Neuro Approach
INVESTMENT NEWSLETTER

RBC Wealth Management Dominion Securities

RBC Dominion Securities Inc, 2701 Highway 6
Vernon, BC V1T 5G6 Ph: (250) 549-4084 Fax: (250) 545-4139
Website: www.rbcds.com/terry.curran
E-mail: terry.curran@rbc.com

June 22, 2016 *Written by* ***Dr. Terry Curran, MD, CIM, Investment Advisor***

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Preparing For The Next Recession!

I appreciate that nobody can predict the timing of the next recession but part of my investing strategy has always centered on having the odds in my favor and right now I see equity market risk versus reward very tilted towards risk. This is because I feel the odds of a US recession (and possibly global) over the next 12 months have become very elevated.

As a money manager this is a flashing RED warning for my clients portfolio's as markets ALWAYS decline 25-35% during recessions and it behooves me to act and tilt accordingly. Of course, markets can also drop 15-20% or more without a recession but these are briefer and less traumatic affairs such as we witnessed in 2011 when the US market transiently dropped 19%. With these briefer declines investor emotional and behavioral stability is less affected versus the protracted full blown recession bear market.

The strategy behind my recession vigilance is that bear markets associated with recessions are quite nasty in degree and duration but also because the market decline typically starts on average **9 months before the recession.** In other words, the market always forewarns about impending recessions as they are very good leading indicators for those who pay attention and remain vigilant!

With this knowledge it is a worry to me that the US stock market peaked May 2015 and despite several attempts to break above that level it has failed repeatedly. I think the savvy investor must consider this as a warning sign of escalating risk especially when one also looks at the soft global economic backdrop. Since 1929 we have had a recession every 5-6 years and they last 21 months on average (12 months if we exclude the Great Depression), and over this time frame the average market decline has been a whopping 35%! The last US recession ended March 2009 so this equity bull is now going into its 8th year which is very long in the tooth. In fact, this is the second longest bull market in history which has my recession alert antenna elevated and flashing red!

But it is not just the duration of this bull that has me worried—it is the frothy valuations at a time of rising global headwinds and economic weakening trends that have me on high alert!

THE PSYCHOLOGY NEEDED FOR RECESSIONS

If my hunch is correct and we do see a recession in the next 12 months then it wise to start thinking about the plan of attack now before the emotional limbic system takes over, as it always does during bear market recessions, resulting in panic selling. We know from our last newsletter that for a variety of reasons most investors are wired to "sell low and buy high" especially during times of escalating emotions. To avoid these recurrent (and predictable) investing flaws investors need to be forward thinking and have a steadfast written plan in place for when the fear & panic emotions escalate with the next recession e.g. our Master Investment Portfolio Plan ("the MIPP"). During these times of excessive emotions and uncertainty we automatically switch to our primitive limbic brain, and investors need to find a way to inhibit this reflexive brain activity. Fortunately, I have outlined in great detail our "protective system" in the last newsletter as well as in our *Currant Generic News* report.

I am reminded at times such as this of Jeff Gundlach's statement that "you make 80% of your money in 20% of the time in investing and you have to be patient". With global markets now flat to negative over the last two years I sense that our 20% buying opportunity is close at hand (and yes we have been very patient as you all know).

THE RISING RECESSION RISKS

So let's review some of these risks to see why my "recession alert" antenna is now the highest it has been in 8 years!

#1 Europe and the Brexit Vote

We will know very soon (June 23) whether the UK decides to stay or leave the EU. Although the UK represents only 3% of global GDP the implications for a UK exit vote are much larger. This could start a contagion vote with other EU members such as France and Holland which could quickly unravel the whole EU and the euro currency. Many also feel it could be the start of a more global populist movement-vote (such as with D Trump and B Sanders in the US) over the growing income inequality and the declining middle class seen in most developed countries.

