A good friend of mine once told me years ago, “Craig, the best thing to do is walk away, as sometimes the juice just ain’t worth the squeeze.” In this context though, the advice was given in reference to relationships, as there are times in our lives when a “dispute” amongst partners is an arduous task and the easiest option is to avoid the issue in its entirety. Now, for all the male readers out there who take time to peruse these monthly commentaries, they will most likely agree that indeed sometimes “the juice ain’t worth the squeeze;” Admittedly though, and in defense of the woman out there, the male end of the story usually “ain’t worth the squeeze” as our stubbornness and lack of accuracy tends to get in the way of our better judgment. Sorry men, but we know there is some truth here….just ask your wives!

From an investment perspective, the same truism could apply today as a large majority of investors refuse to respect the upward bias of the equity markets. Clearly, this untrusting and underinvested crowd has felt that “the juice (risk) ain’t worth the squeeze (reward).” Now perhaps their hesitations will prove correct, but looking at the attendant charts, one can see that equity markets have indeed been “squeezing out” some solid performance numbers since the fall of 2011. The following chart of the S&P 500, illustrates the strength of the advance over the past four months. Since the early October 3rd closing low of 1099, this broad based index has posted a gain of 25%. In fact, as I write this commentary most indices are trading at or near 4 year highs, with the Dow Jones Industrial Average recently touching 13,000 for the first time since May of 2008. In addition, the tech heavy NASDAQ has breached 3000, a reading not registered in over 12 years! Here in Canada, the TSX Composite is still off of its three year highs (March 2011), but the overall direction has been positive. To put things into perspective, the equity markets are off to one of their strongest starts in over 25 years. All this despite a pretty negative backdrop (at least if you follow the news) and what continues to feel like an overwhelmingly pessimistic crowd. As is often penned in these commentaries, the market tends to behave counterintuitive to the general perception and often climbs the proverbial wall of worry when fear is present. From our pencil, the current landscape is no different.
Looking back over the past year, I must agree that indeed these have been challenging times. Over the course of the past 12 months, the media headlines have continued to plague the mindset of investors. For most, it has felt like one impending crisis after another. One day it is Greece, the next it is a Euro Crisis, followed by the ongoing fears of a double dip recession. Add in the continual negative talking heads on BNN or CNBC and one would believe that the world is about to suffer from financial Armageddon. Hey, we even admit, at times this market environment has riddled our team and on several occasions tested our emotional fortitude.

But at times like this, we cannot stress how important it is to avoid letting your inner emotions guide your investment decisions. As often stated in these commentaries, it is best to take a step back during difficult times and revisit your objectives and more importantly assess the data at hand. This is the path our team has followed over the past 6 months. Over this timeframe we have repeatedly stated that we thought the lows for this latest correction had been registered in early August and again in early October. This was not based on an emotional hunch, but on the indicators we constantly monitor that were showing that economic data was improving and selling pressure was subsiding. For those who attended our early October luncheon/breakfast presentations, they will recall that during these meetings, we suggested that the equity markets were at/near critically important inflection points. Either the 1100 “line in the sand” for the S&P 500 was in jeopardy (the low seen in August) or this level would hold as support and the market would bounce off of these lows. Looking at the chart above (first page), we can see how it all played out, as the lows held. Throughout this whole sequence though, we felt the action of the markets were similar to the 1978-1979 bottoming process. The chart to the right (1978-1980), which we showed during these presentations and discussed in past commentaries, illustrates a series of lows during the fall of 1978 (orange arrows). As you can see, over the course of the next few years, the market produced a series of advances and declines, but never broke below the lows of 1978. We feel the current environment closely resembles the sequence described here, which is why over the past 4 months we have attempted to give this market every benefit of doubt and advised our clients to stay the course.

