HugganWhite Wealth Management

Protect Capital. Manage Risk. Provide Income.

Market Insight & Investment Strategy

October 2015

"Frustrated Incorporated"

"They say misery loves company
We could start a company and make misery
Frustrated, Incorporated
Well I know just what you need
I might just have the thing
I know what you'd pay to see"

Of the many passions that I surround myself with, music is indeed at the top of list. With now over 2 terabytes of data stored, I can proudly say I have accumulated a library of music that will be hard to replace. Today with streaming services such as Apple Music, Spotify, Galaxy Radio and SiriusXM, music is more readily at hand than ever before. New musicians, a range of genres and diverse styles can be uncovered with the click of a mouse. That said it is always hard to forget quality music of yesteryear. The above lyrics are from a song I was recently reminded of while on my travels from east to west. For those not familiar with the lyrics, they were written for a song called Misery by frontman David Pirner of the popular 1990's band Soul Asylum. The song is about people chasing after mainstream standards like paying to get a degree just to build a frustrating career which leads to a life of continuing misery, systemically ignoring their true passions and spiritual freedom. When it was released over 20 years ago, yours truly was fittingly working through the trials and tribulations of a young male as well; a career path yet to be decided, debts that had amassed, an income that was extremely low and a poor success rate of chasing women. Certainly, it was a time that could be summarized best as being Frustrated Incorporated.

As I sat on the tarmac listening to these lyrics, after several meetings with portfolio managers that day, it was apparent that these verses summarized the current feelings amongst the majority of retail investors. Frustrated Incorporated to say the least, as the recent "hit" to equity markets has generated a short term feeling of misery. Look no further than the various media sources that are constantly inundating participants with an endless flow of miserable news, statistics and negative opinions regarding investing and markets over the past number of weeks. As stated above, misery loves company, which is why so many fall victim to such prognostications. Once this occurs the negativity feeds on itself and investors begin to worry that all future outcomes will be just as miserable or worse. At that point, emotions generally drive decision making. For those who have read our past newsletters, they will undoubtedly know my thoughts on emotions and their impact on investment decision making. They are like oil and water, they don't work well together. That said, emotions appear to be elevated at this time so it's always important to address these issues. This should help you to draw a more educated assessment of the current landscape. As Pirner elegantly sang, "Well I know just what you need, I might just have the thing…."

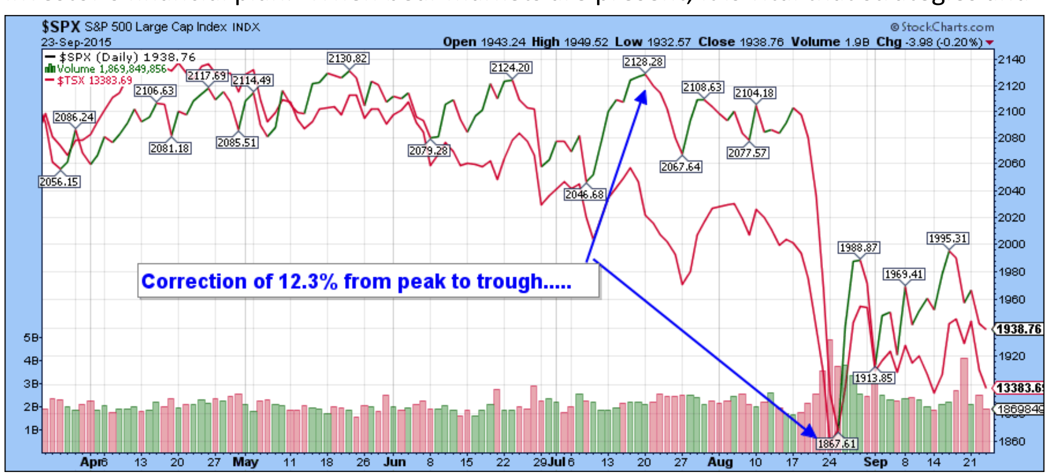
Let's first address the topic of risk. It is staggering how the word risk is thrown around in today's environment. Equity risk. Interest rate risk. Credit risk. Duration risk. Long Risk. Short risk. Cash risk. Purchasing powering risk. Monetary policy risk. Fiscal risk. Inflation risk. Issuer risk. Dividend risk. It is simply relentless. Risk is essentially the uncertainty of a future outcome. Crossing the street, driving your vehicle, flying in a plane all have inherent risks. **From our perspective (relating to investing) risk is permanent loss of capital**. Permanent loss of capital is a direct result of allocating capital to a speculative business or investments where the probability of a likely outcome is unknown and the structure of the investment itself may be questionable. This is often referred to as speculation. **We do not speculate with our clients' capital**. Rather we focus on risk management and work hard to reduce the uncertainty in portfolios.

