HugganWhite Wealth Management

Protect Capital. Manage Risk. Provide Income.

Second Quarter 2017

"Cadence"

As many readers of these commentaries will note, yours truly has a tendency to test himself across various forms of physical challenges. In the past these "tests" have included marathon running, tough mudder competitions, back country skiing and my "fair weather" favourite at this time of year, cycling. Not surprisingly, a few weeks ago I found myself once again tethered to my six inch saddle, dressed in none other than Raymond James blue spandex, slathered in 50 block sunscreen, traversing the roads of southern British Columbia. This journey had a group of six cyclists travel from the B.C./Alberta border to the beautiful shores of Victoria B.C., encompassing 900kms over seven "numbing" days in support of the BC Cancer Foundation and Prostate BC. Unfortunately, my journey had to be shortened due to prior engagements, but I was still able to participate in 550kms and experience all of the beautiful topography that this province has to offer.

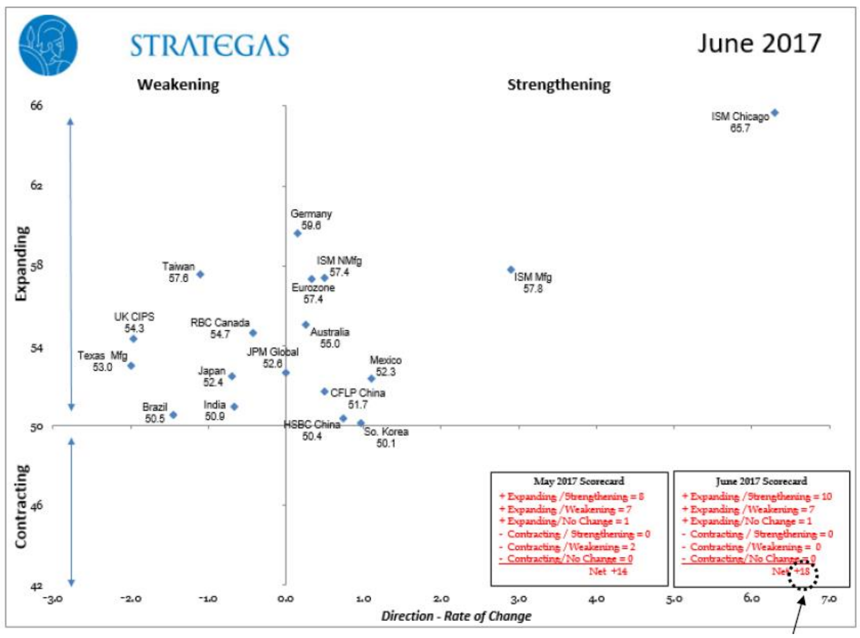
To be successful during these lengthy encounters, it is vitally important to track and monitor your output known as watts and cadence. Wattage is the rate at which your energy in consumed, while cadence is the revolutions of your crankset per minute. Optimal cadence suggests that 90 rpms per minute is most efficient on flat surfaces, with an expected reduced cadence of 50-60 rpms when ascending. During descent, cadence greatly increases as gravity becomes a cyclist's best friend, but a high cadence can lead to instability and cause injuries to joints and ligaments. That's why maintaining a consistent cadence at the optimal pace will create a more efficient pedal stroke, while reducing wattage, and allow for the rider to reach the finish line with far more ease and comfort. An uneven cadence will cause imbalances and inherently create more risks. As Albert Einstein once noted, "Life is like riding a bicycle, to stay balanced you must keep moving".

When it comes to portfolio management, one can relate an investor's cadence to his or her ability to maintain a consistent pedal stroke as well. The pedal stroke in this case, though, is finding the optimal strategy that complements the ever-changing landscape; from range bound markets (flat surfaces), to descending bear markets (valley bottoms) to bull market peaks (mountain tops). Adhering to that process and strategy at all times is integral to one's success. At HugganWhite Wealth Management, we are always looking to perfect our "pedal stroke" and work hard to ensure that our client portfolios are operating at or near the optimal cadence. By focusing on this end goal each and every day, we believe our clients' success in crossing that "finish line" with far less output (wattage or energy) is greatly increased. In essence, we strive to be the Eddy Merckx of the investment industry on behalf of those who have entrusted us with their wealth.

