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of RBC Dominion Securities

Wealth Management
Dominion Securities

April 2017

Integrity, Trust and Experience
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Welcome and thank you

A warm welcome to the clients who have recently joined us, and a special thank you to the people who mentioned our name to them. We appreciate your trust and support.

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PORTFOLIO MANAGEMENT GROUP

Confirmation bias

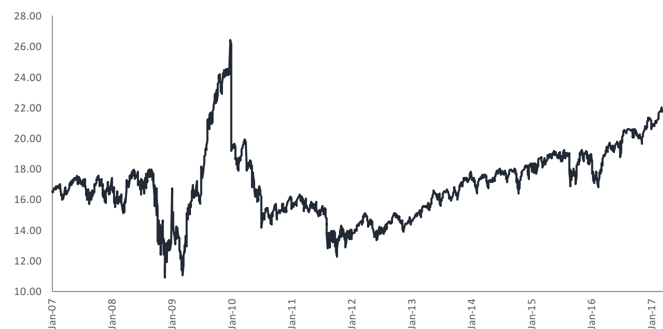
Confirmation bias is a cognitive thought process that causes us to selectively notice and pay attention to what confirms our beliefs and to ignore what doesn't. Everyone does it naturally to some extent, and in aggregate a group of people do it as well. Groups tend to nurture this, which reinforces the bias further. "Group think" is a popular term that describes confirmation bias. This sort of sentiment creates its own reality for longer periods than one can imagine. Beyond a group, markets are crowds that believe their own rhetoric and exhibit a further extension of confirmation bias and often include emotions that can lead to extreme behavior.

I think that this is worthwhile remembering when looking at various markets as markets are inherently as much about individual businesses and their valuations as they are about confirmation bias and crowd behavior. Consequently, markets often demonstrate erratic and extreme movements that cannot be attributed to much more than mood swings, which are, of course, inherent in human emotions.

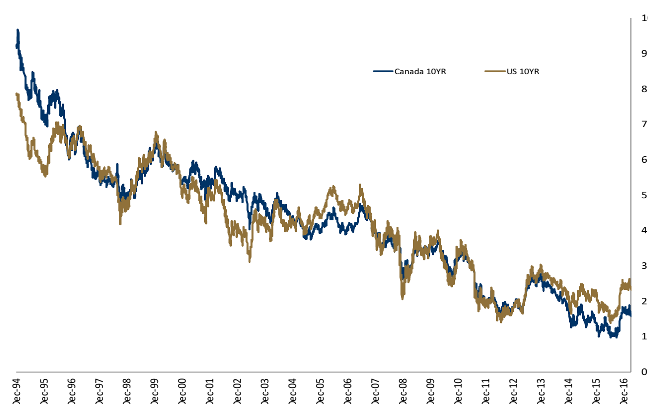
As we all know, interest rates are artificially low and by and large credit is easy to get in many places. Although the cost of borrowing was historically attractive before the financial crisis nine years ago, central banks pushed interest rates lower and used aggressive actions to stabilize the banking system and revive the world economy. It has taken longer than most expected, but it worked. While there are many challenges ahead in Europe and other places, most developed economies have demonstrated improvement. The threat of an imminent deflationary spiral looks over. In short, the crisis that warranted the emergency and extreme monetary conditions has passed. The U.S. Federal Reserve has begun to raise interest rates and, while the direction for short-term administered rates is clearly up, the timing is uncertain. Led by the U.S., central banks know that prudence dictates that they normalize interest rates now that the crisis is gone. By doing so they will prevent future broad inflation and manage asset bubbles that have been forming in several asset classes. The aggressive monetary policies that were required to revive the world economy have caused unwanted side effects with potentially disruptive consequences. Presumably central bankers learned some things from their lack of monetary policies that surrounded the U.S. housing bubble that in turn contributed to the financial crisis. Once again, too cheap and ample money is creating bubbles in some places.

The election of President Trump was welcomed by the stock market as investors saw his promised policies of infrastructure spending and lower taxes as good for corporate America. Bonds sold off as interest rates rose in anticipation of increased government borrowing and perhaps higher inflation. The stock rally was based on this premise and the market crowd exhibited some confirmation bias and created its own reality. This continued until President Trump's proposed repeal of Obama's health care was blocked due to lack of support by his own party. The savings from repealing Obamacare would have helped balance the books, allowing the proposed tax cuts. Presently, the market is weighing what this all means. Does this mean that the crowd should demonstrate further confirmation bias or change its premise? Regardless of bluster and bravado, it appears that Washington continues to be a tricky place to get bold things done.

S&P 500 historical P/E



U.S. vs. Canada 10-year bond yield



Source: RBC Dominion Securities

With the Federal Reserve signaling higher administered interest rates and The President's spending plans, the bond market continued its sell-off for most of the early part of 2017. The higher interest rates in the U.S. supported a further dollar rally. Both of these trends backed off more recently though as it became apparent that intents and implementation are different things.

The stock market rallied following the U.S. election as the promise of corporate tax cuts and enthusiasm stoked the crowd's animal spirits. As well, I am sure that the stock rally was supported by the sell-off in bonds and caused many investors to allocate away from bonds in favor of equities. Momentum and group think propelled the U.S. stock indices to new high levels in early March. Almost all of this rally can be attributed to an expansion in valuations, and not in earnings. As March progressed and the reality of President Trump's less than full support dawned, the markets have drifted with a slight downward bias.

As usual, I am guided by "the big picture" rather than the chatter that supports the crowd's confirmation bias. What I see is the financial crisis has passed. Large debt problems remain, notably in Europe where resolution was deferred. For many reasons there is excess capacity in most goods and services and diminished demand for them. With low interest rates and low growth, many companies look to takeovers to buy elusive revenue and cut costs. This is becoming unpopular with the electorate in many areas. The "Kumbaya" attitude of world negotiations is over as politicians answer voter's demands of "us first." This attitude will also influence future geo-political negotiations. Inflation and interest rates have likely bottomed, while globalization has peaked.

The cost of money is the key factor that drives the price of assets. It has been and remains artificially and abnormally cheap and abundant as required to fix the financial crisis. The crisis is largely over. Administered interest rates are going up, and the only question is how quickly. Having goofed up 10 years ago with the U.S. housing and asset bubble, I'm not sure if I'd bet that policy makers and central bankers will again.

Putting all of this together, I am wary of interest rates going up and therefore bonds and interest sensitive areas of the stock market. Other asset classes have been inflated by low interest rates as well and are vulnerable to a correction. Known risks are discounted by many investors that are judged by daily performance and confirmation bias and group think may be creating its own reality again. Buying the market through index linked funds could prove risky as the market concentration in these vehicles is very high. However, good companies remain the best asset class, but not all of them. Industries, geographies, valuations and managements matter more than ever. While equities remain attractive, selective investment is more important than in recent times. As always, I will do my best to protect your interests.

Tony Pringle, CFA
March 31, 2017

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