Huggan White Wealth Management

Protect Capital. Manage Risk. Provide Income.

Investment & Strategy Commentary

April 2018

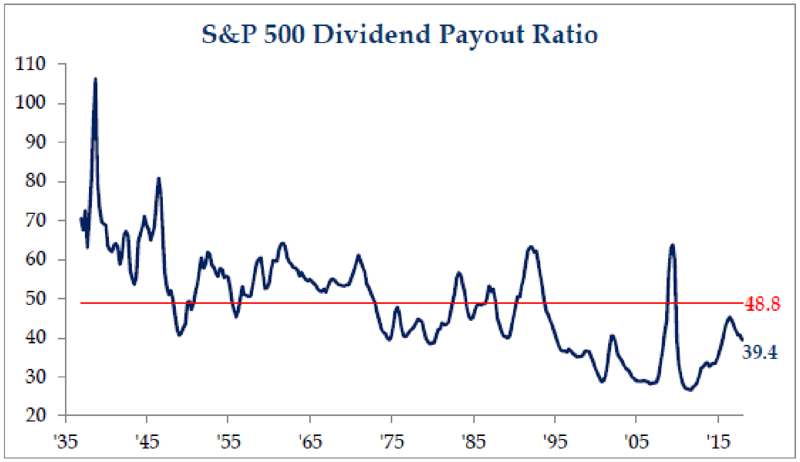
For the first time in more than two years, the stock market experienced a genuinely rough quarter. The year started with a powerful rally but just as optimism seemed borderline euphoric, concerns over the effects of rising interest rates bubbled to the surface. Counterintuitively, the concerns stemmed from a fear the economy was doing a little "too well". The thinking goes that a strong economy and accompanying inflation would justify raising interest rates at a more aggressive pace than previously anticipated. The spillover was the threat that higher interest rates and any missteps by central banks could potentially tip advanced economies into recession; rhetoric that has been noticeably absent since late 2015 when oil prices were collapsing. Furthermore, concerns over a brewing trade war, which were ignored by the markets for all of last year, also added fuel to the fire. These inputs challenged the mindset of investors as the "goldilocks" environment that we have enjoyed over the past few years (just the right amount of growth and just the right level of interest rates) may have reached a point of vulnerability and caution should be warranted. In response, volatility spiked throughout the quarter and the mindset and mental fortitude of investors was once again challenged as uncertainties emerged. Yet based on our work, we believe these concerns are transitory in nature and we remain confident that our current positioning should continue to work well in today's environment and one potentially riddled with heightened volatility as we move forward.

A question being asked by many market participants is an important one: *Is the recent correction and associated volatility a sign of a coming recession? The short answer is "maybe, maybe not."*

Certainly, the escalating trade disputes between China and the USA, along with a host of related events such as the renegotiation of NAFTA, pose threats to the long-term outlook for global growth. We cannot think of a publicly traded company that would not be affected if there are interruptions to global trade. For now, we believe the announced actions should do little except result in potentially higher costs being passed along to end users, if implemented. If the "tit-for-tat" trade sanctions between the world's two largest economies progresses into actual disruptions in trade, the fallout could upset the positive outlook for corporate earnings. Those same events could spillover and have negative implications for consumers, employment, and a host of measurements relating to economic performance. In other words, at the height of optimism regarding the medium-term outlook for growth, a short-term fear of politically-induced recessionary forces has potentially emerged. Perhaps a better question though, is after the recent ~10% correction from peak to trough, how much of this trade disruption has already been priced in? If the market is a discounting mechanism, than likely a large majority of it has been accounted for.

