HugganWhite Wealth Management

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Market Insight & Investment Strategy

July 2015

"The Biscuit and the Market"

After weeks of self-inflicted procrastination I finally got around to reading the famed biography Seabiscuit. For those who are not familiar with the story of Seabiscuit, this American race horse dominated the thoroughbred racing scene during the 1930s, along the way embodying the heart and spirit of a nation struggling with a depression. The story of Seabiscuit is a fascinating tale as this small, awkward running, knobby kneed colt was seen as a lazy horse and was the recipient of several barn jokes. In his early days, Seabiscuit failed to win many of the races he entered, with most of his showings ending up at the back of the pack. In response to Seabiscuit's poor start, he was eventually sold to automobile entrepreneur Charles Howard in August of 1936 for $8,000. From that day forward, Seabiscuit's career was changed forever.

Charles Howard, well-known trainer Tom Smith and jockey Red Pollard shipped the horse to California and began a rigorous training program that brought the best out of Seabiscuit. In 1937, Seabiscuit won 11 of the 15 races he entered becoming the leading money winner in the United States for that year. He finished second in Horse of the Year voting, losing to Triple Crown Winner, War Admiral. The following year Seabiscuit's career and fame was met with mixed success. Although his success on the track was still respectful, Seabiscuit suffered a few minor injuries and was scratched from several high stakes, high profile handicap races. The most anticipated races were the three scheduled match races between Seabiscuit and War Admiral, which Smith and Howard eventually cancelled at the last minute due to injuries to Seabiscuit and/or poor track conditions. The racing public was furious and became increasingly impatient. Newspapers, fans, race organizers, bookies et al. began discarding Seabiscuit, claiming the best days of this derelict horse were behind him. Eventually, they gave up on Seabiscuit placing their attention and bets elsewhere. That all changed in late 1938 when the "Match of the Century" was again rescheduled at famed Pimlico Race Course; a 1 and 3/16 head to head race between War Admiral and Seabiscuit. As the underdog, Seabiscuit went on to win by 4 lengths, despite War Admiral running his best time ever at that distance. Seabiscuit regained his following and reemerged as a symbol of strength, courage and resilience.

After 1938, success on the track followed. Seabiscuit went on to win a number of races including the Santa Anita Handicap, also known as the "Hundred Grander", in 1940. At the time, he was horse racing's all-time leading money winner. The "Biscuit", as he was often referred to, officially retired from horse racing in April 1940 and unfortunately passed away at a young age of 14. Today he still resides at his resting place on Willits Ranch in Mendocino County, California. In the end, Seabiscuit is often referred to as the Horatio Alger hero of the turf; the horse that came up from nothing on his own courage and will to win.

The storied racing career of Seabiscuit carries a lot of similarity to today's investment landscape. Since the lows of the financial crisis of 2009, investors have been faced with a number of successes and setbacks. In the early stages of the recovery (2009 and 2010) equity markets were seen as high risk and unstable and often overlooked by investors. As momentum built on the back of revived economic strength, improved earnings and a reduction in volatility, retail investors began placing their bets for further gains. The "smart money" however (Howard and Smith) had already placed their bets recognizing the value in the early stages of the race. The next several years, 2011 and 2012, were relatively successful for investors. A number of "injuries" appeared as the initial stages of the European debt crisis emerged, quantitative easing was met with skepticism and global economies faced a number of headwinds. But the markets looked beyond these injuries and advanced to new highs. Equity investors were rewarded in 2013 and 2014 with decent returns. The champion thoroughbreds with strong track records managed to outperform (read: dividend equities). Turning to 2015, it is evident that success at the "race track" has been much more challenging. Equity returns for the first six months of this year have been met with resistance. Impatience and recent injuries (China and Greece) have caused many to question the likelihood of success going forward. In typical fashion, short term thinking has taken precedence, current news has stirred emotions and longer term fundamentals have been forgotten. Much like Seabiscuit's career in 1938, equity investors today feel the best days are behind us. For those who can look beyond the current machinations, the outcome may be much more encouraging than some think, and patience at the "track" may be met with success. A good trainer and jockey, as always, is required.

