Huggan White Wealth Management

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Portfolio Management Report

Fourth Quarter 2018

Putting Things into Perspective

Needless to say, 2018 will be chalked up as a year that challenged the mindset of most investors. The first quarter of the year saw the first meaningful decline since early 2016, which commenced in late January before finally printing a low in early April of 2018. The subsequent five months (May to September) saw equity markets regain more sustainable upward momentum as earnings came in better than expected and triggered a "risk-on" environment. This allowed most global markets to move to new all-time highs between the months of August and September. The final quarter of 2018 brought with it a much different tone as substantial volatility emerged and we witnessed the first 20% decline from those third quarter highs to the Christmas Eve lows. In fact the drop in global markets left all major indexes in the red for the year with most asset classes (stocks, bonds, commodities, alternative investments) also showing negative returns. In the end, the Toronto Stock Exchange finished down ~12% in 2018, while most leading U.S. indices fell approximately 6%. This first negative year in quite some time caught most investors and analysts by surprise as the economy continued to show positive growth and corporate earnings across most sectors improved. While any period of negative returns is unpleasant for investors, those with a tactical approach and an investment horizon greater than months or quarters, should look at times such as this an opportunity to invest in high quality businesses that are indiscriminately sold without regard for fundamentals. After all, good investing is less about predicting the next correction and more about capitalizing on volatility when the backdrop supports higher prices.

At this time, there is no certainty that the worst of this corrective phase is behind us but we can take some solace in the fact that our work in 2019 has presented a much more compelling environment thus far. The rally off of the Boxing Day lows has allowed a significant portion of our clients' holdings to recover some of the fourth quarter losses and portfolios are reflecting these positive developments.

What caused the market to sell off is debatable. Most will point to the U.S. 10 year treasury yield which jumped to 3.2% from a previous range of 2.70% and 2.80% in October, causing what is known as a yield curve inversion (defined as when the 10 year treasury yield is less than the 2 year treasury yield). This well followed indicator, which carries a good track record of predicting an economic downturn, quickly gained mainstream attention and throughout much of the fourth quarter economic projections worsened. In addition, the U.S. Federal Reserve, headed by Jerome Powell, remained aggressive in their monetary policy outlook and cited that the path forward would include additional rate hikes in 2019. This "spooked" the markets as the Federal Reserve has historically relied on incoming data such as inflation and employment to assist in setting their interest rate policy. Over the past few weeks, this outlook has softened and the rhetoric out of the Fed has carried a much more data dependant tone. Markets have viewed this outlook more positively and rates have once again retracted to lower levels.

November brought a small recovery as economic data remained mostly positive and the rhetoric out of both the White House and the Federal Reserve softened somewhat. But, just as volatility subsided and the envisioned "Santa Clause Rally" was set to emerge, equity markets once again took another turn for the worse as selling pressure increased throughout December. Profit warnings from economic bellwethers such as Fedex, Apple, United Technologies and J.P. Morgan Chase caused an already fragile market to decline further. Also contributing to the weakness was year-end tax loss selling, a reported wave of hedge funds that were forced to liquidate their portfolios as closures mounted for these types of strategies and computer algorithmic programs arbitrarily sold positions without rationale. Although December has historically been one of the strongest months of the year for investors, 2018 proved to be an extreme outlier. In fact, it was the worst December since 1931. That said the nadir of this decline appears to have occurred on Christmas Eve when markets suffered from what appears to have been outright panic selling. Although painful to witness and experience as portfolio managers, capitulation such as this is generally a good sign that sellers have completely exhausted themselves. Cue in Boxing Day.

Boxing Day must have brought investors a little bit of confidence as December 26th brought on a rush of buying, with most U.S. markets printing one of their best one day advances in history. Those that identified the real "Boxing Day sales" have so far been rewarded as markets have managed to recover a good portion of the losses seen in December at the time of writing this commentary. Recently, Raymond James Chief Investment Strategist Jeffrey Saut referred to this latest three week rally off of the Christmas Eve low as a "buying stampede"; a period in which markets are engulfed in a wave of buying pressure as participants are forced back into the market in an attempt to play catch up.

With the fourth quarter now behind us, we continue our efforts in managing portfolios with the same prudent approach as we entered the quarter and have done so for many years in the past. We continue to preach diversification across various asset classes, with a strong focus on cash flow generation, sustainability of dividends, while working hard to display less volatility across portfolios than benchmark indices. In our view, the recent correction has provided an opportunity to reallocate capital to businesses that are presenting valuations that we have not seen in quite some time. As such, across our model portfolios, we have recently added to names like Canadian National Railway, Bank of Montreal and Walgreen Boots, in most client portfolios. We are also aware that certain areas of the market have become "expensive" and we have tactically reduced our exposure to names that have performed well and have run up for no other reason than they are defensive in nature. North West Company, which operates grocery stores in remote areas of Canada, gained in value through the recent market turbulence. This classic "flight to safety" trade was indeed welcomed by our team, with a 10% lift in market value, but our process guided us to harvest some of these profits and reallocate the proceeds to more attractive opportunities. We also implemented similar strategies across a number of our healthcare related positions, such as Amgen, Pfizer and Eli Lilly which also showed strong relative outperformance in late 2018.

While some companies within our coverage universe have reduced expectations for 2019, many are still optimistic and guiding towards strong growth and they believe they are well positioned for continued economic expansion. If these projections are accurate, then we believe prices will follow suit as the market rewards those businesses that can adapt to varying economic conditions.