While the macro picture has indeed been clouded by political gamesmanship, let's not forget what precipitated this correction was a fear of the global economy doing "too well". Lost in all of this has been a plethora of corporations announcing increases in capital spending and progressively favourable wage increases. Since the financial crises, corporate conservatism has restricted capital investment, as a lack of visible growth opportunities and a restrictive US tax environment incentivized companies to favour buying back their own stock rather than pursuing organic growth. We are now seeing and hearing evidence that this is starting to change as a more favourable tax code and talks of a $1.7B US infrastructure plan have companies preparing for economic expansion. By and large, corporate balance sheets are in excellent shape as they have been in a decade long repair since the financial crises. Strong balance sheets and accommodative monetary policy (interest rates) relative to historic levels should enable companies to pursue forecasted growth opportunities. Indeed, growth in almost every sector has continued to surprise analysts on the upside and the global synchronized recovery remains foundationally strong.

From a portfolio perspective, we are constantly evaluating our asset allocation assumptions and continue to scrutinize our individual holdings against this changing backdrop. In spite of higher interest rates and increased volatility, we remain confident equities offer a better risk adjusted return than bonds or cash in the medium and long term. Additionally, our investment process tends to favour companies with "boring" profiles. As such, we prefer to invest in firms with long term track records of dividend growth, high free cash flows and above average returns on equity. In recent years this has resulted in excluding some of the best performing companies that are grabbing the majority of market headlines. The likes of Amazon, Tesla and Netflix are all great businesses with terrific products yet they don't quite pass our investment screens. During the recent correction it has benefitted our clients that we have owned more stable businesses that are exhibiting less volatility and have remained committed to their dividend policy. Over the years this strategy of focusing on dividends as a contributor to total return has assisted greatly in portfolio performance. The good news is that after years of



relatively benign dividend growth rates, there remains ample room to increase the payout ratio as seen in the chart above (Strategas). Essentially, this represents a "pay raise" for clients and their portfolios if corporations begin to improve upon their return to shareholders through dividend increases.

In the end, our goal of constructing and managing portfolios is to capture as much of the upside as possible in good years while avoiding as much of the downside as possible in challenging years. Over time this has resulted in consistent risk adjusted returns and a more comfortable client experience. Managing risk is in large part about building durable portfolios that can withstand any environment. Despite the recent quarterly bumps, we are encouraged with how our client portfolios behaved throughout this correction. Often times, our portfolios look materially different than referenced indices such as the Toronto Stock Exchange or the Dow Jones Industrial Average and this quarter was no different. In fact, based on most performance metrics, our Canadian portfolio outperformed the TSX by over three percent. With markets now looking more buoyant, we should emerge from this corrective process far ahead of comparative benchmarks and passively managed strategies.

Finally, if the upcoming corporate earnings season is another one dominated by positive surprises (so far it has been upbeat), then the stock market does not look expensive at current levels. Any improvement in global trade disputes should be celebrated by the market. Higher interest rates need not be feared so long as they accompany a growing global economy, which looks to be robust at this juncture. Going forward, we are well positioned for the next leg of growth, but if we are proven wrong by the market's recent volatility, the companies that we own will not only endure but likely outperform based on the strong underlying fundamentals of their businesses.

We will keep you updated.

As always, a few charts for your consideration.

