The Stan Clark Financial Team's

PERSPECTIVES

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Volume 10 - Issue 7 October 2019

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It's only natural to prefer opinions that support our own views. But, as I discuss in this month's behavioral finance article, our all-too-human *confirmation bias* can lead us to unwise decisions – in investing as in life. In our *Quarterly Economic Update*, Michael Chu and I review the continuing good performance of market and economy, despite headlines and supposedly reliable indicators that suggest otherwise. And Sylvia Ellis explains the advantages to retirees of checking out something not many taxpayers are aware of: the Pension Income Tax Credit.

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Behavioral finance

Avoid confirmation bias – be open to contrary evidence

By Stan Clark - Senior Investment Advisor

What do the following all have in common? Wishful thinking, first impressions, radical talk-show hosts and poor investment decisions.

They're all related to a strong psychological tendency called *confirmation bias*.

In this issue, I'd like to examine confirmation bias – and how important it is not to reject evidence that goes against our beliefs.

Confirmation bias has been studied extensively for over 50 years. One expert thinks this natural human bias, "by itself, might account for a significant fraction of the disputes, altercations, and misunderstandings that occur among individuals, groups, and nations."

Confirmation bias is our tendency to search for, interpret or remember information in a way that confirms our preconceptions.

Consider this puzzle. Four cards are set out on a table. We're told that each card has a letter on one side and a number on the other. The four cards we see have A, C, 2 and 3 facing up. We are also told that all cards with vowels have even numbers on the other side. Which cards would we need to turn over to prove that statement true?

Most of us would choose A and 2. These seem consistent with the statement about vowels and even numbers. But turning over the 2 won't help prove the case! If a vowel were on the other side of the 2, it would be consistent with the statement. However, if a consonant were on the other side, it would not disprove the statement – because *the statement said nothing about what's on the other side of a consonant*.

We can best solve the puzzle by trying to disprove the statement. To do that, turn over the A and the 3. A vowel on the other side of the 3 would immediately disprove the statement.

Our puzzle shows that, when asked to test a theory, we have a natural tendency to look for information that confirms rather than disproves it.

All of us have difficulty holding conflicting ideas at the same time. This difficulty is known as *cognitive dissonance*. If we believe something to be true, we have a strong tendency to seek and remember information that supports our belief – and to ignore or forget information that argues against it.

When we first meet someone, we tend to quickly form an opinion about them. After that, we filter additional information based on our first impression, favouring only what supports that impression. The saying "first impressions are lasting" is based on this human tendency.

> *Confirmation bias affects many areas of our lives, including investing. It causes us to be overconfident, and to make mistakes in our decisions.*

We also tend to subscribe to publications, tune into TV or radio shows and do Internet searches that support our beliefs. In the United States, how many Democrats listen to Rush Limbaugh or watch Fox News? How many Republicans watch Jon Stewart or Stephen Colbert or any MSNBC host?

Confirmation bias affects many areas of our lives, including investing. It causes us to be overconfident, and to make mistakes in our decisions. Confirmation bias is something we should be on guard against in ourselves – and in those we rely on.

It's a good ideal to practise keeping an open mind and searching for information counter to our views. It might be uncomfortable, but it can help us see the world more clearly and prevent us from making mistakes. ■

Team Talk:

A family member we were Lucky to know and love...

In April of this year, we said goodbye to a very special member of the Stan Clark Financial Team: Lucky Ellis. My husband Craig and I officially adopted Lucky, then aged five, in November 2010.

Lucky started coming to our office in 2012. He was an amazing team member, attending most client meetings, team meetings and office parties. As many of you will recall, he was in our newsletters, Thanksgiving and Christmas cards.

When out for walks, he attracted admiring stares. People's smiles just grew as they got closer. They took pictures, stopped for pats, asked what kind of dog he was. They'd comment on his soft fur, calm demeanour – and be shocked that this youthful 13 year-old wasn't still a puppy.

For those who were able to meet him, we're so happy you had the opportunity. Lucky left an undeniable impact on so many. We miss him dearly.

Quarterly Economic Update

Despite the headlines, low rates and good earnings keep the stock market healthy

By Stan Clark - Senior Investment Advisor and Michael Chu, Investment Advisor

The year so far

For 2019's third quarter, stock markets around the world chalked up mixed but mostly positive results. At home, the TSX was up 2.5%. The World Equity Index, a gauge of stocks around the world, was up 1.7% (in C$).