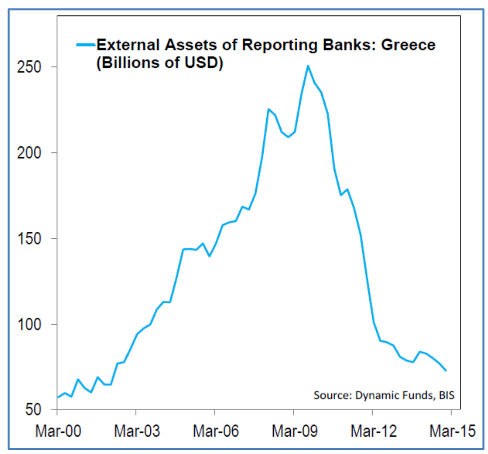
In this month's commentary, we will discuss our take on the recent headlines, review economic data and look at some technical indicators before wrapping up with comments on our strategy and portfolios.

Markets loath uncertainty. Uncertainty breeds anxiety and discomfort. We as humans underestimate the amount of uncertainty to which we are exposed. Our judgements and response to uncertainty causes us to draft illusions that are negative in nature. If you've ever bungee jumped or sky dived you will know what I am referring to! The truth of this human tendency is evident with the two most discussed issues over the past number of weeks, Greece and China. Although both events are important global macro issues, they appear to be more transient than permanent in our opinion. Let's first start with Greece.

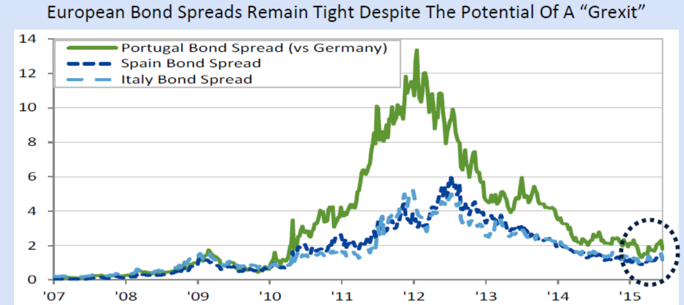
At the beginning of July, I sent out a special commentary related to Greece discussing a number of issues facing the Eurozone. In the commentary I pointed out a number of factors including:

- Greece has not defaulted on their debt (at the time of writing)
- Greece owes the International Monetary Fund (IMF) approximately $1.8 billion which is due June 30. If funding is not received, Greece will likely miss the payment. If Greece does default on the payment, this does not necessarily result in an automatic default of the entire country.
- Greece represents approximately 1.3% of the Eurozone economy. Their economy is irrelevant to the overall health of the European economy. This is a "Greek" problem, not a "Europe" problem.
- If contagion is a serious threat, you would expect European bond yields to move substantially higher. <u>This is not happening.</u>
- We still believe that a last minute deal could be worked out. As Raymond James's Chief Market Strategist Jeff Saut points out this morning; *"Politicians, bureaucrats and bankers are the same in Europe as they are here. They do not want to lose their jobs and if the EURO implodes, they lose their jobs. Therefore if Greece needs another cheque, Greece is going to get another cheque."*
- That said, we are <u>not</u> impulsively reacting to these headlines as many tend to do. We are not counselling our clients to raise cash or dramatically alter portfolio composition. **We are digesting the news, reviewing the trading action of the markets and closely monitoring our positions. We feel it is only wise to avoid letting a country such as Greece impact our portfolios in the short term.**

