak with your advisor, who can help you take advantage of new opportunities as they arise and ensure your finances can stand up to potential challenges.

[1] www.bankofcanada.ca/rates/indicators/capacity-and-inflation-pressures/inflation

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COMPANY ANNOUNCEMENTS

A new associate, Terri Carr was recently welcomed to Bill Vollmer's team as Dina Le went on maternity leave. Congratulations to Dina and her husband on the birth of their baby boy!

Our teams are still working hard for you and we continue to mainly hold virtual and telephone meetings, with meeting in-person as an option, as needed.

If you would like to receive the newsletter by email rather than paper, please let us know by emailing klarisa.mcdonald@manulifesecurities.ca and stating 'newsletter by email' in the subject line.

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Years of inflation ups and downs

The Canadian economy has come a long way from the days when inflation ran into double digits. Of course, today's inflation, which is reaching its highest levels in decades, is a concern for consumers who see their money falling short of what it used to buy only a brief time ago. But to keep it in perspective, even a five or six per cent inflation rate is low when compared to some years. Here's a look at some of the past levels of inflation in Canada.

12.65%
(1974)

12.78%
(1981)

6.8%
(average inflation in the 1970s, nearly triple the rate of the 1950s and '60s)

14.76%
(peak inflation in 1980; the average for the year was 10.11 per cent)

3.96%
(1986, the only time during the 1980s inflation dipped below four per cent)

4.98%
(1989, about 10 percentage points lower than a decade earlier)

1.49%
(1992, the first time in six years that inflation dipped below two per cent)

0.71%
(1994)

3.7%
(May 2011 and July 2021)

Source: https://www.inflation.eu/en/inflation-rates/canada/historic-inflation/cpi-inflation-canada.aspx

The whole deal

Whole life insurance provides lifelong protection with valuable additional features.

Choosing the right life insurance solution for your situation is extremely important – but the process can feel overwhelming since there are so many different products available.

There's term life insurance, which offers straightforward coverage for a specific number of years. There's universal life insurance, which provides lifelong protection and includes the opportunity for tax-sheltered investment growth. Often less well understood is whole life insurance, which provides lifelong protection, like universal life insurance, but with different features.

How does whole life insurance work?

Whole life insurance is what's known as a permanent insurance policy. Regardless of how long someone lives and whatever health issues that person encounters, beneficiaries will receive the

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guaranteed death benefit. The only requirement is that premium payments – often referred to as modal policy payments – must continue to be made according to a set annual or monthly schedule.

With some whole life insurance policies, beneficiaries may receive more than the death benefit, which is the face amount on the policy. They may also get the amount of "paid-up insurance." This is extra coverage the policyholder bought either using the policy's earnings or by depositing additional payments. In some policies, paid-up insurance only increases the death benefit. In others, it also increases the policy's "cash value."

The cash value is an amount that accumulates inside the policy which the policyholder can access while still alive. Not all whole life insurance policies have a cash value, but it is a useful feature that offers flexibility if the policyholder needs an extra source of funds. Some policies offer guaranteed cash values, providing helpful certainty for planning.

Many whole life insurance policies offer another useful feature: the ø90 or 100) or in a specific number of years (e.g., 10 or 20 years). The latter option, also known as limited pay, allows the policyholder to pay all the modal policy payments early on. This can help with planning because it ensures no more payments are due after retirement or at a time when someone anticipates needing funds for extra care at home or perhaps in a long-term care facility.

How do policies add value?

Different policies offer a variety of extras that can add value for policyholders, such as:

- Allowing policyholders to make extra deposits that build cash value and/or face value
- Offering annual performance credits that build the policy's cash value and/or face value
- Offering annual dividends that build the policy's face value and cash value
- Facilitating cash value withdrawals when needed – note that these withdrawals are generally subject to tax, but may be tax-free if the policyholder becomes disabled
- Allowing the policyholder to use the cash value as collateral for a bank loan
- Permitting the policyholder to decrease the policy's face value as their needs change

It may also be possible to add features through riders – for example, increasing protection with term life insurance, including the option to skip payments if the policyholder becomes disabled, and protecting children and guaranteeing they will qualify for their own policies when they grow up.

Who can benefit?

Like all life insurance, whole life insurance can be part of an overall strategy to maximize your legacy, providing a guaranteed, tax-efficient death benefit that you can pass on to the next generation. It can also fund a sizeable charitable donation.

The cash value makes it possible to access money if needed – for example, to pay for unexpected costs such as home repairs or home care services. Also, the cash value grows on a tax-deferred basis, meaning taxes are due only on withdrawn amounts, making this a tax-efficient way to build wealth.

Your advisor can help you decide what type of life insurance is most appropriate in your circumstances and explain the ins and outs of various whole life insurance policies. Once you've made your choice, you'll know you've implemented a strategy that helps to optimize your estate plan and provide a secure legacy to your beneficiaries.

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