HugganWhite Wealth Management

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Market Insight & Investment Strategy

June 2016

"Noise Cancelling Investing"

Every year like clockwork the month of May tends to be incredibly busy, and this year was no different. Looking back over the past month I have found myself on 11 different flights, amounting to 23 hours with a total distance covered of roughly 14,000 kms. My travels had me visiting a number of different cities including Edmonton, Fort St. John, Vancouver, Calgary, San Francisco, Seattle and San Jose Del Cabo (I admit the latter was a personal trip as I ventured off for 3 days of deep sea fishing in the hot Mexican sun with a few friends). As someone who enjoys travel and has become acquainted to its complexities, I tend not to get too bothered by its time consuming and invasive process. In fact, the conversations and stories shared with complete strangers can be quite interesting and thought provoking. Of course, there are times when your inflight experience can be rather aggravating as when the passenger seated next to you doesn't follow the unscripted rules and considerations involved with sharing a confined area. Case in point, Westjet Flight 310 from Kelowna to Edmonton, in which I was seated beside "Johnny know it all" who proceeded to tell me everything about everything, from loading to taxi to final cruising altitude. Not only was he a waterfall of "knowledge" but his delivery was unmistakably loud and in your face. In search of peace and quiet, I dug into my carry on and found my pair of Bose noise cancelling headphones which are part of my travel essentials. Within seconds, I found complete relief and liberation. The conversation ended rather quickly as there was a mutual understanding that I was no longer interested in pursuing a dialogue. Furthermore, I wanted some quiet time to read through my morning emails, study a few notes from various sources and prepare for meetings with investors. Thankfully, the remaining 45 minutes were peaceful and unobtrusive as I was locked away from the noise of 8B and the roar of a GE/Snecma jet engine.

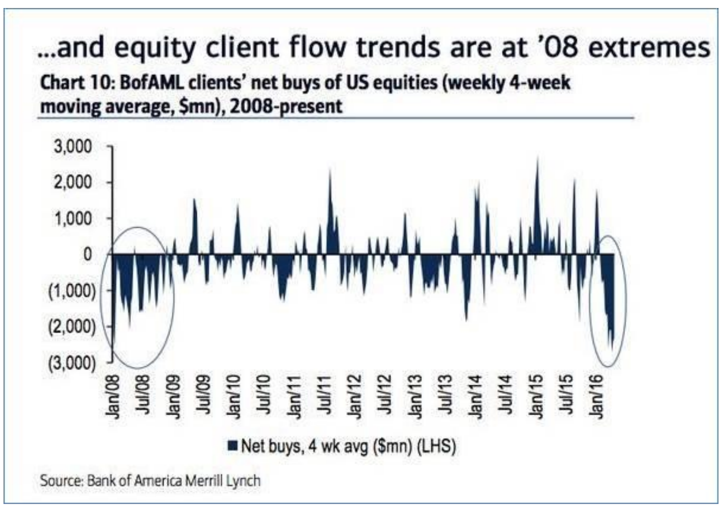
Thankfully, engineering today has allowed us to block the noise often accompanied with travel. In the real world though, the ability to consistently remove noise from our everyday lives is impossible. When it comes to the world of finance and investing, it seems to be even more challenging as the unrelenting flow of available information has created an environment where it is digested and assessed minute by minute. The spillover of this has fostered an impulsive reactionary bias amongst many and a view or outlook based on a perceived yet uncontrollable outcome. This year has once again been riddled with such news and events, including a 10%+ correction to begin the year, oil prices collapsing to multi-year lows, recessionary fears, an earnings slowdown, talk of an interest rate cut, talk of an interest rate increase, a "Brexit", a 16% rally from mid-February to mid-April, improving economic data, an earnings trough, possible new all-time highs for equity markets, and so on. Although this list is not exhaustive, the point is there is always going to be news and varying opinions regarding that news. From our perspective, the majority of these topics are simply noise. The volume and source will certainly change over time, but the direct, lasting impact of today's noise is negligible in the long run. That is why it is critically important to sift through that noise and draft an educated response that is rational and justified. Our team carries this out on a daily basis. We assess the landscape at hand, eliminating the irrelevant noise, and build an investment strategy that is suitable and hopefully impermeable to the noise of the day. Essentially, we enter our offices on a daily basis equipped with our noise cancelling headphones and advise and invest accordingly. After reading the following comments, we hope and recommend that investors do as well.

