TD Wealth

Commentary – Q1 2018 – Sunsets and Black Swans

After a period of relative calm and complacency in the markets, the start of 2018 has brought with it the return of the dreaded V word – volatility, particularly towards the end of the first quarter. Over the past three months, anxiety about inflation, rising interest rates and a global trade wars have weighed on global markets. While these are all valid reasons for caution, looking past current consternation and towards the actual facts, continues to underpin a bullish case for stocks. Global growth is accelerating and synchronized. Earnings for the fourth quarter of 2017 were exceptionally strong and the outlook for 2018 is excellent. All of this is occurring with a Price to Earnings ratio (P/E) on the US market of 15.5 times 2019 consensus Earnings per Share (EPS) – certainly not a sign of overvaluation. Importantly, economic growth looks sustainable with, as Investment Bank JP Morgan argues, the most pro-growth policies for businesses in at last three decades.

As always, there are counter arguments, and these underpin the necessity in having a diversified approach to investment selection. In the US, the potential for the recently passed Congressional Tax Reform laws to blow a hole in the Federal deficit, and potential policy mistakes by the Federal Reserve in their management of interest rate hikes, are risks to be sure, and they are important to monitor closely.

Since the last financial crisis of the late 2000's, the term black swan event has become fairly commonplace. In the financial world, it has become normal to refer to potential risks on the horizon, using this term. The French financial giant Société Générale, even releases a quarterly list of black swan risks for their clients to be mindful of. But there is a slight problem: acknowledging an event's possibility means it cannot be a black swan. Indeed a black swan, or tail event, as the originator of the term, statistician Nassim Taleb, would call it, are occurrences that hitherto would have been considered so unlikely, that they are completely unforeseen.

Think of the example used in Taleb's book, of the life of the poor Thanksgiving turkey. In the weeks leading up to Thanksgiving, from the bird's perspective, things are wonderful. It is being fed every day, and the amounts of food seem to be increasing. Every single day that passes where this continues, will firm up the turkey's belief that the general rule of life is to be fed every day by beneficial members of the human race

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who are looking out for its best interests. That is, until, on the afternoon of the day before Thanksgiving, something unexpected will happen to the turkey. It will incur a revision of belief.

The point here is that forecasting, particularly economic forecasting, and the practice of using past results to predict anything meaningful about future events, is mostly useless. Using inductive reasoning to forecast future events, poses not just a problem of inaccuracy, it potentially has negative value.

Consider that the turkey's feelings of safety reached their maximum, just when risk was approaching its highest level. But the problem is even more general than that, and it speaks to the nature of empirical knowledge itself. Something has worked in the past so it should work again. Some branded investment products may even call themselves low volatility, because their constituent parts have displayed these characteristics in the past. Logically, this should then work in the future – until it doesn't.

And this is what the parable of the black swan is all about: It isn't just that we can't know the future, but that we delude ourselves into thinking we can, making forecasts about events that are inherently unforecastable and giving us false belief about what can or will or might happen. When a black swan event really occurs, it will seem outside what had previously seemed possible.

One great explanation for this phenomenon is outlined in Sapiens, historian Yuval Noah Harari's great book about the evolution and development of human societies. The argument is that history cannot be explained deterministically and the future cannot be predicted with any great accuracy, because it is chaotic. So many forces are at work and their interactions are so complex that extremely small variations in the strength of the forces and the way they interact produce huge differences in outcomes. Not only that, but history is what is called a level two chaotic system. Chaotic systems come in two shapes: Level one chaos is chaos that does not react to predictions about it. These systems tend to describe natural phenomena. The weather, for example, is a level one chaotic system. Though it is influenced by myriad factors, we can build computer models that take more and more of them into consideration, and produce better and better weather forecasts.

Level two chaos is chaos that reacts to predictions about it, and therefore can never be predicted accurately. Typically these systems are societal and/or cultural in nature. Commodities and securities markets, for example, are level two chaotic systems. Think of what would happen if a computer program was designed to predict the price of oil with 100% accuracy, one day into the future. The price of oil will immediately react to the forecast, due to human action, and the prediction would consequently fail to be accurate. Why? Because while the price did move, it did so right away, and hence the forecast was meaningless. The

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truth is that the stock market depends on contrasting predictions about its fate, in order to function properly, and this is fundamentally at odds with the concept of predictability.

Most major developed markets outside of North America fell in Q1/18. The MCSI Emerging Markets Index, dominated by Chinese and Indian listings, gained 0.76%, outperforming most of their developed market counterparts, and highlighting the sheer demographic force behind GDP growth in these areas, despite threats, including escalating trade tensions between the US and China.

The US stock market while experiencing better performance than its Canadian counterpart, overall during the quarter, displayed a degree of turbulence that has not been seen in some time. The S&P 500 Index (S&P500) was down 0.76%, the Dow Jones Industrial Average (Dow) fell 1.96%, while the NASDAQ Composite Index (NASDAQ) gained 2.59%, during the quarter.

At home, the Canadian economy downshifted to an annual pace of 1.7% growth in the final months of 2017. The realization that the stronger growth seen earlier in the year was now fading, saw the Canadian stock market experience a decline of 4.52% during the first quarter. Contributing to the general uncertainty in domestic equities, was the ongoing process of renegotiating the North American Free Trade agreement (NAFTA) and it showed few signs of resolution. Factor in a moderating real estate environment in stronger performing markets like Toronto and Vancouver, influenced by the federal government's introduction of a foreign buyers tax to deter speculative excess in these markets (certainly a desired outcome from an inflation perspective), and you have a recipe for softening Gross Domestic Product (GDP) numbers. Not surprisingly, the Canadian dollar (CAD) lost ground to the US dollar (USD) and fell 2.40% in value against the USD during quarter.

Lurking in the background for some time, but emerging as a major topic during the quarter, is the mounting political controversy over the development of the Trans Mountain pipeline project. The conflict here is not simply limited to head butting between Alberta and British Columbia or even a dispute involving Federal and Provincial jurisdiction over development project deemed to be in the national interest.

Rather, it is multi-faceted, in that it not only high-lights an already existing capacity road-block for the industry, which has resulted in a disparity in oil and gas revenues for domestic producers in a period where oil prices have been firming, but more importantly, has injected uncertainty in some circles as to the desirability of direct investment in Canada. The picture is complicated by the argument that expanding capacity to increase production and sales of fossil fuels, which has now been labeled a sunset industry, is wrong-headed from a long haul perspective.

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The challenge for Canadian policy makers now, from all sides of the debate, is to square the short term needs of all stakeholders, with an eye on the long term implications of planning for an industry in gradual decline, and what to do, for the sake of our future prosperity, to replace it.

Best regards,

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Montreal
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Sources: Sapiens – A Brief History of Humankind – Yuval Noah Harari; The Black Swan – Nassim Taleb; The Great Unwind – TD Economics – April 2018; TD Wealth – Straight Forward – Spring 2018; TD Wealth – Q1-18 – Quarterly Market Review

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