The Stan Clark Financial Team's

# PERSPECTIVES

In this issue...



*Volume 10 - Issue 3 April 2019*

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Human beings love trying to guess the future. But our age-old fondness for predictions can lead us to make unwise financial choices. In this month's behavioral finance article, I look at our addiction to prediction – and why we should be wary of it. In our Quarterly Economic Update, Michael Chu and I review how stock markets snapped back into positive territory in recent months; also, the factors keeping the economy fairly good even as various issues remain a concern. And Sylvia Ellis gives us need-to-know highlights of the 2019 federal budget.

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CIBC Wood Gundy

Behavioral finance

## Beware the natural human addiction to prediction

*By Stan Clark - Senior Investment Advisor*

**"What's going to happen with house prices?" "How about oil and the stock market?" "Is a Canadian team ever going to win the Stanley Cup again?" We hear such questions all the time. There's no way people can know the answers – but that doesn't stop them from coming up with predictions.**

Human beings are driven to try to predict the future. The drive is so strong that researchers have called it a *prediction addiction*. Brain research has actually identified a region of the brain and a specific chemical – dopamine – that practically forces us to forecast.

Over the course of history, we've used dozens of predicting methods, such as tarot cards, tea leaves and crystal balls. Since the beginning of time people have sought out fortune-tellers, psychics and seers. Unfortunately, most prophets are false prophets.

Truth is, although we're strongly attracted to forecasting, we're just not very good at it. As the eminent philosopher and baseball player Yogi Berra once said: "It's tough to make predictions, especially about the future."

Some bold forecasts from the past bear this out:

"A severe depression like that of 1920-1921 is outside the range of probability." That's what the Harvard Economic Society wrote on November 16, 1929 – just before the start of the Great Depression. How about: "It will be years, not in my time, before a woman becomes prime minister." Margaret Thatcher said that on October 26, 1969. Or this more recent one: "There's no chance that the iPhone is going to get any significant market share." That was Steve Ballmer in *USA Today*, April 30, 2007.

Forecasting company earnings is just as bad. Earnings are the key bottom-line number that investment analysts try to predict. In a study covering more than 94,000 estimates over 24 years, earnings estimates were off, on average, by an amazing 44%! That's a *huge* error for something so important. But, even though their ability to forecast is so poor, analysts still fool themselves and others into thinking they're good at it. Perhaps their real skill is getting us to remember the rights – and to forget the dead wrongs.

We're attracted to forecasting because we're wired to do it. And, because our brains fool us into thinking we're better at it than we really are. Behavioral finance has uncovered many biases that keep us trying to divine the future – including hindsight bias, optimism, filtering and confirmation bias.

Economic forecasting is especially difficult, for three reasons:

First, there are thousands of factors involved. The human mind just isn't wired to take that many factors into account. Studies show we can hold maybe six or seven facts in our mind at any one time.

Second, many of the factors, such as human creativity and the emotional reaction of crowds, are simply unpredictable. You know things are going to change, but it's super hard to figure out the details.

Third, there's an element of circularity involved: People adjust their actions based on the forecasts themselves. An example of this was the Y2K hype in 1999. Predictions of planes falling from the sky and computer systems crashing turned into non-events. This is because people took actions that prevented the predictions from coming true! I

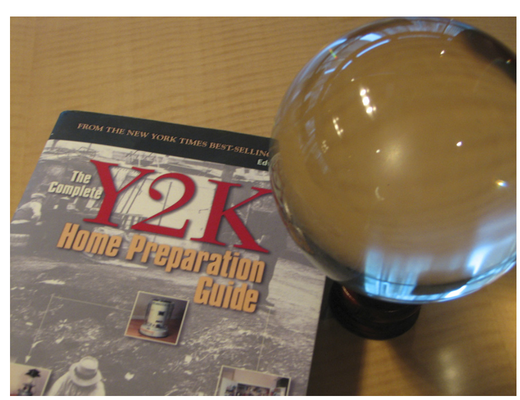


*Photo of Stan's desktop, complete with Y2K Guide and crystal ball.*

## Team Talk:

### Heather Guzak

Associate Investment Advisor

*September 2018, Pitt Lake*

**How has the past year been?**
We have seen a lot of changes in our house over the past year! Quentin made the transition to Kindergarten French Immersion, Tayla started a new preschool and we moved into our brand new home!

