CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

IN THIS ISSUE:

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According to economic theory, investors take risks based on the utility of potential gains, balanced by the dis-utility of incurring losses. In reality, as I discuss in this month's behavioral finance article, two biases often influence investors into making emotional, rather than practical, decisions. In our *Quarterly Economic Report*, Michael Chu and I look at the growth of economy and stocks – and the factors that may or may not affect their continued growth.

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

HOW LOSS AVERSION AND THE ENDOWMENT EFFECT CAN CLOUD YOUR FINANCIAL DECISIONS

By Stan Clark, Senior Wealth Advisor

With investing, knowing when to sell – i.e., when to take a loss and when to take a profit – is often just as important as knowing what to buy.

Two biases can cloud our judgment and prevent us from selling investments we should be selling: *loss aversion* and *the endowment effect*.

Let's look first at loss aversion. Standard economic theory holds that people take risks based on the utility of potential gains, balanced by the dis-utility of incurring losses. This balanced version of utility certainly sounds good. In reality, though, it doesn't often happen. According to Nobel Prize winner Dr. Daniel Kahneman, we're far more influenced by losses than by gains.

To illustrate, Kahneman poses two unusual choices in his book *Thinking Fast and Slow*:

1. Would you rather get $900 for sure, or gamble on a 90% chance of winning $1,000 with a 10% chance of winning nothing?
2. Would you rather give up $900, or gamble on a 90% chance of losing $1,000 with a 10% chance of losing nothing?

The two choices mirror each other. Yet in the first, most people would take the certain $900 over the substantial chance of winning more. It's the bird-in-the-hand idea: Most people are risk-averse.

In the second choice, loss avoidance, we would rather gamble and risk losing even more money because of our faint hope of losing nothing. It's a major reason people hold on to a falling stock far longer than they would if they gave proper weight to the stock's fundamentals. Selling means taking a loss, so people gamble on the stock recovering. Often they simply add to their loss.

Now let's look at the second bias: that curious influencer, the endowment effect.

Every day people exchange money for goods, or goods for money. Nobody thinks anything of it. As Kahneman notes, they mentally earmark the money and the goods as being "for exchange."

But sometimes it's different. Remember the *Seinfeld* episode where Jerry craves a loaf of marble-rye bread worth $3? A woman ahead in the line buys the last loaf. Jerry offers $50 for it. But the woman refuses, ultimately goading Jerry into become a loaf thief!

With the endowment effect, people place far more value on things they already own than on things they would have to buy. The *Seinfeld* woman likely wouldn't have paid much more than $3 for the loaf. But once she owned it, she didn't want to part with it, even for an outrageous price.

The endowment effect happens when people develop an emotional attachment to things. We see it with tickets to major sporting events such as the Super Bowl, the Stanley Cup and Olympic Gold Medal competitions. People refuse to sell their tickets, often giving up thousands of dollars – amounts they would never pay for the same tickets. Similarly, people can develop emotional attachments to their investments. They hold on, even though these investments are priced far higher than their actual worth.

Beware of loss aversion and the endowment effect. Don't develop emotional attachments to your

TEAM TALK

Tom Cowans
Portfolio Mangaer/Wealth Advisor

Disneyland, October 2024

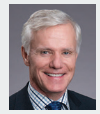
What have you been up to lately?

My son Ryan recently began grade 1 at school and my daughter Ellie has started at a local Montessori so we're back in the routine again after a fun summer. We went to Vancouver Island to Rathtrevor Beach Provincial Park and Qualicum during the summer holidays which was great. The ferry always makes for a fun trip - especially with little kids that always want to be on the move!

We also recently returned from a few days at Disneyland. It was a lot of fun and we definitely made the most of our time down there. It was very busy and hot, and we certainly got our steps in during the long days. It was worth it just to see Ryan and Ellie's reactions when they met Mickey Mouse.... and Darth Vader! I'd been to Disneyworld nearly 30 years ago so it was amazing to see how the new rides compare – the Star Wars rides are something else!

We have a family trip planned in the new year and one to England to see family in July which we are looking forward to already!

investments. Instead ask yourself, "If I didn't own this investment already, would I pay the current market price to buy it?" If you wouldn't, then maybe you shouldn't own it. Using a disciplined approach to buying and selling can help you avoid these biases – and the mistakes they can cause.