In this month's newsletter we will review some of the key metrics which we follow and update a number of charts that we haven't discussed in some time. As you will see, the set up for higher prices in the months ahead looks plausible, which will likely cause a lot of confusion for those who are under-invested or bearish. With sentiment at the lowest level we have seen in years, we believe the secular bull market that began post-financial crisis is alive and well…

One of the benefits of sitting on this side of the desk is the plethora of information I receive from various sources. In return, I also discuss the information I receive with a select few as it helps "us" better understand the message of the market. During one of my email conversations with a few friends on a recent Sunday afternoon, I sent the following commentary, which prompted several responses:

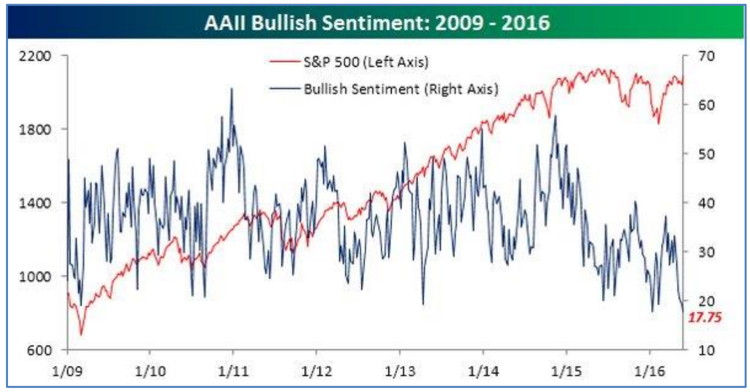
"Happy Sunday friends! Not a lot of surprises here, but chart 1 is evidence of just how unloved and untrusted equity markets are today. This, after a 13% run off of the February 11th low putting stocks within 4% of an all-time high (SPX). Toronto continues to struggle around 14,000 as this is serving as key resistance. Fund flows, I would assume, are very similar to the Bank of America ML chart here in Canada. Earnings have "hooked up" in Q1/2016, likely confirming that the earnings recession we have faced for the better part of 2 years has finally run its course. With energy now trading back around $47/barrel, this should further dampen the blow to future earnings, putting forward P/E multiple in reasonable territory. Although I have not included AAII sentiment in these charts, one doesn't need to see an illustrated version of this gauge to summarize just how negative most retail investors are. In the dozen plus meetings with clients last week, not one provided a positive outlook. These are the same conversations I have heard from many colleagues across the country. This is likely why equity markets should push higher in the comings days/weeks and subsequently break out to new highs, ultimately confusing the mindset/outlook of the majority. It always does at inflection points such as this. We all know that those who follow the mass often get the "bet" wrong…"

Fittingly, I thought it would be prudent to share those same charts with you and provide further analysis of them as I think they provide a great summary of where we are today. Anyone who has followed these commentaries over the years will certainly know that I analyze the behaviour of investors and use sentiment as a key indicator. This is based on data that shows the majority of investor decision making is reflective of the commonly held view at that time. The movement of capital, referred to as fund flows, is evidence of this behaviour. The chart to the left illustrates the net purchases of U.S. stocks since the financial crisis of 2008/2009 to May of this year. As we can see, the selling pressure has increased this year, as money coming out of stocks is at multi-year lows. The causa proxima of this equity capital outflow is likely in response to recent corrections and the perception of persistence amongst investors. Two 10%+ corrections over the past nine months (August 2015 and January/February 2016) and a 20% correction seen back in the summer of 2011 will do this. The nervousness amongst retail investors is heightened during these corrective phases (and more so today) as most are expecting the next big "fallout" for equity markets. The past is expected to occur again. Think about it as once bitten twice shy.