Sincerely,

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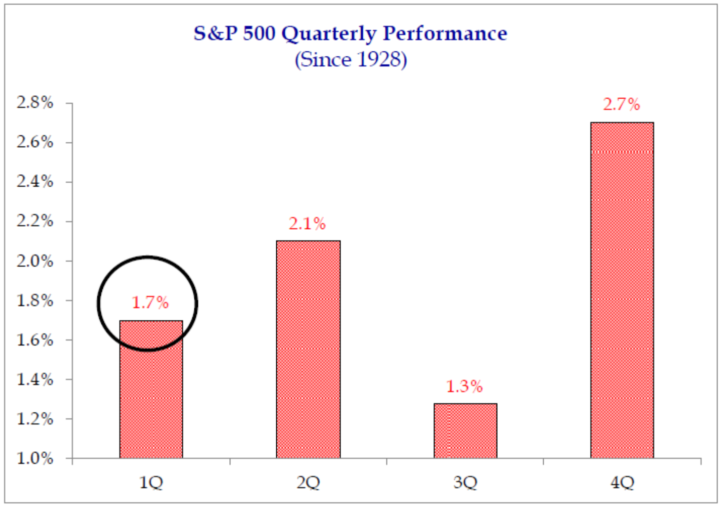
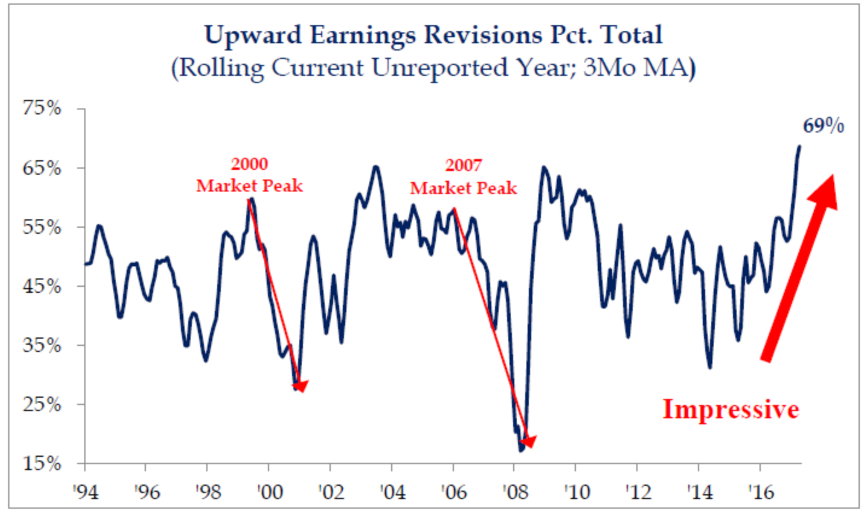
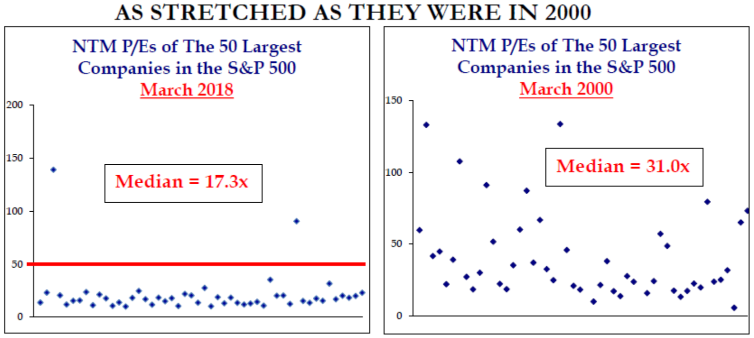




VALUATIONS TODAY NOT NEARLY
AS STRETCHED AS THEY WERE IN 2000



Net Flows into Mutual Funds + ETFs ($BN)						
	Domestic Equity		International Equity		Bond	Money Mkt
Year	MF	ETF	MF	ETF		
2009	(27.6)	30.9	29.6	39.6	417.2	(539.1)
2010	(81.1)	46.7	56.7	41.5	262.0	(525.1)
2011	(133.3)	47.3	4.1	24.3	163.7	(124.1)
2012	(159.1)	80.9	6.4	51.9	358.5	(0.2)
2013	18.1	104.1	141.4	62.8	(59.0)	15.0
2014	(60.2)	141.5	85.4	46.6	94.5	6.2
2015	(170.8)	65.4	93.9	109.7	29.4	21.5
2016	(235.4)	167.6	(24.5)	20.1	190.1	(30.3)
2017	(236.0)	186.0	76.7	159.8	381.1	106.9
2018 YTD	(44.1)	13.6	28.7	36.7	58.6	(9.0)
TOTAL	(1129.4)	883.9	498.4	593.0	1896.1	(1078.3)

Charts Sources: Strategas