The Stan Clark Financial Team's

PERSPECTIVES

In this issue...

Volume 10 - Issue 6 September 2019

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Deciding on investments is like flying a plane. Feeling off-balance by what's around you, you're tempted to change course. But, as I explain in this month's behavioral finance article, emotional reactions to the unexpected can lead to disaster. Instead, trust your instruments: the rules, guidelines and strategies that keep you on course. Meanwhile, amid the media panic about the inverted yield curve, Michael Chu takes a level-headed look at what the curve really means. And Sylvia Ellis sets out the options for withdrawing funds from a Registered Education Savings Plan.

Stan

CIBC Wood Gundy

Behavioral finance

Trust your instruments over your senses

By Stan Clark - Senior Investment Advisor

Just over 20 years ago, on the evening of July 16, 1999, John F. Kennedy, Jr. crashed his plane into the Atlantic Ocean. Kennedy was an experienced pilot who had flown the route many times. What happened – and how does it relate to behavioral finance?

According to the U.S. National Transportation Safety Board, the probable cause of Kennedy's accident was his "failure to maintain control of the airplane during a descent over water at night, which was a result of spatial disorientation."

Spatial disorientation can happen like this: A pilot is flying in dark or hazy conditions where he cannot see the horizon, and cannot tell using his eyes alone if he is level or not. He becomes distracted for a moment, and while he's distracted, his plane gently tilts. The tilt happens gradually, so he doesn't notice. To him the plane still feels level.

If the pilot follows his instruments and changes back to level flight, he will then feel as if the plane is leaning the other way. This experience is known as the leans, because of the compelling urge to change from the level flight back to the tilted one. But a pilot who is well-trained in flying with instruments will resist that feeling. He will trust his instruments, and keep the plane level.

However, a less experienced pilot can be overwhelmed by his feelings. He may, as JFK, Jr. did, override his instruments and mistakenly change back to the tilted position. Things then go from bad to worse. The plane's tilt causes it to point down, speed up and lose altitude. The pilot takes more actions that feel right – but are in fact opposite to what he should be doing. The plane enters a spinning nosedive, called a *graveyard spiral*, and crashes.

Our feelings, emotions and intuitions are powerful, and have compelling influences on us. They have evolved over hundreds of thousands – in some cases, millions – of years. While indispensable to us, these senses sometimes lead us astray. Just as our senses were not developed to deal with flying, they were also not developed to deal with many other modern phenomena.

Take investing. The world of investing can play tricks with your mind, just as darkness, haze and clouds can obscure your vision when flying. The modern world's information overload; our complex interrelationships with each other in personal matters and in business; and the media's influence on us – all of these are as different from what our ancestors faced as flying is from walking. Just as our senses can point us in the wrong direction when flying, our feelings, emotions and intuition can lead us astray in investing.

> *Having a set of rules, guidelines and strategies to guide your decisions will help you avoid being overly influenced by your emotions.*

That's why it's important to have a set of investment instruments to guide us. That's also why it's important to follow and trust those instruments – especially when they are telling us something different from what we feel with our senses.

Having a set of rules, guidelines and strategies to guide your decisions will help you avoid being overly influenced by your emotions. It will help you determine which way is up and which way is down in the world of investing. And that can make the difference between reaching your long-term goals – or falling short. ■

Team Talk:

Stan Clark

Senior Investment Advisor

Stan with his brother Fred and their grandsons

Any major events in the family over the past year?
The first big news was the November arrival of our first grandchild, Ryan, to my eldest daughter Lindsay and her husband Tom. We are proud grandparents and can't get enough of the little guy.

My brother Fred also had his first grandchild earlier last year. Then, in August, our youngest daughter Jess got engaged to Daniel. Daniel organized a surprise proposal with both families secretly watching. Jess was thrilled and we are all very happy for them.

Where did you go on vacation?
We began the year by taking a cruise. It started in Abu Dhabi and ended in Singapore, with stops in Oman, India and Sri Lanka. We also went on a cycling trip to Croatia, with a stop in Germany for our niece's wedding; and another cycling trip to Ireland. We added a three-hour "political tour" of West Belfast, perhaps the heart of the current Brexit conflict. Another very interesting part of the world!

Asset Allocation

Inverted yield curve: What is it *really* predicting?