The basis for our assessment: 1) Greece represents just 0.3% of global GDP and 1.3% of the European Union GDP. In perspective, this is equivalent to the GDP of the state of Alabama or Rhode Island at approximately $200 billion. 2) European banks have limited exposure to Greek bonds. As of December, European banks held roughly $27 billion euro or 10% of total Greek debt, which is down 80% from its peak according to the Bank of International Settlements. The majority of the debt is held by European governments and institutions, which will surely lose if Greece defaults. That said, it is likely not going to "spill-over" into other parts of global markets as the debt is not widely held. In fact, the private sector holds only $63 billion euro of Greek debt (upper chart to the right), of which $18 billion euro is held by non-Greeks. The Greek people themselves have a vested interest in avoiding an outright default. 3) Eurozone economies are in a better place to absorb shocks. Fiscal pressure is receding as many of the formerly weak links in the Eurozone (Italy, Spain, and Portugal) are in much better fiscal position and have made progress on structural budget balances. Moreover, these economies are beginning to show signs of growth. 4) If the market is anticipating or expecting contagion, other peripheral Eurozone debt would be at risk. The bond market would be pricing this in with yields moving higher (recall; bond yields rise when there is fear of default or the creditor is downgraded). Over the course of the past number of months we have not seen yields "gap" higher as we did back in 2012 and 2013 (bottom chart).



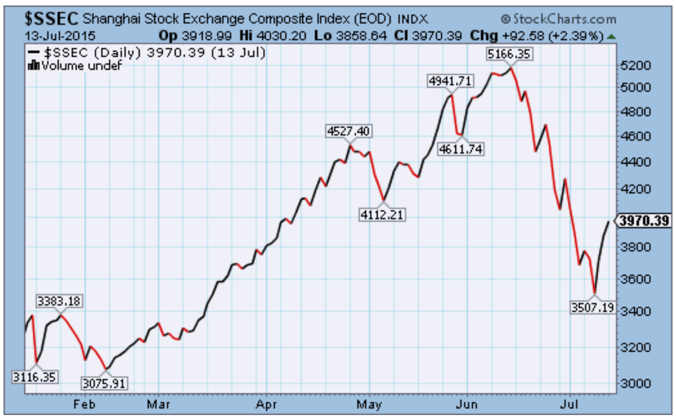
European Bond Spreads Remain Tight Despite The Potential Of A "Grexit"

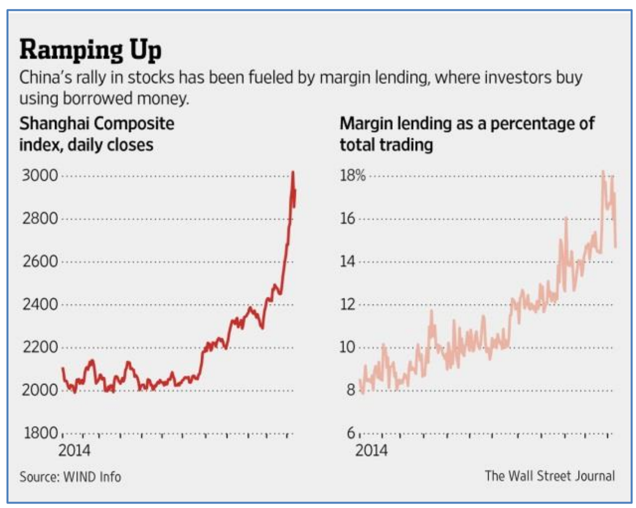


Source: Bloomberg, Raymond James Ltd.

Although this list is not exhaustive, it should provide evidence as to why we were unresponsive to the headline news. As it turns out, it appears as though the Eurozone and Greek officials have reached a tentative bailout out package. Terms of the deal are yet to be finalized, but according to sources, many of the conditions are binding and require collateral from Greece. As stated in the Eurozone Summit commentary: *"The Euro Summit stresses the crucial need to rebuild trust with the Greek authorities as a pre-requisite for a possible future* *agreement on a new ESM (European Stability Mechanism) programme. In this context, the ownership by the Greek authorities is key, and successful implementation should follow policy commitments. Given the need to rebuild trust with Greece, the Euro Summit welcomes the commitments of the Greek authorities to legislate without delay a first set of measures".* These measures include significant pension reforms, broadening of the tax base to increase revenues, adopt more ambitious product market reforms with a clear timetable for implementation of all OECD recommendations, proceed with privatization of electricity transmission network operator (ADMIE), rigorous labour market reforms and a transfer of valuable Greek assets to an independent fund that will monetize these assets through privatization and other means. These commitments are significantly stricter than previous bailout terms and are contingent on a joint effort between the Eurozone and Greek government officials. How it all plays out remains to be seen, but it appears as though Greece is willing to accept these major structural changes at this time. The Band-Aid has been re-attached; perhaps these new terms will heal the wound that has been Greece for a number of years.

