CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

IN THIS ISSUE:

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As I discuss in this issue's behavioral finance article, humans have two minds. Our intuitive mind tends to reach conclusions faster than our more deliberate, logical one – yet often it's the former we pay attention to. In our *Quarterly Economic Report*, Michael Chu and I look at how the year's robust economic start got somewhat tempered, for example, by banking stresses. And Tom Cowans shows that saving on the cost of that daily Starbucks will add up to savings your future self will appreciate!

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 RATIONAL ARE YOU?

By Stan Clark, Senior Wealth Advisor

One of the best books on how human minds work is *Thinking, Fast and Slow*, by Nobel Prize winner Daniel Kahneman. In this seminal book, Kahneman explores the workings of our minds – and how the mind can really be thought of as two separate systems.

System 1 is fast, intuitive and emotional, he says. This is our "emotional mind," or our intuition. System 2, by contrast, is slower, more deliberate and more logical. System 2 is our "rational mind."

System 1 is extremely powerful, able to make amazing decisions in the blink of an eye. In chapters three and five of *Thinking, Fast and Slow*, Kahneman introduces a series of questions to illustrate System 1's speed in coming up with answers.

I encourage you to get a pen and answer the following three questions from his book. Just for fun, time yourself to see how long it takes you to answer them all.

Question 1: A bat and a ball cost $1.10 in total. The bat costs a dollar more than the ball. How much does the ball cost?

Question 2: If it takes five machines five minutes to make five widgets, how long would it take 100 machines to make 100 widgets?

Question 3: A patch of lily pads floats in a lake. Every day, the patch doubles in size. If it takes 48 days for the patch to cover the entire lake, how long would it take for the patch to cover half the lake?

Before we go on, what was the total time you took to answer these questions?

Now we'll proceed to the answers. The answer to Question 1 is five cents; to Question 2, five minutes; and to Question 3, 47 days. How did you do?

When these questions were given to university students, the best results came from the Massachusetts Institution of Technology. Even so, only 48% of the MIT students got all three answers right. At Harvard, only 20% answered all three right, with 20% getting none right. Several other universities did much worse. At Michigan State, for example, only 6% got all three right, with 49% percent getting none of them right!

These are not particularly difficult questions. So why did such a large percentage of bright students in very selective universities get them wrong?

The reason comes back to System 1, and the fact that although System 1 is extremely fast, it is sometimes *too* fast and ends up being wrong. But when System 1 comes up with an answer of any sort, too often our rational, logical System 2 accepts it without further thought.

The three questions above are called the *Cognitive Reflection Test*. They were specifically chosen because they are not really that difficult, but each presents an "obvious" (though incorrect) answer via System 1. What the test measures is how readily so many people will accept the intuitive answers, rather than reflecting on them and questioning their intuition.

Note: When given to students, these three questions were part of a much longer set of questions. The students were not alerted to the fact that these particular ones might be somewhat tricky. For that reason, I asked you to time yourself in answering them.

The researcher who developed these questions, Shane Frederick, has examined the personalities of people who do well on this test compared to the personalities of those who don't. Frederick found that people who score low tend to be more impatient and impulsive – and keen to receive immediate gratification.

Frederick's findings also make it clear that while our System 1 is extremely fast and powerful – and we couldn't survive without it – this System sometimes leads us astray. Our conscious, rational mind needs to know when to intercede, when to trust our intuition and when not to. That balance, that wisdom, is all-important in many areas of life, especially in investing and our other financial decisions.

TEAM TALK

Tom Cowans
Wealth Advisor

Ellie's first birthday, Ocean Park March 2023

Hi Tom! Any changes since we last spoke?

Yes, there have been a few! My wife, son and I welcomed our daughter Elizabeth Mae into the world last March – on my birthday no less! It was the best birthday present ever and Elizabeth just enjoyed her first birthday cake smash. Ryan has embraced his big brother role and helps out whenever he can. We also moved to Ocean Park in South Surrey in June of last year – we actually sold our last home from the maternity ward of Surrey Memorial the day after Elizabeth was born – it was a surreal experience!

Do you have any plans for the rest of the year?

We are planning a trip to the interior of BC in July to see friends and family, then a trip to England in August to see Ryan and Elizabeth's English grandparents, aunts, uncles and cousins! Then Ryan starts Kindergarten in September so that will be a big change that we are all very excited about. Other than that we're looking forward to having a quieter year compared to 2022!

