THE STAN CLARK FINANCIAL TEAM'S

# PERSPECTIVES

IN THIS ISSUE:



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STAN CLARK
*Senior Wealth Advisor*

To combat inflation, the U.S. Federal Reserve and other central banks have raised interest rates. But have they raised them too much and too fast? Michael Chu and I discuss this and other financial issues in our Quarterly Economic Update. Speaking of inflation, I look at the money illusion, the tendency to focus on the face value of money – without considering how inflation affects its purchasing power. Sylvia Ellis spotlights annuities: Is now the right time for you to invest in one?

Stan

Stan Clark is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Behavioral Finance

## THE MONEY ILLUSION: HOW INFLATION THREATENS WHAT TODAY'S MONEY CAN BUY IN THE FUTURE

*By Stan Clark, Senior Wealth Advisor*

**In their excellent book** *Why Smart People Make Big Money Mistakes*, **Gary Belsky and Thomas Gilovich look at how three people, Peter, Paul and Mary, each buy a house that costs $200,000. Each then sells their house after one year.**

Let's follow what happens to all three in discussing how inflation threatens what today's money can buy in the future – what we call the *money illusion*.

In Peter's case, the country undergoes 25% deflation in that year, and he receives just $154,000 for his house, 23% less than he paid.

In Paul's case, a year later, inflation has risen by 25%. He can sell his house for $246,000, a 23% percent gain.

In the year Mary owns her house, the cost of living is flat. At the end of the year she sells it for $196,000, or 2% less than she paid.

Taking inflation and deflation into account, and assuming none of the three carried debt, who was financially better off after selling their home?

I'll tell you the answer shortly. You may be surprised. But first here is another example to consider:

Let's say you set aside $100,000 cash in your safety deposit box. You leave it there for 15 years while inflation averages 2% a year. At the end of 10 years, you open the box and count your money. It's all there: your $100,000, sitting safely inside. Should you feel good about that?

Both examples above illustrate the money illusion – the tendency to focus on the face value of money but overlook the effects of inflation on its purchasing power. With the cash in your safety deposit box, sure, your original money is still there. But 15 years of inflation have cut its purchasing power by $26,000, to just $74,000.

In the housing example, most people feel Paul does best because he's made a $46,000 profit. But the real winner is Peter, even though he sold for a $46,000 loss. Why? Because of inflation, Paul's profit falls 2% short of the inflation rate. His purchasing power is diminished. So is Mary's. But Peter, despite what seems like a sizeable loss, comes out with purchasing power 2% *greater* than inflation.

The point I'm making is this: Money is only good for what it can buy. So, what you can buy with your money is more important than the absolute quantity you have.

The money illusion has three major effects on people's financial planning.

First, they underestimate how much money they will need, especially after they retire. An average couple retiring today can expect at least one of them to live another 30+ years. That's plenty of time for inflation to dramatically increase costs, as it chips away at the purchasing power of fixed investment.

Second, people overestimate the value of fixed assets such as cash on hand, as shown in the cash example I described above.

Third, they overestimate the ability of real estate to keep them ahead of inflation.

Inflation has averaged 2.1% over the past 151 years.

## TEAM TALK

**Meghan Jones**
*Client Associate*

**What are some of the highlights of the past year?**

Getting married to my partner, Adam, in June tops the list! We had a small ceremony in a neighbour's garden and were then joined by the rest of our guests at my parent's house across the street for our reception. It was a surreal feeling having all the people we love together in one room. A day we will never forget! As well, embarking on an extensive renovation of our condo in New West. We redid the kitchen, one of the bathrooms, our floors and painted everything! Move-in day was a week before our wedding and we have been enjoying decorating and living in our new space since then.

**Where did you honeymoon?**

As with a lot of Covid couples, we postponed our wedding. We didn't postpone our honeymoon; however, and went to Maui for 3 weeks last November. We are planning a trip to Japan for the fall of 2023, which will be our first official vacation as a married couple.

*Meg & Adam, June 2022*

Central banks around the world, such as the Bank of Canada and the U.S. Federal Reserve, seem determined to ensure we have similar inflation going forward. Markets are betting it will be almost half a percent higher over the next 10 years. Many people think even that is overly optimistic.

