Henny Penny

Equity Markets

Developed equity markets reversed a very weak conclusion to 2018 with a comparably impressive rise in the first three months of 2019. In Canadian dollar terms, the domestic S&P/TSX Composite index gained 13.3%, the S&P 500 index rose 11.2%, and the MSCI EAFE index increased 7.6%, in all cases serving to nullify the losses posted over the prior quarter. For Canadian investors with exposure to foreign markets, strength in the Canadian dollar served as a slight headwind to returns. Strength was broad-based across all developed markets, with every single sector in each region posting gains. In the Canadian market, renewed optimism about the nascent cannabis industry triggered a 48.9% rise in the Health Care sector, while a 32.4% higher West Texas crude oil price provided the impetus for a 14.4% rise in Canadian Energy stocks, even as domestic producers continue to navigate a shortage of pipeline capacity and resultant oversupply issues.

In the US, Information Technology stocks set the pace, rising 19.4% as investors shrugged off dismal results and cautionary commentary from semiconductor manufacturers, taking the view that better times are ahead for the industry. Bringing up the rear in the US was the Health Care sector, where political jawboning about the need for lower drug prices and some headline-grabbing drug trial failures were enough to dampen investor spirits and produce a relatively modest 6.1% gain for the group. In the EAFE region, cyclical sectors such as Materials and Information Technology stood out positively, while the Financials sector acted in a more disappointing fashion, a reflection of an increasingly dour view from the European Central Bank on the near-term growth outlook. A notable inflection towards a dovish interest rate regime across all developed markets suggests that any initiative to raise interest rates is, at the very least, on pause for now. The change in sentiment prompted stock price strength in yield-sensitive sectors such as Real Estate and Utilities, spurring some uncharacteristic outperformance in what was a solid quarter for equities.

The impressive strength of equity markets worldwide to begin the year stands in contrast to some signs of slow but steady economic deceleration in North America, Europe, and Japan. Despite periodic hints about progress, the trade tariff standoff between the Trump government and China remains unresolved, and the resulting lack of clarity is likely a contributing factor to an incremental slowdown in worldwide economic growth, and the reason behind the recently subdued tone from major central banks. Beyond this, signs of a pause in the residential housing market are an additional headwind facing many Canadian homeowners, as well as major Canadian banks. Investors will need to balance the potential of a favorable trade resolution with China alongside the current muted economic environment when viewing equity market valuations, now at higher levels following a strong start to 2019.

Fixed Income Markets

Canadian government bonds and investment-grade corporate bonds returned 3.9% and 4.7% respectively in the first quarter, while high yield bonds returned 4.0%. Overall, as in 2018, bond markets continued to make a solid contribution to a balanced portfolio.

The most-often-heard word in the bond market last quarter was "inverted yield curve", a term describing an environment where short-term bonds offer higher yields than long-term bonds. At the end of the first quarter, with an overnight rate and 10-year Canadian government bond rate yielding 1.75% and 1.62% respectively, this suggests that the Bank of Canada may have gotten ahead of the economy with rate hikes, and going forward may need to reduce the overnight rate.

Both the Federal Reserve Bank of the United States and the Bank of Canada paused their hiking programs in the quarter, with many interest rate observers believing that policy rates are likely to hold steady in the United States, while the Bank of Canada rate may need to reverse course.

Commentary

In the folktale "Henny Penny" (also known as "Chicken Little"), the eponymous lead character gets hit on the head by an acorn that drops from a tree and reaches the alarming conclusion that the sky is falling. She then sets out to warn everybody, ultimately amassing an ardent following of farmyard fowl (such as Ducky Lucky, Turkey Lurkey and Goosey Loosey) who ignore their better judgment and seek refuge from the collapse of the heavens in the den of a wily and very hungry fox.

There are two main morals to this story. First, one indicator looked at in isolation and without proper context does not tell the full story. It is always a good idea to look beyond a narrow subset of data to reach well-founded conclusions about what is going on. Second, it is essential to understand what a reasonable range of outcomes is, and not place undue weight on low probability events regardless of what some people may be saying.

In general, people are not so much "risk averse" as they are "loss averse", meaning that they tend to want to protect against losses rather than make similar gains. That asymmetric view of risk means, given even odds, the average person is more willing not to lose $5 than win $6, even though the latter yields the better-than expected outcome — and some research into decision-making suggests that the psychological impact of losses can be twice as significant as that of gains. As a result of this irrational cognitive bias, people place additional emphasis on downside risks, focusing on potential adverse outcomes and preparing for the worst regardless of how low a probability event that may be. This approach can lead investors to act against their best interests in the name of avoiding potential (though unlikely) losses — and as Henny Penny & Co. found, this is to their detriment.

This tale serves as a good allegory for financial markets and particularly for what has been playing out over the last six months. Stock prices fell aggressively in the final months of 2018, with December marking the worst final month of a calendar year since the Great Depression. This poor performance and concurrent jump in volatility had many analysts and pundits arguing that it was a sign that the near-decade-long economic expansion (and with it, the bull market) was in its death throes. This rhetoric further weighed on investor sentiment and spurred on more selling in equities, in a negative cycle, as investors looked to save their portfolios from the sky falling on top of them. Equity markets, however, do not have the best track record at predicting downturns — as Nobel-winning economist, Paul Samuelson noted in 1966, *"the stock market has forecast nine of the last five recessions."*

Moreover, looking beyond what was happening with stocks suggested that the four horsemen of the financial market apocalypse had not yet left their stable. While it was the case that the dataflow showed economic momentum was slowing globally, the moderation was coming from elevated levels, still implying growth. Slower growth is still growth, and by its literal definition, a recession cannot occur when the economy is expanding. While many economic data points are lagging indicators, none of the fundamentals suggest, that right here, right now, a recession is imminent.

Indeed, despite the more tumultuous performance of the stock market at the end of last year, corporate fundamentals remained constructive — the increase in volatility was very much sentiment-driven as investor psychology took over and pessimism swung to an extreme. However, while markets can detach from fundamentals for some time, they typically do not remain detached forever. The more extreme the dislocation, the more often it is followed by sharp reversals — such as was recorded through the first three months of this year, which marked the best quarter for global equities in 8½ years.

The bottom line is that investors need to maintain a disciplined and long-term approach to managing their wealth and avoid letting emotion guide their decision-making. History shows that markets go up more often than down; planning around the expectation that the sky is going to fall means missing out on the upside when the clouds clear and blue skies remain firmly above our heads.