Secondly, the topic of volatility. Volatility, which is so often mistakenly used as a reference of risk, is the day to day action of the markets. For an investor who has exposure to equity markets, volatility cannot be eliminated. Fortunately, volatility can be reduced through various forms of diversification: asset class, sector, currency and geographic allocation. This again is part of risk management and essential in good portfolio management.

Looking at recent equity markets, investors are once again confusing risk and volatility. Volatility has undoubtedly increased which is evident in the various indices and indicators we track. But has risk increased? To answer this question, one has to assess the current make up of their portfolio. What is the likelihood that the businesses we have allocated capital to will be out of business 6, 12 or 24 months from now? Are the securities owned at risk of permanent loss in value? Is the fixed income exposure at risk of default? From our perspective, we believe the risk of permanent loss is <u>extremely minimal</u> at this time. Volatility, as seen in the names we own, is a reflection of the supply/demand battle that determines price movements and is not a reflection on the quality of the investment itself. We do not judge the value of a business, or strategy for that matter, on the short term fluctuations often seen in equity markets. Rather, we invest with the premise that well managed portfolios will be rewarded with higher prices through increasing demand over the longer term. As opposed to seeing volatility as a detriment to portfolios, we instead take advantage of it and use these short term dislocations to add to existing names/strategies that have served us well in the past. We strongly advise investors should do the same.

If you have read this far in the newsletter, I commend you. It proves that you take an interest in your wealth management and you believe that knowledge is important. I write these commentaries to educate clients and investors on the intricacies of markets, while provoking thought. Hopefully, in the end, it allows you to become better investors over time. With that, let's look at what we are seeing so you can draw your own conclusion based on the evidence presented.

What is a true definition of a market correction? Let's put this into context. A pullback is seen as a decline from peak to trough of approximately 5%. These occur 2-3 times per year. A correction is seen as a decline from peak to trough of 10% or more. These occur on average every 12 months. Corrections are generally short lived as selling pressure increases over a period of a few weeks, followed by a recovery process that takes weeks to settle out, before finally resuming the previous bullish uptrend. Bear markets are often seen as a loss of 20% or more. These occur far less frequently and are often accompanied by a weakening economy, high inflation, rapidly rising interest rates, advancing unemployment, high valuations or a liquidity crisis (none of which is evident today). Bear markets can dramatically impair the long term success of an investor's financial plan. When bear markets are present, it is vital that strategies and asset allocation are altered as wealth preservation becomes the first priority.