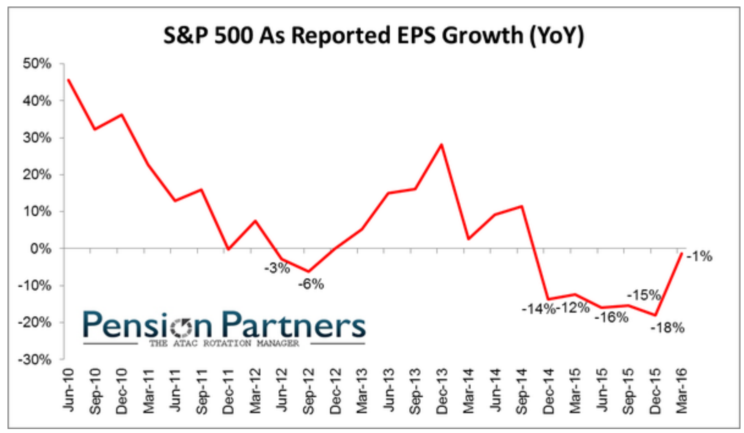


Historically, each time these corrective phases have exhausted themselves, the market has found a footing, regrouped and resumed the previous uptrend. Not surprisingly, confusion mounts as those sitting in cash (after selling their equities) try to understand why stocks have resumed that uptrend. They search for reasoning to support their bearish outlook and remain firm that stocks will go down… FOREVER. This cycle repeats itself slowly pushing more and more capital out of stocks and into other asset classes, such as cash and fixed income (more on this later). A**s I write this newsletter, U.S. equity markets are within a few percentage points of all-time highs, while the TSX Composite Index is trading at 10-month highs. Plainly, this is the most unloved and untrusted equity market environment we have seen in a while and capital flows are proof of this.**

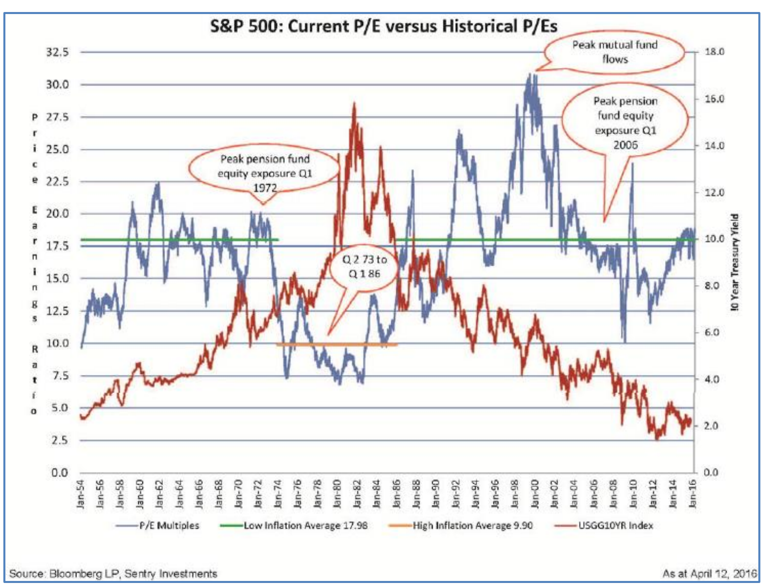
Not only are fund flows indicative of an extremely negative environment, but so are sentiment readings. According to the American Association of Individual Investors, the bullish outlook amongst investors, currently at 18%, is lower than was seen in March 2009 (chart, right). Neutral sentiment, is also sitting at the highest level in seven years at 53%, proving that very few are confident in stocks. Further examination shows that such excessive negative readings coincide with key turning points (red line showing the S&P 500). In this case, the turning point is generally positive for stocks as the majority of sellers are already "out of the market" and when supply dries up, so does the selling pressure. This is why we have not dramatically shifted our asset allocation, as we believe the equity markets have been quite resilient despite the lack of participation. As Raymond James Chief Strategist Jeff Saut recently stated; *"Ladies and gentlemen, these are NOT the kind of metrics you see at a market top. Rather, this kind of skepticism is what is seen at market bottoms, which is why we stated on CNBC we think you saw the low for the S&P 500 on February 11."* We couldn't agree more.