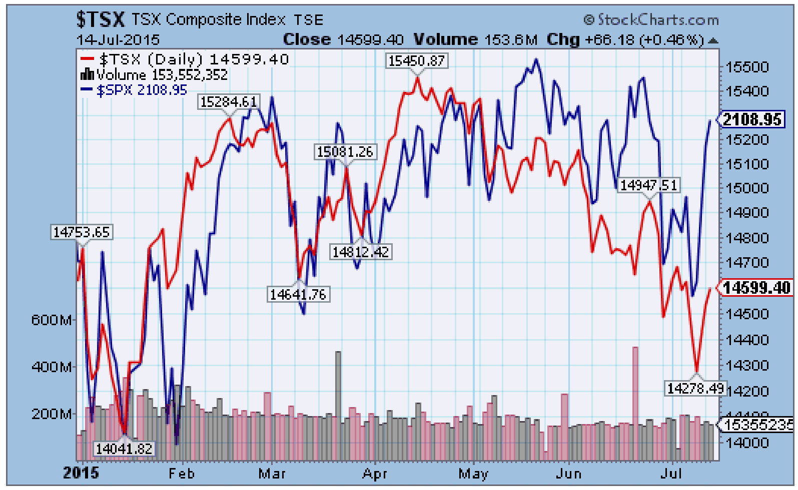
One doesn't have to look much further than the chart of the Shanghai Index (SSEC) to summarize the recent trading action. By definition, Chinese stocks were in crash scenario leading up to last week. From the peak in mid-June at 5,166 to the low in early July of 3,507, the SSEC fell 32%. This has shed some ¥3 trillion from the value of Chinese markets. More recently, these markets have found a footing after strict government intervention to help fend off further rapid declines. That said, the Chinese markets are still up over 80% year-over-year. A large contributing factor to the dramatic rise in Chinese stocks can be attributed to the rampant excess leverage Chinese speculators have used to fund purchases. It is estimated that there are currently 90 million active trading accounts in China, with 20 million of those opened in 2015 alone. According to a recent survey, two thirds of these small investors (speculators) do not have a high school education. The Chinese stock market has been viewed by many as a seemingly riskless enterprise where prosperity can be quickly achieved…on borrowed money! As the market began collapsing, speculators were forced to sell what they could, not what they wanted. Margin calls expanded, selling intensified and the freefall became self-fulfilling. As stated above, in response, the Chinese government intervened. Interest rates were cut. Regulators stopped short selling. Initial public offerings (IPOs) were suspended, while funds were created to buy shares back (with central bank cash I might add). The results at first were mixed but as we can see over the past week Chinese shares have rebounded. Some analysts suggest this is merely a "dead-cat bounce" and the routing seen in Chinese equity markets is a sign of pending despair for the Chinese economy. We believe this is incorrect at this juncture.





So why did the Chinese government intervene so heavily? One answer; politics. As an article in The Economist recently stated, *"The government has staked much credibility and prestige on the stock market. When the going was still good, the official press was chock-a-block with articles about how the rally reflected the economic reforms that Xi Jinping, China's top leader, was set to push. Li Keqiang, the premier, said repeatedly that he wanted equity markets to provide a bigger share of corporate financing - comments, from punters' perspective, not unlike waving a red cape in front of a bull. The sudden end to the rally is the first major dent in the public standing of Xi-Li team."* For a leadership team that has pledged to reduce government intervention and promised their citizens stewardship and rising prosperity in return for political quiescence, the recent turmoil has shaken the confidence of the Chinese people. Thus, much like in the Eurozone, Chinese politicians are doing everything in their power to instil confidence. The recent emergency policies and reduction in selling has managed to throw water on the proverbial "fire" for the time being.

