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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

A(nother) Triumph of Optimism

Two Thousand Nineteen was a good year for investors. But it didn't start out that way. It began with a surprisingly sharp decline in the last quarter of 2018 that took the US equity index down 19.8% peak to trough, most of which occurred in a breathtaking drop between December 4th and Christmas Eve.

Seems a long time ago now, but at the time, human psychology being what it is, people naturally focused on the possibility that the trade war with China and slowdown of corporate earnings growth might be conjuring up an economic storm of some sort.

Spooked by the decline, investors south of the border pulled US$13billion out of equity funds and ETFs, and sent US$25billion into bonds, the biggest weekly inflow to bonds since 2013, according to Nick Murray, longtime industry commentator.

Anyone selling equities to buy bonds made a poor trade: the markets immediately reversed after Boxing Day and ran up the best first half since 1997. Reuters news agency said it was the best first half for global stocks ever.

Yet even this spectacular 6-month run didn't assuage the fear lurking just below investors' skin: a minor pullback of less than 7% in May 2019 - not even enough to meet the 10% definition of a correction - triggered another stampede out of equities and into bond funds and ETFs on par with the financial crisis of 2008 (Bernstein Research).

These weekly flows out of equites were not flashes in a pan: both Canadian and American investors were net sellers of equities all through 2019, and huge buyers of bonds, according to industry data. Lipper, a financial research firm, said Americans pulled US$156 billion out of equity funds and ETFs in 2019 - the largest since Lipper began collecting data in 1992.

These investors too, made a poor trade: the market seesawed back and forth between July and October, before taking off on a wonderful run through the yearend, climbing the proverbial wall of worry, and as I write in late February is now about 22% higher than the May correction, just eight short months ago, an astonishing 43% higher than the bottom of December 24 2018, and near all-time highs.

The great thing about 2019 is that these nice returns happened directly in the face of unrelenting bad news: Brexit tearing apart the EU; trade war with China, civil war in Syria, Taliban in Afghanistan, the wasting of Venezuela, the antics of the White House, and on and on. While each of these things are undoubtedly serious - even tragic - in their own right, it is simply not possible to draw lines from any of them to make any sort of prediction about how the investment markets might respond.

Fear is Good

Financial journalism likes to point out that because the 2018 air pocket of 'only' 19.8% didn't meet the bear market definition of a decline of 20% or more, so this is now 'the longest bull market on record'. With markets now at all-time highs, the inference is that we must therefore be closer to, and you should worry about, the next big decline. Here's why I don't worry about either.

It is of no matter that the correction of December 2018 was 'only'19.8% and not 20.1%. Of course it wasn't a megaton detonation like the -57% in 2009; nor was it the emotionally crushing two full years to decline -45% in 1973-74. But it was mini-bear in that it triggered fear that scared a lot of people out of the markets and onto the sidelines.

The operative emotion in investment markets today is fear: a market decline of less than 7% triggers weekly flows out of equities and into bonds on a scale not seen since the greatest financial crisis of our time – when the lemmings fled equities en masse at generational market lows. And they flee the best 6 month run in 20 years in the largest dollar volumes in 27 years.

This zeitgeist of fear in investment markets today is the lingering remnant of the great financial crisis of 08 and 09, now 12 long years ago, but still smoldering, maybe unconsciously, in people's psychology. This fear of volatility may persist for a generation, as the 1930s were seared into that generation's memories. (Younger investors, who didn't have much money in 2008, won't have these memories; they will be the first victims of the next round of overconfidence – but that's another newsletter.)

Fear is a positive indicator because it means people are cautious. They have only limited investments in equities. They are sitting on cash or bonds and are waiting until their confidence returns to invest.

The buyers of equities in these downdrafts are experienced investors who know the declines are temporary. These people, true long-term investors, see their equity shareholdings almost as permanent family assets, to be acquired patiently over time, and certainly not to be sold at low prices in a downturn.

Going forward, these 'strong hands' see the value of their investments go up, and they become even less likely to sell. This process tilts the balance of sellers and buyers, slightly but critically, to reduce the number of sellers. Fewer sellers means that the market prices tend to rise. At the same time, the cautious people are seeing their confidence return as prices edge higher; Fear Of Missing Out (FOMO in social media) begins to set in, and they begin to return to investment markets. They become buyers again, and markets continue to rise…

This process is how the predominant psychology of markets turns from fear to greed and back again. It is where the cyclical nature of markets comes from.

