Happy Second Birthday!

Everyone knows that they have a specific birthstone that is placed in jewelry and trinkets to signify the month they were born in. However, many people don’t know that just like the stones, each month has a flower or two as well, which symbolizes birth. For the month of March, the birth flower that symbolizes this month is the daffodil. Daffodils symbolize rebirth, respect, regard and unrequited love. The daffodil is one of the first flowers of Spring, therefore it is a symbol of rebirth.

Fittingly, as we approach the month of March and say goodbye to February, we will soon celebrate the second birthday (or re-birth) of the bull market that began on March 9th, 2009. Unlike the daffodil that embodies “respect”, it amazes me to this day that the current “bull” does not receive the respect that it so rightfully deserves. To put things into perspective, last “birthday” the TSX Composite was trading at approximately 12,000, while today as I write this commentary we are closing in on 14,000. Yet, a lot of money is still hiding in cash and fixed income, indicating a lack of “regard” for the strength of this recovery. As we move into the third year, I am curious to see if this will change as the economy appears to be operating on a more stable platform.

Interestingly, each year as we approach these momentous birthdays, an impulsive trend usually takes hold as armchair experts engage in their practice of predicting what the next year will bring. It happens every time and it comes in various forms. Some of these predictions are relatively innocuous, offering an opinion that lacks any true direction or clarity. Others are a bit more esoteric and are seemingly put out there for pure shock value; such as the prognostication for “a historic shifting of the San Andreas Fault on August, 17th 2011 @ 10:17am.” Still others, however, offer investment predications that often result in outcomes either unexpected by the prognosticator, or unpalatable by the investor.

The best part about predictions is that very few people let the accuracy of last year’s predictions have any bearing upon their gusto for this year’s forecasts. The issue is not really that their predictions have been so horrible, but rather that predictions of any kind in the market often have undesirable outcomes when an “of the year” moniker is attached. In our view, sound portfolio management should not be about predicting what will happen from now until next year’s birthday. Instead, our approach to investing is based upon studying the action of the markets, finding leadership in asset classes and then attaching a discipline that reflects that work.

In this newsletter I will discuss the current state of the markets, what the third year of bull market may offer and discuss our increasingly cautious stance on the fixed income markets. There are a lot of charts and text presented throughout the letter, but I believe it makes for an interesting read.
But first let’s review a few of my comments issued in my previous newsletter commenting on the state of the markets at that time (January 2011): “To sum up all of the parts, I continue to believe that the markets are functioning at the higher end of their respective trading ranges and caution should still be warranted. That being said, I am not afraid to buy select stocks on any pullbacks as I still believe the markets have upward momentum as we move forward. Add in the fact that many portfolio managers are sitting on substantial cash positions, should put pressure on them to redeploy their cash reserves as they are quickly becoming exposed to performance risk. This all leads me to believe that any correction should be short lived and shallow.”

Well folks, not much has really happened since I penned those comments as the equity markets on both sides of the border have drifted marginally higher driven predominantly by certain sectors like materials and commodities. This has all occurred without the envisioned and expected 5%-7% correction, causing me to become even more cautious today than at the start of 2011. According to Raymond James Chief Market Strategist Jeff Saut, (who wrote on February 14th);

“As for the shorter term, today is session 113 of the longest “buying stampede” I have ever seen. To be sure, a stampede typically last 17 -25 sessions, with only one- to three-day pauses/pullbacks, before resuming its upward onslaught. A few have lasted 25 – 30 sessions, but I can count on one hand those that have extended for more than 30 sessions. Previously, the longest such skein encompassed 52 sessions. The current stampede began on September 1, 2010, at the intra-day Dow low of 10016, and has continued higher into last Friday’s closing price of 12273.26 for an eye-popping 22.5% surge. Over that timeframe the senior index has not experienced anything more than a one- to three-day pause/pullback; truly an amazing run.”

Much like Jeff, short term I remain cautious. That doesn’t mean the markets have to correct, but the odds are not tipped in favour of the “bulls,” based on the technical evidence registering currently. I must stress once again though, that any correction should be considered as a buying opportunity as I believe equities offer the most attractive returns longer term.

