Neuro Approach
INVESTMENT NEWSLETTER

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2016 - A Challenging Year for Investors

Investing in global stock markets has proven to be challenging in 2015 as most global stock markets have been flat to very negative! At the time of writing (December 11) the TSX index is down **-12.5%** in 2015 and from its August 2014 high of 15,657 it's down a whopping **-18.3 %!** The DOW is down -3% in 2015 and the S&P 500 is down 2.3%.Unfortunately, many financial firms are now predicting much of the same sideways market trauma for investors in 2016. More worrisome, over the last month the expectations for a US recession have dramatically risen and here are some of the recent comments:

Citigroup- "the outlook for the global economy next year is darkening and the probability of recession (US) will reach 65%" in 2016.

Goldman Sachs – "sell in December and go away" as they expect only 1% gain in 2016 for the US equity markets.

Credit Suisse—recently turned bearish on stocks reducing their equity weight to the most cautious stance since 2008! They have a year end 2016 target of 2150 for the S&P 500

ECRI –one of my favorite independent research companies is now showing its US Coincident Index has dropped to a 22 month low and very close to zero. They go on to say that "since 1948 such US slowdowns lead to recessions 50% of the time"

Adding more fuel to the recession risk fire is a recent Trim Tabs report revealing that corporate insiders i.e. the smart money have been dumping shares at the fastest pace since 2011!

So the Wall of Worries appears to be escalating going into 2016 and in this newsletter I will review some of these and finish with a conclusion on how best to proceed.

#1 THE NIFTY SIX IS A WORRY

Back in the 60's and 70's the investing herd drove the valuations of the 50 most popular large cap stocks on the NYSE to very frothy levels over the belief that these large blue chip stocks were solid buy and hold stocks forever. Unfortunately these stocks got pulverized in the prolonged 1972-1982 Bear market. Investors learned the hard way that great companies are NOT always great stocks! We are seeing the same **Herd Reflex** in 2015 as the 30 largest stocks in the Russell 3000 (i.e. the largest 3000 US stocks) now constitute a whopping 29% of that market cap index (Bespoke)! More worrisome is that these 30 stocks are up + 6.6% in 2015 and the other 99% (or 2970 stocks) are down a **negative 3.2%!** But it gets worse—most of the gains on the Russell 3000 come from just six stocks which I call FAAANG—Facebook (is up 35% in 2015), Amazon (up 117%), Alphabet (up 45%), Apple (up 7%), Netflix (up 152%) and Google (up 41%). These FAAANG stocks (or the new "NIFTY SIX") are up about 40% in the last 6 months alone while the S&P 500 is negative! A recent Goldman Sachs report says that market breadth for the S&P 500 is now at the "lowest level in 30 years".

More concerning is that investors have bid these stocks up to crazy valuation levels eg. Facebook P/E is 107x, Amazon is at 950x, Netflix is at 348x and Google is at 36x (Gary Halbert)! So we are seeing a repeat of the Nifty Fifty valuation mania but also (and perhaps more scary) a repeat of the Tech Bubble 2000 mania days where skinny market breadth and frothy P/E levels were rampant.

#2 THE BOND MARKET MESSAGE

We are getting one clear message from two different bond market segments. On the US Treasury side we are seeing the short end of the yield curve (i.e. 2 year yields) rise in anticipation of the Dec rate hike BUT the long end is disagreeing with the Fed over worries about the future economy and so is attracting investors who are risk adverse and want a safe haven. The end result is that the yield curve has been flattening in 2015.

The other message is coming from the High Yield (HY) bond market and it is again one of caution. Corporate bond issuances (including these HY junk bonds) have soared over the last few years to record levels so as to match the record Merger & Activity (M&A) requirements and massive stock buy-back activity. Global M&A in 2015 is just shy of the 2007 record of $4.6 Trillion while the US activity has pushed to a new record level above $2 trillion in 2015 (Dealogic). This tremendous M&A requires a lot of bond selling by corporations. On the HY side issuance have reached a record $77 billion in 2015 and yield starved investors gobbled up these high yield bonds as they were the only game in town as far as yield goes (or another TINA—there is no alternative) and was actively encouraged by the FED and its zero IR policy!

