The Krygier Report

An exclusive newsletter from Mark J. Krygier, Senior Portfolio Manager | November 2021 www.krygierwealthmanagement.ca

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Suffering from cognitive dissonance?

There is an amazing phenomenon going on with investors, politicians and economists today. When I look back on my early university years in the mid-80s, one of the few things I still remember is the psychological concept known as "cognitive dissonance." The on-line Merriam Webster dictionary defines it as, "psychological conflict resulting from incongruous beliefs and attitudes held simultaneously." If I believe strongly in "A", and yet I have very strong proof of "B", to be logically consistent I have to either change my belief from A to B, or I have to fool myself that B is really A, despite evidence to the contrary. As the definition suggests, it is a psychological conflict, and one which requires mental gymnastics, as per my example, or a change in one's attitude and ultimately one's behaviour.

Imagine you are the Chair of America's Central Bank (the "Fed"). Prices of labour and goods are rapidly increasing across the country and globally. Supply chain delays are exacerbating price increases. Shortages of truck drivers are delaying the movement of goods and services in the economy while adding costs to the movement of these goods. Your peers in Europe are reducing their fiscal stimulus. Your peers in Canada – your largest trading partner – are going to end their quantitative easing (i.e. artificial stimulus) program and push forward their timeline for raising interest rates to combat rising inflationary pressures. You therefore have strong evidence of "B" (it's time to remove stimulus). However, you know very well that the U.S. economy has been propped up by maintaining low interest rates and by government purchasing of U.S. Treasury bonds, ETFs holding bonds, mortgages, etc., all of which has artificially strengthened the financial system, and which has extended the housing market well beyond previous cycles. You know in your gut that if you raise interest rates the stock market will likely drop, and it may even cause a recession. How do you know? Well, in the last quarter of 2018 when you just talked about raising rates three times in the coming 12 months it caused a dramatic market drop, especially in technology stocks which thrive in a low inflation world. How did you react? You were forced to do a complete "about-face" and backtrack in early January 2019 and instead say you may actually reduce rates instead. You therefore strongly believe in "A" (stimulus has to remain). From a layperson's perspective, this appears to be a clear-cut case of cognitive dissonance. The result? "Temporary inflation" is the most bandied about slogan from the Fed. If inflation is only "temporary" there is no need to overreact. But what if you are wrong? What if "B" is really true? If so, the longer you choose to take action means you exacerbate the problem – kind of like not seeking medical attention until it's "too late." Early intervention seems to work in the medical field, so why not in the field of economics too?

Now imagine that you are a nervous investor and, all things being equal, you would rather not experience a drop in the value of your investments, even though you know that to reap gains you have to be invested in something that can potentially lose money. Traditionally, such an investor would hold a certain proportion of their portfolio in "fixed income" investments, such as bonds, GICs/CDs and even preferred shares. The investor believes in "A", that such fixed income instruments protect your capital from volatility, and notionally that is true as if held to maturity, the capital invested will be returned unless the lender goes insolvent. However, you know or have heard that when interest rates rise, something that has not been seen for any extended period of time since the late '80s, "fixed income" instruments drop in value. For example, the I-Shares "Core Canadian Government Bond Index ETF", which holds only high quality "safe" bonds, is showing a 2021 year-to-date return of -4.59%, while during the same time the resource-laden Canadian stock market is up over 20%. You have evidence of "B" (that bonds do NOT always protect your investments from dropping in value). To sell all of your bonds and invest only in those types of investments which are working well in this inflationary environment is to acknowledge the veracity of "B", however if in your gut you still believe in "A" – you have what a layperson would describe as an example of cognitive dissonance. As an aside, bank issued GICs and CDs help obscure this reality by always showing you the maturity value rather than the "market" value, since there is almost no way to cash in the GIC/CD prior to maturity.

Finally, imagine you are an economist, and you believe in Modern Monetary Theory ("MMT"), which Investopedia describes as a theory that "governments with a fiat currency system under their control can and should print (or create) as much money as they need to spend because they cannot go broke or be insolvent unless a political decision to do so is taken." You believe in "A", that there is no limit or consequence to the amount of debt a government can issue. Yet, you have studied the negative impact of excessive debt on economic growth for individuals, corporations and for governments. You are faced with evidence of "B", that fiscal prudence is important and that there is a difference between "good" debt (used to invest in productivity) and "bad" debt (used for personal consumption). Sounds like another example of cognitive dissodance.

Bottom line

It is not easy to change one's attitudes or behaviours at the best of times. When faced with evidence that contradicts one's hard-held beliefs, this challenge is even more difficult. Politicians, investors and economists are all facing a conundrum and their decisions will have significant consequences on their financial well-being and those of many others in the coming years. Ask yourself, when faced with evidence that contradicts your hard-held beliefs – what do you do?

Global benchmarks
As at October 31, 2021 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	23.4%	38.8%	15.4%
S&P 500 TR - US$	24.0%	42.9%	21.5%
NASDAQ Composite - US$	20.3%	42.0%	28.5%
MSCI Europe Index Price Return	9.7%	28.2%	7.4%
MSCI Emerging Markets	-4.7%	6.6%	7.6%
China S.E Shanghai A Price Return	1.3%	6.9%	11.8%
MSCI World Index Price Return	14.8%	28.8%	13.9%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - US$	-5.1%	-4.5%	12.3%
10-year U.S. T-Bond - US$	-4.8%	-5.0%	6.3%
Long GOC Bond (2051)	-15.6%	-14.6%	4.9%
10-year GOC Bond	-7.3%	-7.3%	3.9%
5-year GOC Bond	-3.7%	-3.6%	2.9%
3-month CDN T-bill	0.1%	0.1%	0.9%
US$/CDN$ (1.2387)	-2.7%	-7.0%	-2.0%

Source: RBC Capital Markets Quantitative Research

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Wealth Management
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