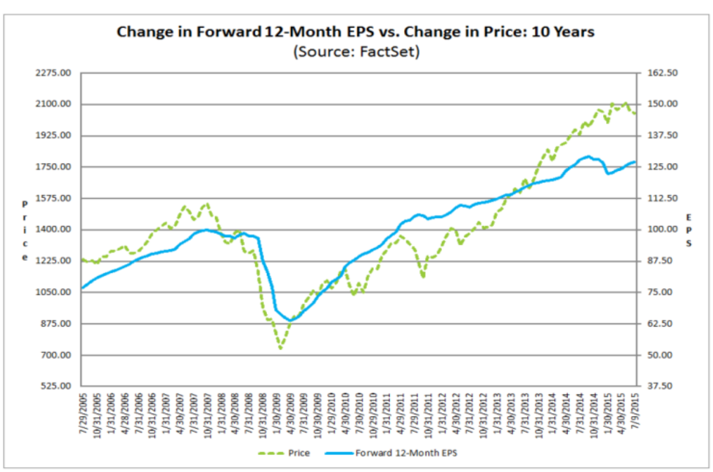
Lost in all of this though, is the fact the Chinese stock market plays a surprisingly small role in the overall Chinese economy. The free-float value of Chinese markets – the amount available for trading – is just one third of GDP. This compares to most developed economies that hover around 100% of GDP. Furthermore, less than 15% of household financial assets in China are in the stock market, which is why soaring shares failed to materially boost consumption. Moreover, the subsequent fallout has had little impact on the downside. Many stocks were bought on leverage and the unwinding of this debt helps to explain why the government was unable to prevent the crash initially. This financing and leverage is not a systematic risk to the Chinese economy in our opinion, as it represents less than 2% of total assets in the Chinese banking system. <u>It is forced liquidation amongst those who speculated</u>. Need we say more!



Turning over to North American markets, despite the aforementioned global headwinds, most indices close to home are performing relatively well. Looking at the year-to-date chart of both the S&P 500 (blue) and S&P/TSX Composite Index (red), we can see that any attempts to push these markets lower has been short lived. Here in Canada, we do continue to see weakness across most of the energy sector, with the recent pullback of WTI crude oil from $60/barrel to $51/barrel weighing heavy on exploration and production companies. Canadian financials, including the big five banks, have fared relatively well on a year-to-date basis, but are still being held back by their indirect exposure to the energy patch (financing, M&A, debt). Year-to-date the TSX is posting a negative return of approximately 1% to July 15th. The benign equity market environment in Canada is a reflection of the weaker economy and GDP data we have received over the past two quarters. In fact, the latest quarterly print for the Canadian economy showed a contraction in our economy of -0.1%. This follows a softer fourth quarter reading in 2014 of just 0.6%. Not surprisingly, this has put pressure on the "loonie" with the current USD/CAD exchange rate at 1.27, after a bounce to 1.19 in early May. This morning (July 15th), the Bank of Canada announced a 25bps cut in the benchmark interest rate to 0.5%. Evidently, the downside risks and lack of growth is greater than originally anticipated. In response the dollar has slipped below 0.78 cents.

The U.S. markets continue to be the stronger of the two markets showing a gain of roughly 2% for the S&P 500 (SPX). With a current reading of 2,108, the SPX is within 1.5% of its annual and all-time high of 2,134. Considering the brunt of negativity that has been thrown at these markets, we view this as very constructive trading action. Volumes have been lighter than usual on the upside (perhaps summer seasonality), but the recent pickup in volume we witnessed during the pullback was short lived. More importantly, the critical 200 day moving average (DMA) residing around 2,050 held as the low point and selling pressure was contained around these levels. Since the October low of 1,820, the 200 DMA has held as support on any meaningful pullback attempt.