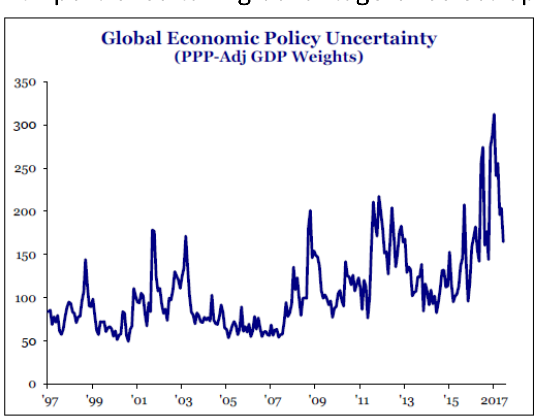
In this month's newsletter we will provide an update on strategy, touch on a number of charts that have caught our attention and finish up with a review of our favourite talking points. To summarize this newsletter with a few short expressions, "our chains remain well-greased, with no signs of air leaks and plenty of road well ahead for all of us." We hope you enjoy!

With the passing of the second quarter, we are now officially half way through the calendar year. Much of the second quarter was similar to how the first quarter ended, with a lot of attention still focused on Washington machinations and the inability of the political "elite" to achieve any meaningful accomplishments on either healthcare reform or clarify their pro-economic agenda. One might expect that markets would view these constant delays as a negative, as the ability for the new administration to move forward becomes more arduous, but underlying support held and the resiliency of stock prices to trade near all-time highs was the chosen path for U.S. markets over the quarter. This is likely a reflection of an environment that is still being held up by strong business confidence, economic data that remains buoyant, earnings that should print another quarter of high single digit growth and a credit cycle that remains hospitable (we will address each one of these in the pages ahead).

For the quarter the S&P 500 total return tacked on 3.1%, the Dow Jones Industrials managed a gain of 3.3% , and the NASDAQ gained 4.2%. Even the economically sensitive Dow Jones Transportation Average closed in the black with a gain of 4.9%. As for the Canadian market, the TSX once again struggled for the quarter, printing a loss of -2.4% as commodities weakened and financials partly lagged. The big news for Canada was the strength in the "loonie", as reports mounted that the Bank of Canada will likely raise interest rates in July, the first time since 2010. These rumours, that now appear to be a reality, resulted in a ~7% gain in the Canadian dollar relative to the U.S. dollar, with the market pricing in a 90% certainty of a 25 basis point increase at the time of print. As for global markets, it appears that the extreme uprising of populism across Europe has been delayed, with elections in the Netherlands and France resulting in a more comforting and sanguine outcome as opposed to one plagued with protectionism and potential disorder. This lifting of uncertainty allowed investors to once again focus on the improving economic data coming out of the Eurozone, and in turn lifted many leading indices to multi-year highs.