	3rd Quarter 2019	Year to date 2019	Trailing P/E	Trailing Earnings Yield	Dividend Yield
Canada	2.5%	19.1%	15.9	6.3%	3.1%
U.S.	2.8%	17.1%	21.1	4.7%	2.0%
Europe	-0.6%	11.2%	16.2	6.2%	3.6%
Japan	3.9%	8.9%	13.3	7.5%	2.5%
EAFE (Europe, Australia, Far East)	0.0%	9.5%	15.3	6.5%	3.4%
Emerging Markets	-3.2%	2.8%	13.2	7.6%	2.9%
World	1.7%	14.2%	18.6	5.4%	2.5%

Source: Bloomberg

Although volatility has seemingly become the norm, stock markets did pretty well. This was despite headlines about such alarming news as: the drone attack on Saudi oil infrastructure; experimental monetary policy; Brexit; the Trump impeachment inquiry; inverted yield curves; trade wars; and global economic growth. Just to name a few! But it wasn't all bad news. Interest rates remain low, helping companies to invest, buy back shares or raise dividends. And manufacturing may be slowing, but the services sector, driven by a healthy consumer, has proven far more resilient.

Stock valuations are slightly elevated but still reasonable because of robust company earnings. Stocks look good when comparing dividend yields to bond interest rates. U.S. and Canadian stock dividend yields are higher than their respective 10-year bond rates, indicating good value.

Rates so low

In the U.S., interest rates are low already – and look to be getting even lower. Rates are negative in many parts of the world, predominately in the Eurozone and Japan. Denmark released its first negative interest rate mortgage: You would earn 0.5% a year from buying a home!

At the end of August, U.S. 10-year rates dropped to about 1.5%, down from 2.5% five months ago. That's quite dramatic. It seems either the economy is quickly heading to a recession or the collapse of global yields has resulted in a massive flow of capital to the U.S. bond market.

Recent economic data indicates that it's the latter. Retail sales, consumer sentiment, business inventories and the Institute for Supply Management (ISM) non-manufacturing data, among other economic measures, came in above forecast. So, the economy appears to be on solid footing. Rates did go back up partway after news of more trade talks.

We all know that low rates aren't desirable for bond holders. But are low rates better for stocks? According to noted investor Ray Dalio, most people interpret rate cuts as a "buy" signal. Their thought process is simple, says Dalio: weak economy -» rate cuts -» economic stimulus -» stronger Gross Domestic Product (GDP) -» higher corporate profits -» higher stock prices. But there's more to the story. The Fed is cutting rates because it anticipates economic weakness. However, second-level thinkers wonder how bad the outlook is, how bad it might have become without a rate cut, or whether the rate cut was sufficient.

The bottom line is the economy is still expanding. Monetary stimulus via rate cuts makes sense when the economy is slow or failing to create jobs. But with the economy growing, employment at a 50-year low, and wages rising, more stimulus might be unnecessary. The economy is healthy and you don't need medicine for someone who is healthy. But things might change depending on how the trade war with China turns out.

Negative rates?

Throughout history, it was widely believed that central banks could not move short-term interest rates below zero. After all, why would anyone pay to deposit money in a bank or lend someone money? Just keep the money at home, under the mattress, for free – so went traditional thinking. Might negative rates cause investors to withdraw all their cash en masse?

Well, central banks did start dropping rates below zero. Denmark was the first to go below zero in 2012. Several more European countries followed in 2014 and then Japan in 2016. It did not result in stress in the financial system, as it turned out many people were willing to pay to not have cash sitting at home.

Setting rates below zero is unconventional, but it can be seen as a continuation of normal monetary policy used to influence the economy. The goal of the central bank is to grow the economy while keeping inflation in check. Lowering rates is used to encourage growth, as this lowers the cost of borrowing and also encourages spending. Negative interest rates have become part of the central bank's toolkit for responding to economic

downturns. There probably is a limit to how negative interest rates can go, but we've learned it's not zero and we haven't hit any limit yet.

Currently, approximately one-third of global bonds have negative interest rates. Canadian and U.S. rates currently stand out, simply by being above zero.

Plus, don't forget we're just talking nominal interest rates. If we're talking real rates, that is, net of inflation, we have already experienced negative interest rates here at home. Using three-month treasury bills less inflation, real rates have been negative or near negative in Canada and the U.S. since 2008/09, around the time of the Global Financial Crisis.

