The Market in Review

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This week's articles and insights

1. *Surprise!*
2. *Gaming the Surprise Factor*
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"If you think the problems we create are bad, just wait until you see our solutions."

- ***Poster at Despair.com***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,439	+ 1.07%	+ 9.05%
S&P 500	2,746	+ 1.47%	+ 9.53% (+6.72% in $CDN)
TSX	15,696	- 0.05%	+ 9.59%

Surprise!

1. To attack unexpectedly
2. To strike with astonishment or amazement

Humans are pattern seekers. We evolved by watching for signs that led to food or danger, then extrapolated these into survival techniques. Lots of bees in the air? Honey must be nearby. Paw prints in the grass? Tigers could be close. We then incorporated these into our lives until something contrary happened, when our patterns were disturbed by new information.

"Surprise is an individual's psychological and emotional response to experience that does not align with that individual's paradigm and expectations."

- Jeremy Smith

While we like consistent patterns, humans also crave change. Our brains contain something called dopamine which is secreted when we are stimulated. Change – variety, knowledge - is stimulating, which causes dopamine to be released. This may also explain why modern Homo sapiens feel an addictive need to check incessantly for e-mails and texts. We are wired for it.

Not all surprises are good, of course. Native Hawaiians, for example, knew not to swim in murky water because sharks, which normally avoid humans, would attack when surprised by what they could not see.

In the 1930s, stock market analysis was revolutionized by the study of valuations. Company balance sheets were scoured more closely than ever to uncover assets in the form of hidden cash or undervalued real estate. These led to outsized returns when people realized how much a company was truly worth. We still do this today, although with modern disclosure rules, there are fewer and fewer secret treasures to be found.

In the 1960s and 1970s, new techniques rooted in psychology led to different ways of picking stocks. In particular, we began looking less at what investors were buying and more at the investors *themselves*. The analogy is picking the winner of a beauty pageant. To correctly guess the winner, you don't succeed by selecting the most beautiful contestant - you win by picking the contestant the other judges think is the most beautiful.

Why were investors buying the stocks they were, and reacting in often manic fashion? The concept of surprise was incorporated into equity analysis because it produced outsized effects. The more the market was surprised, the bigger the move in the stock price.

"The expectancy of surprise is a powerful catalyst for motion."

- Jeremy Smith

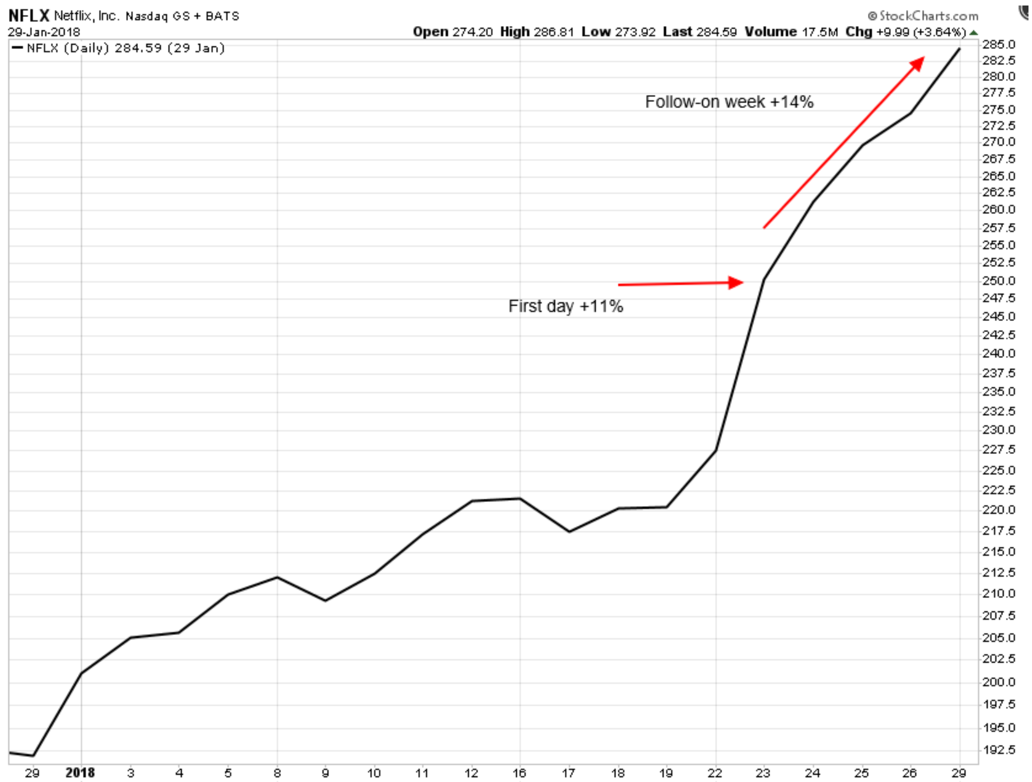
A prime example occurred in April of 1985, when Coca-Cola (**NYSE KO**) introduced New Coke. This was a sweeter version of its traditional cola and was intended to head off the growing popularity of Pepsi-Cola (**NYSE PEP**). The company suspended production of Old Coke the same day as New Coke debuted.