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Quarterly Economic Update

GROWTH SEEMS ON TRACK TO CONTINUE, THOUGH NOT WITHOUT RISKS

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

In the third quarter of 2024, under the weight of previous central bank interest rate increases, global growth continued to slow. But in September, the U.S. Federal Reserve made its first interest rate cut of this cycle, joining the Bank of Canada and other central banks that had already begun reducing rates due to retreating inflation and increased risks to growth and employment.

The third quarter turned out to be a Goldilocks scenario: Growth was weak enough to let central banks ease interest rate policy, but not so weak that there were obvious signs of a recession. Regardless of whether central bank easing corresponded to a recession or a soft landing, equities have historically gone higher after the first central bank cut.

The stock market continued to do well. However, performance broadened out over the third quarter, with the technology sector lagging as investors questioned higher valuations due to AI spending. Canadian markets led the advance: TSX was up 10.5% for the quarter. The World Equity Index, a gauge of stocks around the world, was up 4.7% (in C$).

	3rd Qtr. 2024	Year to Date 2024	Trailing P/E	Trailing Eanings Yield	Dividend Yield
Canada	10.5%	17.2%	18.5	5.4%	2.9%
U.S.	4.7%	24.7%	25.2	4.0%	1.3%
Europe	3.9%	15.6%	15.2	6.6%	3.1%
Japan	6.9%	15.5%	14.9	6.7%	2.2%
EAFE (Europe, Australia, Far East)	6.1%	15.4%	15.5	6.4%	3.0%
Emerging Markets	7.5%	19.3%	16.3	6.1%	2.5%
World	5.2%	21.4%	22.7	4.4%	1.8%

Source: Bloomberg

Licence to cut

Inflation continues to grind lower, both in Canada and the U.S. Inflation in Canada is now at 2%, compared to 2.9% in the previous quarter. In the U.S. the drop wasn't as big; it is now at 2.25%. Cuts by other central banks give the Bank of Canada the option to be more aggressive with future interest rate cuts, especially with inflation coming in less than expected and growth slower.

One and done?

Earlier this year, the outlook for interest rates in the U.S. was "higher for longer," that is, keeping interest rates higher to fight inflation. But this summer it switched to "lower and sooner" in response to the economy's soft patch. According to top economist Ed Yardeni, recent stronger economic data suggests there might be another pivot back to "higher for longer." Along similar lines, Professor of Finance Jeremy Siegel, of the University of Pennsylvania's Wharton School boosted his estimate of the neutral interest rate – the interest rate consistent with full employment and stable inflation.

In the past, initial rate cuts have usually been followed by a quick succession of more cuts. But this time there's no credit crisis, credit crunch or recession. Instead, the economy continues to grow at a solid pace around 3%. So, there's no rush for the Fed to ease further, especially if the economy continues to perform well. The data shows the economy to be remarkably resilient.

With a strong economy and no recession in sight, why then did the Fed reduce interest rates? Perhaps it was doing some fine-tuning to boost demand for labour and reduce unemployment. Still, this won't rectify the mismatch between the skills employers seek and the skills job seekers offer.

Yardeni thinks that any further rate cuts would increase the odds of a late 1990s-style melt-up for the stock market to 30% (from 20%). But, for now, this most likely continues to be a Roaring 2020s-type economy – a reprise of the Roaring 1920s (50% chance from 60%).

The third scenario would be like the 1970s, with geopolitical shocks causing oil prices and inflation to spike (20% chance). These changes in probabilities were prompted by Fed Chair Jerome Powell's August Jackson Hole speech, when he signaled his shift from being an inflation hawk to an employment dove.

While the U.S. economy shows signs of cooling, it does not seem to be heading towards a dramatic downturn. Instead, a careful recalibration of interest rates by the Fed could help sustain growth and alleviate potential pressures, making the next few months critical for policy direction, economic stability and the market's behaviour.

Un-inverted yield curve

Because central banks are easing policy and the markets expect them to continue, the yield curve has started to normalize.