Inverted curve

Last month, we had an article on the inverted yield curve. It's still a hot topic, as many continue to assume the inverted yield curve has a perfect track record. In fact, as an indicator the curve's record is far from perfect, and the recent inversion looks like another false alarm for the following five reasons:

1. In the last 55 years, there have been six recessions but also six false alarm inversions: 1966, 1968, 1986, 1988, 1995 and 1998. That means the signal was right only half the time.
2. There are 10 components of the Leading Economic Indicator (LEI). The yield curve is just one of them, but receives the majority of the press coverage. The current LEI is still trending positive (but slower). When the LEI trends down, a recession usually follows, but averaging 10 to 20 months lead time for the last four major recessions.
3. Company revenues and profits continue to grow.
4. Overseas negative rates have pushed U.S. long-term rates down. With US$17 trillion in negative rates between Europe and Japan, investors have no choice but to invest in U.S. bonds if they want a positive yield in a reserve currency. This has pushed U.S. rates artificially lower, so this is not your normal inverted yield curve.
5. After raising short-term interest rates nine times over three years, the Fed sharply reversed course with two recent rate cuts. This should help encourage growth in the economy.

You never know what's going to happen, but it seems likely that this would be another false signal.

Junk bonds aren't worried

As the trade war drags on, one has to think about how badly the U.S. and other economies get hurt. For example, a slowing Chinese economy has an effect on Germany, which is the economic engine of Europe. But what about the U.S. economy? Since the trade imbalance is so lopsided ($400 billion), a trade war should hurt the Chinese economy more than the U.S. one. Seems true so far, but with targeted economic retaliation to influence the U.S. election, this may change.

If the U.S. economy were getting weaker, bond investors would be running away from junk bonds. They aren't. Spreads are wider, but the high-yield market doesn't seem overly worried about the U.S. economy.

The next downturn

It's natural to be worried about the next recession, especially since the 2007-2009 Global Financial Crisis was so severe. A downturn will inevitably happen at some point – but with the right perspective, it'll be easier to get through. Investors have been worried about the next recession since the last one ended. First, it was double-dip recession fears, sovereign debt crisis in Europe, China's slowing economy, U.S. 2016 presidential election results. Now it's the inverted yield curve. The thing is, there is always something to worry about and media headlines always make it worse than it is.

According to Ben Carlson, there's an old saying that the stock market has predicted nine of the last five recessions. The stock market is supposed to be forward-looking, anticipating what will happen in the future. But by itself, it's not a great predictor of future recessions. For the last 12 recessions since 1945, stock market performance for the prior six months was only preceded once by a big downturn (down 18% prior to 2001 recession). The other 11 times, it was preceded by a mild range of +/-10%, with an average of 1.2%. Every time stocks fall, it feels like they're going to fall a lot. But most of the time, market corrections are head fakes and don't lead to big crashes.

The average recession since 1945 averaged about 11 months, with a median GDP decline of 2.4%. The U.S. has been in a recession 130 out of 897 months (roughly 15% of the time over the last 75 years). Recessions are worrisome, and some of the worst bear markets do coincide with nasty recessions. But keep in mind that other 85% of the time, the economy is expanding. So, don't overly focus on the negatives.

Survey says...

Investor sentiment is in the tank. The latest American Association of Individual Investors (AAII) survey has bullish sentiment down to 26%, well off its historical norm is 38%. As you may recall, this survey is a good contrarian indicator of the stock market as it signals market tops and bottoms. When bullishness is low, that's good news for stocks.

Made in China

Trade tensions between the U.S. and China have been dominating the news and driving uncertainty in markets around the world. Whether or not there is a truce in the near future is anybody's guess. As investors in global companies, what are the broader implications of deteriorating geopolitical relations?

The initial reason for the U.S. trade spat with China was to reduce its trade deficit and boost domestic manufacturing. But it's actually more complex and far-reaching. With the decision to target fifth-generation cellular technology (5G), it seems that tensions are less about trade, and more about China's increasing power and influence globally – i.e., about the growing threat posed by China's technological leadership.

Through sanctions involving semiconductor chips, the U.S. has left China feeling vulnerable and exposed. This could help the U.S. in the short term, but may have triggered China to double-down on efforts to achieve its longer-term goals of technological leadership and self-sufficiency. In China, we've already seen a fall in imported components and lower exports as a percentage of GDP. This shows that China is producing components that were previously imported, and that the domestic market has increasingly driven demand.

