The Market in Review

Paul Siluch, Lisa Hill, Peter Mazzoni, and Sharon Mitchell
Financial Advisors
Raymond James Ltd. – Victoria BC

March 17th, 2017

This week's articles and insights

1. *The Fed Chair of Oz*
2. *Active vs. Passive*
3. *Value in the Home*
4. *Security Fatigue*

Scarecrow: "I haven't got a brain…only straw."

Dorothy: "How can you talk if you haven't got a brain?"

Scarecrow: "I don't know...But some people without brains do an awful lot of talking…don't they?"

Dorothy: "Yes, I guess you're right."

- ***The Wizard of Oz - 1939***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	20,915	+0.06%	+ 5.83%

S&P 500	2,378	+0.23%	+ 6.22% (+5.40% in $CDN)
TSX	15,490	-0.10%	+ 1.33%

The Fed Chairman of Oz

On May 17, 1900, L. Frank Baum published his children's novel "The Wonderful Wizard of Oz". It was described as the first American fairy tale because it referenced real places in the United States, like Kansas. A modest run of 10,000 books sold out quickly. Children loved the book, and its popularity was further fueled by a musical stage play. By 1956, it had sold over 3 million copies worldwide.

In 1964, Henry Littlefield examined the novel from an American cultural point of view in the *American Quarterly*. He determined that there were many financial allegories present in the story, all relating to life in America at the turn of the century. The two Wicked Witches were economic forces that suppressed the common man of the day, for example. The Wicked Witch of the West symbolized drought, a scourge that routinely devastated crops and farmers for years at a time in the west. It was fitting, then, that the Wicked Witch of the West was killed by water. The Wicked Witch of the East imprisoned her captives, which was symbolic of the way the industrial east subjugated its poor working classes in its factories and stockyards.

The story was also an allegory about the gold standard. An ounce of gold is abbreviated as "oz.", from which the story's title derives. The US dollar was bound to the price of gold and all credit flowed from the amount of gold the nation's banks held. A bank made its loans based upon the bullion in its vaults, so even if there was increased demand for money because of a buoyant economy, the bank could not lend more if it did not possess the physical gold to back the loans. Farmers, who borrowed heavily every spring for their seed and then repaid these loans at harvest time, were often the casualties of this tight credit. They favoured "bimetallism", which would add silver bullion to the banks' reserves. Silver was (and still is) more plentiful and cheaper than gold. Banks would have been able to make more loans if the dual-bullion standard were adopted.

In the original story, Dorothy wore silver slippers, not ruby ones, as she travelled the Yellow Brick Road to Oz. This was symbolic of the farmers (Dorothy) and their quest for the powerful city (Oz) to adopt silver (the slippers) in addition to

gold. While bimetallism may have been accepted in the Emerald City and the world of Oz, the US stuck to its gold standard until 1971.

The Wizard of Oz himself may have been the President of the United States – a man with a powerful office but little actual power. The Great and Terrible Wizard was found to be just "a common man" who fooled everyone into thinking he was omniscient. He made promises he could not keep, like most politicians in 1900. And today, for that matter.

"*How can I help being a humbug*," the Wizard says, "*when all these people make me do things that everyone knows can't be done?"*

And speaking of powerful wizards who see and control everything, the US Federal Reserve chair, Janet Yellen, raised interest rates for just the third since the 2008 Financial Recession this week. Interest rates have been the blunt tool used to cure all ills since the 1990s, when then-Fed Chair Alan Greenspan cut rates whenever a crisis arose. And because the US dodged the Asian meltdown of 1997, the Russian default of 1998, and the Y2K bust of 2000, lower interest rates came to be seen as a panacea.

When the world seized up in 2008 and prices of everything from homes to stocks to oil plummeted, the entire world jumped on the bandwagon of lower interest rates. Some central banks, such as Japan and Europe, took things to the extreme with negative interest rates. Again, this seemed to work. Stocks, bonds, and real estate prices have been rising since 2008, thanks to this zero interest rate policy. It is a policy that is getting old and shopworn, however, even as everyone still believes that low interest rates are the magic pill for everything. Some even wonder if the persistent sluggishness of the world economy has been caused by low interest rates, rather than being cured by them.