**How is the new house?**
We moved in August 2018 and after 8 months we finally seem to be operating a bit smoother. The kids are enjoying having more space, exploring the new parks/trails and making new friends in the neighborhood!

**Any plans to get away this year?**
Yes! Since our children are so young, we have been slow to venture outside of BC. However, this year we are going to take them to San Diego. We will spend a couple days in the city exploring some of the major attractions, then up to Lego Land for a day or two. Lego is a huge hit in our house, so it will be nice to see them experience a world made entirely of it. Hopefully we will come back relaxed and rejuvenated!

keep a copy of the book *The Complete Y2K Home Preparation Guide* right beside my crystal ball to remind me of this.

The problem with predicting is that we bet too heavily on what we think are the likely outcomes. And, we over-pay for things based on highly suspect forecasts. Besides, forecasting takes time, and this diverts us from focusing on things that are truly productive.

Summing up: Looking for economic or stock market *prophets* is not the best way to make economic and stock market *profits*. ■

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Quarterly Economic Update

# What a difference a quarter makes!

*By Stan Clark, Investment Advisor, and Michael Chu, Investment Advisor*

**Strong start**

What a difference a quarter can make! Even though we're long-term investors, it's worth noting that after a steep decline for stocks at the end of 2018, markets snapped back in the first three months of 2019.

The first quarter of 2019 was positive for all major stock markets around the world. At home, the TSX was up 13.3%. The World Equity Index, a gauge of stocks around the world, was up 10.1% (in C$).

| | 1st Quarter 2019 | Trailing P/E | Earnings Yield | Dividend Yield |
|---|---|---|---|---|
| Canada | 13.3% | 17.4 | 5.8% | 3.2% |
| U.S. | 11.2% | 20.2 | 5.0% | 2.0% |
| Europe | 8.5% | 15.5 | 6.5% | 3.7% |
| Japan | 3.5% | 12.8 | 7.8% | 2.4% |
| EAFE (Europe, Australia, Far East) | 7.7% | 14.7 | 6.8% | 3.4% |
| Emerging Markets | 7.6% | 13.1 | 7.6% | 2.7% |
| World | 10.1% | 17.8 | 5.6% | 2.5% |

*Source: Bloomberg*

While the markets came back, the topics at hand remained quite constant: interest rates, China-U.S. trade, decelerating economic growth and Brexit, to name a few. There have been some positive developments, though. The U.S. Federal Reserve hit the pause button on raising interest rates and shrinking its balance sheet. Other central banks followed suit, shifting to more accommodative policies that could lead to a longer period of low interest rates.

China-U.S. trade relations appear to be moving forward. But as yet no agreement has been officially reached.

Anything written on Brexit is outdated by the time it's printed. At this point it seems like the voters will head back for another referendum. A no-deal exit, while increasingly probable but still unlikely, would be most disruptive, ushering in an era of uncertainty sure to frustrate companies in the region.

While global economies show signs of slowing, there hasn't been negative growth. This is important: We remain in a Goldilocks economic environment of low inflation, slow-but-positive growth and low interest rates.

**Inverted yield curve**

We've been talking about the flattening yield curve for some time. To recall, the yield curve is a graphical representation of interest rates across various maturities (one month, one year, five years, 30 years, etc.). Usually, the curve is upward-sloping, meaning longer-term rates are higher than shorter-term rates. An inverted yield curve is the opposite, when short-term rates are higher than long-term rates.

Lately, the curve has been quite flat, causing some to worry that an inversion is possible. An inversion is thought to be bad. But bad for what? And when? The three-month-to-10-year yield curve did actually invert for (just) five days at the end of March; this generated much attention in the media. Let's discuss what it means.

Firstly, we shouldn't overreact to slight or temporary inversions. According to top economist Ed Yardeni, "Prior to the last seven recessions, the yield curve inverted with a lead time of 55 weeks on average, with a high of 77 weeks and a low of 40 weeks. Along the way, it gave a few false, though short-lived, signals during the 1980s and 1990s."

Notice Yardeni's reference to false alarms. Every recent recession was preceded by an inversion – but not all inversions have led to a recession. Even if the signal were accurate, once the curve stays negative for a few weeks or months, we still have about a year to plan before a possible recession. Plus, what happens to the stock market during this lead time? It's reasonable to assume that the market will go down. However, when we look at the data for the past seven recessions, the performance in the stock market between the inversion and the market peak was about 12% over eight months, on average. In other words, the market gained after the recession warning. Granted, this was only seven data points, but that goes against what you would normally expect. Of course, with a recession, the market does go down eventually. But this shows that there are gains in the meantime. Perhaps the stock market could be a recession indicator, too – and that leads us to our second point.