There have been many misleading economic indicators signalling a recession since the Fed started tightening monetary policy in early 2022. Among the most ominous is the inverted yield curve. According to Siegel, the Fed typically reacts to a jump in inflation expectations with rapid increases in interest rates to bring down these expectations. Past hiking cycles that caused inversions have typically been followed by recessions.

However, unique post-pandemic economic factors heavily influenced the recent yield curve inversion. Throughout the pandemic itself, longer-term inflation expectations never became unanchored. This is a major reason a soft landing is highly probable. Also, upward revisions in the S&P 500 operating forward earnings have been a remarkably useful guide in keeping us from falling into the recession-prediction trap.

Valuations

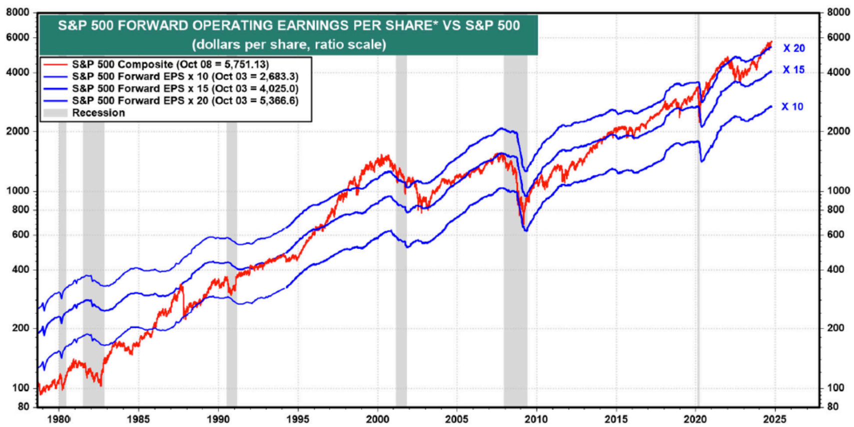
Ed Yardeni is expecting significant growth in earnings. Yardeni's forward estimate for the U.S. S&P 500 is 269. That implies a forward price-to-earnings (P/E) ratio of 21.8 (vs. trailing 25.2) and a forward-earnings yield of 4.6% (vs. trailing 4.0%). Forward earnings are based on the expected earnings over the next 12 months. The consensus analyst expectations are similar to these.

Yardeni also estimates full 2025 and 2026 earnings will grow, to 300 and 325 respectively. The average P/E ratio over the last 153 years is 16, suggesting the stock market valuations are above average. But if forecasted earnings turn out to be in the ballpark, then today's valuation of U.S. stocks would be much more reasonable, at around 18 to 20. Further, if you remove the more expensive technology stocks, the P/E ratio falls another few points. This means there are many other companies at better valuations.

The key will be how much earnings grow – which can change valuations significantly.

Siegel says the *earnings yield* (the inverse of P/E) is a good predictor of long-run real stock market returns. Based on this, if next year's earnings estimates are not abnormally high, we can expect U.S. stocks to return 4.6% plus inflation on average per year over the next 10 years. Earnings yields in Canada and many other areas of the world are substantially better – a good reason for diversification.

Siegel describes a market priced at around 21 times earnings, with a close to 5% earnings yield, as perfectly reasonable. With stock prices in record territory, fortunately, forward earnings are also in record territory, though not to the same extent. So higher prices are partly supported by higher company profits. During the current bull market, the forward P/E has increased from 15.3 in October 2022 to 21.8. That's not quite a record high in valuation, nevertheless it is inching to the 25.5 reached in 1999 before the tech bubble burst. But the global markets offer good diversification and better valuations.



Source: LSEG Datastream and © Yardeni Research.
* Forward earnings per share is a time-weighted average of analysts' consensus earnings estimates for the current year and the coming year. Monthly through March 31, 1994, then weekly.

Stocks vs. bonds

U.S. 10-year Treasury bonds now yield about 3.8%, which is 1.4% above the expected 10-year inflation rate of 2.3%.

U.S. stocks' forward earnings yield today is 4.6%. As Jeremy Siegel has pointed out, earnings are claims on real assets, and this earnings yield is a reasonable estimate of future returns above inflation.