Quarterly Economic Update:

AMID CONTINUED UNCERTAINTIES, SOME STABILIZING

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

2022 centred on actions by central banks around the world to fight raging inflation. While the fight continues into 2023, discussions are now more focused on the economy and a potential recession. Stock markets were resilient for the first quarter of 2023, finishing with strong returns despite ongoing economic risks. Markets benefited from such factors as: falling inflation; anticipation that the U.S. Federal Reserve may be nearing the end of its rate hike cycle; and reduced fears of a hard landing for the economy. The Bank of Canada paused its rate hikes to let the impacts flow through the economy. Central bank policy changes are like steering an oil tanker – with the economy being massive, it takes a long time to alter the heading.

While markets were robust, the robustness was far from maintaining a straight line. Much volatility occurred in connection with bank collapses in the U.S. and Europe. While the possibility of further instability remains, quick intervention seems to have restored confidence and prevented further contagion in the banking industry.

The first quarter of 2023 was positive for stock markets around the world. At home, the TSX was up 4.6%. The World Equity Index, a gauge of stocks around the world, was up 7.4% (in C$).

	1st Quarter 2023	Trailing P/E	Trailing Eanings Yield	Dividend Yield
Canada	4.6%	14.3	7.0%	3.2%
U.S.	7.2%	21.9	4.6%	1.6%
Europe	10.3%	14.8	6.7%	3.2%
Japan	6.8%	15.7	6.4%	2.5%
EAFE (Europe, Australasia, Far East)	8.2%	15.1	6.6%	3.1%
Emerging Markets	3.7%	12.4	8.1%	3.3%
World	7.4%	19.1	5.2%	2.1%

Source: Bloomberg

Banking turmoil

Banking stress has dominated recent headlines. Two U.S. regional banks failed in early March. While the two weren't among the handful of largest banks in the country, neither of them was particularly small. Each was felled by a classic *bank run*: too many customers trying to withdraw their deposits at the same time. The banks couldn't accommodate all the withdrawals. The reason: a combination of insufficient liquidity and ultimately insolvency, with the banks' long-bond investments suffering massive losses. As this played out, customers at other banks became nervous, too – creating the risk of cascading bank failures.

The problems in the banking sector primarily arose from the sharp increases in interest rates over the past year. Banks often hold a part of their assets in bonds. The value of these bonds fell substantially as interest rates rose.

There's still fear among depositors and investors in U.S. banks. While understandable, it seems mostly unfounded, given recent government intervention.

What about Canadian banks? Rising rates also mean investment losses. Additional challenges from household leverage and a weak housing market will affect Canadian banks more than U.S. ones. But Canadian banks have their strengths, too: They're larger, more diversified, better capitalized and better regulated. As many of you will recall, Canadian banks have a history of stability even when U.S. banks encounter severe distress, as in the 2008 financial crisis.

Bringing back the punchbowl

To help the banks by ensuring liquidity, the Fed has essentially brought back the economic *punchbowl*, that is, loosening the reins on monetary policy. This should prove positive for financial asset prices.

For 2023, top economist Ed Yardeni is optimistic about U.S. stocks. Yardeni expects the central bank actions to contain the banking turmoil. At the same time, he says these actions may keep the Fed from raising rates further. A pause in interest rates should help boost stock prices. The Fed raised rates from near zero to just under 5% in the past 12 months, attempting to bring inflation down to its 2% target.

Previously, the Fed was juggling the need to tame inflation without excessively slowing the economy.

With all the banking stresses, that balancing act got more complicated. Going forward, the Fed is likely approaching the finish line of its rate-rising journey.

A Fed pause would help prop up the value of struggling banks' investments – and help prevent the current situation from escalating into a full-blown crisis. Some warn that if under-pressure banks become more conservative in lending, the economy could slow down. But Yardeni shrugs off these concerns. He believes that, over the past year, companies have shown they can weather the tightening credit conditions.

We've often observed that recessions are caused by financial crises triggered by the tightening of monetary policy, which results in credit crunches. But we aren't convinced that the banking crisis will morph into a credit crunch. With that in mind, Yardeni predicts a 60% chance of a soft landing; a 40% chance of a hard landing.

Inverted yield curve

The *yield curve* has been inverted (short-term rates higher than long-term rates) since last summer. This is often a warning sign of troubled times ahead.

The current inverted yield curve has made a couple of right calls so far. First, inverted yield curves are associated with the end of monetary tightening and the peak in bond yields. So, the current inverted yield curve called that one well. Its second right call was that, if the Fed kept raising rates, something might break – and it did, with the regional bank crisis.