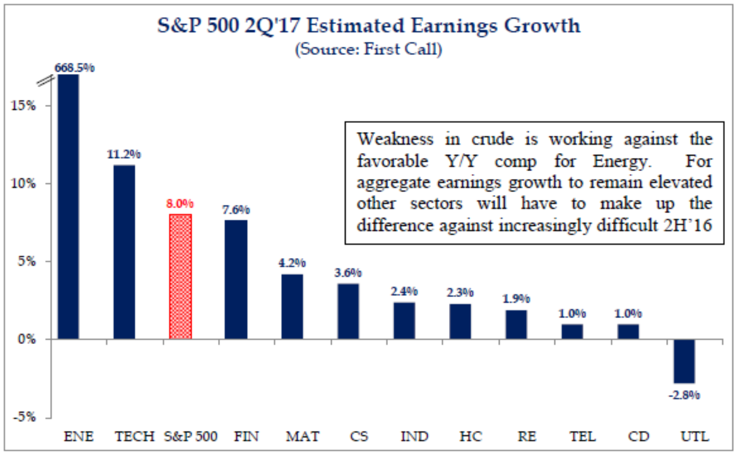


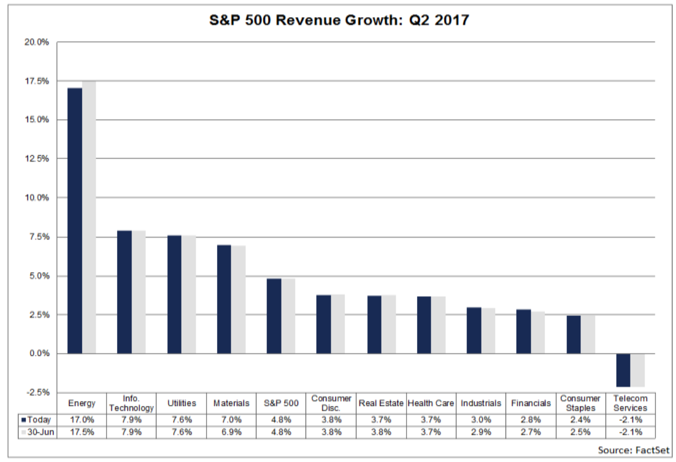
Evidence of this global economic growth theme can be seen in the chart to the right, which shows global surveys remain in an expansionary phase, with a number of key economies such as the Eurozone, Germany and the U.S. leading the way. Of note again though are the weakening figures coming out of commodity based economies such as Australia and Canada, with the "peak" in Chinese headline data also catching our attention more recently. In addition to these generally upbeat readings, we have also seen a significant reduction in the global economic policy uncertainty index, which spiked to a 20 year high earlier this year (lower chart). In response, bond yields across a number of peripheral European countries dropped to multi-year lows and relative spreads tightened across keynote yields such as the French 10 year and the German 10 year bund. These are positive developments as the once beleaguered Eurozone appears to have found a footing and the "green shoots" that once sowed the seeds of economic growth here in North America appear to be emerging after years of disappointment and impairment in this region. Our strategy and work over the past number of quarters has been reflective of these changes with portfolios taking advantage of select opportunities in pockets of Europe. Going forward, we continue to look for investable ideas within this region as part of our mandate to maintain a geographically diverse portfolio within the equity component.



Moving back over to this side of the Atlantic, we continue to believe North American equities offer the most attractive risk-reward for those looking to build wealth over the medium to longer term. More recently, we have seen an increase in negative commentary as a number of forecasters are whispering warnings of recession and even hints of an ensuing bear market. The backing for these calls stems from the belief that stocks are expensive, the yield curve appears to be inverting, consensus and sentiment is outright bullish and the current bull market is long in the tooth. We respectively disagree as we are not seeing signs of a “topping” process at this juncture.

First off, the earnings recession that started in 2015, and lasted five quarters, ended in the fourth quarter of 2016. Despite weaker crude prices that are hampering earnings contributions from the energy sector year to date, second quarter earnings estimates are calling for 8.0% earnings growth in the year over year comparison. This follows a strong first quarter of 2017 in which we saw ~10% earnings growth; second quarter 2017 contributions will likely again be led by financials, information technology, materials and real estate. Weak spots will be reflected in utilities, consumer discretionary and telecom, areas of the market that we have been underweight within portfolios. As for revenue





growth, we also expect to see mid-single digit growth rates of around 5%, with 10 out of 11 sectors showing upbeat numbers. Looking out for the remainder of 2017, if earnings growth can remain in line with expectations, aggregate numbers should come in around $130 for the S&P 500, allowing for a current price to earnings multiple (P/E) of 18.7x. Any surprise earnings “beat” and our forecast may prove to be too conservative. (As a side note, we are not pricing in any favourable corporate tax cuts being proposed by the Trump administration). Yet, many continue to focus on the trailing P/E multiple, which does print a multiple above 20x, but these perceived stretched valuations should also be considered in the context of interest rates and inflation, which are materially different than the double digit figures seen in the 1970s and 1980s. Thus, we prefer to look forward and view valuations in an environment that justifies higher multiples and supports the thesis that quality equity should demand a premium.