In the short term, the tariffs should result in changing the supply chain to be more diversified and less reliant on China. But U.S. sanctions designed to suppress China will only add impetus for China to innovate and add to its technological prowess.

Looking forward

Anything can happen in the short term. But earnings are still good and interest rates remain low, which should be supportive of the stock market. Developments around politics and global trade will keep dominating the headlines. These events are hard to predict – as are their consequences. It's therefore vital to have a custom asset mix to help you remain resilient while you continue to grow your wealth. ■

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Financial Planning

Are you a retiree? The Pension Income Tax Credit may reduce your taxes

By Sylvia Ellis, Senior Estate Planning Advisor

Many tax deductions and credits can help you reduce the amount of taxes you have to pay each year. For retirees, one of the more common credits is the *Pension Income Tax Credit* (PITC).

How many individuals actually take advantage of PITC? Not many – because not many are aware of it. In the January 2019 CIBC Retirement Poll, only 22% of respondents knew that a non-refundable federal PITC of 15% may be available on the first $2,000 of eligible pension income. Provincial credits for pension income are also available.

This apparently not-widely-known tax credit is worth discussing in more detail. PITC is available if you are 55 years or older. It allows you to deduct a tax credit equal to the lesser of your pension income or $2,000.00. By claiming the pension income credit, you could save taxes averaging about $400 annually, depending on your province of residence.

In order to claim the credit, you as a taxpayer must be in receipt of certain types of income, which also depends on your age.

- If you are 65 or older in the applicable year, pension income includes:
- income from a superannuation or pension fund
- annuity income out of a Registered Retirement Savings Plan (RRSP) or a Deferred Profit Sharing Plan (DPSP)
- income from a Registered Retirement Income Fund (RRIF)
- interest from a prescribed non-registered annuity
- income from foreign pensions
- interest from a non-registered Guaranteed Investment Certificate (GIC) offered by a life insurance company.

If you are younger than 65 for the entire year, pension income includes only income from a superannuation or pension plan or annuity income arising from the death of your spouse under an RRSP, RRIF or DPSP.

What is *not* eligible pension income?

- investment income from market based investments
- interest income from GICs with banks, trust companies and credit unions
- Old Age Security (OAS) and Canada Pension Plan (CPP)
- Lump-sum death benefits
- Lump-sum withdrawals from RRSPs
- Retiring allowances.

How can *you* take advantage of PITC?

If you are over age 65 and not part of a superannuation or pension plan, you can do any of the following:

1. **Convert an RRSP to a RRIF.** At age 65, transfer $12,000 to a RRIF and take $2,000 out per year from age 65 to 71 (inclusive). This allows you to get $2,000 out of your RRSP tax-free for six years.
2. **Transfer Locked-in Retirement Account (LIRA) assets to a Life Income Fund (LIF) and then annuitize.** In most cases, you can transfer your LIRA to a LIF or Locked-in Retirement Income Fund (LRIF) once you reach age 55. To make the most of this strategy, you must transfer the LIRA to the LIF and then to an annuity in order for the income to be reported as eligible pension income. If you purchase the annuity directly from the LIRA, the annuity is considered an RRSP annuity, which only qualifies for the pension income credit after age 65.
3. **Life insurance company GIC.** You purchase a GIC through a life insurance company because it is considered eligible pension income. To determine how much principal you would require to be able to claim the full credit, divide $2,000 by the applicable interest rate for the term you want. For example, if you wanted a five-year term and the current annual rate was 2.0%, you would need to invest $100,000 ($2,000 divided by 2.0% = $100,000).
4. **Split income.** If you want to lower your overall household tax bill, you can split up to 50% of your eligible pension income (which includes an RRIF from age 65 onwards) with your spouse or common-law partner.
5. **Transfer of unused credit to a spouse.** Unused pension income credit is transferable to a spouse or common-law partner. The ability to transfer this credit should be explored in circumstances where one spouse is earning pension income in excess of $2,000 and the other spouse is not otherwise fully utilizing their pension income credit.

The pension income tax credit is non-refundable and may not be carried forward each year. If you are over age 65, look at line 314 in your tax return to see if you are taking advantage of the Pension Income Tax Credit. If not, consider one of the tax savings strategies described above. ■

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