Over the next few weeks, earnings for a majority of SPX reporting companies will be released. According to several analysts we follow, it is expected that 2nd quarter earnings will be modest, with several downward revisions in the energy sector. That said, most of the revisions are backdated and if energy prices firm up over the back half of 2015, future earnings may come in better than expected. Additionally, if the anticipated second half economic expansion can gather momentum, overall earnings may surprise to the upside as well. For companies reporting 2nd quarter earnings thus far, approximately 60% have come in above the mean estimate. As for valuations, the current 12 month forward price to earnings (P/E) ratio is 16.6x. This is based on a closing SPX of 2,108 and forward earnings per share estimate of $127 (2,108/$127 = 16.6x). A multiple of 16.6x falls within the longer term average for valuations and by no means implies that stocks are overpriced or richly valued. Perhaps the recent push back over 2,100 is reflecting an improving economy and restored earnings? We think so.



Quickly turning over to recent economic data we follow: Job growth in the U.S. continues to be strong, with the unemployment rate declining to its lowest levels and is now residing at figures that were consistent with full employment in the past. This is a reflection of a shift in the labour force participation rate, which is declining as the population ages and younger workers have given up on looking for work. That said, slack is being taken up, as evident in the reduction in the overall unemployment rate. Manufacturing remains encouraging with the ISM Index rising to 56.0 in June vs 55.7 in May and 57.8 in April. This is consistent with moderate overall growth as business activity and new orders increase marginally. As for inflation, both Canada and the U.S. inflation rates remain near longer term central bank mandate targets. Year-over-year, the PCE Price Index is roughly flat, while the core inflation rate has moved lower in recent months (energy). In summary, inflation expectations remain well anchored.

Of the technical data we follow, most of the indicators are showing resilience and have not indicated a material breakdown in various markets. As stated above, important support levels are holding (200 DMA). **The one breadth technical indicator that has caught our attention more recently has been the negative divergence seen in the advance/decline line (a measure of the underlying health of the market). If this downtrend continues, it may suggest market internals are weakening and caution may be warranted**. At this time, we are not there yet, but we are carefully monitoring this important breadth indicator. In summary, the key over the next couple of weeks is the ability for the equity markets to break above their May highs, which has acted as resistance in the past. If this does occur, the few indicators that have flashed yellow should reverse and confirm improving fundamentals and a healthier equity environment.

Our portfolios are once again showing signs of leadership after a tough few months. The increased exposure to U.S. based stocks has provided favourable returns over the past number of weeks and equity values are trending higher. Within our managed accounts, the strength of the U.S. dollar has acted as a tailwind for U.S. equities as there is no currency hedging within these portfolios. Recall, the month of April was a challenging month for these accounts as the Canadian dollar outperformed vis-à-vis the U.S. dollar. This has recently reversed course and our longer term view of a stronger U.S. dollar has once again resurfaced and benefitted client accounts. The few energy and material related names that remain in portfolios continue to underperform at this time, but we remain patient as we believe we still own quality names. As often referenced in the past, of the ten securities we may choose to build a portfolio around, three will turn out better than expected, three to five will turn out as expected, while two to three will not perform as expected (read: underperform). It is our job to recognize the two to three that do not perform and act (sell) if warranted. This is generally based on a material, fundamental change within the security. We do not see this occurring in the names we own at this time which is why we have not sold a few of the individual names involved in these sectors.

Finally, I believe the patience our clients have displayed over the past number of months will be duly rewarded. We often state that our annual target for our portfolios is between 7-9%. Over the past numbers of years, the majority of our strategies have produced and in some cases exceeded these returns. It is sometimes expected that this occurs in a straight line, and new highs in portfolios should be followed by new highs. Regrettably, we know this is not the case all the time. Investing is hard work and requires sound judgement, timely recognition and an ability to remain focused on the end game. In a recent conversation with an investor I was asked what our annual returns were over the past five years. I responded by stating three things: 1) that is a function of your entry point 2) that is a function of your expectations and 3) that is a function of your commitment to stay the course. I also showed him the following chart of two different portfolios and asked him which appealed most to him. My final question to him; who had the more consistent journey and arrived at the final destination with more comfort and less stress (less volatility)?