It was a disaster. The surprise announcement shocked loyal Coke drinkers and sent the shares down almost 10%. Coca-Cola beat a hasty retreat in the next three months and brought back the old Coca-Cola, calling it “Coke Classic.” It ended up being so successful, Coke ended up gaining market share on Pepsi, and the shares hit new highs three months after the debacle.

A big reaction to a negative surprise, and an even bigger reaction to a positive one.

The poster-child for surprises today is probably Netflix (**NASDAQ NFLX**). We have watched television in much the same way for decades, so the company’s success has certainly been a shock to the traditional TV channels. Netflix has added subscribers at a furious pace domestically, but when international viewers began to sign up in the millions in 2017, the stock soared to new highs. It also demonstrated the second effect of how surprise can affect stocks: the element of persistence.

Netflix shares rose not just for one day, but for the whole week:



“Earnings surprise” is now a key factor in stock analysis.

Surprise also helps to explain the dramatic moves in the overall market in the last six months. As we approached September last year, the world was caught off guard on several fronts:

- In August, the US implemented tariffs on $16 billion worth of Chinese goods. It shocked the world by slapping on an additional $200 billion in September.
- The first signs of economic slowdown began to show up in Asia and Europe.
- The US Federal Reserve stated it was not even close to being done with interest rate hikes. After lending and mortgage rates had already been raised six times, the Fed dropped a bomb on investors when it stated that four more hikes were in the cards.

Markets react poorly to negative shocks; hence, the 9% decline we experienced in December.

January, however, saw the reverse: positive surprises. The Federal Reserve chief did an about-face and dropped his rate hike warning. And then China and the US began talking seriously about a new trade deal. This week, President Trump delayed further tariffs on Chinese goods by an extra two months as trade talks intensify. And the compromise on the US-Mexico border wall was also viewed positively by equity investors.

All these positive surprises led to an 8.5% jump in equities here in Canada in January.

Gaming the Surprise Factor

The question is, are we too positive? Surprise works best when the news is truly a surprise. We now expect lower rates and a favourable trade deal. Markets will not be surprised when they occur.

Just as analysts began to notice how positive surprises affected stock prices, companies also took notice. By guiding analysts to lower their expectations, they could “set the bar” at a low level so they could leap over it when they reported earnings. Almost all companies today beat their estimated numbers (the average is over 70%) because they set the expectations themselves.

Some companies did this too successfully, such as the conglomerate Tyco decades ago. Once they started beating estimates every quarter, they couldn’t stop. Soon, rigged financials and dubious accounting were used to keep up the beats, and the company eventually collapsed in a giant accounting scandal and was broken up and sold.

The majority of companies don’t go this far, and the “earnings beat rate” is still a commonly followed statistic. This quarter, things are not looking as rosy as in past quarters.

Half way through US Q4 earnings season, US companies have shown an average earnings surprise of 4.0%, which is below the 5-year average of 4.8% - the first sign of slowing we have seen for a while.