The lesson here is: Be sure you consider inflation when planning your future and when comparing different investments. History shows that despite seeming risky, stocks are actually a good long-term inflation hedge. That's because company earnings generally rise with inflation, whereas fixed-rate investments don't. Incorporate inflation when doing your long-term financial planning. It won't make inflation go away, but at least it allows you to clearly see the effect it might have on your financial future.

Quarterly Economic Update

# STEPPING TOO HARD ON THE BRAKES?

*By Stan Clark, Senior Wealth Advisor, and Michael Chu, Senior Wealth Advisor*

**Despite some early optimism in 2022's third quarter, most major equity markets around the world declined. Many central banks continued to hike interest rates, and the U.S. Federal Reserve was clear in its determination to keep fighting inflation – but just how far and how fast they would go, has been a key factor in the markets.**

Currency markets were also volatile in the third quarter, with the U.S. dollar gaining considerably against other major currencies.

Like the Fed, the Bank of Canada remained committed to fighting inflation. In Canada headline inflation has been easing but is still elevated.

Stock markets around the world had mixed performance in third quarter. At home, the TSX was down 1.4%. The World Equity Index, a gauge of stocks around the world, was up 0.8% (in C$).

| | 3rd Qtr. 2022 | Year to Date 2022 | Trailing P/E | Trailing Eanings Yield | Dividend Yield |
|---|---|---|---|---|---|
| **Canada** (S&P/TSX) | -1.4% | -11.1% | 12.7 | 7.9% | 3.4% |
| **U.S.** (S&P 500) | 2.2% | -16.7% | 18.3 | 5.5% | 1.8% |
| **Europe** | -2.7% | -17.5% | 12.7 | 7.9% | 3.6% |
| **Japan** | -0.1% | -20.0% | 13.7 | 7.3% | 2.7% |
| **EAFE** (Europe, Australia, Far East) | -2.6% | -20.2% | 13.0 | 7.7% | 3.6% |
| **Emerging Markets** | -5.0% | -20.3% | 11.5 | 8.7% | 3.6% |
| **World** | 0.8% | -18.4% | 16.3 | 6.2% | 2.3% |

Source: Bloomberg

### Valuations

According to Dr. Ed Yardeni, president of Yardeni Research, the current forward price-to-earnings (P/E) ratio for the S&P 500 is 15.1. Forward earnings are based on the expected earnings over the next 12 months. Last year, the P/E ratio was over 22, meaning stocks are over 30% cheaper compared to last year. The long-term P/E ratio over the last 140 years is 15 to 16 – in line with today's valuation.

According to Jeremy Siegel, Professor of Finance at the University of Pennsylvania's Wharton School, the earnings yield (the inverse of P/E) is a good predictor of long-run real stock market returns. Based on this, we can expect U.S. stocks to return 6.6% plus inflation, on average, per year over the next 10 years. Earnings yields in Canada and many other areas of the world are substantially higher.

### Policy error at the Fed?

Stable prices while maintaining employment is the number-one job at the Fed. To fight inflation, the Fed has increased short-term interest rates by 3% in the past six months, the fastest pace in recent history. With that rate of change, there's growing concern that the Fed is making a policy error that will cause a significant "hard-landing" recession.

But employment and inflation are lagging indicators, that is, indicators that can only be known after the fact. The Fed also looks at leading indicators, like commodity prices. Leading indicators are those that try to anticipate the future. Many commodity prices have fallen on a year-over-year basis (e.g., gold, lumber, memory, iron ore, copper). Food and energy, strongly affected by the Ukraine war, are up year over year, but both oil and corn are well down from their March/April peaks. While food and energy are important, the Fed may be exacerbating the global pain associated with a supply shock from the war.

Since the beginning of the pandemic, worry about supply constraints has caused many of us to accumulate inventory at home, for example, hoarding a year's worth of products from toilet paper to rice. World-class companies are in the same boat, also over-ordering merchandise. As a result, though sales are up by single digits, inventories at Walmart and Target are up about 30%. Nike's inventory is up 44% globally.

After huge price hikes, used-car prices are coming down. We might soon see dealers disgorging more of their inventories. And, with these stats as a possible portent, we might also see high inflation flip into falling prices.

Many analysts are now suggesting the Fed should take a breather on rate hikes to gauge the effects of the past six months' unprecedented increase in interest rates.

### The Fed overshooting its targets?

Yardeni and fellow top economist Jeremy Siegel think the Fed should, at its November meeting, finish hiking interest rates. Siegel thinks the Fed was too easy on the economy in 2020, when housing and commodity prices were booming, but is now being way too hard on it. He fears the Fed is on the verge of going overboard with its monetary tightening policy.