Portfolio 1	Capital Invested	Annual Return	Portfolio 2	Capital Invested	Annual Return
Starting Value	$ 500,000.00	9.27%	Starting Value	$ 500,000.00	13.24%
Year 2	$ 546,350.00	8.30%	Year 2	$ 566,200.00	-9.81%
Year 3	$ 591,697.05	2.45%	Year 3	$ 510,655.78	7.54%
Year 4	$ 606,193.63	10.76%	Year 4	$ 549,159.23	19.84%
Year 5	$ 671,420.06	4.55%	Year 5	$ 658,112.42	-3.54%
Year 6	$ 701,969.67	12.34%	Year 6	$ 634,815.24	24.23%
Ending Value	$ 788,592.73		Ending Value	$ 788,630.97	
	Annualized Return	**7.89%**		**Annualized Return**	**7.89%**
	Equity Growth	**$ 288,592.73**		**Equity Growth**	**$ 288,630.97**

I will let you draw your own conclusions…

Once again we want to thank you for your continued trust and confidence in allowing us to manage your financial affairs. As always, we will keep you updated going forward. Have a great remainder to your summer!

Until next month,

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Picture I took of Seabiscuit while at the 2014 Breeder's Cup at Santa Anita Race Track last October.

A Personal Note

As many of you know, outside of my daily life of being a father, husband and financial advisor, I am constantly looking for new adventures. Many of these adventures involve an activity that tests my physical abilities (often painful to the say the least!) and have included such events as marathon running, Tough Mudder Competitions, group fitness challenges, bike races, rafting expeditions etc. With the summer now upon us, I am once again embarking on yet another new "test".

On August 29th I will begin a two day journey cycling from Vancouver to Seattle as part of "The Ride to Conquer Cancer" Cycling series. The two day event will consist of approximately 200kms of cycling with each day averaging 100kms. At this time it is estimated that ~2500 riders from across British Columbia who will participate in the Ride, all with the common goal of raising funds for Cancer Research. The money raised will benefit the BC Cancer Foundation and support leading clinicians, scientists and researches whose search for new discoveries and improved patient outcomes will have a real impact in our communities throughout the province, across Canada and around the world. Almost every Canadian has been effected by cancer it some form another. We all know someone who has been diagnosed with cancer, some who have battled and conquered cancer and some who have unfortunately succumb to the disease. I have personally lost family members, good friends, great clients and colleagues over the years; far too many to say the least. My efforts are dedicated to those who have been touched directly or indirectly by cancer. In the end it is my goal and the goal of the BC Cancer Foundation to help accelerate a joint vision of a world free from cancer.

Thus, I am looking for your support and to join me in the fight against cancer. I have set a lofty goal of raising **$10,000** over the next month or so, with the ultimate goal of surpassing that target. In 2008, I competed in the Honolulu Marathon for Team Diabetes Canada and managed to raise over $11,500 for the Canadian Diabetes Association. This year I feel we can better this amount and I will work hard to ensure this does indeed happen! Over the past month I have increased my daily training schedule and am now riding anywhere from 150kms to 250kms per week. Needless to say, this is a lot of time alone in the saddle (as the professionals riders say).

Personally, I will commit to matching 25% of the first $10,000 raised from those who donate to my efforts. Additionally, my company, Raymond James, has also stepped up to donate $1,250 to my cause; equalling $3,750 combined before my fundraising campaign even begins.

For those who do donate, a tax receipt will be issued. For those who do want to make an anonymous donation, there is an option to complete this request as well.

If you are interested in supporting my efforts, please go to www.conquercancer.ca. From there you click on B.C., followed by DONATE. It will then prompt you to enter in my name Craig White which will take you directly to my personal page. From there choose one of the donation options, (Ie: Explorer, Roadie) with the "**Free-Wheele**r" option available for those who want to make a customized donation amount.

Thank you for considering my efforts. Together I think we can reach my target, with the ultimate goal of conquering cancer.

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