The US Federal Reserve is attempting to “normalize” interest rates to get them back to some historic level where people are actually paid to save. But higher interest rates tend to slow an economy down, so Janet Yellen has a very fine line to walk. She has to withdraw the medication from the patient, but not so fast as to cause great pain. Her comments this week were sufficiently cautious as to assure investors that the Fed would not raise rates too fast. Bond, stocks, and gold prices rose. The US dollar declined.

In a sense, we have created our own Wizards of Oz in our central bankers. They are seen as all-powerful and capable of creating jobs, prosperity, and endless money for everyone.

Like the Wizard, does Janet Yellen secretly utter the same words to herself, each time she delivers exactly what the market demands?

"All these people make me do things that everyone knows can't be done."

Active vs. Passive

The years 1995 to 2000 were the Tech Boom. The internet began taking off in 1995 with the widespread adoption of e-mail, followed by early cellphones and the laying of optical cable everywhere. The “dot.com bubble” finally popped in March of 2000 and many companies did not survive. Even the most successful firms, such as Microsoft (**NASDAQ MSFT**), are still below their 1999-2000 price peaks.

But not everything fell. The bank stocks had been declining since 1998 and were very out-of-favour. Same for the oil stocks, as well as the tobacco industry, which was viewed about as favourably as coal stocks are today. Investors who invested in these companies rode out the vicious bear market of 2002 quite nicely, especially those who invested in oil stocks.

The technology and telecom stocks were the recipients of the majority of money flows in the late 1990s. The public bought the trend, then added and added. I remember a client demanding to buy Cisco (**NASDAQ CSCO**) for close to $100 in 1999 only to watch it fall to $10 in 2002. This is what happens when one sector of the market becomes too popular. Buyers run out of money and only sellers remain.

A similar bubble is inflating today. It is impossible to know where we are in the cycle – 1996? 1999? - so it could well have years left to run. The result, though, could be similarly unprofitable for some, and profitable for others.

The trend today is what is called passive, or index investing. Indexes were originally hypothetical baskets of stocks created as a benchmark. The Dow Jones Industrial Average is an index of 30 stocks, for example. The member stocks have changed over the decades as old industries faded and new ones grew, but there are always a chosen 30 in the index. The S&P 500 is the more widely-known index in the US, and in Canada we have the S&P/TSX 60. Investment companies have created investments that mimic the index baskets, with very low management fees. Thanks to these low fees and the high quality of companies held inside the index, these baskets have done quite well. Investors do not have to do anything once they hold the basket (the individual stocks are

changed for them when the list changes), so this is referred to as “passive investing.”

What is now out-of-style is “active investing”, where a trained money manager selects which stocks to buy and sell based on his or her judgment. Active investing has underperformed passive investing for a number of years now, leading to more and more money flowing into passive baskets and out of active funds.

In large part, this is due to the fee advantage low-cost index funds have over active managers. Another factor, though, is just due to money flows. A huge amount of money is now chasing the indexes, which sends them even higher. According to the Wall Street Journal, US $429 billion was invested in index funds in 2016 while $285 billion was removed from actively-managed mutual funds.

So where is this 1999-style bubble? The S&P 500 has 500 stocks in it. Every new dollar placed into an index fund pushes these 500 stocks up. Investors watch the performance rise and add even more money to the “chosen 500”. This is just 9% of all listed stocks, however. There are over 5,300 publicly-listed stocks on US exchanges (source: Financial Post). This means we are pumping most of our money into just a handful of all available stocks and ignoring the rest.

A similar situation is happening in Canada. There are approximately 3,900 companies listed on the senior and junior Toronto Stock Exchanges (source: Canadian Living), suggesting index investors are concentrating on just 1.5% of those available.

Our conclusions?

- Index investing certainly has a place in portfolios.
- The performance edge that index funds have enjoyed for the past decade may start to wane as those few index stocks get pushed to more extreme valuations than the rest of the market.
- The focus on costs brought about by low-cost index products is bringing costs down everywhere. Active managers have sharpened their pencils, which is a good thing for investors.
- Ultimately, money chasing 9% of the market means the remaining 91% of stocks could become huge bargains. Not yet, but given current money flows, a bubble is almost inevitable.

Index investing has grown because of a widespread belief in efficient markets. However, the concentration of the indexes is making the market more inefficient than it has been in years.

Perhaps the stock picker will again, one day, outperform.