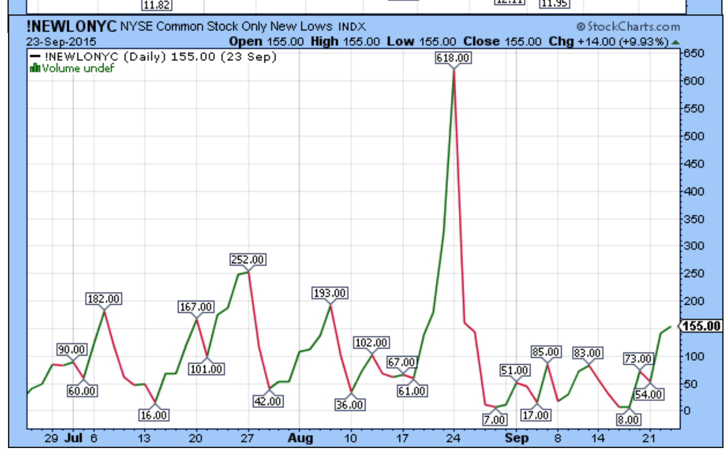


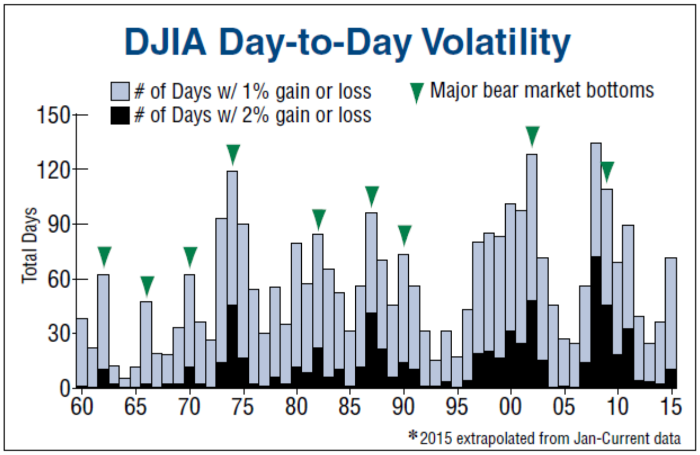
As stated in various emails and conference calls over the past month, <u>we are in the midst of a correction.</u> The last correction of 10% or more was seen in the summer of 2011, 46 months ago. Considering history suggests a correction was long overdue, we are not surprised to see this latest development. In fact, over the past year we had stated on several occasions that a correction was likely and investors should brace for the probability of it. We also stated that we are closely monitoring portfolios to determine if a shift in strategy and asset allocation should be warranted. So far we have "stayed the course", as despite the decrease in equity prices, our indicators continue to suggest that the upside should be favoured. To assist us in our rationale we often rely on a variety of tools that have served us well at times like this. Although we believe fundamentals will prevail over the longer term, we use technical indicators to assess the short term price action to gain a better understanding of what is happening here and now.

As we can see (chart above), selling pressure significantly increased in late August with the largest loss occurring intraday on August 24th. That day I sent an email to clients stating: *"the typical trading action you see at these crossroads is a rebound rally following such extremely oversold conditions. Therefore we would not be surprised to see buyers enter the market in the next few days. What we will be watching is the volume entering the markets and the strength of the envisioned rally."* The following week, we provided an additional update in which I stated "*corrections usually take time to work through. Generally what you see is a bounce off of the recent lows, followed by a retest of those lows. It doesn't always play out that way, but rarely do you see a "V" shaped recovery. What you do see, is something that resembles a "W".*

So far that looks to be a pretty decent call. Both the Canadian and US markets recovered approximately 6%-7% off of the August lows and now appear to be retesting the lows. The key support levels we are watching are 1867 on the S&P 500 and 13,052 for the TSX Composite Index. If these levels are materially breached, accompanied by a breakdown in some of the key indicators, then we will look to shift our asset allocation. This will be relayed to clients. So far though, we still are of the belief that this is a typical bottoming process.

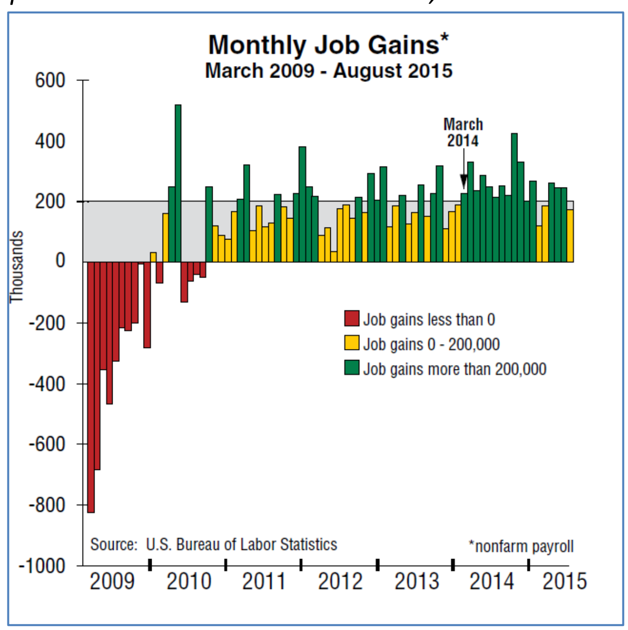
On a positive note, a number of our indicators have improved over the past month. First off, one of the key market indicators we follow is the Advance/Decline line. The Advance-Decline Line (A/D Line) is a breadth indicator based on Net Advances, which is the number of advancing stocks less the number of declining stocks. Net Advances is positive when advances exceed declines and negative when declines exceed advances. As we can see, the A/D line has held above the August 24th lows, signifying that the breadth or health of the market (less declining stocks) has improved. If this continues, it confirms that the market is in a "healing process". Secondly, the number of stocks on the New York Stock Exchange (NYSE) hitting new lows has also declined. After plunging to 618 on August 24th, this reading is also confirming that selling pressure is subsiding. Finally volatility, as measured by VIX, (middle chart), has decreased over the past month. This does not indicate that volatility has been eradicated, but it does