As for earnings, they have indeed "hooked up" in Q1/2016. This should provide solace that the worst of the earnings recession we have experienced since the second quarter of 2014 has come to a conclusion. Recall, that a large contributing factor to weaker earnings over the past number of quarters has been energy. Looking back on first quarter earnings of this year, roughly 65% beat analyst estimates and 57% beat on revenues. These numbers signal that corporations are doing relatively well, driven by a consumer that remains healthy and an economy that continues to muddle through.



From a valuation perspective, we still believe equities are trading at reasonable levels. When we look at valuations, we must remember that the price-to-earnings ratio (P/E) tends to be volatile quarter over quarter and needs to be considered within the context of inflation and interest rates. As shown in the chart to the left, we can see that the current P/E ratio versus historical P/E ratio is not suggesting stocks are trading at an "expensive" multiple (blue line). Back in the early 1950s, the 10-year U.S. treasury carried a yield of ~2.8%, in an environment where inflation was north of 4%. This implies a real negative rate of return of 1.2%. Following the red line over the graph, we can see that the 10-year yield topped out in 1981 at roughly 17%, while inflation increased to 11%, indicating a 6% real rate of return. Today, that relationship has once again shifted back to marginally positive real rates of return, with the 10-year treasury currently yielding ~1.85% and inflation at ~1.4%. This represents a 45 basis point premium. As we can see, the risk premium over the timeframe is 230 basis points, suggesting bonds are



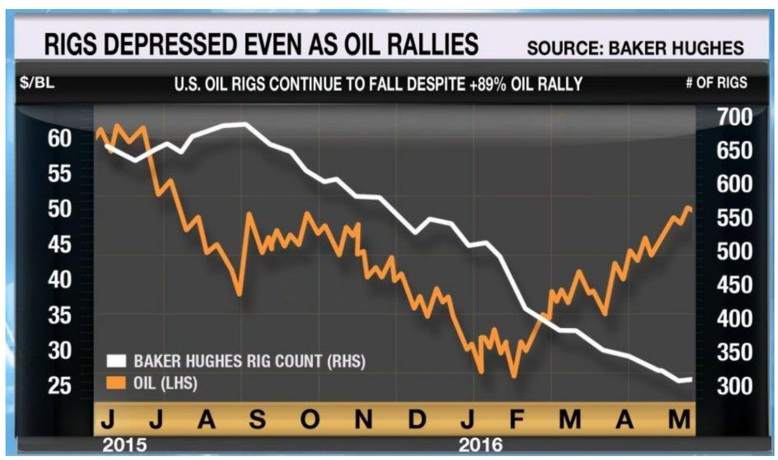
expensive at current valuations, not stocks. In our opinion, with earnings expected to improve and a forward P/E multiple around 16x given today's 2,100 level, equities look well priced in a low inflation, low yielding environment. Regrettably, markets continue to pay-up for "risk-free" assets despite the meager returns and price premium associated with such assets.

Digging deeper into yields and interest rate policy, a lot of conversation will center on the Federal Reserve's monetary policy announcement in June. Three months ago the market was pricing in a 20% possibility of a second rate increase for U.S. interest rates (the first was last December). Today that has increased to ~35%. According to the latest comments by the Federal Open Market Committee:

"Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's 2 percent objective, then it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June. Participants expressed a range of views about the likelihood that incoming information would make it appropriate to adjust the stance of policy at the time of the next meeting. Several participants were concerned that the incoming information might not provide sufficiently clear signals to determine by mid-June whether an increase in the target range for the federal funds rate would be warranted. Some participants expressed more confidence that incoming data would prove broadly consistent with economic conditions that would make an increase in the target range in June appropriate. Some participants were concerned that market participants may not have properly assessed the likelihood of an increase in the target range at the June meeting…"

Economic data and inflation will be the determining factor if the committee decides to proceed with a 25 basis point increase. As inflation is slowly starting to tick higher (ex-food, energy and shelter, CPI rose 0.1%/1.4% y/y), we believe labour market conditions and growth data will be the main considerations. At this time, the jury is still out as to the chosen course of action. With the UK referendum vote on EU membership scheduled for June 23, the Fed may look to delay until July 27.

