The Market in Review

Paul Siluch, Lisa Hill, Peter Mazzoni, and Sharon Mitchell
Financial Advisors
Raymond James Ltd. – Victoria BC

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This week's articles and insights

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"The fortune you seek…is in another cookie."

— fortune cookie message

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	26,728	+ 1.39%	+ 14.58%
S&P 500	2,976	+ 1.76%	+ 18.71% (+15.07% in $CDN)
TSX	16,575	+ 1.16%	+ 15.72%

Addiction to Prediction

Fortune telling has long been one of mankind's favourite pastimes.

Our early ancestors threw bones to determine the future. Medieval seers looked for shapes in clouds and animal entrails. Ancient mythology was full of gods and mystics who could foretell the fates of men and women, though it often came at a price. In Greek myth, Cassandra could see the future but was cursed by no one believing her. She foretold the Trojan War and the trick of the Greek soldiers hiding inside the Trojan horse, but her warnings were ignored. Or so the story goes.

Numerology – the study of the numbers in your name and your life - and phrenology – the reading of the bumps on your head – were popular a hundred years ago. Astrology is perhaps the longest-running method of fortune-telling that has persisted to this day. What they have in common is their seeking of recurring patterns. A sequence of numbers or a series of events that happened before and will happen again with the same results.

"Whatever form the fortune-telling takes, the basic process is the same: seeking meaning in random patterns and phenomenon. Some essentially random event is observed in nature (animal sounds are created, dreams are recorded) or caused to happen (tea leaves are stirred, cards are shuffled), and people closely examine the results trying to make meaning or sense of them. The human brain is very good at finding (or creating) meaning even when there is none, such as in random patterns. That's why people see faces and other images in clouds, Rorschach blots, and coffee stains. This phenomenon, called pareidolia, is well known in psychology."

Benjamin Radford - Fortune-Telling: Fact, Fiction & Fantasy

The finance business has its own unique fortune-telling system, which we call Technical Analysis. This is where we look at a chart of a stock's price and extrapolate its past movements into future ones. It is a useful tool to gauge the direction of a stock, because trends do tend to persist. However, it is also useful to remember that there are very few rich technical analysts.

Mankind's addiction to prediction has exploded since the invention of the computer. Where we once counted carefully by hand to find numerology patterns, we now use data science and machine learning to back-test data in fields from medicine to finance. Computers are very heavily used today in weather prediction and our accuracy has greatly improved, to a point. Forecasts for 5 days are close to 90% accurate, although the further you extend, the less reliable the forecast. Weather forecasts of 7 days have an 80% accuracy rate while a forecast of 10 days is just 50% correct. Day-to-day weather is less variable and easier to model, which explains our improving success rate. When more chaotic conditions appear, such as with hurricanes, our predictive ability declines sharply.

Hurricane Dorian, for example, grew to a Category 5 storm (the worst) and parts of Florida were evacuated. It chose, instead, to wreak havoc on the Bahamas and has now declined to a Category 2 storm as it makes landfall on the Florida coast. Hurricane prediction has come a long way, but still has a long way to go. In the five days before a hurricane strikes, there is still a 350 mile error rate (National Oceanic and Atmospheric Administration). This means it could strike anywhere inside a very wide target. Even the intensity and how fast a hurricane appears are very hard to predict.

The default for governments is to alert everyone when a storm forms, and to evacuate even if the risk is low.

Financial Hurricanes

Financial markets are extremely complex systems. In fact, they are likely even more complex than hurricanes and weather. Why? One person, or even a thousand, has almost no effect on weather systems. Try stopping the rain or creating a wind.

But humans can – and do – move financial markets through buying and selling. The actions of the markets affect us, and then our actions affect the markets. It is a circular causation loop.

One thing investors have noticed in the past is that stock markets tend to drop before a recession starts. This has led to the belief that the best way to predict a recession is to watch stock prices. If stock markets decline, a recession is just around the corner.