So market downturns - whether a mere correction of 10-20%, or a bear market of 20-40%, have a cleansing or strengthening effect: they scare away the weak hands, letting the speculative steam out of the markets, and forming a solid base from which the next advance begins.

This is why experienced investors tend to see doom and gloom as a buying opportunity. As John Templeton said, 'The best time to buy is the point of maximum pessimism'.

Outlook Today

Fundamentals, that is, earnings and prices, are in reasonable territory: consensus earnings for the S&P500 for 2019 are around US$177 (Ed Yardeni Economics); at S&P3300 that represents at P/E multiple (Price/Earnings) of around 18.6x. Against a 25-year average P/E of 16.3 you could say the equity market is high-ish, but definitely not worrisome, and not at all high in relation to inflation or bonds.

More importantly, the equity markets today are cheap compared to bonds: US corporate bond yields (interest paid by the bond) has been very close to the equity market earnings yield for the last 25 years or so. Today if I divide the earnings above of $177 by the market level of 3200 I get an earnings yield of 5.4%.

Compared to the Moody's US corporate yield at around 3.8%, you could say that either the bond yield is too low or the equity yield is too high. Since bond yields go up as bond prices fall, (and vice versa) this means that either bond prices are too high and need to fall to bring the valuations back to normal, or equity prices are too low and need to rise.

Economic fundamentals in the US are also very good: unemployment is at 1950s levels, and wage growth is good: US wages are growing most strongly (5.6% by one estimate) in the lowest-paid segment of the workforce. (I'll come back to Canadian fundamentals shortly.)

The table below shows the major asset classes over the last 20 years.

Index Returns to 31-Dec-19

	1 Year	3 Year	5 Year	10 Year	20 Year
Bonds/Income					
Canadian Bonds	6.4%	3.4%	3.0%	4.1%	5.3%
US Corporate Bonds	8.8%	4.7%	7.0%	7.8%	5.5%
Equities					
Canadian Equity	22.0%	6.6%	6.1%	6.6%	6.1%
Canadian Small Cap	24.6%	5.0%	5.0%	5.4%	6.9%
US Equity	25.0%	14.0%	14.2%	16.0%	5.3%
US Small Cap	20.9%	9.2%	11.7%	15.4%	9.1%
International	16.5%	8.9%	8.6%	8.3%	3.2%
Emerging Markets	12.9%	10.7%	8.4%	6.3%	6.4%

(Data courtesy of my friends at Tacita Capital)

Canadian and US equites had spectacular returns of 22% - 25% in 2019 while government and corporate bonds returned 6% - 9%. Bonds did better than expected because interest rates declined as the US Federal Reserve responded to evidence that rates had gone up far enough. (Bond prices rise when rates fall)

Even with bonds getting yet another breath of life from declining rates, total bond returns of 6% and 8% pale in comparison to equities. Proving once again the folly of trying to switch out of equities in a downdraft.

Narrow Markets: Tech Stocks, Again

But the US market is not a slam dunk. This is not the time to put everything in a US index fund and go away.

The US market has been driven by the FAANG technology stocks (Facebook, Amazon, Apple, Netflix and Google, as well as Microsoft). Microsoft and Apple have contributed a large proportion of the overall market rise, and together now account for 10% of the entire S&P500 index, a situation that has not occurred since IBM and AT&T in 1982, according to S&P Dow Jones.

The market value of the top 10 global tech stocks is almost as much as the top 10 global banks, pharmaceuticals and oil companies combined, according to the Financial Times; yet the tech stock prices are supported by profits that, while growing faster, are still hundreds of billions of dollars less than the others. The danger of course is that the fast-growing high-tech company profits, may stall and knock out the support for the stock price. It's happened before…

Not the Tech Stock Bubble

However, this is definitely not the tech bubble of 1999 again, although it might seem eerily similar. Back then, the techs had little or no revenue, never mind profits. Today, the techs are fantastically profitable: Apple and Microsoft's after-tax profit is about 25% of revenue, according to the FT.

Some of the tech titans do meet your portfolio managers' investment criteria, and you may see some of them in your portfolio's top holdings. But no prudent manager (at least none that I would use) would allow so few stocks to dominate the portfolio. There is just too great a chance that something adverse happens and torpedoes them.

Because most managers wouldn't commit so much to 5 stocks, nor continue to buy more of them as they go up (the index blindly includes more of what's going up), and because those 5 stocks are driving so much of the market, the managers returns must be lower than the market. So the managers seem to be okay.