Is there more trouble to come? As you can see in Figure 1, yield curves tend to bottom out during a financial crisis. The banking crisis might be that crisis, implying that the Fed will stop raising short-term rates; perhaps it will even lower rates. Usually, the inverted curve anticipates a credit crunch, which then leads to a recession. But because of the Fed's actions, the banking crisis seems largely resolved – and perhaps the potential recession, too.

Figure 2 shows inverted yield curves and recessions (blue shade). Is there going to be another blue shade? It's true the economy isn't perfect – but it's been fairly resilient with moderately strong growth. The recession might be more of a rolling one, with different sectors slowing at different times instead of all at once. Also, consumer confidence is good and companies are continuing to invest. For these reasons, while a recession looks likely, it's possible we will get a soft landing. In any event, investors shouldn't be overly scared of a recession. It's just a natural part of the cycle, where a reset occurs to clean up some of the excesses. Having a diversified portfolio of strong companies will help mitigate the downside.

The most anticipated recession

With all the discussion and market behaviour that preceded it, 2023's economic outlook could be described as the most anticipated recession ever. Everyone seems to "know" the U.S. will have a recession; and to "know" that it will be mild. Sometimes when everyone thinks the same, that herd mentality makes us nervous. But we gain comfort in knowing we can get a range of outcomes. And, that we can assign probabilities from no recession to a normal recession, which typically lasts 10 months.

So far, the economy has held up well, given recent events. Employment numbers in both Canada and the U.S. are still robust. Economic data aren't necessarily strong, but neither are they definitely recessionary.

Inflation on a downward trajectory

The main drivers that were initially responsible for most of the inflation surge have mostly been reversed: commodity prices; supply chain problems; and excessive monetary and fiscal policies. Inflation continues to descend from its peak, but the recent rate of improvement has slowed. U.S. inflation has slowed to 6% year over year. This is a huge improvement compared to a year ago, but is still much higher than the desired 2% target. In Canada, although it might not feel like it, especially at the grocery store, inflation slowed to 5.2%. In both countries, goods inflation is declining, but services inflation has been more sticky.

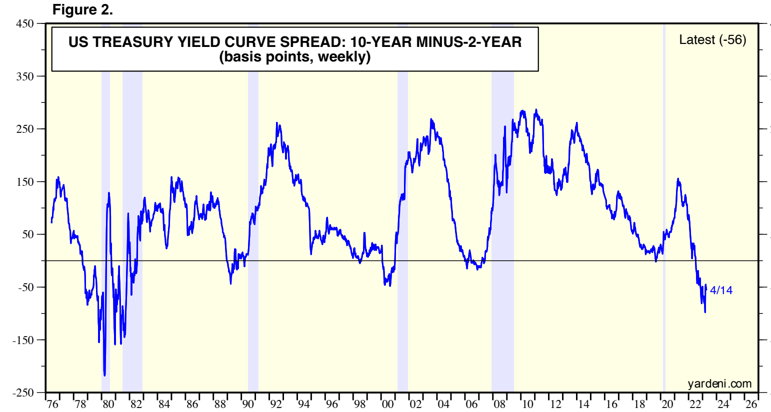
Inflation should continue to fall, given: the current level of interest rates; falling commodity prices; lower wage pressures; and largely resolved global-supply-chain issues.

Fed pauses have been bullish

Since the 1980s, whenever the Fed has paused or completed its rate hiking cycle, stocks have responded positively. Stocks do much better when the economy re-accelerates and avoids recession, as opposed to when the pause comes just before a recession.

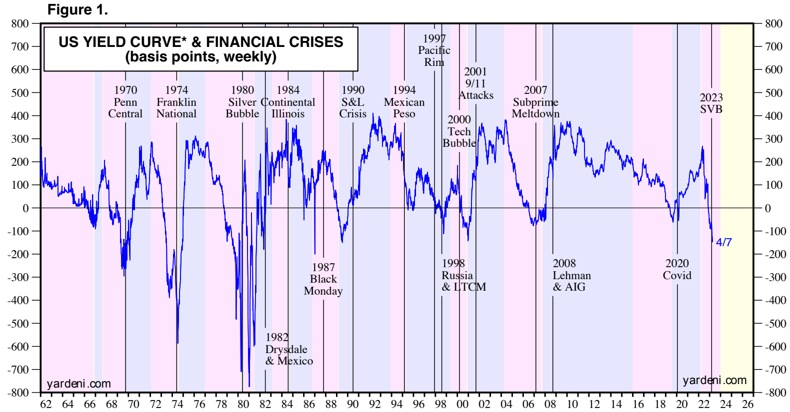
Several factors could limit the depth of a recession this time around. Not helping the Fed's cause, the U.S. government has implemented fiscal programs that are still being rolled out. These programs will support the economy even as the Fed is trying to cool it down. There's lots of government spending in Canada, too.