So what can we expect moving forward? First I think it is important to consider where we have come and what stage of the market cycle we are currently operating in. As mentioned above, on March 9th the stock market will mark the beginning of its third year off of the financial crisis lows. This pronounced movement, which many have stated is only a bear market bounce, is unfolding in a fashion that is remarkably similar to standard business cycles of year’s past. To refresh; the average timeframe for a market cycle, whether bullish or bearish, generally last 3-5 years before exhausting itself on the upside or downside. I recently came across the following chart issued by the invaluable Investech Research team, which offers a thorough snap shot of the various cycles of a typical market:

**Step 1** encompasses the transition from late bear market to early bull market and this is when cyclical sectors such as Financials, Technology and Consumer Discretionary tend to outperform. Remember that the stock market generally leads an economic recovery and as consumers and business start to feel better about the economy, they begin spending again in the more discretionary areas where they have likely held off on purchases during the bear market.

**Step 2** is the mid to late bull market period when economic growth is more firmly established. Materials and Industrials tend to outperform during this stage and are usually joined by Energy and Telecom stocks as the bull market continues.
**Step 3**, as the bull market runs out of steam, the nondiscretionary sectors—Healthcare, Consumer Staples and Utilities—are usually the most resilient. These companies provide products and services that people need regardless of how bad they feel about the economy or stock market.

Since we are now about two years into this bull market, it’s likely that we are now entering the second stage of the market cycle. By examining the recent action of some of the sectors, it’s evident that the materials (Gold, copper, nickel, uranium etc.) and industrials are leading the pack, while financials are lagging most other sectors.

So if you think stocks are overbought at this time does that mean that they are overvalued as well? To answer that question one has to look back and examine where valuations have been to consider the relativeness of “overvalued.” As Warren Buffett once said “Price is what you pay, value is what you get”. And when it comes to investing, VALUE ALWAYS MATTERS. As most of you are aware, I have been stating for a number of years that I believe the markets are trading in a longer-term (10-15 year) secular bearish/neutral market formation. In simple terms, what this means is that since 2000 the market has more or less traded sideways, as we are only approximately 10% higher today than at the turn of the century. That being said, within the confines of this longer-term secular market pattern, there are short-term cyclical markets that present opportunities to make money (we are currently in a 3-5 year cyclical bullish market as mentioned above). But back in 2000, coming off of an 18 year secular bull market that began in 1982, it was clear that stocks were grossly overvalued.

The chart to the right (courtesy of the Bespoke Investment Group), shows the Price/Earnings (P/E) ratio of the S&P 500 Index over the past 100 years. As we can see, back in the late ‘90s, the P/E ratio was trading at over 40x reported earnings, far above the historical P/E average of 16x. Clearly, the market was extremely overvalued, as investors were paying a huge premium for technology stocks and the alike. Fast forward to today, following a devastating cyclical bear market and the deepest recession in years, and we can see that the P/E ratio is trading at roughly 18x. From my pencil, stocks appear to be reasonably priced at these multiples based on historical valuations.

Now according to many market gurus (and several who I highly respect), they will probably disagree with my observations and point out the fact that back in the early 1980’s stocks were much cheaper as the S&P was trading at roughly 10x earnings. But one must also consider the fact that interest rates at that time were at historic highs. Therefore, one can make the case that such a high “risk-free” return in 1980 warranted extremely compressed stock valuations, as most investors would take a guaranteed double digit coupon payment from an interest bearing investment over an uncertain lower paying dividend stock. Looking at the current Fed Funds rate of 0.75% and the accompanying 10-Year US Treasury Note yield of 3.62% (as of February 16, 2011), one can make the case that the “risk premium” to own stocks is relatively attractive. Add in the fact that the “income” generated from bonds is “fixed”, whereas dividends have the ability to grow, should only further strengthen the case for stocks today.