Regardless of the outcome, we will be closely monitoring bond yields and the impact on the slope of the yield curve. Business cycles are driven by credit and as rates rise, the availability of credit is compressed. When short term rates are higher than long term rates, caution is warranted. This is known as an inverted yield curve. A positively sloped yield curve (short term rates are lower than long term rates) indicates that the bond market is not anticipating an end of cycle credit contraction. This is the current structure of the yield curve and still bodes well for further bank lending and economic expansion.



As for Canada, during the last week of May the TSX Composite Index nudged above 14,000 for the first time since July 2015. The 14,000 level has served as strong resistance and with the recent breakout above this level, stocks should carry some momentum in the months ahead. The driving force behind this advance has been a strong rebound in the price of commodities, with WTI crude oil in particular trading back to $50 U.S./barrel. This has put a significant tailwind behind a number of oil and gas producers that only months ago were looking futile. Our exposure to this sector (albeit limited) is helping lift portfolios over the past two months. This strong price recovery in a few individual positions highlights the quality of the companies we own. Many are questioning the sustainability of the oil price recovery, which has seen prices double since late January, but if rig count is representative of an industry that has undergone a dramatic shift since early 2015, then the chart above should offer a compelling argument as to why $26 per barrel is unlikely anytime soon. We believe the worst is over for this beaten down sector.

The likelihood of an interest rate increase here in Canada for the remainder of 2016 is minimal at best. With provinces such as Alberta, Saskatchewan, Ontario and Newfoundland seeing economic contraction, the prospects of higher rates will further “choke off” any prospects for sustainable growth. Thus, the Bank of Canada will likely be on hold until 2017 at the very least. The corollary of this will be further pressure on the Canadian dollar, particularly if the U.S. continues on their path of higher rates which should result in a stronger U.S. dollar. In response, we are managing the currency risk in portfolios going forward by utilizing strategies that have the ability to hedge currency exposure. We have often stated that currencies are extremely difficult to forecast which is why we choose not to play that game. Rather, we’d prefer to manage the asset allocation in portfolios, allowing other professionals to manage currency risk.

From a portfolio management perspective, based on the aforementioned and several other factors we track, we are comfortable and confident with the current asset allocation across client portfolios. Undoubtedly, since June 2014 equity markets have been challenging, with the bulk of most indices trading within a trapped zone. We refer to this as a range bound market. Range bound markets oscillate between a previous high, with bouts of volatility causing prices to break or trade down to previous lows. These peaks and valleys are accompanied with emotional highs and lows and test the commitment and patience of investors. Pre-established investment strategies are often abandoned as many fall victim to the emotional difficulty of a range bound market. <u>Our work leads us to conclude that we are at the latter stages of this current range bound market</u>. For those who can remain committed, we believe their perseverance will be rewarded. Gladly, we can report that 98% of our clients have stayed the course and view investing in the same context as we do; a long term endeavour requiring dedication and hard work.

Furthermore, our long standing income based approach continues to provide solid risk-adjusted returns. Our focus on dividend paying equities remains our core strategy, with dividend growth seen in many positions we own on behalf of clients. This is your inflation protection and maintains the purchasing power of your capital over time. As noted, fixed income is barely treading water with rates of return marginally breaking even. With more money allocated to fixed income than at any point in our investing careers, we feel the real risk can be found in what is perceived as risk-free assets. The normalization of monetary policy will likely reveal this risk in the years ahead and catch many by surprise. Consequently, we continue to believe equity markets are still trading within the context of a secular bull market, which is emerging from a cyclical earnings recession. We see no evidence of an economic recession often associated with bear markets.