Yardeni cites a strong U.S. dollar as an additional reason the Fed should stop raising rates after November. A strong U.S. dollar will make U.S. goods less competitive overseas and will also reduce profits for multi-national companies. But the Fed is notorious for overshooting. It overshot by raising rates too much in 2018 and then kept stimulating too long in 2021. Seems the pendulum of monetary decisions swung too far during the heart of the pandemic – and has now swung too far to the other side.

### A glimmer of hope for a soft-ish landing

The odds appear stacked that the U.S. economy is headed for a hard landing. However, some of the recent U.S. labour market data provides a glimmer of hope that not all is lost. Fear of accelerating wage growth has been one of the main concerns causing the Fed to raise rates so fast. This is still a major concern, but some recent data indicates that over-bidding for workers is easing and, while jobs remain easy to find, wage growth may cool. This suggests a possible soft-ish landing in the labour market.

The Institute of Supply Management (ISM) announced that its manufacturing index slipped in September to 50.9 from 52.8 in August. Anything above 50 indicates expansion, so the index for manufacturing is still growing, but at a slower pace. Export orders fell below 50, meaning the strong U.S. dollar may be hindering U.S. exports. This should also help cool the economy.

### What if earnings fall?

Despite the many predictions of a recession, corporate earnings have held up well this year. Company and industry-focused analysts are forecasting that earnings will hold up well next year, too. But top-down-focused strategists and economists are not so sure. Some believe analyst earnings estimates are too optimistic and earnings may fall. Analysts have usually been more reliable than strategists/economists, but what if earnings do fall due to an economic slowdown? Does that mean the stock market will also fall? That seems to make sense. Still, the relationship isn't so clear.

The following table shows stock market performance year over year (YOY) during positive and negative years for earnings:

**Earnings vs. the Stock Market: 1930-2021**

| % of the Time | When Earnings are Up YOY | When Earnings are Down YOY |
|---|---|---|
| **Returns are Positive** | 72% | 77% |
| **Returns are Negative** | 28% | 23% |
| **Returns 10% or More** | 57% | 61% |
| **Returns 20% or More** | 33% | 45% |
| **Returns 10% or Worse** | 10% | 16% |
| **Average Returns** | **10.2%** | **9.8%** |

Data: Schiller

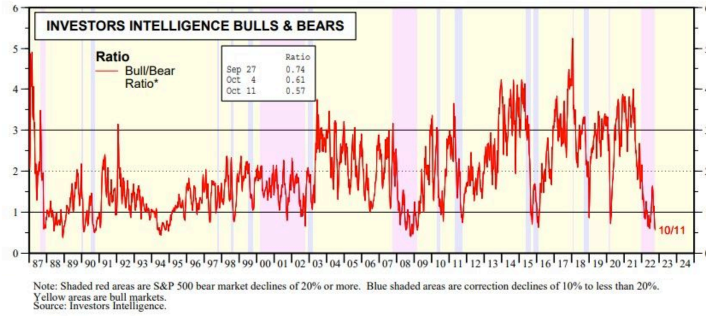
As you can see, there were actually more double-digit returns when earnings were down than when they were up. Though on the surface this doesn't seem to make sense, it actually shows there's a lot more at play. Perhaps the stock market fell in anticipation of future earnings drops, and then rose when an earnings drop actually occurred, expecting a future rebound?

Even if you knew what will happen to future earnings, it would still be hard to predict what's ahead for the stock market. It's possible that an earnings drop will lead to another drop in the stock market, but that's not a foregone conclusion. This is a good example of why it is so hard to predict the market's short-term, year-to-year movements.

### Too much pessimism?

So far, 2022 clearly hasn't been great for the stock market, what with war, rising rates, inflation, energy shortages and supply chain issues. It's all too easy to be pessimistic. However, widespread optimism or pessimism has often worked as a contrary signal – meaning it's often been best to go against the prevailing views. The Bull-Bear Ratio (BBR) measures how many investors are optimistic (bullish) vs. pessimistic (bearish). Often a reading below 1.0 in the BBR has marked the bottoms of corrections. The BBR is has recently fallen to 0.57, which is the lowest point since March 2009 – the lowest point of the market during the financial crisis of that time, and the start of a new bull market. But during bear markets, these readings can persist, and like any indicator, the BBR is not perfect. It is difficult to go against the crowd, but usually the more bearish people feel in the short term, the more bullish we should be for the long term.