However, over the last few months the tide has changed (Aug-Nov) and money has been rapidly flowing out of HY bonds and issuances have dried up. Plunging oil prices and escalating fears of soaring HY energy bond defaults are now a real threat to the whole HY sector and we are already seeing contagion. The proxy for HY bonds is the ishare high yield corporate ETF -HYG and it just closed at its lowest level since 2009 as investors stampede for the exits. Additionally, two large HY bond funds in the US just halted redemptions for the same reasons and lack of liquidity –Third Avenue HY Fund and Stone Lion Capital Hedge Fund. Consequently, HY credit spreads (i.e. the difference in yield between HY and a government bond of same maturity) have widened dramatically in 2015. HY bond spreads are recognized as a great barometer for risk aversion much like the "VIX Fear Gauge" and right now both of these are telling me to be cautious on HY and equities.

Savvy investors know that HY bonds are frequently a leading indicator for equity markets and rising risk aversion. In fact, HY bonds correlate more often with equities than broader bonds. More importantly, history repeatedly tells us that a dramatic sell off in HY bonds is often an early warning of future equity market declines. This can often indicate the end of the credit cycle and the end of risk taking which results in less liquidity. Over the last 10 months Standard & Poor's have announced over 300 credit down-grades which are the most since 2009! Many believe that we are in the early innings of the next credit default cycle. This is bad omen for stock markets and will need to be followed closely.

#3 THE GLOBAL ECONOMY IS WEAK

The mantra up until August was that the US economy was "insulated" from the global down turn for two reasons: 1. the US domestic consumer accounts for most of the GDP (70%) and 2. in the past when the global economy slowed the US sailed through unaffected. But as you will read later I do not believe the US consumer is as robust as many are claiming. Additionally, there is no denying that interdependence between global economies continues to grow thanks to the internet and technology and so I suspect that the US will feel the next global recession more than prior ones.

So let's review how the global economy is doing. The OECD recently lowered its 2015 forecast for global trade to a skinny 2% and noted that over the last 50 years whenever global trade dropped below 2% we experienced a global recession. World trade growth was 6% from 1983 to 2008 and since 2010 it has plunged to 3% (Zero Hedge). But it gets worse--over the last year world trade growth has collapsed even further to 2% with the IMF saying this is the **slowest growth** since 2008! In another report HSBC noted global trade was down 8.4% in 2015 and that Global GDP was down 3.4% implying that a new global recession has already begun! Jeff Gundlach recently stated that nominal global GDP growth is down 5% yoy and called this one of his "scariest slides" as the last time we saw this was 2009 and 1982 when equity markets misbehaved.

These bearish global viewpoints are supported by the Baltic Dry Index (a measure of shipping rates and a barometer for global commodity demand) which is at an all-time low! Additionally, the CRB Commodity index, which trades 19 global commodities, is now at the same level as 2002! Dr Copper with its PhD in economics is at a 6 year low. Oil today is at a seven year low (recall it was $32 in the financial 2008 crash)!

So the common theme is that the global economy is fragile as are the global stocks markets and reflected by the MSCI ALL Country World Index which is down -4.1% in 2015. It should also be noted that this weakness is occurring despite extraordinary GLOBAL policy stimulus that has very likely pulled demand forward from the future. The the question for investors going into 2016 is whether the solo US global engine will remain immune to these negative global forces?

#4 THE US RECOVERY REMAINS TEPID

We know from GDP data that the US recovery has been the weakest post-recession recovery ever with a tepid annual 2.3% growth over 2009-2015. Although food stamp usage has declined slightly to 45.5 million from the 2014 high of 46.6 million it is still extremely elevated from the 2007 pre-recession level of 27 million. The optimist believes that the US recovery is gaining momentum and strong enough to endure a round of interest rate hikes that are typically seen late in all cycles so as to tame inflation and rapid GDP growth. But the pessimist remains skeptical as despite some areas of progress (auto sales, low unemployment levels, housing recovery) there remain many areas of concern and uncertainties.