My guess is that a UK vote to leave would result in a significant decline in EU equity markets in the short term and a gain in the US dollar and US markets as money flows towards "US safety". It is truly remarkable that the 10 year German Bund is now trading below zero (i.e. a negative yield) which spells increasing risk for EU equity markets, and especially EU banks which are already under tremendous stress. What happens in the medium term if the UK leaves is unknown but it is another reason to be defensive I believe in 2016.

#2 The Bond Market Message

The Yield Curve (YC) represents the spread in yields between the US 10 year Treasury and the 2 year and is now the flattest since 2007! In fact, the YC has been flattening since the Fed discontinued QE3 in 2014 and it took a further "hit" when they raised rates in Dec 2015. Flattening of the YC is a sign of tightening in financial markets and explains why financial stocks are doing poorly as this crushes bank earnings (and part of the logic behind lowering our bank exposure last month). A flattening YC tells me that markets have little faith in near term US economic growth, but more importantly, all prior US recessions were first associated with a **flattening** of the YC before it **inverted**. Although we are not there yet this most recent flattening trend is very worrisome. Bond expert Jeff Gundlach has also noted that Japan has had 6 recessions over the last few years and NO inverted YC…

As stated in prior newsletters, it is rare for the Fed to raise rates during a manufacturing recession, a profit recession and during such low GDP growth. In retrospect, the question will be whether the Fed committed a serious "policy error" in 2015 by raising rates during such weak economic times where the trend was already negative (such as we saw in 1937)?

The bond market message is therefore one of recession vigilance and defense. I think the odds of a US recession are above 50% in the next year and I have acted accordingly.

#3 Global Debt Levels Flashing RED

Because of the 2008-09 Great Recession Central Banks around the world had to step up to prevent a repeat 1930's Great Depression. They responded on two fronts with initial large stimulus packages (to replace the consumer void), and then lowered interest rates to zero (ZIRP) to encourage consumers and corporations to borrow and spend to help revive the economy. The problem now 7.5 years later is that consumer/corporate spending never really picked up and so ZIRP remains along with massive debt levels accumulated globally:

1. Global debt levels in 2007 were 269% of GDP and now they are at 290%.
2. The US now has $ 19 Trillion of debt versus $8 Trillion in 2007.
3. US corporate debt in 2007 was $3.5 trillion and now its $7.5 and most of this has gone towards "financial engineering" schemes to window dress corporate numbers with massive share buyback programs but very little towards CapEx.
4. US debt rose 3.5x faster than GDP in 2015 and this is a very unhealthy ratio this late in the cycle (Dr. Lacy Hunt).
5. US corporate defaults have soared in 2016 and are now at the highest rate since 2010. This is expected to soar going forward as with free money (i.e. ZIRP) many inefficient companies have been allowed to survive much longer than they should have in this business cycle.
6. US Household debt stands at 78% of GDP which is below the 2008 levels BUT still 20% above the average level since the 1950's (L Hunt) and implies more consumer deleveraging is ahead.
7. The US household debt-to-income ratio was 60% for many decades prior to the 1970's but then zoomed to 130% in 2008 with the housing-mortgage bubble. It has now declined to 102% but this is still 40% above prior levels and again points towards a frugal consumer going forward.
8. US student debt stands $1.3 Trillion and 43% of the 22 million students with debt are not making payments—these are our future consumers and home buyers!
9. Probably the largest debt concern/bubble is focused in China. China's debt to GDP was 150% in 2008 and has now soared to 300% (D Rosenberg). How and when the Chinese debt and real estate bubble deflates is any ones guess but it could have global repercussions.

There are multiple problems with protracted ZIRP and the resulting excess debt accumulation, but the main one is that it acts as an anchor around the neck of future spenders. In essence because of this massive debt accumulation we have we have stolen from the future, and so we can expect very slow growth and rising defaults going forward for several years.

Finally, nobody understands debt better than the very wise distressed debt expert Howard Marks. I take notice that in 2008 he raised $11 billion in anticipation of soaring defaults and bargain buying, and now once again in 2015 has raised $22 billion in anticipation of a repeat "performance"!