And they are indeed 'underperforming', in the sense that the index may have gone up more in the last block of time than the manager's fund. I for one, am happy to have my growth style managers participate in the tech phenomenon this time around in this limited way. And I am perfectly happy with this so-called 'underperformance'.

Time doesn't allow full discussion here, but for more on how the story of how a narrow market ends please see, 'How the Mighty Are Fallen' July 2001' www.chrishoran.ca , or 'The Tortoise and the Hare', Aesop's Fables, or …

ESG Stock Bubble

Environmental, Social, and Governance related stocks are in the early stages of a full-on bubble. These companies are being propelled into the pricing stratosphere by the wave of green energy enthusiasm. Ballard Power, a Vancouver hydrogen power cell company, has doubled in the 3 months since November 2019, while Enphase Energy, a California solar systems provider, has doubled twice in that time. Tesla is worth more than Ford and GM combined, on worldwide deliveries of 367,000 vehicles, while Ford and GM made more than 4 million.

Lessons from the Numbers

Canada's Performance Poor

Interesting lessons are found in the 10 and 20 year returns. The 10 year returns start from the bottom of the financial crisis, so they capture the recovery to today, whereas the 20 year returns are from the beginning of the tech crash in 2000-03, so they include that decline as well as the financial crisis of 08-09.
Smaller companies in the US avoided both the tech crash and the financial crisis, so the 20 year return of 9.1% is the highest equity category by a wide margin.

Canada's performance on both 10 and 20 years is poor. The Canadian 10-yr return of 6.6% (and small cap's 5.4%) is less than half the US return of 16%/yr. This dismal record reflects Canada's anemic economic performance, centred on our struggle with low oil prices and higher unemployment vs the Americans' more flexible and robust economy. The US' surprising surge in shale oil production has transformed them from import-dependency to now the world's largest producer, in addition to providing high-wage employment.

Canada's poor returns are underscored by the fact that at the beginning of 2019 the TSX was no higher than the pre-crisis high of May 2008. Zero return for 11+ years. (Today, 12 years later, the TSX is only 20% higher, where the US market is well over double its pre-crisis high.)

Normally, a 11+ year return of zero in a major market would have me beginning to look for buying opportunities (the 'buy low' thing). We would like to think about starting to buy Canada, but Canada's situation today is still deteriorating.

Canada's suffering from low world oil prices would be difficult enough, but Canadian oil producers suffer from a further 30% discount to world prices because we cannot build pipelines to get our oil to markets - a self-inflicted wound that is difficult to fathom. The anti-fossil fuel and Indigenous activists are in charge for now, with no sign of a catalyst to reverse course.

The destruction of high-paying jobs in the Canadian oil and gas industry at the hands of political and Indigenous activists (much of which is foreign-funded), results in billions of dollars of real personal economic damage.

Unfortunately our sacrifice of patch jobs is of zero benefit to the global warming panic, because the other oil producers around the world (including Norway, sanctimoniously divesting its sovereign wealth fund of oil stocks while expanding North Sea oil production) are more than happy to make up the difference. Not one less barrel of oil is burned on the planet just because we Canadians decide to stop producing it.

This is more important than many people think. Energy and minerals dwarf autos as our top exports. Canada has world-leading expertise in the production and transportation of oil and gas, as well as the 3rd largest oil reserves on the planet. We are crippling ourselves to satisfy anti-carbon activists, when even the most extreme action – eliminating the entire Canadian oil and gas industry - would have zero effect on global warming.

Just for perspective, China's new coal plants currently under construction will consume more coal than Canada's annual total energy use - hydro, nuclear, and fossil - combined. We could completely eliminate the Canadian economy and the global carbon budget wouldn't notice!

We love to condescend to Americans, and their current president makes it easy, but Americans' per capita income is 25% higher than ours (at equivalent currency; Economist 2018). Every Canadian should think long and hard about that. You can afford a lot of medical insurance with 25% more income. I'll stop there.

Tax Season

Tax slip season is upon us. Just a reminder that T4RSP/RIF slips, as well as T5s and some T3s should have all been mailed by the end of February. Some T3 slips (especially for unit trusts), NR4s and Releve 16 slips are not required to go out until the end of March.

The T5008s have also just gone out in the mail from Assante. Please ensure that you use the Assante T5008s for the calculation of gains/losses and not reports you might have received from the fund companies.

If you are using our tax preparation service, please send your tax information to Barb and she will ensure all Assante tax information is included before the package is forwarded on for completion.

Not sure you have all the tax slips for your investments, send Barb an email at bmckenzie@assante.com.