So, when you compare the 4.6% earnings yield on U.S. stocks to the 1.4% expected real return on bonds, the difference of 3.2% is close to the 153-year average. Based on this, the S&P might be expected to earn a premium of 3.2% vs. bonds going forward, not far off the difference over the past 153 years.

Because the difference in expected returns is now similar to the 153-year average, it also gives us even greater confidence in the targets generated by our proprietary financial plans, which are based on analysis of this full 153-year period.

In Canada, 10-year bonds yield about 0.8% less than U.S. bonds, while the expected earnings yield on stocks is about 2% higher. Stocks look much more attractive vs. bonds in Canada than they do in the U.S.

	Forward P/E	Forward Earnings Yield
Canada	15.2	6.6%
U.S.	21.8	4.6%

Source: Bloomberg

Happy birthday!

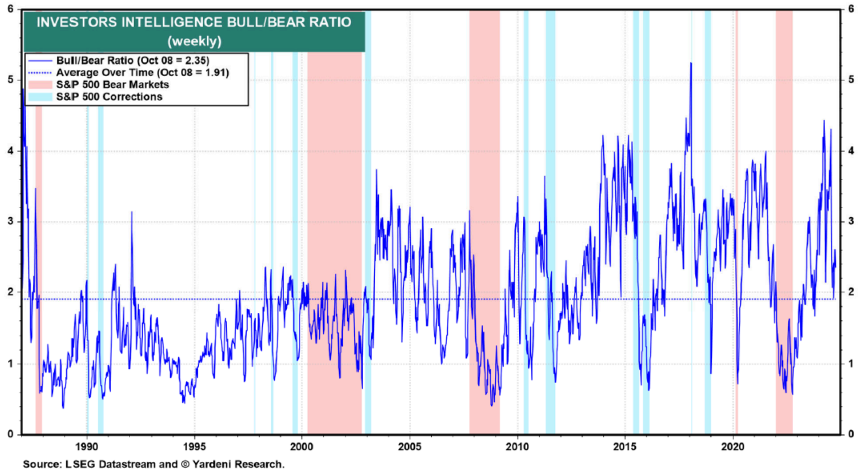
The S&P 500's latest bull market recently turned two years old. As you can see on the chart, sentiment was extremely bearish back in October 2022. At that time there were widespread fears of a recession caused by tightening of monetary policy. Those fears lingered until recent reports of stronger-than-expected employment, falling inflation and resilient economic growth.

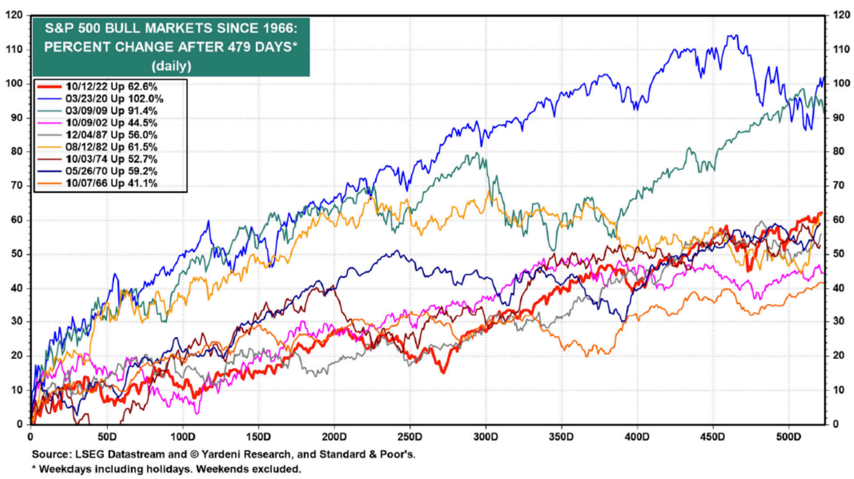
Today, investor sentiment is about average. This doesn't indicate much, as usually it takes a very bullish investor sentiment to become a warning sign to contrarians.

Since the latest bear-market bottom, the S&P 500 is up 61%. The thick red line in the middle shows this to be about average so far, compared to the previous eight bull markets.