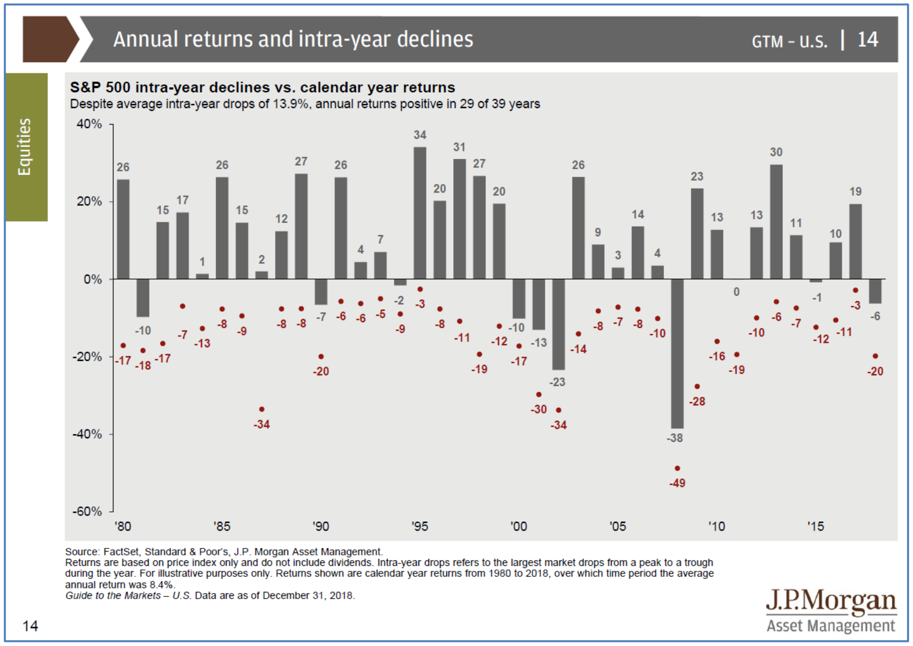
We look ahead to the New Year with guarded optimism. No one knows if 2019 will be another year of negative returns for major averages or if we will revert to the more probable outcome of positive returns. That said, the chart on the last page should help to put equity market performance into perspective and further help educate clients as to the nature of year over year returns. As we can see in the chart, issued by J.P. Morgan Asset Management, the U.S. market since 1980 has seen its share of ups and downs. The dark grey lines indicate where the S&P 500 closed for each respective calendar year, whereas the red dots indicate the low point for this index throughout that same year. 1980 for example (the first line), finished the year up 26%, yet at some point saw an intra-year loss of 17%. The furthest grey line on the chart highlights 2018's return which we can see was down 6% for the calendar year as noted above. Yet, during the calendar year the S&P 500 was down 20% from the September high to the December 24th low (red dot). The main takeaway from this chart though, is that 29 of the past 39 years have finished the year in positive territory. That's a 74.3% batting average! Also of note, is that EVERY single year had some sort of correction or pullback that on average saw a 13.9% loss from peak to trough (20% in 2018). But again we will repeat and emphasize, that 74.3% of the time the market closed with a positive number; a statistic that investors need to put into perspective and embrace if their timeline is measured in years not days.

We are not naïve to the fact that the markets recent performance could be foreshadowing economic weakness ahead. The so called "wealth effect" causes people to spend a little less when they see the value of their net worth drop, which in turn has a negative impact on the economy. This is not a reason to panic. The economy will expand and contract at varying rates and the market will reflect these moves ahead of time. How long the current market weakness will last is anybody's guess. One thing we are confident in and have learned from the past, is that by the time economic data turns for the better the market will have long since made its recovery. As investors, it's important to remember that enduring volatile periods as witnessed in late 2018, generally leads to a more sustainable path going forward. Corrections and pullbacks allow for more balanced longer term returns and only benefits those who employ an active approach to portfolio management such as us. We feel that across the majority of portfolios, the relative outperformance throughout 2018 is a testament to this approach and the recent market recovery has allowed accounts to participate in this upward momentum. Good portfolio management is all about managing risks. If we can avoid significant potholes when markets are challenging, yet participate when they are favourable, the overall risk/return profile will be far more rewarding for clients. That is our modus operandi.

Going forward, we feel the market is still susceptible to further bouts of volatility, yet we are becoming increasingly optimistic that the worst of the selling is behind us. Economic data remains buoyant, consumer sentiment is upbeat, employment is strong and earnings are expected to provide another quarter of positive growth. Tony Dwyer recently stated, *"We believe the fear of recession is likely overblown absent more extreme policy errors, and we therefore expect a retest of the highs in 2019. The Q4/2018 market collapse points to a historic market event at first created by excessive optimism and historically low volatility, which was then followed by policy and communication mistakes from both the Fed and White House. The dramatic weakness has created the perception of a more serious economic swoon, which our fundamental core thesis continues to suggest is unlikely to materialize unless the Fed makes a more serious policy mistake that ends up in a credit crisis through an inversion of the yield curve, and the Trump Administration is unable to resolve the trade issues with China. The consistency of the data surrounding non-recession market* *crashes, our rally requirement indicators, and excessive pessimism suggests investors should expect a bit more reflex rally, and a move toward the 2018 high."* Plainly we agree with Mr. Dwyer and are managing portfolios accordingly.

At the end of the day, forming a personal investment plan that appropriately matches your risk tolerance and objectives based on the expected range of outcomes is far better use of energy than trying to guess what the next year will bring. Our deep rooted team of portfolio managers and supporting staff are working hard to ensure that the capital you have entrusted to us is appropriately managed in this context. We will keep you updated as we move forward.

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



With regards,

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