By Michael Chu, Investment Advisor

The yield curve has been a hot topic lately. We thought it would be timely and useful to discuss this topic in more detail.

The *yield curve* is a graphical representation of bond interest rates across a range of maturities. Yield curves are used to gauge the health of the economy. Most of the time the curve is upward-sloping, meaning that long-term rates are higher than short-term rates.

There are two reasons for this. Firstly, investors demand extra yield for locking up their money for longer periods. This is called *term premium*. So, a 10-year bond rate would normally be higher than, say, a one-year bond rate. Secondly, the curve also slopes upward when future rates are expected to rise. This indicates a healthy economy – with the expectation of more growth in the future.

To make things complicated, there are many different points on a curve to compare. For example, do we compare the two-year rate to the 10-year rate? Or maybe the three-month rate to the 30-year rate? How about the one-year rate to the five-year rate? The results will be all slightly different, and the media will peddle whichever suits their story. But the benchmark comparison is the two-year vs. the 10-year.

The yield curve has gradually been getting flatter over the last six years – that is nothing new. But it has become very flat over the past 18 months, meaning 10-year rates became only slightly higher than two-year rates. Narrower spreads indicate weaker economic health, with most likely slower growth coming up.

An inverted yield curve has a downward slope, meaning 10-year rates are lower than two-year rates. In this case, investors expect that future short-term rates will fall in order to boost the economy.

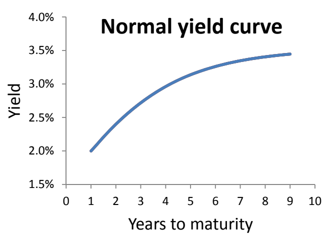
Basically, Yardeni is saying that the yield curve isn't as accurate a predictor of economic downturns as is widely believed. It can precede a recession, but it can also give false signals.

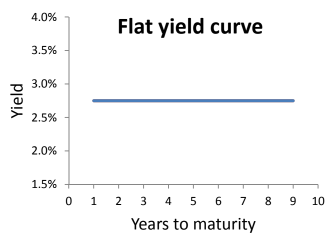
His conclusion was that an inverted yield curve predicts Fed interest rate policy rather than the business cycle. In other words, inverted yield curves aren't the cause of recessions. Instead, they are a useful signal that monetary policy is too tight and risks triggering a financial crisis. This can quickly turn into a credit crunch, subsequently causing a recession. The Fed's recent decision to pause rate hikes and a rate cut in July may reduce the chance of a recession.

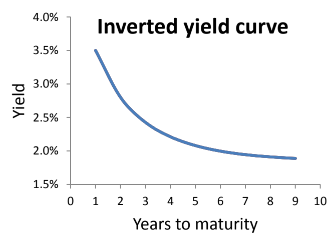
Yardeni says that *Fed tightening followed by credit crunches – not inverted yield curves or aging economic expansions – are the cause of recessions.*

For the last seven recessions, the yield curve inverted with a lead time of 55 weeks on average (the range was 40 to 77 weeks). In other words, if a recession were to occur, it's unlikely to start tomorrow. Rather, it would likely be one to two years away – giving us some breathing room. There were a few false signals along the way in the 1980s and 1990s. The signal seems to work better as a recession indicator the longer the curve has been inverted.

The yield curve tends to flatten when the Fed is raising short-term interest rates. The Fed lowered rates dramatically during the 2008 financial crisis. Then the tightening cycle started in 2015, comprised of nine rate hikes. But as mentioned earlier, the Fed cut rates in July and the expectation is for at least one more cut soon. So are we at a pause in a tightening cycle, or have we started a new longer term easing cycle? Hard to say, but it appears that the yield curve







In mid-August of 2019, the difference between two-year and 10-year interest rates did invert, albeit just a few moments over two days. Still, this caused some panic in the media as well as the stock market. Why the fear?

Such an inversion is widely viewed as a reliable leading indicator of economic recessions. While the stock market is currently near its high, it could fall if investors become convinced a recession is imminent.

Top economist Ed Yardeni recently published a study on yield curves, assessing its predictive ability. He wrote, "An inverted yield curve predicted 10 of the last seven recessions."

will still be flattish for some time, and the Fed seems intent on preventing a credit crunch and recession.

Why tinker with rates anyway?