At the same time, we have experienced a dramatic reduction of volatility which has further supported our bullish stance. The chart below focuses in on the volatility index or VIX. To recap; the volatility is often referred to as the fear index or the fear gauge, as it represents one measure of the market's expectation of stock market volatility over the next 30 day period. As I have mentioned before, levels below 18 are low risk and are associated with minimum volatility and growth for the indices. Moderate risk is generally seen between 18 and 33, while high risk and concern escalates when the VIX breaks above a reading of 33. Lately, the VIX has been around 18 which represents a relatively calm market environment. The graph clearly shows a downward sloping trend from a high of 45.45 in October to the current less volatile reading of 17.26. This is not to say that equity markets going forward will not be faced with repeated bouts of volatility, but one can surmise, based on the evidence provided here, that the equity markets have certainly breathed a sigh of relief for the time being.
Ironically as I write this commentary through my inbox I have received a piece that relates directly to the topic of volatility. The following chart illustrates the daily price movement of the S&P 500 since the start of the financial crisis. Although somewhat difficult to recognize, we can see that at the height of the financial crisis, the S&P 500 was extremely volatile with daily price changes of +10% to -7.5%. “Normal” volatility for the S&P 500 was for decades contained in a band of +2.5% and -2.5%. Since 1940, there have been 30 trading days where the market declined by 5% or more; 14 have been since January 1, 2000 and nine since the start of the current financial crisis. Over the same time period, there have been 18 days with the market up 5% or more; 12 were in the 2000s and nine since the start of the current financial crisis. The last 3 years were the most volatile since the 1930s, but the positive news is that volatility has been declining since the peak in 2008. From my own personal perspective, I believe this is a result of two main contributing factors 1) the creation of financial instruments such as exchange traded funds, swaps, derivatives, hedge funds, leveraged products and 2) computers that work on high frequency trading. The latter I believe is the main culprit and the issue needs to be addressed by regulators.

Digging a little deeper into some of the economic data we follow, we continue to see encouraging developments out of two key inputs: employment and housing. Although we will be receiving February employment after this commentary goes to print, the data in the month of February was upbeat. Perhaps most noticeable was another monthly decline in the Initial Claims for Unemployment in the U.S. (Chart to the left). The latest reading brings us to the lowest level since March 2008. For those who believe that the economy is heading back into recession, the recent decline in claims is in stark contrast to the typical rise in unemployment claims that precede or accompany a recession. When we compare the performance of the S&P 500, we can see that falling unemployment usually yields positive returns for the equity markets. The housing market south of the border is also seeing some glimmers of hope. The National Association of Homebuilders reports that their survey for Traffic of Prospective Buyers Index has rebounded to the best level since 2007, prior to the start of the last recession. In addition, their Builder Confidence Survey has jumped 15 points since last September. According to Investech Research, this sort of strength (an increase of greater than 13 points in less than 6 months) is typically seen at that start or in the firm stages of an economic recovery and not just prior to a recession – or at least never in the past 27 years. Furthermore, new housing inventory is down to a six year low of 5.6 months’ supply. Although the road to recovery will be lengthy for housing, in aggregate, the data is favourable and we are starting to see positive developments.

One of the main influences of economic growth is consumer confidence. Over the past four quarters we have seen mildly positive GDP growth on both sides of the border, but the data shows that we are still below the historical average. We believe growth has been
hindered due to a lack of confidence. That being said we are happy to report that after a sluggish back half of 2011, consumer confidence is once again gaining ground. On top of this you have what appears to be a recent “fix” for the Eurozone, continued positive earnings for stocks and overall attractive price/earnings ratios, strong corporate balance sheets, political gamesmanship taking a backseat (at least for now), the historically strong 4th year of a presidential election at play, lack of confidence in the equity markets and a profoundly underinvested crowd and the environment looks pretty appealing...at least to us. Hence, our strategy to let the supporting data guide our decision making (not emotions) and our repeated advice to give this market every benefit of doubt.

But one must be cognizant of both sides of the story as all figures can’t paint a rosy picture. Certainly there are still concerns and risks in the marketplace. First of all there is the Eurozone and more specifically Greece. Although some believe that Greece will remain within the Eurozone, we believe Greece will eventually default. At this point, it appears as though supporting authorities and central bankers will allow Greece to default in an orderly fashion. But any hint or suspicion of a disorderly default could re-ignite the fears seen in months past. Nevertheless we are optimistic that a solution will be found.