Forward guidance – the estimate a company gives about the next period – has been even more lackluster. Looking out to the next quarter, 80% of US companies have issued negative guidance. They blame the strong US dollar and trade tensions for the tepid outlook. Retail sales plunged 1.2% in December, the most since September 2009, which was surprising for what is usually a strong Christmas season. It was likely a result of the stock market selloff and the partial government shutdown. Automobile production also fell 8.8%, the most since May 2009.

Before we run for the hills, we can see that employment is still solid and consumer attitudes are picking up. So, it may have just been a terrible, horrible, no good, very bad December, and that was it. The declining trend says otherwise, however.

Worst to First

Canada is an interesting outlier this year. The Great White North has struggled the last few years, thanks to low oil prices and very little foreign investment. And yet we are seeing the opposite of what is happening in the US.

Earnings surprises at Canadian companies are at an above-average +5.2%, versus the historical average of +3.4%.

Maybe it is like the 1960s novel “Been down so long, it looks like up to me”. Could this be the year Canada finally outperforms the US?

In our portfolios, we had three standouts this week, and one interesting surprise:

1. Telus (**TSX T**) – Telus added 112,000 new wireless subscribers last quarter, beating estimates of 105,000. Earnings were also ahead of expectations. The company did warn of substantial costs if they have to rip out all their Huawei switches.
2. Manulife (**TSX MFC**) – Manulife is a big insurance provider in Asia, and sales in that region jumped 19%. While earnings were flat with expectations, they plan on buying back almost 5% of the company’s shares. The company obviously sees itself as very undervalued.
3. TransCanada (**TSX TRP**) – TransCanada moved more oil and gas in its pipelines and beat its estimated earnings by 7%. More importantly, they raised their dividend by 9% - something investors always appreciate.

Finally, Warren Buffett surprised investors with a big bet on Canadian energy. For the first time in six years, Berkshire Hathaway (NYSE BRK) purchased just under 1% of Suncor Energy (TSX SU). Berkshire last purchased Suncor shares in 2013 and sold them in 2016.

We own all four companies mentioned in our Dividend Value portfolio.

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

Snowmageddon 2.0

Victoria B.C. is the warmest city in Canada, as measured by average winter temperatures. We delight in broadcasting our annual flower and blossom data to the rest of the country during frigid February, a ploy that has helped draw weather refugees for decades. It also keeps our real estate prices among the highest in the country.

This year, our hubris came back and bit us. When arctic winds reach down as far south as Victoria at a time when winter rains are heavy (we are a rain forest, after all), we can get hit hard. And this year, we did.

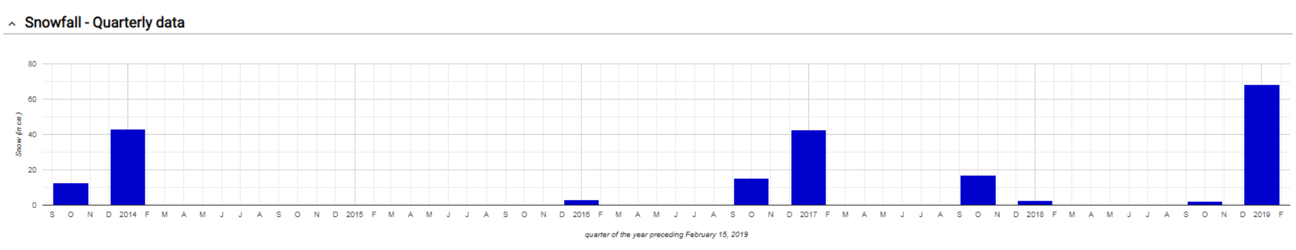
Not only was our snowfall the highest in the last five years, it was the highest over a one week period since Snowmageddon of 1996, when 4 feet of snow fell over three days.

This year, we had 68 cm, 2 ¼ feet, fall in one week. This was the highest weekly snowfall in 22 years.

Of course, Victoria has probably the fewest plows as a percentage of the population in Canada, so everything shut down.

Victoria winter driving tip:

Drive down the middle and don’t hit any mailboxes or headlights.



Source: victoria.weatherstats.ca

http://www.dividendvaluepartners.com

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Prices shown are as of close February 15th, 2019.