The Fed's primary purpose is to maintain full employment and stable prices (low inflation). In the past, the Fed would raise rates during economic booms to stop an acceleration in inflation. Conversely, it would lower rates when the economy is bad in order to promote growth. It's sort of like using the brakes or the accelerator in a car. Sometimes, raising rates too aggressively triggered a credit crunch, meaning even the most credit-worthy borrowers had trouble getting loans – stifling business and the economy. Mounting stress in the credit markets, along with expecting the credit crunch to cause a recession and a bear market in stocks, would cause investors to buy more bonds (and lower long-term interest rates). This would help cause the inverted yield curve. Much like driving a car in rush hour or docking a boat into a tight spot, it's a bit of a balancing act. Too little and nothing happens; too much and you might get into an accident.

What about today? Inflation is low, yet the Fed has been raising rates for the last few years. Many say the Fed doesn't need to be so aggressive. The economy is doing well, but there are few signs of an inflationary boom or major speculative excesses to require such a forceful approach to normalizing rates.

Short rates up, long rates down

Back in 2015, it was well telegraphed and accepted that the Fed was going to start raising short-term rates. The concern was by how much and how fast. The Fed was cautious at first, hiking just once in 2015 and once more in 2016. But it then accelerated the pace with three hikes in 2017, four in 2018 and more expected in 2019. Long-term rates were also going up during these years (a healthy sign) but not enough to keep up with the short-term rate hikes. Consequently, the yield curve started to flatten – perhaps a signal from the market that the Fed should slow down or stop hiking rates altogether.

After the near-bear market in the fourth quarter of 2018, 10-year bond rates dropped dramatically in 2019. Starting the year at about 2.7%, rates dropped to 1.5%, resulting in the inversion. That was a big signal to the Fed that monetary conditions were too tight and that easing might be in order.

About-face by the Fed

The good news was that the Fed listened and lowered rates in July 2019. Fed officials are likely to respond to the inversion with more rate cuts. The next Fed meeting is in September.

The markets welcomed this unexpected about-face by the Fed. In the past, the Fed has been accused of raising rates too aggressively during economic booms – receiving much of the blame for past credit crunches and subsequent recessions.

The world is flat

The U.S. bond market is linked to other bond markets around the world. It is no longer just driven by the domestic business cycle and Fed policies. Lower/negative interest rates around the globe are contributing to the flattening U.S. yield curve. This is because foreign investors are looking for safety as well as better rates. As more foreign investors buy more longer-term U.S. bonds, these rates go down, resulting in a flatter-than-expected curve.

There are many reasons for lower long-term rates besides low inflation and slow economic growth: 1) Pension funds have rules that require bonds to fund their liabilities. 2) Long-term bonds also act as a hedge against deflation. Deflation isn't a big concern yet in the U.S., but it is in Europe. 3) Increased risk aversion by aging investors. 4) The after-effects of quantitative easing.

All the above contribute to lower long-term rates than they would be normally, making it easier for the curve to invert. Perhaps the curve should be required to invert *more* to warrant the same warning?

Barely inverted

The curve barely inverted in August. As mentioned, it occurred just sporadically and only by a small amount. This doesn't necessarily invalidate the signal, but it's still at the faint end of the spectrum. Perhaps a deeper or more prolonged period of inversion would be more significant, maybe over a few months.

No boom, no bust

Recessions are a necessary evil in a financial system like ours. The current economic expansion will end at some point; we just don't know when. Maybe things aren't that different this time and there will be a recession in a year or two. The economy has been growing slowly for a long time, yet there are few signs of an inflationary boom or major speculative excesses. Given the mild growth we've experienced, this leads us to believe that if a recession were to occur, it should also be relatively mild.

Conclusion

Given the history of yield curve inversions, it's understandable that the recent occurrence has caused concern. While the track record in the 1970s and 1980s was good, it has been less consistent in the 1990s and 2000s. Short-term predictions remain difficult, but we've discussed many reasons why the recent inversion may not be applicable as a recession signal.

The key is that credit remains amply available. As well, the Fed appears to be in easing mode, and will likely respond to the recent inversion with more rate cuts, which should help the economy – and perhaps keep any recession at bay.