indicate that fear and panic has decreased more recently. Looking at 2015 as a whole in greater detail though (left chart), we can see that volatility is running at a much higher level with almost twice the number of 1% and five times the number of 2% daily gyrations when compared to 2014. As Investech Research points out, *"All of the daily 2% moves this year have occurred within the past month (averaging 474 points in the Dow Jones Industrial Average)."* It is no wonder that investors are feeling nervous and troubled; it has been a tough year to say the least.

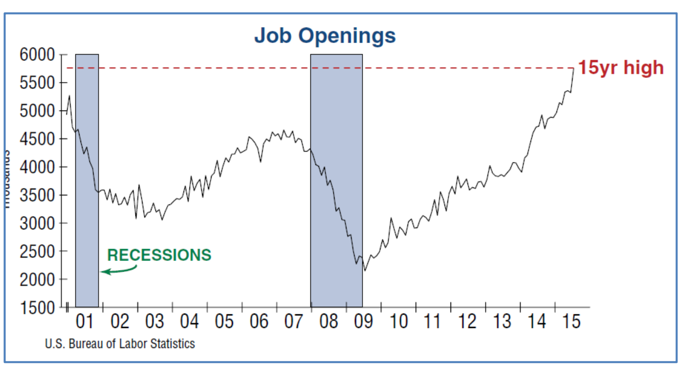
Turning over to the economic data we track, we continue to see mixed signals at this time. One of the most anticipated announcements of the year came on September 17th, when the U.S. Federal Reserve released its policy statement. The response was to delay an interest rate increase, citing concerns about global economic and financial developments. That said, most Fed officials still expect a rate increase this year, but the tone of the release and statements following suggest a more cautious stance going forward. As Fed Chair Janet Yellen stated: *"the outlook abroad appears to have become more uncertain of late, and heighted concerns about growth in China and other emerging market economies have led to notable volatility in financial markets. In light of the heightened uncertainties abroad and a slightly softer than expected path for inflation, the Committee judged it appropriate to wait for more evidence, including some further improvements in the labour market, to bolster its confidence that inflation will rise to 2% in the medium term."*



From our perspective, we still expect a rate increase of 25 bps later this year based on the fact that the U.S. economy is improving. Closer to home, the Bank of Canada also remained unchanged with respect to monetary policy, after two rate cuts earlier this year.

Speaking of the U.S. economy, data for 2nd quarter GDP growth, the value of all goods and services produced, was revised significantly higher. In fact, their economy grew at 3.7% in the second quarter, beating estimate forecasts which called for 2.3% growth. This is being reflected in the labour market as well. Monthly job gains were once again positive both in the U.S. and Canada. Since early 2014, monthly job gains in the U.S. have consistently averaged 200,000+ new jobs per month.

Furthermore, new job openings also recently hit a new 15-year



high. As Reuters writes: *"U.S. job openings surged to a record high in July and employers appeared to have trouble filling openings, the latest signal of an increasingly tight labour market that could push the Federal Reserve closer to raising interest rates."* Additionally, average hourly earnings rose 0.5% in August, retail sales increased 0.2% and core sales (which include autos, building materials and gasoline) rose 0.5% in the month of August. Conversely, industrial production and manufacturing output both fell in August by 0.4% and 0.5% respectively. Not surprisingly, consumer sentiment saw a sudden drop in its latest interim release which is likely in response to the softness in equity markets. The final report for the month, which tends to be less volatile, will be released on Friday, September 25th and should reveal more accurately the current consensus sentiment amongst consumers. We will be following this report closely.