4 Earnings Recession Flashing RED

There are various ways for companies to report earnings but the two most common are the GAAP Earnings (Generally Accepted Accounting Principles) which is the same as "Reported Earnings", and the corporate favorite is the "adjusted" or "operating earnings" which excludes certain write-offs and so is more favorable for the company's profit picture. But no matter which way you view earnings the trend over the last year has been very weak as we have seen consecutive quarter after quarter of declining earnings:

1. It is not just the US that is experiencing this earnings recession—the US y-o-y earnings are now down -8.8% but Asia is also down -19% and Europe is down -27% (D Rosenberg).
2. Dr. Lacy Hunt says we have now had 8 quarters of declining US profits and only once before (1948) was this NOT associated with an economic recession.
3. JP Morgan research over the last 100 years tells us that we have had a US recession 81% of the time when we have consecutive back to back earning declines.
4. GAAP earnings dropped 12.7% in 2015 which is a rare event outside a recession (Brendan O'Boyle).
5. The difference between the stricter reported earnings and the company favorite "flexible" operating earnings has now widened to 18% compared to the average gap over the last three decades of only 4%. This tells me that companies are window dressing (i.e. fudging) the earnings to a major degree and this makes me nervous.
6. Finally, it is also expected that the second quarter will once again see a contraction in earnings by -4.7% y-o-y.

Additionally, investors need to know that corporations always respond to these consecutive quarters of declining earnings and revenues in the same way. They eventually cut back on their largest expense (i.e. wages) so as to preserve the bottom line and the stock price. We have just witnessed this as the pace of hiring has gone from 200,000 jobs per month (averaged over 3 months), from this time last year, to 100,000 per month now. This will be a problem for aggregate consumer spending going forward as well as the markets.

#5 Valuations Are "Egregiously over valued"

Jeff Gundlach summarized it well recently when he said that the US stock market "seems egregiously over valued versus other stock markets". No matter which way I view the US market valuations they are frothy and have been this way now for almost two years! In fact, by most measures the US market has only been more expensive twice before—in late **1929** and early **2000**, and this fact alone should send a shiver down your spine.

Remember that success in the stock market is all about **the price you pay** and you always want to buy low and sell high. Unfortunately, as covered in prior newsletters the Herd always ignores valuation measures and does the reverse by buying the most right at the market top. Interestingly, in this cycle it might be the CEO's who do most of the buying at the top through their share buybacks as retail investors seem to be sitting on the side line!

Here are a few valuation metrics that should make you pause before you hit BUY:

1. The Trailing Twelve Month (TTM) P/E ratio using GAAP is at 24x for the S&P 500. At the peak in the 2008 equity-housing bubble it was 25.3x…so we are expensive!
2. The Shiller CAPE is now 26.1x...that is very rich!
3. The "median" P/E (which excludes outliers) is now 23.2x for the S&P 500 versus the last 50 years average of 16.9x so we are 25% over here according to Ned Davis Research. This is also higher than the 2007 froth levels…so buyer beware!
4. The "Buffett Indicator" of Market Cap: GDP is at 119% versus the historical average of 69.5%, which cries froth!
5. The Price: Sales or P/S ratio is now at 1.9x which is a 15 year high as sales have only increased 33% versus the soaring rise in profits or earnings over the last 7 years. The

only other time that the P/S ratio was higher was March 2000! And because sales cannot easily be manipulated I consider this metric one of the most accurate!

6. The US equity markets have risen 3.7% per quarter on average since March 2009 yet GDP is only up 0.9% per quarter and "the gap is the widest ever" in any recovery says Lu Wong.

So by almost any measure these markets are very expensive. More importantly, several reviews have shown that when investors buy at these high levels the subsequent 7-10 year annualized returns drop to the 0.92 - 2.17% range, which are very weak returns (GMO, Research Affiliates, and Steve Blumenthal). This is one of the risks of buying high and is a reason to avoid it at all costs.