The problem is that it doesn't work very well.

"Declines in U.S. stock prices have correctly predicted nine of the last five American recessions."

- *Paul Samuelson, Nobel Prize winner in economics*

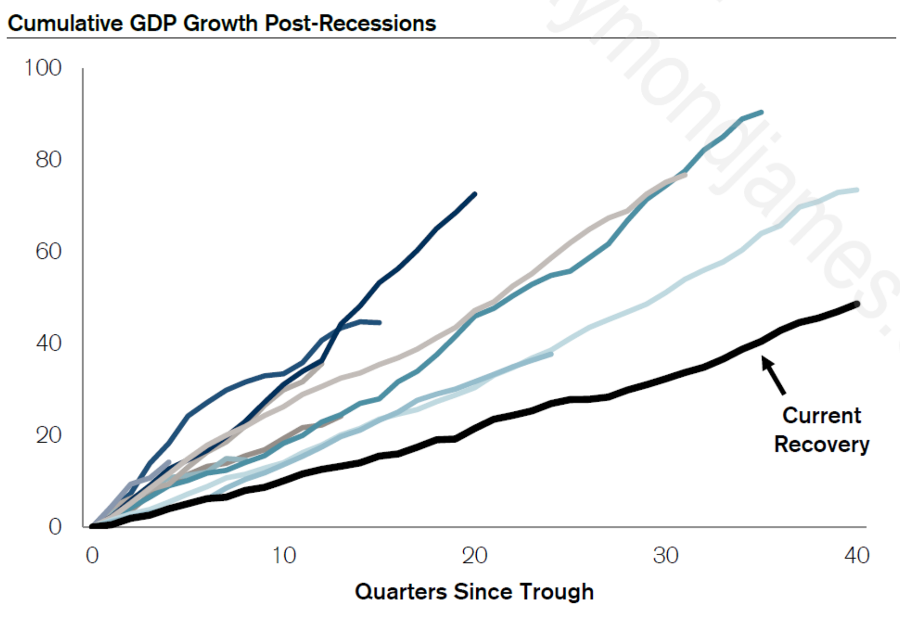
In fact, Samuelson was a bit too optimistic. Since 1945, there have been 13 bear markets (where U.S. stocks declined by 20% or more) that led to recession only 7 times. That is a 53% accuracy rate, which is about the same as a coin toss.

Is there a recession coming? Is there a bear market around the corner that will foretell it? Certainly, there are warning signs of a slowdown:

- U.S. manufacturing activity just declined for the first time in 3 years
- Consumer sentiment has also declined to 2016 levels
- The yield curve has inverted – T-Bills now yield more than 10-year bonds

US production has slipped because of the trade wars and people are nervous because of all the bad news. Both should come as no surprise. The economy has slowed, but it doesn't mean we have to slide into recession.

One aspect of today's economy is how slow the recovery has been. A slower economy has meant a longer expansion – and one that may not be done for several more years:



The current recovery is now the longest in history. It is also the slowest

Note: 1949 to present; Cumulative nominal GDP since trough indexed to 0.
Source: BEA, NBER, ISM, Haver Analytics®, Credit Suisse

Preparing for a Storm

Going back to the hurricane parallel, telling everyone to sell at the first hint of a slowdown is like issuing evacuation orders whenever any storm hits. Yes, you'll be safe, but it is also expensive to sell all your stocks or pack up the house every year. There's a lot of bottled water and canned meat you will never use.

A recent study showed that "of 153 recessions in 63 countries from 1992 to 2014, only *five* were predicted by a consensus of private-sector economists in the preceding year" (Bloomberg). So many economists missed the 2008 downturn that they are determined to raise the alarm on the next one. A full 42% of economists polled recently predict a recession by 2020 (National Association for Business Economics).

Could so many economists be right all at once this time? The odds suggest otherwise.

