# Huggan White Wealth Management

***Protect Capital. Manage Risk. Provide Income.***

## Investment & Strategy Commentary

**January 2017**

*"Don't Look Back…You're Not Going That Way!"*

Based on the host of indicators and data points we monitor, most would agree that 2017 was a successful year for investors and markets in general. Looking back some 12 months ago, the majority of conversations we encountered centered on the tepid outlook based on newly elected President Donald Trump. Hesitation, angst, doubt and pessimism come to mind. This was also reflected across the media, who remained fixated on their disbelief and shock that such an outcome was even possible. This scepticism gained momentum as the new administration put forth an "agenda" to proceed with many of the changes and underpinnings that were proposed throughout Trump's campaign. There were ongoing geopolitical tensions between North Korea as the battle for nuclear supremacy materialized; efforts to repeal and replace the Affordable Care Act (known as Obamacare) became more prominent, while the political malaise inside Washington morphed into a daytime soap opera as collusion, firings and partisanship become the "norm". The fourth quarter saw a major hurdle overcome as tax reform was passed, marking a significant victory for Trump and his Republican team. Meanwhile, Canada was riddled by weakness in the commodity space as energy and resources continued to struggle from the hangover of the 2014-2016 oil rout. Our Federal Government's domestic spending habits remained under strict scrutiny as global investors fixated on increasing deficits and limited contributions from the energy and material sector. Furthermore, Canada's extremely elevated debt levels continued to move higher as generationally low mortgage rates added more fuel to an already overheated housing market. The back half of 2017 did produce some more upbeat data, but as a whole, these aforementioned headwinds were the *causa proxima* that pushed the Canadian stock market to the bottom of the performance scale relative to its developed peers.

Despite what appears to carry a negative overtone as noted above, equity markets marched to new all-time highs here in North America in serene like fashion. Outperformance was seen across U.S. indices as they posted some of their strongest gains since the Financial Crisis, while the TSX Composite Index managed to produce mid-single digit gains. This was also realized in European and Asian markets, further underscoring the belief that the global growth theme is alive and well. With a number of incoming data continuing to show positive momentum, we believe the catalysts that have supported global economic growth remain intact and should support a further extension of this theme.

Noticeably absent throughout 2017 was a lack of <u>downside</u> volatility. Undoubtedly, for those who have remained in the bearish camp, the upward trajectory of the equity markets has yielded volatility, but in the wrong direction. Yet, for those who have tilted portfolios with a bullish tone (as we have), the limited downside volatility has created an environment where pullbacks or corrections are in short supply. To us, this is a sign of strong underlying demand and further confirms our view that equity markets are operating within the context of a secular bull market. Recall, that since the lows of March 2009, our work has consistently led us to believe that stocks offer the best risk-adjusted return potential and portfolios should carry an overweight position to reflect this.

This was further confirmed in 2013 when equity markets broke out of a longer term consolidation pattern as can be seen in the chart on the last page. Moving forward, our stance remains essentially unchanged. Certainly the calmness seen over the course of 2017 will not last indefinitely, so we do expect volatility to emerge at some point in the near term. That said, whereas many view volatility as a negative, we see it as a positive and only an enemy to the unprepared. Moreover, we believe volatility creates opportunity as it allows for new positions to be initiated when they go "on sale". Implementing an active approach to portfolio management allows for such tactics to be employed, something we have adhered to in our managed accounts.

**Supporting our base case for a bullish outlook:**

* *Monetary Policy (interest rates) remain accommodative* – although central banks such as the U.S. Federal Reserve, the Bank of Canada and the European Central Bank (ECB) have backed off of their ultra-loose stance and have begun a path higher, interest rates remain attractive based on historical measures.

* *Fiscal Policy* – tax reform should provide a generous boost to economic growth and financial markets.