Secondly one of the main concerns that have arisen over the past few weeks has been the run-up in the price of oil and gasoline. As I write this commentary, the price of WTI Crude is trading at $108.50/bbl., while Brent Crude has soared to over $125/bbl. The rapid move up in oil prices is expected to escalate if tensions in Iran continue to increase. As stated in David Rosenberg’s latest commentary; “forward contacts are pointing to gasoline breaking back above $4 a gallon in the next two to three months (already there in California and New York State). The nationwide average has already risen 37 cents in just the past month and 7 cents in the last week alone – it hasn’t been long enough in the confidence surveys, though let’s face it, we are already seeing some fraying of the edges in the retail sector. David further goes on to say “it’s not that people have gotten used to $4 –it’s only in the Golden State, Hawaii and Alaska… wait until it grips the whole country. And consumers have yet to fully process this rapid move up in gas prices, but recall what happened a year ago. To be sure, there was no recession, but economic growth came to a halt in the first half of the year because of the impact that energy costs exerted on GDP.”

Clearly we are keeping a close eye on oil prices in the near term. The key is how long this elevated energy price environment lasts and the overall impact on the economy. Prolonged high or rising oil prices is positive for the Canadian dollar, but a stronger loonie vis-à-vis the U.S. Greenback certainly impedes our nation’s exporters.

Finally, as mentioned above most equity markets are now trading at or near 4 year highs. Although we are extremely pleased with this result, we do feel the markets have used a lot of internal energy to advance to these levels. Over the past few weeks, the Dow Jones Industrial Average (red line) has oscillated around the 13,000 level, but we have not seen firm confirmation that this level will hold...at least not yet. Furthermore, the economically sensitive Dow Jones Transportation Average (blue line) which is made up of shipping, rail, trucking, airlines etc. is being held back at least partially due to the firm oil prices discussed earlier. Likewise, the Russell 2000, which is considered the premier index of small cap stocks, has failed to break to new highs. If these non-confirmations persist over the near term, it will most likely take a toll on market momentum.

So what should investors do? The next month or so should see additional consolidation from both the U.S. and Canadian indexes. Consolidation refers to sideways action, while the overbought condition works itself off. Both levels are nearing or are at key resistance levels, which will most likely slow their ascent in the short term. In last month’s commentary we stated that we were steadfastly bullish on precious metals. Despite a one day nose dive for
gold on February 29th, our outlook remains the same for this sector. We have also repeatedly stressed the desire for income producing assets as we feel the risk premium to own higher yielding equities continues to outweigh the limited return seen in fixed income (bonds). So far this “call” has served us well, as higher paying dividend stocks and investments that are “cash flow rich” have been rewarded in the marketplace. Specifically, many of the real estate investment trusts, pipelines and utilities are now trading at or near all-time highs and we may look to capitalize on these profits in the near term. Simply put, they are not cheap at this time and we are starting to see some sector rotation into other income producing assets. As always, we will keep our clients updated when we feel the timing is right.

In summary, we continue to strongly recommend a diversified portfolio approach. Selectively working through the various segments of the market is of utmost importance at this time, as a few sectors have become overvalued in our opinion. This is not to say that opportunities are limited, as there are a plethora of solid investment ideas available at any given time. The objective is to diligently screen through the landscape to uncover these opportunities before the market does, as this is where the profitable stories lie. As always, we are working hard to uncover these prospects and to find the best investment opportunities for our clients. In the meantime, we will follow our technical tools and the constructive economic evidence and continue to respect the current bullish market environment. Short term, don’t be surprised to see some sideways action or a pullback from these levels.

Once again, we want to thank you for your continued support and trust in allowing us to manage your financial affairs. If you know of anyone who may be interested in reading this commentary please do not hesitate to pass this on. For those who would like more information on our team and our services, please log in to our website at www.hugganwhite.com

Until next month,

Sincerely,

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To All My Irish Friends, Happy St. Paddy’s Day!

Tax Reporting Season: With the RRSP deadline now behind us, it is now time to turn our attention to tax season. A reminder that most forms will be sent in the coming weeks. T3’s for Canadian Trust Income will be issued by March 30, 2012. Please do not file without these documents.

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