

Monday morning quarterback

Equities

A rally across Developed Markets in late 2022 continued into early 2023, with gains across all major equity markets in the first quarter. Internationally, the MSCI EAFE Index rose 3% (Canadian dollar terms) as optimism over an economic reopening in China supported stocks across Europe and Asia, even as the Ukraine conflict continued. In the United States, the S&P 500 Index rose 7.4%, buoyed by a resurgence in the Information Technology and Consumer Discretionary sectors, reversing part of a poor 2022 for those constituents; conversely, having been resilient over 2022, the Health Care sector was weak in all regions as investors leaned towards more cyclical industries. Domestically, the S&P/TSX Composite Index posted a somewhat more sedate 4.6% gain, with strength in the Information Technology sector largely offset by lackluster performance from Energy stocks contending with weak natural gas pricing.

Globally, a major story for the quarter was a flareup in volatility across the Financial Services sector, with three banks failing in the US, followed immediately by pressures in the Swiss banking system. Canadian banks have thus far largely escaped the same degree of scrutiny, although, across all markets, the Real Estate sector was also a laggard group as investors worry about the possible impact on funding cost and availability from banks in coming months.

At quarter end, markets sit at an interesting juncture, with central banks still focused on battling inflation but now forced to consider the impact on the banking sector if interest rates continue to rise. At the same time, investors are monitoring if small tremors in the commercial real estate market will percolate into something larger, while remaining watchful for signs of stability in housing markets after declines last year. Equity market valuations have increased due to Q1's gains but remain at attractive levels following a weak 2022, reflecting a degree of investor skepticism, and are potentially well placed to continue climbing the proverbial "wall of worry" over the remainder of the year.

Fixed Income

Fixed income investors' hopes for a more benign backdrop following two painful years have been unmet so far through 2023. For sure, the positive performance for the first calendar quarter is a welcome change from the red that has come to colour bond portfolio investment statements since 2020 (the FTSE Canada Universe Bond Index generated a 3.2% total return, marking its best quarter since Q2 2020; all bond sectors finished the period in the green), but the elevated volatility that saw yields whipsaw through the quarter did not help lessen investor anxiety.

Market yields drifted higher through the quarter as the economic dataflow continued to surprise to the upside and spurred a repricing of the expected path for policy rates and their ultimate terminus. Financial stability concerns that came to a boil following the failure of three regional US banks and rising pressures overseas that precipitated the merger of two large Swiss financial institutions, however, saw an abrupt reversal in the final weeks of March and underpinned a significant drop-off in global government bond yields — the 2-year Government of Canada note yield finished March at an 8-month low of 3.73%, 32 basis points below its level at last year's end level; the 10-year yield ended Q1 down 40 basis points for the quarter at 2.90%, also an 8-month low.

Bond market volatility is likely to remain elevated in the months ahead as markets parse every piece of data and policy comment to see how the gap in the outlook for rates between traders (that are anticipating risks to growth and financial stability to result in rate cuts later this year) and central bankers (that remain focused on inflation and retain a hawkish bias) gets resolved.

That said, the performance outlook for bonds remains fairly constructive. With hiking cycles at minimum nearing their endpoint, there appears to be fairly limited scope for upward pressure on rates from their current levels — and the yield on offer should be more than sufficient to offset the impact of an increase in rates. As well, the persistent uncertainty over the outlook and reemerging risks of a nearer-term downturn could support fixed income, particularly those issues higher up the quality curve.

Commentary

Decision-making is easier and more straight-forward if it can be done after the fact.

Not only knowing the outcome but also having full and complete information clearly indicates the appropriate course of action — the sequence of events leading up to a moment is obvious and the ultimate result is entirely predictable with the benefit of hindsight.

The Monday morning quarterback knows exactly what play to call for the pivotal moment when the fumble-causing overload blitz came on Sunday; market pundits can highlight what former top pick was a clear “sell” at the prior market peak; central bank watchers can deftly prescribe the stance that should have been adopted last year to avoid a looming policy mistake.

Of course, the post-hoc examination of an event is pretty useless — the event has already played out and a (sub-optimal) decision had to be made amid uncertainty and with incomplete information.

In fact, while it is true that understanding history can help to avoid the pitfalls of the past, research into human behaviour shows that such study (particularly surrounding major and negative events) can result in hindsight bias that can actually be harmful to future decision-making, potentially making that backward-looking analysis worse than useless. The clarity of reflection leads to the belief that the world is a far more predictable place than it actually is and that forecasts made at the time were more accurate, and for the right reasons, than they actually were.

The unwarranted high conviction that the future is knowable can lead investors to believe that the market can be accurately timed, with downswings avoided and rallies participated in fully.

Relatedly, the false confidence in what is going to come endowed by hindsight bias can leave investors completely unprepared for the unexpected — as Nobel Memorial Prize-winning behavioural economist Daniel Kahneman noted, “hindsight bias makes surprises vanish.”

Of course, the future is inherently uncertain and chock full of surprises, and change often happens abruptly and without warning — even if it all the signs were apparent after the fact.

The likelihood of an investor accurately calling a market top like the Tech Bubble peak on March 24, 2000, or calling the cyclical bottom such as those seen on March 9, 2009, or March 23, 2020, is slim, and the odds of doing both consistently are virtually zero — and even being a day late can have significant negative performance implications in the long-run.

Moreover, unanticipated shocks that impact the trajectory of the economy (and financial markets with it) are not a rarity — something that was again emphasized this past month when the market momentum established late last year was (at least temporarily) derailed by the failure of a regional US bank on March 10. It sent panic into the world that the financial system was perhaps not on its soundest footing and triggered memories of the surprise collapse of Bear Stearns almost exactly 15-years ago that teased the broader financial crisis that followed. The adverse impact of these events on unchecked risk exposures can have lasting negative consequences and spur rash decision-making.

Obviously, controlling these impulses that serve as a detriment to successful long-term investing — through inadequate risk management, excessive and ill-timed trading, and undisciplined reactions to periods of uncertainty and stress — is easier said than done.

But as with most things related to psychology, simply acknowledging that there is a problem that needs to be addressed is a good first step.

The next is seeking qualified help, and with respect to your finances, a trusted advisor can serve to help rein in those worst impulses and create a plan centered on achieving longer-term objectives — this does not mean finding a way to make “better” predictions, but developing an investing framework that considers a wide range of potential outcomes to help better navigate an uncertain world.

Hindsight is always clearer than foresight, but even the best Monday morning quarterback will not help anybody avoid getting blindsided on gameday.

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Q1 IN REVIEW

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