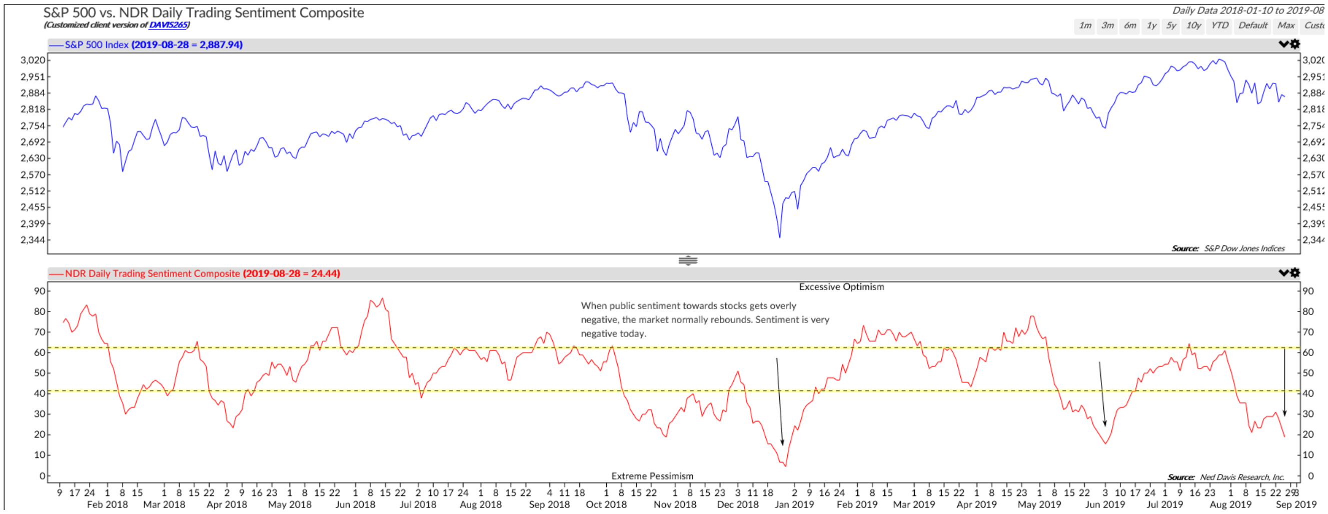
Here's how we see it:

- The next recession may be more of a slowdown than a sharp collapse. Why? Deep recessions happen only a couple of times every century, and we just had one a decade ago.

- Could stock prices decline by 20% - the technical definition of a bear market? Sure! They did last December. Then they recovered. It will happen again, and they will recover again.

- With interest rates at 1% today, and negative in many other countries, will you sell your utility or bank stock yielding 5%? No? You're not alone. This provides a floor under stock prices.

- There is so much fear in the world today, markets may already be pricing in the worst. We have rarely seen such fear in our client base, and stocks are barely down. The chart below shows that extremes like today are not times you should be selling:



Yes, September can be a weak month. It has fallen -1.5% on average in the last decade. However, September only actually declined in 2011, 2014 and 2015. The month had positive returns in all the other years.

Sometimes a storm arrives, and sometimes – like Hurricane Dorian – it is not as bad as feared. Hold on to your quality stocks and sit tight. That's what wealthy people do (hint: that's why they are wealthy). And try to ignore the warnings of an imminent crash. One may come, but it won't be because the crowd predicted it.

"The stock market contains useful information on the economy, but decades of economic research show that you cannot explain movements in the economy from stocks."

- *Lew Alexander, U.S. chief economist at Nomura Securities*

Insider Buying: Pessimists Selling to Optimists

When markets churn like they have been, it is a sign of shares changing hands.

From the pessimists to the optimists, we call it. Those that are afraid that stocks are about to fall are selling to those who think stocks have fallen far enough.

Corporate officers and directors – the “insiders” – are often those optimists. Insiders won’t always know the exact bottom for their industry, but they have a better idea of improving or worsening conditions than the average investor. This is why they have to disclose all their share purchases and disposals.