Note: On Monday, March 20th, Raymond James Financial (**NYSE RJF**) will be added to the S&P 500 index. From a humble start in 1962, this is a big step for us.

Value in the Home

One area of the stock market where we are seeing very good value is in the US homebuilders. Yes, this is the group that led us off the cliff in 2007 with rampant overbuilding due to "liar loans" and subprime mortgages. But think about what has happened in the intervening decade since then:

- New home builds plummeted because of all the foreclosed homes that came up for sale. Why build when you could buy a house for pennies on the dollar? That supply is now gone.
- The US population in 2007 was 301 million. Today it is 323 million. Do those 22 million new people need homes? Many do.
- The Millennials have now surpassed the Baby Boomers as the largest cohort of the US population, making up 29% of the population (92 million). They have a median age of approximately 27 and are moving out of their parents' basements and starting families. The biological clock is collectively ticking.
- Those people who declared bankruptcy in 2009 had to wait seven years to clear their poor credit scores. This happened last year, meaning they are free to apply for mortgages once again.
- New home starts are finally climbing, and yet they still remain at the same level as in 1993.

Our choice for our Dividend Value portfolios is homebuilding company Pulte Homes (**NYSE PHM**). Pulte has acquired a good amount of land on which to build homes, and the company focuses on starter homes rather than high-end ones. Perfect for the new Millennial buyers.

Rising interest rates could hurt home sales, but they are also a good incentive to buy today and lock in the low rates.

Pulte's CEO Ryan Marshall recently said "We believe that continued favorable trends in the economy, job growth, demographics and consumer confidence can more than offset the impact of modestly higher rates, allowing the housing recovery to continue at a steady pace."

It has a modest dividend of 1.5% and at today's price of $23.85, we see potential upside over the next few years into the mid-$30's.

The graph below compares the share price and its intrinsic value - what analysts calculate the company to actually be worth. You can see the steep decline in both in 2007-2008.

Since 2013, the share price has been flat while earnings have climbed. The analyst community sees the shares as substantially undervalued.

Referrals are the nicest way to grow any business. If you have friends or colleagues who could be helped by our commitment to prudent investing and world-class, personal service, we'd be delighted to hear from you and to gently follow up with them.

Just call us at (250) 405-2417 and we'll take it from there. Thanks!

Security Fatigue

WikiLeaks recently spilled the beans on something called "Vault 7", a trove of documents from the CIA that detailed how they can hack devices in the home. We already knew they were capable of listening in to phone calls on smart-phones, but we did not know they could hijack your voice-activated TV and microwave oven by turning them into recording devices. The coming boom in driverless cars has security companies very worried that car electronics will also be hacked, causing sudden braking or locked doors from remote locations.

A recent article from RPost on-line magazine says we may be suffering from security fatigue. This is when people collectively throw up their hands and ignore all the warnings. Security fatigue is a boon for the hackers, who prey on easy-to-crack passwords and open servers. Apparently, there are now search engines anyone can access that show what devices are on-line anywhere in the world and their default passwords. Is your new "intelligent oven" communicating to the world without your knowing it? A visit to the Shodan website just might tell you.

The good news is that leaks like this spur the good guys to fight back and plug the holes. It should also be a reminder to people to change their passwords more frequently than they do. The leaks also show that *encrypted* messaging and e-mails are still safe. No one has managed to crack what we say to one another when we use this protection.

Raymond James is implementing encryption in our e-mails when we send out sensitive documents, such as statements, over e-mail. It takes a bit of time to set up, but once done, it is easy to use. We are staying ahead of the bad guys, wherever possible.

Stay vigilant!

We thank you for your business and your referrals and we hope you find our site user friendly and informative. We would welcome your comments.

How to contact us:

paul.siluch@raymondjames.ca
lisa.hill@raymondjames.ca
peter.mazzoni@raymondjames.ca

(250) 405-2417

Disclaimers

The information contained in this newsletter was obtained from sources believed to be reliable, however, we cannot represent that it is accurate or complete. It is provided as a general source of information and should not be considered personal investment advice or solicitation to buy or sell securities. The views expressed are those of the authors, Paul Siluch and Lisa Hill, and not necessarily those of Raymond James Ltd. Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This newsletter is intended for distribution only in those jurisdictions where Raymond James Ltd. is registered as a dealer in securities. Any distribution or dissemination of this newsletter in any other jurisdiction is strictly prohibited. This newsletter is not intended for nor should it be distributed to any person in the USA. Raymond James Ltd. is a member of the Canadian Investor Protection Fund.