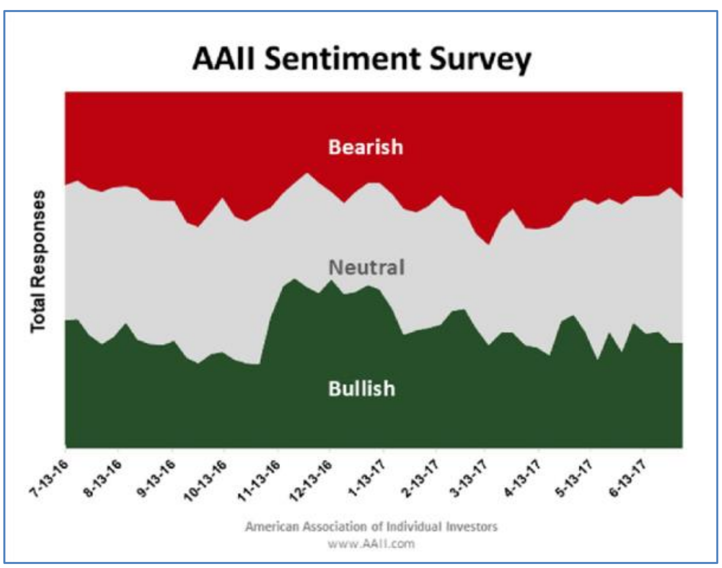
Turning over to interest rates and the bond market, as mentioned above, the Bank of Canada appears to be pulling in the reigns of their ultra-accommodative monetary policy. Recall, that since the financial crisis of 2008/2009, the majority of global central banks have embarked on a strategy to stimulate economic growth through loose credit conditions. The end result has been a significant increase in central bank balance sheet liabilities, yet the velocity of money has remained subdued. Moving forward, we believe that could change if an agenda lined with financial deregulation comes to fruition, which would result in an increase in money flow (easier access to credit) and foster further economic growth. The corollary of this would likely be higher inflation, which has so far remained within the “bandwidth” of the Federal Reserve’s comfort level. As the Fed’s dual mandate is to maximize employment while maintaining price stability, the former has not been of a concern as the U.S. unemployment rate is now at post crisis lows. Conversely, according to the Fed, inflation expectations, which were soft in the first quarter, are expected to pick up in the second half of this year as GDP growth improves. This outlook prompted the Fed to increase rates another 25 basis points in June, the second increase of 2017. Yields on shorter term bonds moved higher, with the 2 year (1.39%) and 5 year (1.93%) bond yields showing gains, while the bellwether U.S. 10 year treasury yield closed the quarter around 2.3%. This is essentially where the 10 year entered the quarter in April, yet the closing of the 2 year and 10 year spread has caused many to suggest an inversion of the yield curve is developing. (An inverted yield curve is an interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality. This type of yield curve is the rarest of the three main curve types and is considered to be a predictor of economic recession.) We disagree and view the recent “normalization” of monetary policy as a reflection of a more selfsustainable economic environment supported by growth and inflationary trends that are transitory as opposed to permanently muted as seen in first half CPI data. Over the coming days, we will be closely watching incoming data and how the bond market reacts (higher yields?) on the short end of the curve. For the time being though, we believe the Fed will remain temperate in their policy and outlook for the remainder of 2017, as additional tightening does carry a risk of eating into further growth potential. Longer term though, we believe that the path of least resistance is ultimately higher rates and yields and the 35 year run for bond prices has duly run its course.

As for consensus and sentiment, our work continues to point to hesitation in the retail investing public mindset. In conversations with investors, institutions and other portfolio managers, we have heard disbelief, lack of trust and a general feeling of uncertainty remain at the forefront. Allocations and fund flows are representative of this view as can be seen in the chart to the right. As we can see, the ongoing redemption of equity based domestic mutual funds has continued well into 2017, with the majority of both domestic and international equity flows benefitting ETFs (passively managed ETFs which is cause for concern and a topic for another newsletter). Amazingly though, despite the fact that equity markets are at/near all-time highs, the highest net inflows are still finding their way into the bond market. With our cautious outlook on rates and bond prices as mentioned above, we feel that the $1.6 trillion dollars that has found a home in the "safety net of bonds" may be exposed to a few headwinds moving forward and allocations will need to be adjusted accordingly.

Net Flows into Mutual Funds + ETFs ($BN)

Year	Domestic Equity		International Equity		Bond	Money Mkt
	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 YTD	-57.7	70.1	23.6	74.0	170.2	-77.9
TOTAL	-907.0	754.4	416.6	470.5	1626.6	-1254.0

Further evidence of this reluctance can be seen across the most recent American Association of Individual Investors survey (chart below), which once again showed that those with a bullish outlook remain 9% below the historical average of 38.5%, while those that carry a neutral or bearish outlook account for more than two thirds of all surveyed. Certainly not a sign of optimism or euphoria that is often associated with market tops.