Epic bull markets

The bull market during the 1980s and 1990s was amazing. The S&P 500 was up almost 18% per year during those two decades – one of the greatest bull markets in history. Sounds great, but it wasn't a super-smooth ride: Back-to-back recessions occurred in 1980 and 1981. There was also a 17% correction in 1980, and





period appears low. Meanwhile, upside potential seems quite favourable, thanks to strong expected productivity growth. If we experience a Yardeni-style melt-up, with a few more years of 20% to 30% increases as at the end of the 1990s, the likelihood of a subsequent major drop for those much higher levels would be higher. Of course, unexpected drops can always happen in the short term, so we continue to recommend that investors stay invested close to their targeted allocation of equities.

Contrast between the economy and stock market

It's important to note the contrast between slowing growth, slowing inflation and employment on the one hand, and a booming stock market on the other. You would think the two scenarios wouldn't occur together. But this isn't actually unusual after central banks start easing. Whether central bank easing corresponds with a recession or not, stocks usually go higher. In 2001 and 2008, the Fed cut a few months before the recession started and stocks actually went up before moving down. By contrast, in 1995 rates were cut but there was no recession. Stocks moved up and then continued to go up.

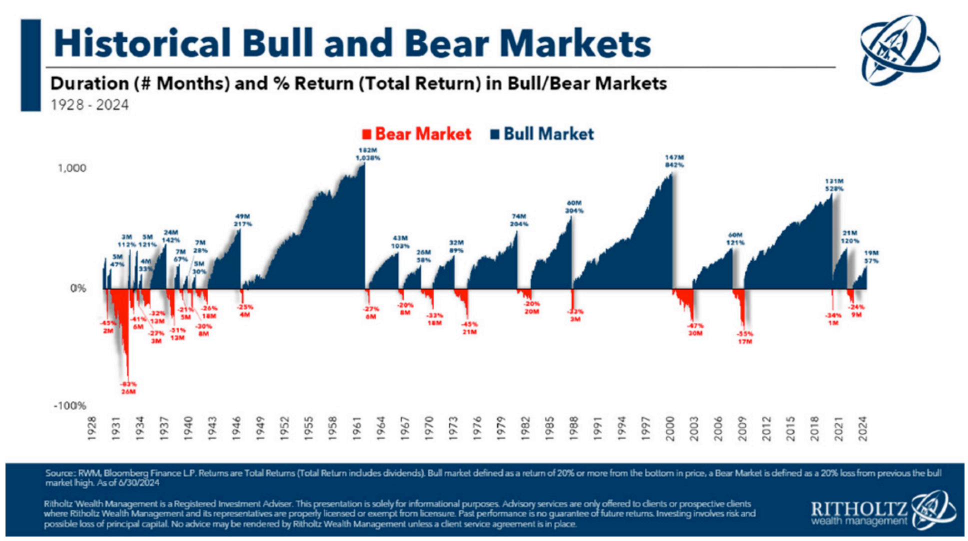
What about now? We can break it down into growth and policy. Policy-wise, we went from restrictive to supportive. Growth, while slower, is still positive – and that's also good.

a near 30% bear market that bottomed in 1982. But, from that 1982 bottom, the S&P 500 increased an impressive 20% per year until the end of 1999.

That previous bull market finished with a bang as the dot-com bubble took off at the end of the 1990s. From 1995-1999, the S&P 500 was up 37%, 23%, 33%, 28% and 21% respectively.

It's also worth noting what came after that bull market: a lost decade from 2000-2009, book-ended by two of the biggest market crashes in history. Investors in the S&P 500 lost 10% in total over the first decade of the 21st century. The U.S. stock market has a history of extended bull markets followed by lost decades. The original Roaring '20s ushered in one of the biggest booms in history – followed by the notorious lost decade of the 1930s and beyond.