Raymond James does not accept orders and/or instructions regarding your account by e-mail, voice mail, fax or any alternate method. Transactional details do not supersede normal trade confirmations or statements. E-mail sent through the Internet is not secure or confidential. We reserve the right to monitor all e-mail.

Any information provided in this e-mail has been prepared from sources believed to be reliable, but is not guaranteed by Raymond James and is not a complete summary or statement of all available data necessary for making an investment decision. Any information provided is for informational purposes only and does not constitute a recommendation. Raymond James and its employees may own options, rights or warrants to purchase any of the securities mentioned in e-mail. This e-mail is intended only for the person or entity to which it is addressed and may contain confidential and/or privileged material. Any review, retransmission, dissemination or other use of, or taking of any action in reliance upon, this information by persons or entities other than the intended recipient is prohibited.

This email newsletter may provide links to other Internet sites for the convenience of users. Raymond James Ltd. is not responsible for the availability or content of these external sites, nor does Raymond James Ltd endorse, warrant or guarantee the products, services or information described or offered at these other Internet sites. Users cannot assume that the external sites will abide by the same Privacy Policy which Raymond James Ltd adheres to.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. There can be no assurances that the fund will be able to maintain its net asset value per security at a constant amount or that the full amount of your investment in the fund will be returned to you. Mutual funds and other securities are not insured nor guaranteed, their values change frequently and past performance may not be repeated.

PulteGroup Inc. - Raymond James & Associates makes a market in shares of PHM.
Cisco Systems - Raymond James & Associates makes a market in shares of CSCO. Raymond James & Associates received non-investment banking securities-related compensation from CSCO within the past 12 months.

Microsoft - Raymond James & Associates makes a market in shares of MSFT. Raymond James & Associates received non-investment banking securities-related compensation from MSFT within the past 12 months.

Prices shown are as of close March 17th, 2017.

You are receiving this message because our records indicate that you have requested this information. If you no longer wish to receive research from Raymond James, please reply to this message with unsubscribe in the subject line and include your name and/or company name in the message. Additional Risk and Disclosure information, as well as more information on the Raymond James rating system and suitability categories, is available at www.rjcapitalmarkets.com/Disclosures/Index.

To unsubscribe and no longer receive any email communications from this sender, including information about your account, please either click here or send a reply email to the sender with [UNSUBSCRIBE] in the subject line.

Pour vous désabonner de cet expéditeur soit cliquer ici ou envoyer un e-mail de réponse à l'expéditeur avec [UNSUBSCRIBE] dans la ligne d'objet.

This email, and any files transmitted, is confidential and may contain privileged information. Any unauthorized dissemination or copying is strictly prohibited. If you have received this email in error, please delete it and notify the sender immediately. We may monitor and review the content of all email communications. Trade instructions by email or voicemail will not be accepted or acted upon. Please contact us directly by telephone to place trades. Unless otherwise stated, opinions expressed in this email are those of the author and are not endorsed by Raymond James. Raymond James accepts no liability for any errors, omissions, loss or damage arising from the content, transmission or receipt of this email. Raymond James Ltd. is a member of the Canadian Investor Protection Fund.

Le présent courriel, de même que tout fichier transmis en pièce jointe, est de nature confidentielle et peut contenir des renseignements privilégiés. Toute diffusion ou reproduction en est strictement interdite. Si vous avez reçu ce courriel par erreur, veuillez le supprimer et en informer immédiatement l'expéditeur. Nous pouvons surveiller et examiner le contenu de toutes les communications électroniques. Les instructions portant sur des opérations, données par courriel ou dans une boîte vocale, ne seront pas acceptées ni exécutées. Veuillez communiquer avec nous directement par téléphone pour donner des ordres en bourse. Sauf indication contraire, les avis exprimés dans le présent courriel sont ceux de l'auteur et ne sont pas avalisés par Raymond James. Raymond James décline toute responsabilité en cas d'erreurs, d'omissions, de pertes ou de dommages découlant du contenu, de la transmission ou de la réception du présent courriel. Raymond James Ltd. est membre du Fonds canadien de protection des épargnants.