A. US Manufacturing Remains Weak

The US manufacturing sector has faced the double pressure of a surging US dollar (which makes US exports more expensive) and a decline in foreign demand because of the weakening global economy. US Industrial Production has now declined for 9 straight months in a row. It is also a worry that imports fell at each of the three busiest US sea ports over Sept-Oct—the first back to back declines in a decade (WSJ) and this just before Xmas! The most recent November ISM manufacturing index slipped below 50 and into contraction territory (at 48.6) which is the lowest reading in 36 months. Rauol Pal says that the ISM manufacturing index is a good predicator of future GDP and since 1948 whenever it falls below 50 there is a 65% chance of a recession. The optimist point out that the much larger ISM non-manufacturing (or service) index remains strong but the fact remains that manufacturing has always been the early barometer of the business cycle and indicates a cyclical slowdown is underway (but not necessarily a recession).

B. The US Job Picture

We know that 70% of the US economy is consumer based and so the status of jobs and wage growth are important predictors for 2016 economic growth. The main stream news on jobs is all good—211,000 jobs created in November and October number was revised up to 298,000. The unemployment rate remains very low at 5% and this low rate is often referred to as the optimal "full employment" rate and is usually associated with booming consumer spending, good wage growth and GDP gains.

But there are some notable differences in this recovery that have many economist stumped:
-wage growth remains elusive at only 2.3%
-the broader U6 under employment remains high at 9.9%

-the Participation Rate remains very low at 62.5%
-Jeff Gundlach recently noted that most of the Oct new jobs were in the 55 and older age group and there were actually job losses for the younger cohort!?
-Economic research company ECRI recently showed that a large percentage of the "new job growth" is coming from "multiple job holders". They point out that as soon as you reach 35 hrs/week you are counted as full time even though its two low paying part-time jobs
-the current largest adult population cohort are now those millennials aged 23-33 and only 25% have bought homes so far - significantly lower than prior generations (William Smead). The problem is high debt, late marriages, weak jobs and protracted schooling (W. Smead)
-Pew Research has reported that the percentage of millennials (age 18-34) still living at home is at levels last seen in the Great Depression! Females living at home are at 36.4% and males are at 43%. Again financial issues are at play and they see this as a hindrance to the housing recovery. Marriage rates for the 18-34 age group are also very low at 26% versus a 48% rate for the same age group boomers back in the 1980's.

The bottom line is that the future spenders are the millennials and they are not taking the spending torch from the elder boomers thus far for a number of macro reasons.

-Ok so what about the rich baby boomers, can they help? Harry Dent tells us that the average age of the boomer is now 54 and his research shows that spending plunges past the age of 55! Hope you see the spending & job gap here going forward…
-retail sales y-o-y continue to show weakness as the fragile consumer opts to save (at the highest rate in 3 years) this year over spend and thus far holiday sales have been very weak despite the money saved on cheap gasoline!
-Finally, Dr Jim Paulsen tells us that once the unemployment level reaches 5% (or full employment) a recession is seen within 2 years and stock returns are very low once 5% is reached

So for all these reasons I am not sure that the "booming job picture" is going to provide the economic boost in 2016 that most are hoping for?

C. Earnings, Revenue and Profit Margins

The staggering divergence between US profit margins (PM) and declining corporate earnings-revenues is a worry. Although PM is just starting to roll over they remain extremely high on a historical basis. Earnings have now declined on a y-o-y basis for the last two quarters (first since 2009) and most are expecting a repeat in the 4th quarter. The S&P 500 earnings expectations in Jan 2015 was for $131 and this has steadily declined –March was $118, Sept was $110 and now they are at $107! In fact S&P earnings peaked in the 3rd quarter of 2014 and that is one reason that markets have gone nowhere over the last year (or more).

There is no doubt that energy companies have played a large roll in this decline but even earnings for ex-Energy in the 3rd quarter came in at only 4% yoy growth which is the lowest since 2009!

On the revenue side we have now seen 3 quarters in a row of declining yoy sales!

So it is very hard to see PM remaining elevated going into 2016 as all the past tail winds are now becoming head wind with declining E and R, rising IR, (maybe) rising wages and declining buybacks. Declining PM is never a good omen for stocks in a slowing economy!