Unfortunately, markets can stay expensive for very long periods so valuations alone are not good for timing the markets. But what worries me about the current frothy valuations is that most of the equity buying over the last 2-3 years has been by Corporations through massive share buybacks and this trend has now suddenly reversed. A recent report from Birinyl Associates says that in 2016 US corporate share buyback announcements have fallen 40% versus 2015 and this could be a real challenge for markets going forward…

#6 Job Trends Weakening

The May US employment data surprised most investors in that the US only created 38,000 new jobs and the previous two months were revised lower. The 3 month average job growth now sits at only 116,000 jobs per month which pales compared to the same time in 2015 when it was over 200,000. The Feds "favorite" measure of employment is the Labor Market Conditions Index (LMCI) which is a constellation of 19 different job indicators, and it plunged in May to -4.8%. In fact, it is the worst reading in 7 years and has been in decline now for almost a year.

My hunch is that we will now see the weekly initial jobless claims start to rise as firings escalate. Additionally, we are now seeing a decline in "temporary help employment" (down 3 of the last 4 months) which is another early warning that we are nearing the end of this cycle and one step closer to the next recession. I will be watching these early job indicators very carefully over the next few months.

Despite the headline unemployment number of "only" 4.7% it has been my assertion that "quality job creation" has been very weak over the last 1-2 years in the US. Most of the new jobs are low paying and the broader U6 under-employment number is stuck at 9.7%. Additionally, when you look at wages/salaries as a percentage of GDP you get a real picture of how the average worker is doing, and these numbers look very weak. In 1970 aggregate wages were at 51% of GDP, in 1980 they were 48.5%, in 1990 they were 46%, and in 2015 they have declined to only 42.7%!

#7 The Shrinking Middle Class

The combined financial stressors of the elder boomers and the millennials are each having a negative impact on the economy and stock market. The oldest boomer is now turning 70 and the median age is 60. History tells us that this age group does not consume as they are razor focused on balancing the books during retirement and not interested in acquiring "new stuff". But because of multiple financial hardships over the last 15 years (market collapse in 2000 and 2008, the pathetic 1-2% yield on their bonds) the number of Americans working past 65 has hit a new record, and 1/5 (or 9 million) must now postpone retirement and remain in the work force (Gary Halbert). Unfortunately this takes jobs away from the younger worker who is more likely to be a larger consumer.

We have already covered the large debt problem of the millennials who are being forced to live at home with their parents well into their 30's. These young adults are not getting married and therefore not supporting the housing market which historically has been a major boost for the US economy during recoveries (this recovery was "saved" mainly by the new shale oil jobs).

The downside to this financial stress for both the boomers and the millennials is that the percentage of persons considered middle class in the US has dropped from 55% in 2000 to 41% in 2015! Remember folks that it is the middle class that keeps the US economy ticking and this class is rapidly shrinking. Adding more insult to the working middle class is that the average middle class income in 1999 was $77,898 and now it has is shrunk to $72,919 in 2015!

Between the shrinking middle class, the frugal elder boomer and indebted millennial we also see why there is a shrinkage of credit use by consumers in the US. The annual Household credit growth from 1955 to 2008 was always in the 5-10% range but since 2009 it has been stuck in the 2-3% range. Consumer credit is what makes the US economy tick and I see no potential for improvement here in the near term.
Worsening demographics and a shrinking middle class is a real structural head wind for the US economy (and globally). This has the potential to make the next recession very challenging especially if interest rates are still stuck at zero.

#8 Presidential Election Risk

Hard to do a newsletter without a few words on the upcoming November US election. We know that the historical average market return in Year 8 (i.e. a two term President) has been – 15% (Stock Traders Almanac), but I will admit that the sample size is very small. But we also know that the more traditional 4 Year Presidential Cycle has a big influence on the markets and the occurrences of recessions. Since 1948 we have seen seven recessions occur in Year 1, three in Year 4, one in Year 2 and none in Year 3. We are in the final innings of Year 4 right now and soon will be in Year 1 after the US election. So using these numbers alone we can state that there is a 92% chance that we will see a recession in the next 12-18 months. We have covered in prior newsletters why this occurs (its priming of the pump and the timing) and why it is not data mining. This is all part of the reason why my recession alert has been escalated.