The end of World War II through the mid-1960s saw an extended bull market (with some hiccups along the way). From the late 1960s through the early 1980s, the stock market went nowhere again (after inflation). Then came the '80s and '90s bull run, followed by another lost decade – followed,



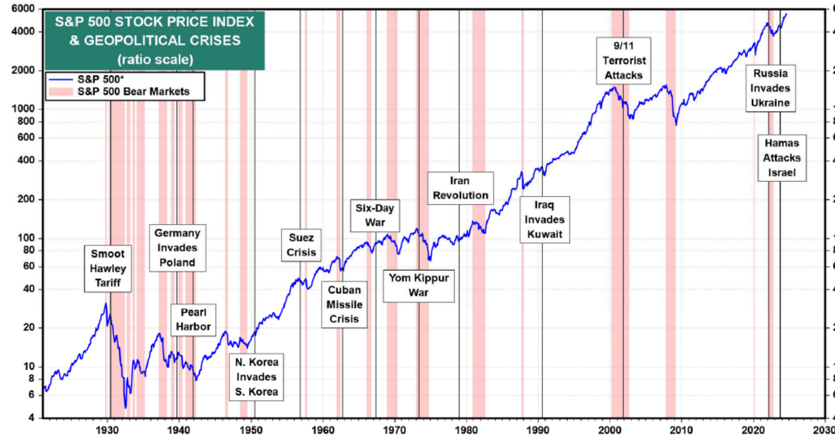
in turn, by another bull market after the Great Financial Crisis.

Are we due for another period where the stock market goes nowhere? The Stan Clark Financial Team believes the large market drops of 2020 and 2022 reduced this likelihood. From current stock market levels, the chance of an extended down

So, we have two tailwinds. But for how long?

Since we're likely at the beginning of an easing cycle, we should believe this will remain supportive all year, which is good for stocks. The real question is growth. Will it slow more, maybe even go negative? Or will it level off?

Ed Yardeni thinks the recession scenario dogging the markets for the last few years has been put to bed due to strong recent economic reports. So much so, in fact, that he doesn't think future rate cuts are needed, let alone the initial rate cut. Maybe we don't have two tailwinds, but just one or a smaller amount of two – either way, it's better than having none.



Source: LSEG Datastream and © Yardeni Research.
*Monthly through 1964, weekly after

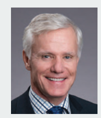
Risks

So far so good, but even with stocks at record highs, there's lots that might unsettle the markets. Corporate earnings meeting high expectations will be important. And all eyes will be glued on the upcoming U.S. election. The stock market tends not to like uncertainty. Hopefully, whoever wins, there won't be any surprises.

A widening Middle East war has been one of the top risks for the bull market in stocks. For any crisis, it's best to be prepared with a plan – but as we've often noted, geopolitically-induced selloffs are usually buying opportunities.

Looking ahead

The path of inflation and interest rates is never certain. And with that uncertainty is an inability to predict the stock market over the short term. That's why we prefer to stick with our investment process: picking companies with strong features using strategies that have long track records of generating above-average returns. No matter what the 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.



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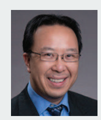

Michael Chu is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

SCFT Trivia

Trivia Time!

Thank you for reading this month's newsletter. Test your knowledge with our trivia questions! Each question relates to one of the articles featured in this edition. See how many you can get right, and check your answers at the bottom of the page. Good luck and happy quizzing!

Hint: You can find the answers inside this newsletter.

1. Often people hold on to a falling stock far longer than they should because:

   a) They cling to the faint hope of losing nothing.

   b) Selling means taking a loss, so people gamble that the stock they have will recover.

   c) It's the bird-in-the-hand idea. People think holding on means they're not taking a risk.

   d) All of the above.

2. Person A has tickets to a Super Bowl game. Person B offers to buy the tickets for much more than Person A spent on them. Influenced by the endowment effect, Person A:

   a) Eagerly accepts, happy to make a profit.

   b) Tries to bargain up for an even greater profit.

   c) Refuses, because Person B's offer makes Person A feel emotionally attached to the tickets.

   d) Advises Person B to attend a Stanley Cup game.

3. With the U.S. economy showing signs of cooling:

   a) We shouldn't assume we're headed for a dramatic downturn. A careful recalibration of interest rates could help sustain growth and alleviate potential pressures.

   b) We're in for another Great Depression.

   c) We should sell off all our stocks before the market crashes.

   d) We should hold on to the stocks we have, no selling, no buying.

4. U.S. stocks' forward earnings yield today is 4.6%. According to Professor Jeremy Siegel of the University of Pennsylvania's Wharton School, earnings are claims on real assets. This earnings yield is a reasonable estimate of future returns above inflation:

   a) True. b) False.

Answers: 1. D, 2. C, 3. A, 4. A

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