In any event, the yield curve is just one indicator. There are many others to consider. But anything can happen in the future, including a recession. Best is to be prepared for a range of outcomes. Our belief is that a customized asset mix that factors in your needs and risk tolerance is the best approach to weathering storms while achieving growth. ■

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

Financial Planning

RESPs: What to do when funds-withdrawal time comes

By Sylvia Ellis, Senior Estate Planning Advisor

Registered Education Savings Plans (RESPs) have long been (27 years in fact!) a great government registered-savings vehicle for a child's postsecondary education.

If you have one for your child or children, you're probably aware of all of the key features, i.e., single or family beneficiary, tax-deferred growth, lifetime contribution of $50,000 per beneficiary and the Canada Education Savings Grants (CESGs) that are offered. In this article, we'll focus more on the withdrawal aspect of RESPs.

In order to make a withdrawal, the plan beneficiary must be either a full-time or part-time student enrolled in a Canadian or foreign postsecondary institution. This includes students enrolled in distance education courses, such as correspondence courses.

Qualifying postsecondary programs include academic and occupational skills programs at institutions certified by the Employment and Social Development Canada (ESCD). To give you an idea of how many there are to choose from, the ESDC has a current list of 247 designated educational institutions in BC and a similar number in other provinces.

So, what's the best way to start withdrawing? Any contributions you made to the plan were not tax-deductible and can generally be withdrawn at any time, tax-free. Any other funds coming out of the plan for postsecondary education are referred to as *educational assistance payments* (EAPs). EAPs include the income, gains and CESGs in the RESP.

It usually makes more sense to withdraw the EAPs first, thus ensuring your beneficiary receives 100% of the grant money received on their behalf.

The money withdrawn will be taxed as income in your child's hands. Because their income is likely to fall under the basic personal exemption limit, an EAP equates to a tax-free withdrawal. If they're working and their income exceeds the personal limit, they can claim several tax credits for tuition fees, textbooks, transit passes, the education amount, even school-related moving expenses. These credits should eliminate, or at least minimize, any tax owed. All of this needs to be taken into account to determine the optimal amount to withdraw.

Note that there is a $5,000 maximum withdrawal for full-time enrollment during the first 13 weeks of schooling for any EAPs; and $2,500 for part-time enrollment. Once that timeline has passed, you can request additional funds with no limit, unless the student takes a break from their studies and does not re-enroll at a qualifying postsecondary program for 12 months.

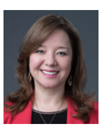
After EAPs have been paid, then start withdrawing the contributions you made.

Let's face it. though: Things change. Maybe your child will decide to delay continuing their education and want to travel or work; or not continue their education at all. Any of these situations can have an effect on the RESP.

RESPs have expiry dates, which means they can remain open for 40 years from when they're created, while family plans remain open for 35 years. This provides plenty of time for your child to decide what to do!

If they do decide against continuing with their education, and there is no sibling to transfer the RESP funds to, the last resort is to close it. Any grants and bonds from the government will need to be returned. Again, your contributions are tax-free. You can also withdraw some of your investment earnings if the RESP has been open for at least 10 years, and each beneficiary is at least 21 years of age. However, your earnings will be taxed at your regular income tax level, plus an additional 20%, which is known as the Accumulated Income Payment (AIP). Or, you can roll up to $50,000 in AIP money over into an RRSP if you have unused contribution room.

When the time comes, we recommend you talk to us to help determine the best strategy for you and your child/ren. ■



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. Making wise investment decisions is like being a successful pilot because:
   - a) You let emotions guide you in changing course
   - b) You let your investment instruments guide you
   - c) If there's turbulence, you panic
   - d) You react instinctively rather than thinking out a strategy.

2. The yield curve can be defined as a graphical representation of bond interest rates across a range of maturities:
   - a) True b) False.

3. Top economist Ed Yardeni concluded that an inverted yield curve is better at predicting interest rate policy rather than the business cycle:
   - a) True b) False

4. You have a Registered Education Savings Plan for your child. When you want to take advantage of the funds, be aware that the plan beneficiary:
   - a) Can be a full-time student enrolled in a Canadian or foreign postsecondary institution
   - b) Can be a part-time student enrolled in a Canadian or foreign postsecondary institution
   - c) Can be enrolled in distance education courses, such as correspondence courses
   - d) All of the above.

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 September 30, 2019.

Trivia challenge runs September 1 - 27, 2019. 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. © Stan Clark 2019

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