With stocks in the US and Canada near their annual highs, we have seen a fair amount of insider selling. That is not unusual. However, we are also seeing pockets of insider buying. One sector seeing quite a bit of insider buying is Canada’s energy sector, which has fallen sharply in the last year. Both Suncor (**TSX SU**) and EnCana (**TSX ECA**) have seen heavy insider buying from several officers and directors.

In the US, we are seeing insider buying in several stocks we own, including Intel (**NASDAQ INTC**), JPMorgan (**NYSE JPM**), CVS (**NYSE CVS**), and especially Expedia (**NASDAQ EXPE**).

While it may feel like the end of the world, these insiders would argue for a more optimistic outcome.

The Future of Family Practice?

Remember when cable TV was the way we all watched television? That began to change with the advent of the video cassette and video rental stores which allowed us to pay a fee to watch movies at home when we wanted, instead of waiting on the cable company’s schedule.

Where the TV world has really come apart is with the new streaming services, like Netflix (**NASDAQ NFLX**). Now, you don’t even have to get out of your recliner to watch whatever you want, whenever you want. Streaming services have completely disrupted the way we watch television at home.

The way we get family health care may be at the beginning of a similar disruption. Here in British Columbia, it is getting increasingly difficult to find a family doctor. A physician who works alone in a small office and has known you for years is fast becoming a thing of the past. Why? The demands on family doctors are high, from low fees per visit to crushingly long evenings of paperwork mean most new MD graduates don’t want the hassle. Mostly it is about economics. Our government-run medical system is encouraging walk-in clinics and hospital-based physicians to rein in costs. Old-style family doctors are retiring and can’t even give their practices away.

While there are differences between Canada and the U.S. in terms of how doctors work and are paid, the economics are similar. This kind of personalized medical care is expensive and time-consuming. And with an aging population, the demands and costs are only going to rise. The medical industry, therefore, is primed for disruption. It needs to deliver more timely services at lower costs.

The first to attempt disruption in the U.S. is the drug store chain CVS (**NYSE CVS**). CVS has over 9,600 stores in the U.S. alone and so has a huge built-in network of locations where people already go to get their prescriptions. The company rolled out a new concept called HealthHUB, which is an in-store clinic that offers vaccinations, prescriptions, lower-level diagnostic and medical care through nurse practitioners and medical assistants. The initial “menu” of offerings targets the easier medical conditions, such as pre-existing problems, check-ups, and physical exams. CVS plans on having 1,500 of these in-store clinics open by 2021.

The second entrant announced this week is Walmart (**NYSE WMT**). Its Care Clinics target the same lower level of services as CVS does, but it also publishes an on-line price list for its services. It has just three clinics open, but it plans on doing the same thing to the medical industry as it did to retail stores – become the juggernaut of affordable medical services.

For now, CVS has the edge. It has far more locations and can use its Aetna insurance arm to enroll and cover almost any new patient. Walmart does not yet have its own in-house insurance service.

Could this ever come to Canada? Many pharmacies now offer vaccinations, so check-ups and physicals can’t be far behind. Ultimately, you will probably be seeing a doctor at your local pharmacy, much as you do at a local walk-in clinic today. When you tell your kids that you used to have a doctor that looked after you for life, they’ll look at you like you just said “let’s go to the video store and rent a movie!”

Hopefully, the line-ups we face today to see a family doctor will disappear as new companies enter the medical field.

Our Dividend Value portfolios hold shares in CVS. The shares yield 3.2% in dividends.

Thank you for your referrals this month! They are always handled with great care and discretion.

http://www.dividendvaluepartners.com

We thank you for your business and your referrals and we hope you find our site user friendly and informative. We welcome your comments.

How to contact us:

paul.siluch@raymondjames.ca
lisa.hill@raymondjames.ca
peter.mazzoni@raymondjames.ca

(250) 405-2417

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Prices shown are as of close September 5th, 2019.