#9 This Business Cycle is Tired

Industrial Production (IP) is a broad monthly measure of the US economy with emphasis on manufacturing, and with the May number coming in negative again that makes 9 consecutive months of negative growth on a yoy basis. This would be the longest such streak **ever** without a recession according to Michael Snyder (assuming we are not already in a recession…). Doug Short's research reveals that 16 out of the last 17 recessions since 1919 had IP numbers **above** this level when the recession started. This weakness in manufacturing is also evident in the Case Shipping Index which has been falling on a yoy basis for 14 consecutive months!

And it is not just manufacturing that is weak (or recessionary), as we just saw the service sector decline to a new two year low(ISM service). Manufacturing is a small part of the US economy (12%), but it has always been a great barometer of the business cycle and it is currently telling us that we are at the end of this cycle. That in turn puts the odds for a recession in the near term very high, I believe.

#10 The Global Economy is Weak

We continue to see a steady weakening in the global economy with The World Bank just lowering its 2016 global GDP expectations from 2.9% to 2.4%, which is very weak growth. The *volume* of global trade in 2015 was only 2.8% and most expect the same weakness in 2016. The historical volume growth rate has been 5% over the last 4 decades so we are now running at only half speed. Additionally, on a *value* basis things look much worse with global trade down 13.5% in 2015 and Mark Yusko says this never happens outside a recession. This ongoing global weakness is confirmed by the declining Baltic Dry Index (a barometer of global trade via shipping rates) and the renewed plunge in copper prices.

The forward looking global stock markets are reflecting this economic weakness with large market losses over the last year. China is down 45% from its recent high, Germany is down 22%, France is down 20% and the UK is down 15%.

I think the odds of a global recession in the next 12 months are elevated and this risk would rise if the UK votes to leave the EU. All in all more reason to remain defensive and ready to buy if a good opportunity should arise.

CONCLUSION

The main objective of this newsletter is to highlight that on many accounts the risk of a recession in the next 12 months has increased significantly (in my humble opinion) e.g. global stock markets flat to negative, the yield curve flattening, job trend weakening, manufacturing in a recession, earnings in a recession etc.. I think the risks are now the highest they have been since the last recession 7.5 years ago. At the same time we must also be aware that predicting recessions is a VERY humbling experience and many of us never get it right, and so you can never bet the whole farm on such a possible outcome! Instead it is wise to assume (or continue) a *Defensive Investing Strategy*, which is what we have had in place for almost two years (see prior communications) and this has served us very well. I agree completely with bond guru Jeff Gundlach who recently stated that he sees a 2% upside and 20% downside in today's market and I would stretch this to a 5% upside and 30% downside. In my world these are very **asymmetrical odds** and favor defense.

Regardless whether we have a recession or not in the next 12 months this is NOT a time to be aggressively invested in this very expensive and sideways market. My sense is that we will get plenty of better buying opportunities in the next 3-12 months and I am happy to remain defensive and tactical during these times. More importantly, if we do see a recession and the associated panic selling that always occurs, I know that my clients will have both the financial and cognitive resources to make the correct investing decision!

**** We also offer a bi-weekly "Curran't Generic News Report" e-mail. If you would like to receive this no obligation e-mail, please e-mail my assistant at val.rybka@rbc.com***

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PLEASE FEEL FREE TO CONTACT US:

RBC Dominion Securities Inc.
2701 Highway 6
Vernon, BC V1T 5G6

Toll Free: 1-800-663-6439
Direct Ph: 250 549-4084
Fax: 250 545-4139

terry.curran@rbc.com

val.rybka@rbc.com