**Bulls & Bears**




### Long-term bullish

Things could still get worse in the short term. However, we buy stocks for their long-term returns, so we feel it's important to look past the short-term uncertainty. Consider: This is the ninth time the S&P 500 is down 25% or more since 1950. The following chart shows the one-, three-, five- and 10-year returns after a 25%+ drop in the stock market over the past 70 years.

**When the S&P 500 is Down 25% or Worse Since 1950**

| Peak | Trough | % Decline | +1 Year | +3 Years | +5 Years | +10 Years |
|---|---|---|---|---|---|---|
| 12/12/1961 | 6/26/1962 | -28.0% | 31.2% | 69.2% | 94.8% | 171.1% |
| 12/29/1968 | 5/26/1970 | -36.1% | 32.2% | 44.3% | 27.9% | 97.5% |
| 1/11/1973 | 10/3/1974 | -48.2% | 1.4% | 23.8% | 42.0% | 188.4% |
| 11/28/1980 | 8/12/1982 | -27.1% | 43.9% | 81.2% | 238.6% | 403.9% |
| 8/25/1987 | 12/4/1987 | -33.5% | 14.7% | 34.1% | 96.8% | 387.1% |
| 3/24/2000 | 10/9/2002 | -49.1% | 0.2% | 1.9% | 21.5% | 38.3% |
| 10/9/2007 | 3/9/2009 | -56.8% | -6.9% | 3.7% | 61.2% | 209.6% |
| 2/19/2020 | 3/23/2020 | -33.9% | 56.4% | ??? | ??? | ??? |
| 1/3/2022 | 9/30/2022 | -25.2% | ??? | ??? | ??? | ??? |
| Averages | | **-37.6%** | **21.6%** | **36.9%** | **83.3%** | **213.7%** |

Data: Ycharts

As you can see with all the green, almost every subsequent period after a 25%-or-greater decline was positive. Although we've had two big drops in the last three years, these don't happen too often (nine times in the last 70 years). The key is that good returns soon follow, so it's important to measure your performance in years as opposed to months or even days.

We don't know what will happen in the short term. We do know that every single bear market has eventually recovered to new all-time highs. We also know that future returns in the stock market should be better if you buy when prices are lower. It's always tempting to wait until "things look better," but by the time that happens share prices will most certainly be higher and future expected returns that much lower.

### Looking ahead

As we move forward, it seems likely that markets will continue to focus on how central banks respond to economic data. There are major headwinds, so the probability of an economic slowdown remains high. The rise in interest rates might be priced in, but valuations may not reflect a bigger-than-expected earnings drop. And if earnings forecasts fall, stocks might fall more, too.

However, several positive surprises could happen. Supply chains have improved, commodity prices have moderated and inventories are building up. So, inflation might moderate faster than expected. This could cause interest rates to stop rising and maybe even fall. And earnings might not drop as much as economists and strategists fear.

With all the economic news dominating the headlines, we continue to stick with our investment process: picking companies with strong features that have track records of generating above-average returns. No matter what the economic outlook, we take comfort in our disciplined methods and asset mixes determined by your financial plan. We continue to rely heavily on the durability of our philosophy and processes in an effort to responsibly steward our clients' investments through uncertainty. Having the right asset mix is key. An equities target customized to your own personal and financial needs is important – and will help you stay resilient through these unusual times.

Financial & Estate Planning

# ANNUITIES: IS NOW THE RIGHT TIME?

*By Sylvia Ellis, Senior Estate Planning Advisor*

**With interest rates rising, we're seeing more and more articles written about annuities.**

Annuities are designed for those seeking a low-risk, tax-efficient investment. Here's how they work. An individual invests a lump sum with an insurance company in exchange for a set monthly income, which can be for a specific period of time or for life. Payments can start immediately or be deferred to a later date. It is often recommended that, if you wish to have an annuity, it represent a portion of your overall investments.

There is a significant tax advantage with what is called a prescribed annuity, a non-indexed annuity purchased by an individual with non-registered funds. That is, funds outside of an Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF). The income payments are made up of a blend of capital and interest, with only the interest taxable. Qualifying for special tax treatment allows the taxable portion to be level over the life of the annuity, as opposed to starting out high and reducing over time.