D. US Equity Valuations A Worry

Goldman Sachs in a recent report stated that the US market valuation is now more expensive than 96% of prior times over the last 40 years. Ned Davis Research recently showed that by looking at the **median** P/E and P/S the US stock market is more over valued than both 2007 and 2000! By using the median value they avoid been skewed by outliers such as energy or companies such as Apple and Facebook. The median P/E for the NYSE is now 25.6x vs 20x in 2007 and 17x in 2000. That's frothy folks.

Conclusion—So while I agree that the US is the strongest and perhaps SOLO global engine (albeit growing at a slow pace) I worry what will happen in 2016 after an IR hike and further slowing of earnings/revenues and a US election?

#5 A FED POLICY ERROR?

The December interest rate (IR) hike has been the most telegraphed rate hike ever and many expect that all outcomes have now been "baked in". In fact this is why the FED (despite the listed weakness and concerns here) MUST raise IR this week so as to save credibility. But for many reasons this is not your "typical" IR hike.

The "typical" economic backdrop for a new round of IR hikes is that: 1. we have strong GDP growth (we are only ½ that) 2. we see strong inflation data (we are very weak here) and 3. we have surging job growth and wage growth (we have very little wage growth). The Fed then typically raises IR to cool the economy and stay ahead of rising inflation and after an initially brief pull back equity markets then continue to rise higher as strong growth prevails DESPITE the rate hike.

However, I believe that this could be one of those rare times when it is truly **"different this time".** Here are some view points on why:
-it's rare to be raising rates when earnings and revenue are declining quarter after quarter
-it's even rarer to be raising IR when the US is in an industrial-manufacturing recession
-historically, the S&P 500 has been up an average of +8.3% in the 6 months prior to a rate hike over the last 4 decades says BMO Capital—this time we are negative in the markets
- 43 Central Banks globally have lowered IR in 2015 over continued global weakness—the US is at odds with the globe and this alone has got to make you wonder about a repeat "policy mistake"
-it's rare to be raising IR when credit spreads are exploding and HY spreads have never been this wide prior to a first rate hike (J. Gundlach)!
-bond king Jeff Gundlach thinks the Fed is making a mistake raising rate as does Nobel Laureate Joseph Stiglitz.

So the Fed is under fire on both sides of this IR hike argument. The Fed is aware of the financial asset bubbles being created with prolonged zero IR (ZIRP) such as real estate pricing, frothy equity markets and bond markets (esp. high yield) and therefore runs the risk of popping these bubbles with raising rates. But it also is aware that it needs some tools available for when the next recession hits.

The unknown for the 2016 equity markets with this new round of IR hikes is #1 -the effect on the US dollar and #2 -the path of future rate hikes? The strong US dollar has already caused significant headwinds and slowing US growth (manufacturing, multinationals and exports) and the worry is that any further rise in the US dollar could seriously raise the risk of a recession. This in turn could harm the already fragile global economy and especially the Emerging markets where they have accumulated massive amounts of US dollar denominated debt. We expect the Fed language will attempt to guide us towards a "very gradual" IR hike path in 2016 but the reality is that with rate hikes, global liquidity will further dry up and negatively affect global growth. The US dollar after all is the global currency reserve and has far reaching implications!

#6 WHAT IS THE US RECESSION RISK?

Prior to just a couple of weeks ago the general consensus was that the US recession risk was remote as the US has always been insulated from the global economy thanks to its strong domestic consumer economy. But as you read in the introduction many firms have recently changed their 2016 outlook raising the recession odds for a variety of reasons eg. plunging oil prices, declining global trade, ongoing China risks etc.

There are many models and data points used to predict US recession risks and honestly most have very poor track records! The most recent Bloomberg consensus by economists puts the odds of a US recession at only 15%.

But for what it is worth the three that I follow are flashing at least yellow and put the odds (for me) at 50% based on 1. Credit spreads 2. Profit margins and 3. The Yield Curve shape. Credit spreads have widened significantly over the last few months, profit margins are just rolling over and will face huge head winds in 2016 and although the yield curve has not inverted it has flattened.