* *Economic growth, both domestic and internationally, should continue to accelerate*. With tax reform approval, GDP growth should surprise to the upside. Buoyant optimism on both the

consumer and business fronts remain re-energized, which should spillover into lower unemployment, high capital expenditures, better corporate profits and a pick-up in wage growth.

* *Business confidence* – small to mid-sized businesses are becoming increasingly optimistic about future plans. The ever-present global headwinds that hindered business confidence from 2011-2016 have now turned into a tailwind.

* *Fund Flows remain absent* (see chart below -*Strategas*) – despite the strong performance of equity markets, the majority of funds continue to flow into fixed income. Market tops are generally associated with euphoria, greed and excessive optimism that choose to ignore deterioration under the surface. This is clearly not a trend that we are seeing at this time.

**IS THIS THE LEAST LOVED BULL MARKET OF ALL TIME?**

Net Flows into Mutual Funds + ETFs ($BN)

| Year | Domestic Equity MF | Domestic Equity ETF | International Equity MF | International Equity ETF | Bond | Money Mkt |
|---|---|---|---|---|---|---|
| 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 | (169.1) | 132.3 | 64.3 | 136.0 | 340.3 | 2.0 |
| *TOTAL* | (1018.4) | 816.7 | 457.3 | 532.5 | 1796.8 | (1174.1) |

* *Technical Evidence* – the majority of the indicators we track continue to point to a favourable underlying technical environment. Market breadth remains resilient, new highs have increased during the latest rally, volume is supportive and the majority of indices are confirming each other's advance.

* *Inflation remains well anchored at this time* – core inflation remains in the middle of a 20 year range and remains within Central Bank's targets. Based on forward projections, there is still room for rates and yields to move higher before the short end of the interest rate spectrum exceeds the long end (known as a yield inversion).

* *Earnings* – The earnings story has materially improved after the cyclical "earnings recession" realized between the first quarter of 2015 and the third quarter of 2016. 2018 should produce earnings growth of ~10% led by energy, technology, financials and materials. Estimated earnings call for $155/share; based on current prices, valuations are not all that expensive (despite what some may suggest).

**Possible Impairments to our Bullish Outlook:**

* Political error or dysfunction in Washington, Ottawa or any other developed government

* Escalation of geopolitical concerns/disputes

* Inflation spikes beyond the "comfort zone", velocity of money increases and Central Banks are forced to increase rates quicker than current expectations

* Populism remerges with important elections in the Eurozone (Italy)

* Euphoria takes over and pushes valuations to overheated levels and risk management is ignored

* A "Black Swan" Event

Overall, we believe earnings will be one of the main drivers of equity market performance in 2018. With earnings season now upon us, we are constantly monitoring sectors to determine where the best opportunities lie. Looking at portfolio composition, we remain confident in the process we have in place when determining which securities deserve an allocation across accounts and which ones warrant a removal. Our focus continues to be on medium to large cap names that offer reliable liquidity and limited day to day volatility. As always, consistency of earnings, positive free cash flow and a historically strong track record of dividends remains at the forefront of our mandates. Our preference remains skewed towards U.S. names, as the concentrated TSX Composite Index offers limited opportunities in sectors that we feel are attractive abroad. We also view the recent strength of the Canadian dollar as another opportune time to take advantage of U.S. dollar assets, much like we did back in July and August of last year. An active approach to managing portfolios has become increasingly important as performance across sectors, asset classes and developed markets has diverged materially over the past 12-24 months (correlations). When correlations unwind, as just noted, the "good" show clear separation from the "bad" and security selection becomes ever more integral. Finally, cash remains part of our asset allocation as we look for investable opportunities and view the odds of near term pullback or consolidation as heightened at this time. That said, we remain confident in our longer term view that this is indeed a secular bull market and investors should continue to give this advance every benefit of the doubt. We continue to invest based on this premise and are optimistic in our forward thinking.