From a technical perspective, most of the indicators we follow are showing signs of strength and a generally healthy underlying environment for stocks. Of note: 1) the advance/decline line surged to new all-time highs, highlighting that participation remains broad as advancing issuers continue to outweigh declining issues on the NYSE; 2) the Dow Jones Transportation Average broke out to new all-time highs, confirming the Dow Jones Industrials and thus signalling another Dow Theory buy signal; 3) the small-cap Russell 2000 hit a new all-time high; 4) the ISM manufacturing sector data is once again near a post-recession high; 5) net long positioning for the S&P 500 has fallen more recently, indicating that speculators are not aggressively bullish. Net long positioning for fixed income remains elevated; 6) credit spreads are at fresh new lows; 7) banks and financials, often seen as leaders, are once again trending higher and gaining momentum; 8) recent weakness has been mostly contained within the technology sector; 9) homebuilders are breaking out and; 10) the slightly weaker U.S. dollar should help repatriated profits. On the negative side, 1) weakness in crude oil is mildly concerning, as correlations between WTI and equity prices remains relatively tight; 2) complacency in the volatility index (VIX) as seen at these levels, has a tendency to reverse course quickly; 3) seasonality indicates that the third quarter is historically the worst quarter of the year (although still positive at 1.2% since 1928 – bottom chart next page); 4) mega cap names which are widely held across passively managed ETFs, could mask the positive performance of other constituents should they fall further, as they command the largest weighting on most major indices. This may be the catalyst that shapes the appearance of a more serious "headline" pullback or correction; 5) political partisanship gains additional traction and boils over into delayed policy implementation; and 6) a geopolitical or black swan event shocks the market (we do not invest or base our decisions on an unknown and unpredictable event such as this).

As for portfolio management, the transition to our Private Investment Management Group (PIMG) has been a great success thus far. The feedback from clients, who have been introduced to PIMG, has been extremely positive as they also see the many benefits that this platform offers. The individual tailored asset allocation, greater transparency, individual tax planning, increased trading efficiencies and lower management costs are all highly beneficial and are "tools in the box" that we can utilize to further enhance our offering. However, the change of individual positions will take time as we want to diligently manage that process and ensure that we are exiting or entering names when timing is best. With so many names/strategies already "best in class", we are looking to tweak portfolios and only introduce positions that will enhance return, without assuming undue risk.

This was carried out in the second quarter as we reduced our exposure to a number of underperforming energy names, while we continued to add to consumer staples, insurance companies, large cap technology and midstream energy infrastructure. Our U.S. exposure remains in line with our targeted allocation as we added to names like Metlife, Starbucks, Las Vegas Sands, Alibaba and Whole Foods (which was recently targeted by Amazon) in select portfolios. <u>The strength of the Canadian dollar in the month of June did impact total return for our U.S. positioning, but we believe the business fundamentals of the companies we own far outweigh the impact of currency over the medium to longer term</u>. Our dividend focused portfolio showed strong relative performance over the quarter, as cash flow helped offset some of the weakness seen across the Canadian market. Our very limited exposure to commodities, materials and precious metals has served us well as these sectors continue to be challenged in the face of a weak commodity price environment. At this time, we are also looking to increase our global exposure and are considering a few different names in developed parts of Europe. We are also carrying out some extensive research on the Japanese market as our contacts have brought this to our attention as a possible investible theme. Look for ideas or implementation on the global front in the coming weeks.

In summary, we are very pleased with the positioning and performance of the portfolios over the quarter. Our focus going forward on the equity side will be on high quality, dividend paying names, while the fixed income component will be on shorter term, corporate issuances that carry a solid credit rating and offer attractive liquidity. As always, our main focus will be to protect your capital, manage the volatility and ensure that we provide an acceptable rate of return that compliments your risk tolerance and longer term objectives. **And finally, if you find that your cadence is slipping, please do not hesitate to call any member of our team. We are here to ensure that your pedal stroke and balance remain optimally strong and your momentum is always moving forward.**

Thank you for your trust and confidence in allowing us to manage your financial affairs. We will keep you updated moving forward. (P.S. - A few charts of interest on the final page for your consideration)

As this is the first time clients will be seeing our new design for their quarterly PIMG statements, should you have any questions or comments regarding the layout, please do not hesitate to call Sherri or Diana. Sample attached below.