This produces a higher after-tax return than a similar fixed-income investment, such as a guaranteed investment certificate (GIC). For example, if an individual in their mid-60s earned $1,000 per month, about 30% would be taxable (the taxable portion varies with age). Using a 30% marginal tax rate, the actual tax paid would only be $90, leaving a monthly net income of $910 for life.

Are the conditions now right for an annuity? A good time to buy is when interest rates are high and expected inflation is low. As noted, interest rates have indeed risen – however, past inflation has risen even more. The question becomes: How do interest rates compare to future forecasted inflation?

A good measure for this is to look at the yield on long-term real return bonds. These are bonds that pay an interest rate equal to the Consumer Price Index (CPI) inflation rate, plus a fixed percentage. Long-term real return bonds in Canada are currently yielding 1.64%.


Source: Bank of Canada

This is the highest real return in over 10 years, and well above the negative real yields of the pandemic. But it is still well below the real returns offered in the "good old days" of annuities, 2010 and earlier.

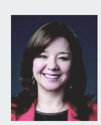
Let's say the conditions now are right. However, you're concerned about what will be left over for beneficiaries. There are a few ways to preserve your investment. The first is to opt for a guarantee period. The income is guaranteed for the annuitant's lifetime. Or, for spouses, a Joint Life annuity is guaranteed for both lifetimes.

You could also purchase an additional guarantee for your beneficiaries. Examples are for five, 10, 15 and 20 years. If you choose an annuity with a 15-year guarantee, and you pass away in seven years, it means that you have eight years of payments remaining. One thing to remember, though: the higher the guarantee period, the lower the income.

Another option is to insure your annuity, that is, couple it with life insurance.

Annuities are not for everyone. Nevertheless, they are beneficial in many situations. When discussing annuities, again, you need to consider: the various types available; and inflation and interest rates at the time. If you wish to gauge what is being offered now or in the future, CANNEX.com regularly publishes annuity income reports. Generally, as a benchmark, CANNEX posts information for males aged 65 and single, with 10 years guaranteed.

If you would like more information on annuities, or wish to see a quotation based on your specific situation, we will be happy to provide it to you.



Sylvia Ellis is the Senior Estate Planning Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Sylvia provides support to the team in projecting and planning client financial affairs.

# SCFT Trivia

**Play our trivia – support the cure!**

For every correct entry we receive in our trivia contest, the Stan Clark Financial Team will contribute $1 to CIBC's "Run for the Cure" to raise money for breast cancer research. Each correct entry will also be entered into the draw for this month's prize. Email or phone in your entry today.

Answer all four questions to be entered into the draw for this month's prize. *Hint: You can find the answers inside this newsletter.*

1. Since the beginning of the pandemic, worry about supply constraints has caused many individuals to:

   a) Cut back on their lifestyle and live more simply

   b) Increase their orders of every product, since they don't know what will actually be delivered

   c) Accumulate and hoard products

   d) Start growing their own food and sewing their own clothes

2. According to top economist Ed Yardeni, the U.S. Fed should stop raising rates because:

   a) A strong U.S. dollar will make U.S. goods less competitive overseas

   b) A strong U.S. dollar will reduce profits for multi-national companies

   c) The Fed is notorious for overshooting when it raises rates

   d) All of the above

3. The *money illusion* can be defined as:

   a) What misers believe, that it's better to hold onto money than ever spend it

   b) The tendency to focus on the face value of money and overlook the effects of inflation on its purchasing power

   c) Thinking money is overrated, so why not spend all you have?

   d) The theory that money in itself is worthless, so invest every cent in real estate

4. With an annuity, you invest a lump sum with an insurance company in exchange for a set monthly income for a specific period of time or for life:

   a) True b) False

Email answers to: **stanclarkfinancialteam@cibc.ca** or call (604) 641-4361

One prize winner will be chosen by a draw from all those who submit correct answers. The draw will take place on November 30, 2022.

Trivia challenge runs November 1 - 29, 2022. No purchase necessary. There is one prize to be won. Simply complete the trivia questions correctly to be entered in the draw. Limit 1 entry per person.

Chances of winning depend on number of eligible entries and whether you correctly answer the trivia questions. Open to adult Canadian residents (excluding Quebec). For full challenge rules, write to: The Stan Clark Financial Team, CIBC Wood Gundy 400-1285 West Pender St, Vancouver, BC V6E 4B1. 

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