In closing, looking back on 2017 we are content with how the year unfolded. Our ongoing focus and build out of our Private Investment Management Group service continues to evolve effectively. Our strategic association with one of Raymond James's leading Canadian portfolio management teams has expanded our management capabilities which only benefit our clients. Moving forward, we remain diligent, focused and committed to building out the best wealth management offering in the business.

Sincerely, Craig White, CIM, FCSI
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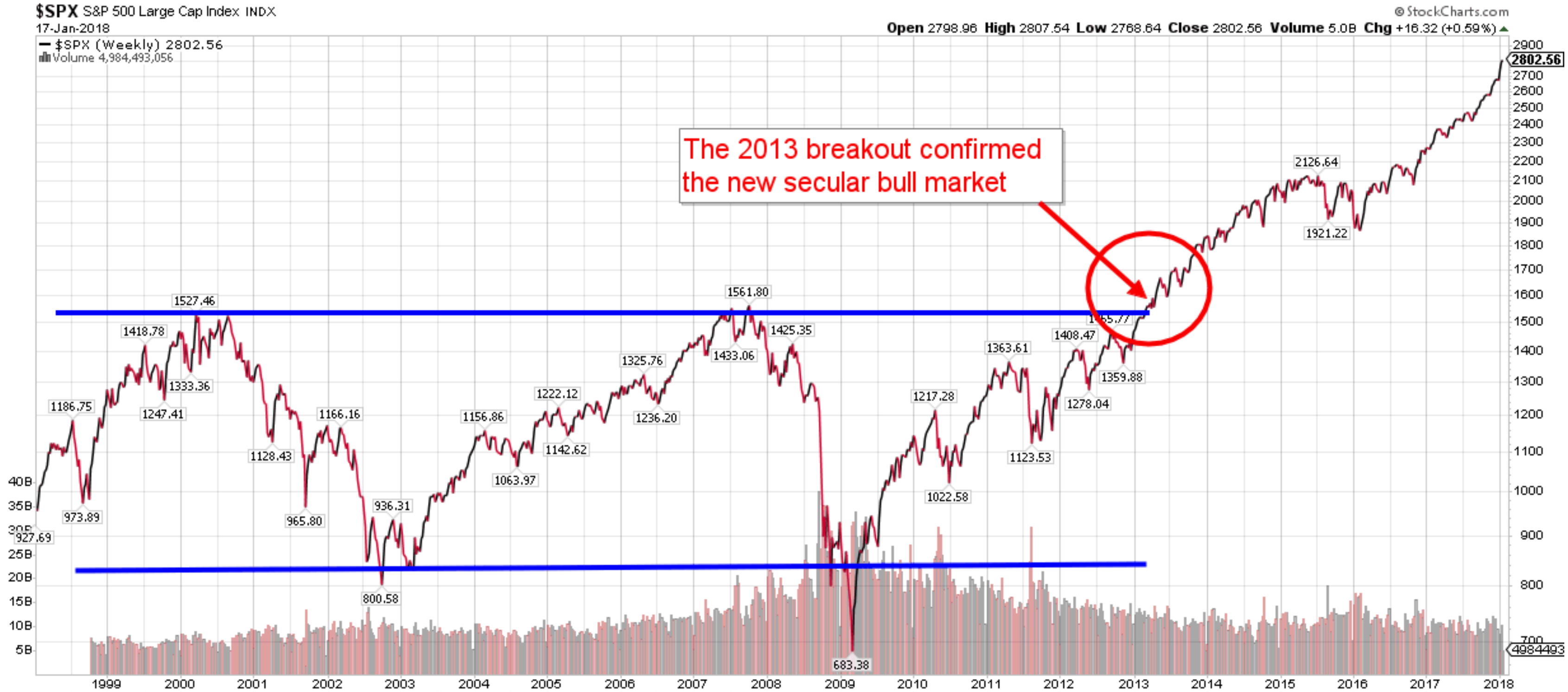


Source: stockcharts.com

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