Given this wide disparity between the yields available from common stocks and fixed income securities, it is hardly surprising that most stocks continue to hold steady. With approximately 73% of stocks beating earnings expectations last reporting period and interest rates expected to hold steady for several more months (although recently the bond market may be signaling something different), the stock market should be poised to trade higher.
While on the topic of interest rates, one of the questions that comes up quite often is where do I think interest rates are going and what impact does that have on bonds? As we all know, attempting to predict when interest rates are heading higher is clearly foolish. The simplest way I can answer that question is: THEY ARE HEADING HIGHER. For those who are familiar with the relationship between interest rates and bonds, they will recall that rising rates is a negative for bond prices (positive for yields) while falling interest rates is positive for bond prices (negative for yields). The following two figures will summarize this relationship: The top figure shows the Bank of Canada interest rates from 1976 to present day and as we can see that over the past 25 years, interest rates have trended lower. The bottom figure represents the yield on the Government of Canada 10 Year bond. The chart illustrates that yields have drifted lower (bond prices have moved higher) in concurrence with falling interest rates. As stated above, it is of our belief that interest rates will trend higher into the future. If this is the case, I have to assume that higher interest rates are negative for bond prices; hence our repeated cautious stance for fixed income investments going forward.

Furthermore, if we examine the actual “fund flows” over the past three years, we can see that investors have been stuffing cash into bonds and money market funds despite the lowest interest rates in over a generation. While equities are losing investors, bonds are enjoying overwhelming popularity! Although this has provided a sense of security (which is a debate for another time) I feel that investors are being lured into bonds without recognizing the risks. Even the so called “smartest investors” on Wall and Bay Street have been piling cash into bonds, as pension plans are still underweight equities relative to bonds. (Top chart to the right) The historical average is roughly 45% exposed to stocks; however today their exposure is only ~35%. Even household treasury ownership (bottom chart) is sitting at all-time highs with an alarming $1 trillion dollars exposed to U.S. government debt. Based on these statistics, I feel that when interest rates begin to rise, we may see an exodus out of bonds and into the most likely candidate...stocks. This could act as the proverbial “fuel” that further ignites the equity markets.

All this isn’t to say that one should avoid fixed income entirely. Bond investments can play an important role in any retirement portfolio, but don’t blindly accept the adage that you have to dedicate more and more of your assets to fixed income as you age. The bottom line, there are higher risk and lower risk times to invest in bonds. This is not one of the lower risk times. My advice is to carefully examine all of your fixed income options before allocating your capital to this asset class. There are several guidelines that we adhere to when considering our allocation to fixed income investments: maturities, liquidity, active or passive management, credit ratings and balance sheet coverage are just a few of the rules to take into account.
In summary, our outlook remains positive for the medium-long term. Short term, we are mindful of the overbought condition of the current markets. As global equity markets will only start their third year of this new bull market on March 9th, this should leave us with another 12-18 months of upward momentum. If past corrections and economic recoveries are a guide, this bull market should carry into 2012 and 2013. Corrections, when they come, are part of the ongoing process of bull markets, they are healthy and they should be expected. Our investing approach suggests that we should stay the course, owning top quality businesses and third party managers that have the ability to produce positive results.

With that I am going to conclude for another month, as it is quite late and my typing abilities are deteriorating. As always thank you for your continued trust and confidence in allowing us to manage, preserve and build your wealth over the long term.

If you have any questions or comments please do not hesitate to contact any member of our team. If you know of anyone who may be interested in this commentary, please do not hesitate to pass this on.

Sincerely,

Craig White & John Huggan

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Reminder: Just a quick note to all of our clients, that March 1st, 2011 is the deadline for 2010 RRSP contributions. If you haven’t already made your contribution and are wishing to do so, please contact Sherri or Diana directly.

On a personal note: I will be attending a wedding at the end of this month in the Mayan Riviera. As I have not ventured to the East Coast of Mexico before, I am quite excited to experience the crystal clear waters and sunny blue skies of the Caribbean. If you require any assistance while I am away, please feel free to speak with John, Sherri or Diana.