Additionally, John Early has looked at recessions over the last 100 years and found that the yield curve invert (warn) in 13/17 recessions but **NOT** in 4 of these. What was interesting about these 4 during the 1930's and 40's was that the 3 month T bill yield was less than 2% such as it is now. Dr John Paulsen in a recent report stated that the "unexpected recession" risk has risen recently and that "most of the gauges used during post-war era to weigh recession risks have lost their predictive abilities in recent years".

Finally I want to remind readers that on average we get 20% bear equity declines every 5 years and NO recession. The common themes during these non-recession bear markets are: 1. high P/E ratios 2. IR hike commencement and 3. yield curve flattening. Another common theme is the so called "Death Cross" where the 50 DMA crosses the 200 DMA such as we saw in 1962, 1966 and 1987 bear markets. Our most recent Death Cross was Sept 2015 and markets have not been gentle since then!

Consequently, I think the odds of a US recession in 2016 are above 50% right now (despite the 15% rating by Bloomberg's) and we always see equity bear markets in recessions. I also think that the chances of an Equity Bear market and NO recession are even higher than 50% for all the reasons mentioned. Either way 2016 could offer us a great buying opportunity.

7 INVESTOR EMOTIONAL IQ AGAIN!

With this potential bearish backdrop it seems prudent to conclude with the famous Dalbar 21st annual quantitative analysis of Investor Behavior just published earlier this year. Once again the average equity mutual fund investor **underperformed** the S&P 500 equity index by a large 8.4% (fixed income was by 4.8%)!! The 20 year S&P annualized return sits at +9.5% versus the average equity mutual fund investor who sits at only +5.2%. That annualized gap of 4.3% is huge year in and out!! Dalbar concludes that there are 3 reasons for this underperformance but at least 50% of the underperformance is due to **"psychological factors"**. Under this umbrella Dalbar identifies 9 behavioral biases or investor flaws but the two worst offenders are **Herding** and **Loss aversion**. Herding (I call it the Herd Reflex) is the process by which investors follow what others are doing (regardless of the valuations or macro picture) resulting in the classic buy high and then later sell low—think tech bubble 2000 and the current FAANG group covered earlier here. The other is Loss Aversion which is the fear of loss which leads to selling at the worst possible time resulting in "panic selling". I see Herding and Loss Aversion as two big repeat investor risks as we move through 2016.

To avoid or at least minimize these flaws I suggest that the reader review our last newsletter where I covered how to enhance your investing Emotional IQ.

CONCLUSION ON 2016

I am happy that we have been in "defensive investing mode" for the last year and a half. It is always wise to focus on "wad protection" over "wad growth" when risk versus reward is so skewed and asymmetrical. As I have repeatedly referenced, we are making our way through many uncharted waters and this prolonged duration of uncertainty and volatility is not unusual after a global financial crisis (Reinhart & Rogoff). Unfortunately, my macro outlook continues to flash yellow-red on several accounts – the third longest bull market ever, very frothy valuations, deteriorating market breadth, peak earnings/revenue & profit margins that are now rolling over, a fragile global economy (re record low commodities & global trade, massive debt), a plunging high yield bond market, and now we can add rising interest rates (90% odds) for the first time in a decade & a US Presidential election in less than one year. I also note that many of the leading indicators I follow are telling me to remain defensive going into 2016.

However, despite this long list on the "wall of worries", markets could see a bounce off these recent lows as we are in the "seasonably favorable" time for markets from i.e. December to April. Additionally, I have been adding tranche positions in select core equities & countries that are already in Bear market territory (e.g. energy and Emerging markets). The major unknown going forward is whether we will see contagion into other sectors &

countries in 2016? If we do we will be aggressive buyers in all client accounts.

As referenced in the last Newsletter, if we see a US recession in 2016 (odds now at 50%) equities will fall on average of 30% and we can then take our time utilizing our sizable cash position as these bear markets typically stick around for a long time. If however we see an equity bear market and NO recession then we will have to be more nimble as these sales don't last very long.

My best guesstimation for 2016 is that the US **economy** can withstand a slow path of interest rate hikes, but **I don't think equity markets** can for the reasons outlined. Because of this it seems prudent to remain defensive and cautious going into 2016.

**** 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 assistants at sharon.velisek@rbc.com or val.rybka@rbc.com***

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