Figure 2.



Source: Ed Yardeni

Figure 1.



Source: Ed Yardeni

De-globalization is also boosting the capital spending for many companies, as they protect their businesses against the supply chain disruptions experienced during the pandemic and the war in Ukraine. If that war ends in 2023, there will be tremendous rebuilding and spending on defence replenishment; this would be another economic support around the world. Falling commodity prices should also provide economic support.

Now that it has done an about-face on pandemic restrictions, China continues to enjoy an economic recovery. This should further boost global economic growth. China's monetary authority has cut interest rates and is expected to make more cuts to rapidly restart the economy. Property values are showing signs of revival, as is travel.

On the other hand...

Jeremy Grantham of GMO made his name predicting the dot-com bust in 2000 and the financial crisis in 2008. Now the famous investor warns of another epic bubble about to burst in the financial markets. According to Grantham, the recent banking turmoil is just the beginning. However, Grantham is known for his bearish views. Most recently, back in 2021, he made a big prediction about "one of the great bubbles in financial history." However, the market continued to go up, hitting an all-time high in early 2022. U.S. stocks have dropped about 15% since that peak.

Still, Grantham sees steeper declines on the horizon: "Every one of these great bursts of euphoria, the great bubbles with overpriced markets... has been followed by a recession. The recessions are mild if everybody does everything right and there are no complications. They are terrible if people get everything wrong."

While we don't agree with everything Grantham says, his opinion should still be respected. We appreciate different points of view – yet we shouldn't overreact to them. When bubbles break, the aftermath is stressful and difficult to deal with. However, that's how a financial plan helps. A financial plan ensures we have short-term cash needs available, giving us the ability to ride through a storm – if or when a storm happens.

Looking ahead

We've seen one of the fastest periods of interest rate hikes by central banks. One of the major risks at such a time is something breaking. We just witnessed this with the banks that needed to be rescued. Nevertheless, even while instability continues, for now our confidence has been restored.

How high the Fed will go with interest rates and how long will the rates remain elevated? A high level of uncertainty remains. A Fed pause is likely near, but stubborn inflation due to tight employment may require the rates to stay high longer.

As usual, that and other uncertainties remain on the horizon. But rather than overreact to uncertain predictions, it's best to have a disciplined process combined with a resilient financial plan. This will help us navigate an unpredictable future.

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Financial & Estate Planning

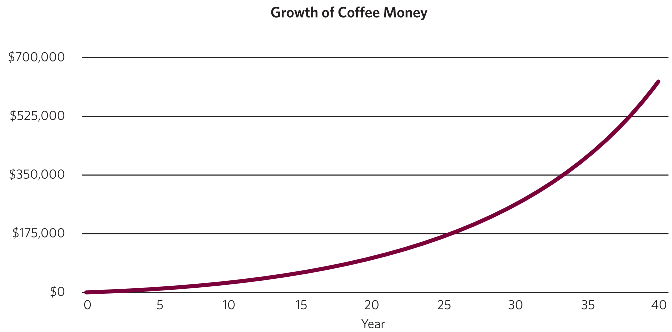
COMPOUND INTEREST – IT PAYS TO START EARLY!

By Tom Cowans, Wealth Advisor

The first key to planning for your future is to focus on saving – and the sooner the better. Saving means not spending all the money you make. Saving and spending go hand in hand. One key to managing your spending is to give some thought to what you regularly spend money on and how those costs can add up. For example, buying a coffee every day or eating out once a week. Although these seem natural choices on busy days, most of us, whatever age, rarely realize how much we end up spending on such purchases – or the long-term consequences.

A drink at Starbucks can cost up to $6. If you make a daily stop for coffee, that means you are spending $180 per month. This adds up to $2,160 each year!

A lot of us cherish our coffee in the morning. (Full disclosure: Some members of the Stan Clark Financial Team are no strangers to Starbucks.) But ultimately it comes down to making choices and sacrifices now to ensure that you are financially well-prepared in the future. Being aware of your budget, and choosing between those daily hits of Starbucks and your weekly restaurant dinner, rather than indulging in both, can significantly benefit your financial health.