Our second point is that the yield curve is just one measure of the 10 leading economic indicators (LEI) that are used to predict the economy. The stock market is one of the other LEIs. So when making big decisions, it's important to look at the other measures, as well. Overall, the LEI has been rising solidly for 10 years, but also has been slowing in the last few months.

Thirdly, the Fed can apply a fix to an inverted yield curve overnight with a rate cut. It's true that the Fed has only recently been raising interest rates. But they have been known to change their minds: they recently cut their rate-hike outlook to no more hikes for the time being.

There are a number of other reasons this yield curve isn't representative, for example, due to central bank intervention and globalization.

### Earnings still growing in 2019

The first quarter of 2019 will have negative earnings growth of about 4%. This is due to a huge earnings year in 2018 plus a recent cut in earnings estimates. But earnings for the full year of 2019 are still expected to be up 3.7% and revenue up 4.8%.

In 2018 we had better than 20% earnings growth, but a 4.5% decline in the stock market. It's possible that we will have the opposite in 2019: low earnings growth, but good returns to make up for last year's anomaly.

### Happy birthday

Just over a decade ago, on March 5, 2009, the bearish sentiment on the stock market was at an all-time high, based on the American Association of Individual Investors' (AAII) weekly poll. If you recall, this survey is widely thought to be a contrarian indicator, since investors tend to be super-negative at market bottoms and super-positive near the top. Historically, the lowest bear rating was 6% in August 1987, when the market peaked just before the catastrophic 1987 crash.

Over the life of the survey, the average bearish sentiment is around 30%, and ranges between 20 and 40% about two-thirds of the time. On March 5, 2009, the bearish sentiment was at a record high. From a contrarian point of view, the indicator was perfect, as it marked the start of a 10-year and still-going bull market.

At the end of March 2019, the sentiment was 28% bearish, which is in neutral territory.

### Room to grow

As mentioned earlier, the U.S. stock market was down almost 20% in late 2018. According to Yardeni, Fed Chairman Jerome Powell caused that drop when he said interest rates were "a long way from neutral." This spooked the markets, as it implied many more rate hikes to come. But now, in an about-face, the Fed has hit the pause button on rate hikes. According to Yardeni, the market can resume its upward trajectory as the Fed's current stance is supportive of continued economic growth. "Typically, bull markets are killed by recessions, not by old age – and recessions have typically been caused by credit crunches." Credit crunches occur when the lending system seizes up, preventing even good borrowers from getting loans.

In terms of economic expansion, the U.S. is on track to be in its longest ever. The current expansion started in 2009 and is at 39 quarters and growing. The record, 40 quarters, happened between 1991 and 2001. Post-war, there have been a handful of relatively long expansions, so this isn't that unusual. The key is that this expansion, while long, hasn't been particularly strong – it also followed a particularly deep recession. That means things could continue to grow for some time.

With the rate hike pause, the economy now has a chance to absorb the previous rate hikes. As long as inflation remains tame, the Fed can afford to be patient. Once the economy demonstrates the ability to absorb more rate hikes, the Fed should raise rates. This would give the Fed the capacity to cut rates in the future if these are needed to keep the economy going.

### Headwinds in Canada

Canada's economy often rides on the coattails of the American one. As the U.S. economy has slowed, so has Canada's. Canada has a few other challenges, too: weakening housing market; poor competitiveness vs. the U.S. (taxation and regulations); the oil sector (production and transportation); and trade issues with China. Also, the new United States-Mexico-Canada Agreement (USMCA), replacing the North American Free Trade Agreement, is still awaiting approval.

Canada's unemployment rate sits at multi-decade lows. What's unusual is that wage inflation has yet to escalate. This means that the Bank of Canada is not under pressure to raise interest rates anytime soon. Hopefully that means the economy can continue to support this level of employment.

### Looking forward

As stock prices have recovered, valuations are also back to being slightly elevated – but are still reasonable, especially when compared to bond interest rates. We remain cautiously optimistic about the future, but continue to expect lower-than-historical-average returns for stocks, bonds and most other assets.