Despite these mixed figures, we continue to believe that the world's largest economy is expanding and growth will persist. The impact of the latest correction is certainly having an influence on overall sentiment amongst Main Street and Wall Street, yet we consider this to be transitory. Although Canada is technically in recession after two quarters of negative GDP, we also believe that the impact of a weak commodity price environment has been the driving factor behind this. The U.S. is not showing any signs of recession at this time as highlighted in the GDP figures above. The benefactors of a strengthening economy should be equities, as revenues and earnings expand, ultimately rewarding shareholders.

Let us be clear though, we are not discounting the recent weakness in equity markets and are cognizant of the fact that a perpetually definitive bullish outlook/viewpoint is ignorant at this time. The weight of evidence still has us standing on the cautiously optimistic side of the field, but should this change based on a breakdown in the indicators noted above, then we will take a more defensive approach. One thing that has caught my attention this week is short term seasonality. (left graph courtesy of Ryan Detrick). To be fair though, we strongly consider the portfolios we have invested on behalf of clients to be well managed and the strategies are still relevant today. A dividend based approach, which has always been our central tenet, historically outperforms most other growth strategies during corrective phases (and bullish environments) as the cash flow generated reduces volatility and assists in total return. Confirmation of this was evident in August, when equity markets were down 7-9% in North America over the course of the month, while our income based portfolios were half or in some cases better than half of this. As our clients know, over the medium to longer term these same strategies have delivered solid returns that far outpace most indices and benchmarks. Once we work through this latest "challenging" period, we strongly believe it will be no different.

Weekly Returns for SPX Past 10 Years (2005-2014)

Week	Avg Return	% Higher	Week	Avg Return	% Higher
1	0.14%	60%	27	0.63%	50%
2	-0.59%	50%	28	0.73%	70%
3	-0.93%	30%	29	0.97%	70%
4	0.38%	50%	30	-0.47%	60%
5	0.89%	70%	31	-0.29%	60%
6	0.08%	70%	32	-0.50%	50%
7	0.10%	60%	33	0.08%	50%
8	-0.59%	50%	34	0.26%	40%
9	-0.69%	60%	35	0.23%	50%
10	0.76%	50%	36	0.48%	60%
11	0.73%	60%	37	1.74%	90%
12	0.99%	50%	38	-1.23%	20%
13	0.85%	70%	39	-1.13%	30%
14	0.13%	60%	40	-1.05%	70%
15	0.05%	40%	41	1.29%	70%
16	1.06%	80%	42	-0.48%	60%
17	0.77%	80%	43	1.62%	80%
18	-0.22%	50%	44	0.10%	60%
19	-0.34%	40%	45	-0.70%	60%
20	-0.94%	40%	46	-0.94%	60%
21	0.86%	70%	47	1.07%	60%
22	-0.43%	50%	48	1.25%	60%
23	-0.16%	40%	49	-0.03%	70%
24	0.04%	60%	50	0.30%	60%
25	-1.16%	10%	51	0.87%	80%
26	0.42%	70%	52	-0.02%	30%
			53	0.02%	50%

From a business perspective, we are always striving to build healthier relationships with our clients. We fondly look upon our business and confidently say that we work with some of the best clients. As part of our relationship building, we try to dig deeper into our clients' lives by understanding what is important to them. The days of the stock broker are finished in our opinion. Wealth management is the new business model that is based on a holistic approach. This includes financial planning, tax planning, estate planning, insurance needs and portfolio management. Far too often the portfolio management becomes the topic of conversation and the focal point of the advisory business. We are trying to change that at HugganWhite Wealth Management. Admittedly, we discuss strategies and markets on a regular basis, which is vitally important at times like this as communication is essential. Investing is indeed hard work and requires sound judgement, timely recognition and an ability to remain focused on the end game. **But a solid wealth management relationship is not based on what the markets may or may not do today or tomorrow, it is based on a working knowledge of each client's lifestyle, goals, objectives and aspirations.** <u>To achieve</u>

<u>and exceed these goals we need to constantly remind ourselves of what they are and remain focused on them at all times…not just the price of a stock or bond on daily or weekly basis.</u>

To quote legendary investor Warren Buffett, "The rich invest in time, the poor invest in money"

Once again we want to thank you for your continued trust and confidence in allowing us to manage your financial affairs. If you have any questions or comments, please do not hesitate to call or email any member of our team.

As always, we will keep you updated going forward.

Until next month,

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