Suppose you made your coffee at home or at work and invested the $180 savings every month. What would happen? Looking at rates of return for stocks and bonds over the last 151 years, we have an average annual return of 9.60% for stocks and 4.5% for bonds. Assuming you spread your money evenly between stocks and bonds, the average rate of return would be around 8%. In 40 years, investing $180 per month with an 8% annual return works out to over $600,000! And all because you made coffee at home instead of going on that daily Starbucks run.

Give yourself as much time as possible to let compounding interest – the eighth wonder of the world, according to Albert Einstein – take effect. Start saving early! Letting that Starbucks monthly allowance grow for 30 years would accumulate to just over $260,000. And that's less than half the value you'd reach after 40 years.

A perfect example of the positive impact of saving over time is American business magnate Warren Buffett. Everyone knows Buffett has been a wonderfully skilled investor. But were you aware that he began saving at the age of 10? Buffett continues to save now, at the ripe old age of 92. Of Buffett's current wealth, over 95% of it was amassed after he turned 65.

Buffett's partner, Charlie Munger, once said that the first rule of compounding is to "never interrupt it necessarily." As important as time is when investing, it is equally important not to abuse your time advantage by "taking extra risk" when you're young, e.g., by making speculative investments and permanently losing capital. Even with a long time horizon it is extremely important to invest prudently and let compounding interest work its magic.

Another important point is that, over time, small differences in return can have big differences in results. As the table below shows, the difference between 8% and 12% over 30 years is nearly $2 million on an investment of $100,000.

Compound Growth From $100,000

Time	6% Return	8% Return	10% Return	12% Return
10 Years	$179,085	$215,892	$259,374	$310,585
20 Years	$320,714	$466,096	$672,750	$964,629
30 Years	$574,349	$1,006,266	$1,744,940	$2,995,992

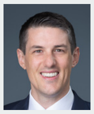
There are many options for investing your savings, for example, using a Tax-Free Savings Account (TFSA) and/or Registered Retirement Savings Plan (RRSP). Both are great vehicles to help you invest.

All your growth in TFSAs is tax-free. You can withdraw savings at any time, with no tax consequences. Your savings are easily available – though of course that may or may not be a good thing, depending on what you do with the savings.

RRSPs also provide tax-free growth, with the added benefit that your contributions reduce your income tax. RRSP savings are not as accessible, since you need to pay taxes to withdraw them. The silver lining here is that, because of the taxes, you tend not to withdraw from your RRSPs, which helps you refrain from spending what you've saved.

Everyone has different needs. TFSAs might be better suited for some than RRSPs, or vice-versa – or there might be a need for both. It helps to think about these options early and develop a plan for your future.

The key is to start early and often – remember to pay yourself first!



Tom Cowans is a Portfolio Manager and Wealth Advisor for the Stan Clark Financial Team at CIBC Wood Gundy.

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. As Nobel Prize winner Daniel Kahneman observes, we humans have two minds: the first, quick and intuitive; the second, more deliberate and logical. When making financial decisions, we should pay more attention to:
   - a) The first, as it makes decisions fast and therefore saves us time.
   - b) The second, as it's the conscious, rational mind and provides balance and wisdom.
   - c) Both minds in equal measure.
   - d) Neither. Just look up whatever advice you need on the Internet.

2. In the first quarter of 2023, two U.S. regional banks failed. Should Canadians panic about our banks?
   - a) Yes, because rising rates mean investment losses here, as in the U.S.
   - b) Yes, because our banks, too, feel the effects of a weak housing market.
   - c) Yes, because what happens in the U.S. inevitably trends over the border.
   - d) No, because Canadian banks are larger, more diversified, better capitalized and better regulated.

3. Investors shouldn't be overly scared of a recession. It's just a natural part of the cycle, where a reset occurs to clean up some of the excesses. And, having a diversified portfolio of strong companies will help mitigate the downside:
   - a) True b) False

4. Sure, everyone knows it's a good idea to save for their future self. But does saving on a small amount every day, like the price of a coffee at Starbucks, make that much difference?
   - a) No, better to set aside a much larger amount every month.
   - b) You'll save a bit, but then you have the hassle of making your own coffee at home every morning.
   - c) Just stop buying a pastry with that daily coffee and that'll be savings enough.
   - d) Yes. Saving $6 on that daily coffee adds up to $180 per month. Investing that over 40 years with an 8% annual return works out to over $600,000!

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, 2023.

Trivia challenge runs April 26 - May 30, 2023. 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 2023

CIBC WOOD GUNDY | The Stan Clark Financial Team
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