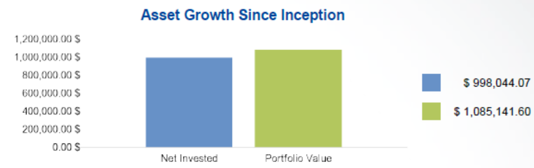
HugganWhite Wealth Management

Portfolio Summary

Period from April 1, 2017 to June 30, 2017

Activity Summary

	This Period ($)	Year to Date ($)
Opening Portfolio Value	1,080,314.14	1,055,945.34
Net Invested (Deposits less Withdrawals)	0.00	0.00
Net Income (Dividends & Interest)	10,087.64	21,272.61
Management Fees	-3,532.07	-6,903.18
Change in Market Value	-1,728.11	14,826.83
Ending Portfolio Value	**$ 1,085,141.60**	**$ 1,085,141.60**



Asset Allocation

	Current Asset Value ($)	%
Cash & Equivalents	15,476.74	1 %
Fixed Income	205,876.27	19 %
Equity	649,263.49	60 %
Alternative Investments	214,525.10	20 %
Total	**$ 1,085,141.60**	**100 %**

Investment Policy Objectives

	Min %	Target %	Max %
Cash & Equivalents	0	**0**	0
Fixed Income	0	**30**	50
Equity	50	**70**	100
Alternative Investments	0	**0**	10

Portfolio Performance

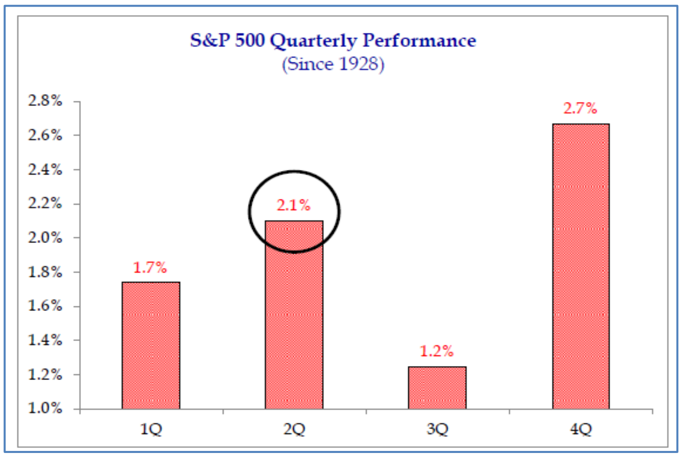
Description	3 Months	Year to Date	1 Year	Since Inception
Time-Weighted Net	0.45 %	2.76 %	10.16 %	6.23 %

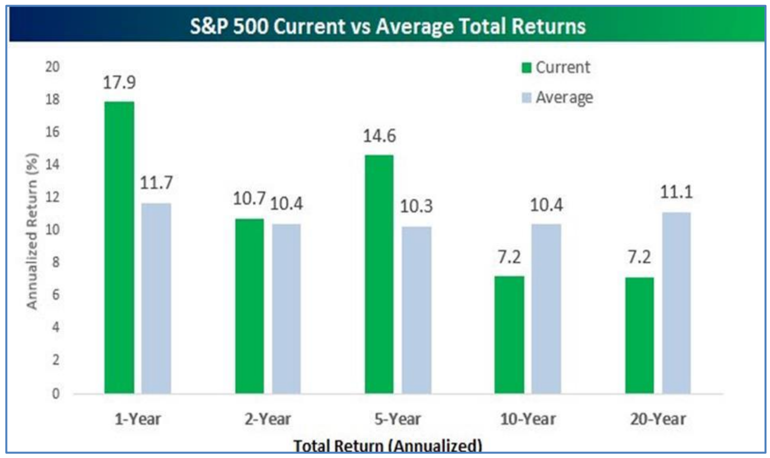
Values in percentage are annualized for periods of more than twelve months.
Accrued income is included in the market value.

Account Summary

Account	Currency	Name	Account Type	Program	Description	Inception Date	Market value
11111MA0	CAD		Investment Account CAD	PIMG		03/22/2016	$ 1,085,141.60
Total							**$ 1,085,141.60**

Reporting Currency: CAD





Sincerely,

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HUGGANWHITE WEALTH MANAGEMENT

RAYMOND JAMES®