We can never be sure of what will happen in the short term. As we repeat in all our reviews, it's important to have a time-tested financial plan, based on long-term data, that also provides a custom asset mix for your investments. For your individual stocks, we continue to invest in companies that have strong characteristics of doing well in the future. ■


*Stan Clark is First Vice-President, Portfolio Manager and Senior Investment 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.*

*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

## 2019 Federal Budget

*By Sylvia Ellis, Senior Estate Planning Advisor*

**Last month, Jamie Golombek and Debbie Pearl-Weinberg, Managing Director and Executive Director (respectively) of CIBC's Tax & Estate Planning Group, wrote a summary that focused on some of the tax measures from the 2019 Federal Budget that are of most interest to individuals. We've distilled it down even further and included the highlights.**

### Canada Training Credit

The Budget introduced a new refundable tax credit aimed at providing financial support to help cover up to half of eligible tuition and fees associated with training. Starting in 2019, eligible Canadians will begin to accumulate $250 annually in a notional government tracking account that can be accessed in a future year to help cover the costs of training. Certain conditions apply.

### Home Buyers' Plan (HBP)

The HBP withdrawal limit has increased to $35,000 from $25,000 to provide first-time home buyers with greater access to their Registered Retirement Savings Plans (RRSPs) to purchase or build a home. As a result of this change, a couple will potentially be able to withdraw up to $70,000 from their RRSPs. The new limit applies to the 2019 and subsequent calendar years for withdrawals made after March 19, 2019.

### Tax Credit for Digital Subscriptions

The Budget also announced a temporary, non-refundable 15% tax credit on amounts paid for eligible digital news subscriptions. This will allow you to claim up to $500 in costs in a year, for a maximum credit of $75. In the case of a combined digital and newsprint subscriptions, you'll be limited to claiming the cost of a stand-along subscription. The credit will be available for amounts paid from 2020 through 2024.

### Automatic Enrolment for Canada Pension Plan (CPP)

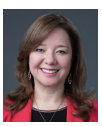
The government announced that a small number of Canadians are currently missing out on receiving their CPP benefit because they applied for the benefit late, or not at all. To ensure that all Canadian workers receive the full value of the CPP benefits to which they contributed, the government announced that, starting in 2020, it would proactively enroll CPP contributors who are age 70 or older but have not yet applied.

**Annuities for Registered Plan Holders**

Under the current tax rules, you can use your registered plan to purchase an annuity to provide income in retirement, subject to specified conditions. The Budget is proposing to allow Canadians "greater flexibility in managing their retirement savings" by permitting two new types of annuities: advanced life deferred annuities (ALDA) and variable payment life annuities (VPLA). An ALDA is a life annuity that begins at age 85 and essentially provides a sort of longevity insurance guaranteeing you an annual amount each year until death. A VLPA, which will only be available under pooled registered pension plans and defined contribution registered pension plans, will provide payments that vary based on the investment performance of the underlying fund and on the mortality experience of VPLA annuitants. These options will be available starting in 2020.

There are other measures of the Budget that will affect Canadian taxpayers, such as the new rules for employee stock options, individual pension plans, registered disability savings plans and donations of cultural property. If you would like to see Jamie and Debbie's expanded report, here's the link:

*https://www.cibc.com/content/dam/personal_banking/advice_centre/tax-savings/2019-federal-budget-en.pdf*



*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. Human beings have an addiction to prediction. Part of the reason we're so attracted to forecasting the future is:
   a) Fortune tellers do a great job of advertising
   b) Forecasters actually have a high rate of success
   c) Brain research has identified a region of the brain and a specific chemical – dopamine – that practically forces us to forecast.
   d) There's a lot of truth in those tea leaves!
2. The expression Goldilocks economic environment, the type we are in now, means we're enjoying a period of:
   a) low inflation
   b) slow-but-positive growth
   c) low interest rates
   d) all of the above.
3. According to economist Ed Yardeni, it was the U.S. Federal Reserve chairman who caused the late-2018 market downturn by saying interest rates were "a long way from neutral."
   a) True b) False.
4. To ensure that those eligible are enrolled in the Canada Pension Plan, the federal government:
   a) starting in 2020 will proactively enroll CPP contributors who are age 70 or older but have not yet applied
   b) will set up a special 1-800 number for anyone who is eligible but hasn't yet applied
   c) will set an arbitrary apply-by date; those who neglect to apply in time won't ever receive CPP
   d) will send reminders by Canada Post to every household in Canada.

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 May 31, 2019.

Trivia challenge runs May 1 - 30, 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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