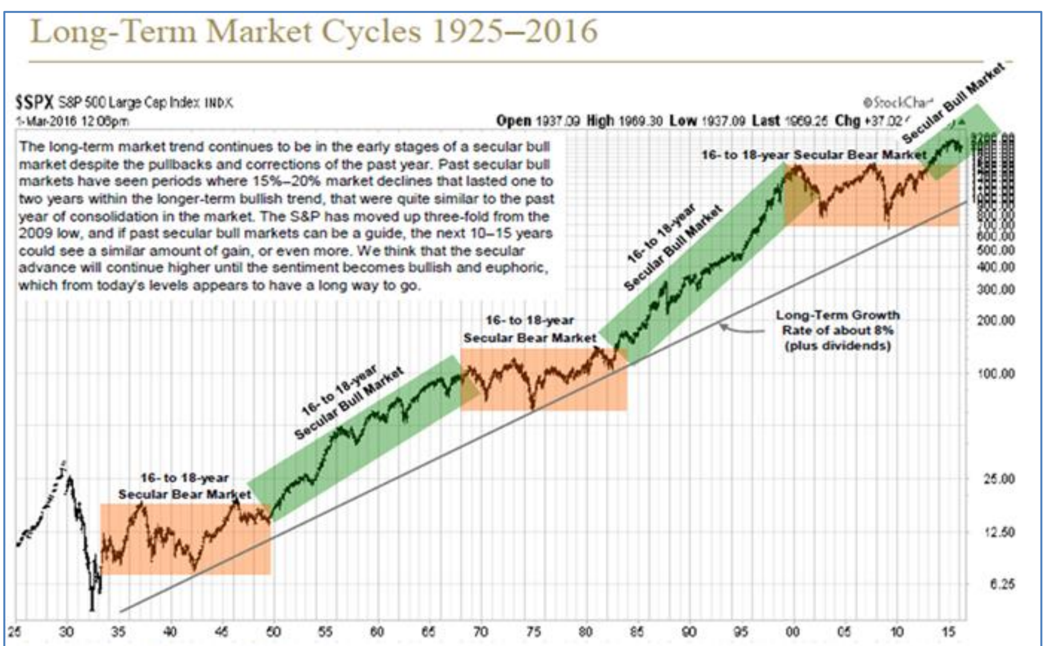


Chart courtesy of StockCharts.com and RBC Wealth Management

On another note, the recent invention of low volatility, structured products (I refuse to call them investments) is concerning. The very notion of marketing a product based on past metrics, including volatility, and suggesting it will "guarantee" a relative rate of return that is less volatile than an index or sector is simply baseless. Fundamentals, including earnings, revenues, valuations, debt etc. are the influences behind returns and volatility. The past is not, and we worry that the mainstream are getting "sold" on products with fancy names that resonate well with their current emotional state. Additionally, the perception that all low cost, passive investment strategies will generate better returns also carries limited credibility in our opinion. Active management has proven to outperform a passive, buy and hold approach over time. Look no further than the performance of various passive strategies over a bear market cycle. As one colleague stated *"Sure passive investing is cheaper. You could also save money walking to the airport, but you probably won't catch your flight*." Need we say more!

On a personal note, I am very proud of the team we have built here at Raymond James. We are now entering our 11^{th} year at Raymond James and 15^{th} as a team. Over the years, we have faced a variety of market environments and have met some amazing people along the way. Today, we continue to work with a best in class client base that we are truly proud of and sincerely appreciate. Month over month our business continues to grow as new clients join our team. The referrals that contribute to this growth do not go unnoticed. Thank you! The biggest challenges we face today (outside of navigating these markets at times!) is the rapidly changing regulatory environment. The time and capital required to remain current is extensive. Yet, we recognize the importance of these changes and are 100% committed to this business, 100% committed to our work ethic and integrity and 200% committed to you, our valued clients.

Once again, thank you for the trust and confidence in allowing us to manage your financial affairs.

As always if you have any questions or comments please do not hesitate to call or email. **Likewise, if you find yourself getting caught up in the "noise", do not hesitate to contact yours truly directly; I may have a pair of noise cancelling headphones you can borrow…**

Until next month,

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