Neuro Approach
INVESTMENT NEWSLETTER

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

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Written by Dr. Terry Curran, MD, CIM, Investment Advisor

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The Investing Asymmetry Strategy

"*To achieve superior results an investor must be able – with some regularity – to find asymmetries – instances where the upside potential exceeds downside risk*" - Howard Marks.

Equally important (and perhaps even more so) is identifying those times when the downside risk significantly exceeds the upside potential. This scenario often occurs late in the cycle when most of the easy money has already been made. Essentially, the "Investing Asymmetry Strategy" identifies those times when the odds become asymmetrical in risk vs reward, and the forward looking investor makes the necessary changes to become more offensive or defensive. Although the media and fund companies frequently present the case for "*not missing out on the 10 best days*" (in favor of the buy and hold strategy) many other reviews have shown that it is more important "*to miss the 10 worst days*" in the stock market. This insight is core to the Investing Asymmetry Strategy and I believe we are now close to this point in this cycle.

Before I expand on this topic it is important to acknowledge that **nobody** is able to (repeatedly) predict the short-midterm market direction! There are simply too many unknown variables eg. "9/11", Bear Sterns, earthquakes, etc. so most investment plans must start with a core "Strategic Asset Mix" based on your risk tolerance and investment objectives. This forms the foundation of your investment strategy and does not waiver with emotions. But there are infrequent times when we see market extremes or significant asymmetries in risk vs reward where the odds become very tilted. These are the times when one should consider a **tactical** maneuver with 15-25% of the portfolio. The critics would argue that this is a form of market timing and I would agree. But when the risks versus rewards become very tilted, as they often are at both ends of the economic/market cycle, it is a reasonable action I believe. I have referenced this recurring "cyclical" market activity in prior newsletters as a swinging pendulum where at both ends of the swing, asymmetry in risk versus reward becomes stretched and sometimes extreme. Asymmetry occurs with predictable recurrence for a variety of reasons, but 3 in particular are always present: excessive human behavior (or emotions), central government intervention (often inappropriate), and the fluctuation of the normal business cycle. It is at the extreme ends of the pendulum swing when the odds and asymmetry become very tilted and this is where the prudent tactical investor should separate from the herd and become either more offensive or defensive with their portfolio.

There are several variables that move me away from the usual strategic strategy and into a more aggressive tactical one, but for my brain it often centers around my passion for numbers and percentages, such as these:

- The S&P500 has now seen **double digit** returns for 3 consecutive years – 2012, 2013 & 2014 with an average return of 15%. This 3 year double digit run has only been seen **once** before ever… 1997 to 1999 (WSJ). That catches my attention and makes me wonder about current excessive human behavior…

- The S&P500 has **never** gone more than 6 consecutive years without a loss – never! We are now in year 7 and again that catches my (defensive) attention.

- The S&P500 has gone 3.5 years without a 10% correction and we know this is rare. Only twice before have we seen a longer run – March 03 to **October** 07 (i.e. with the housing bubble) and October 90 to **October** 97 (i.e. with the tech bubble). So again this makes me nervous and thinking about being tactical, especially as we move into **October** 2015…

- Since March 09 the S&P500 has gained 4.7% per quarter on average, which is **5x** greater than the GDP growth over this period which is a very unusual prolonged disconnection (*Gregory Hahn*).

- I am also aware that the last time the S&P500 and NASDAQ were at all time highs in unison was **Dec 31, 1999**…this was a time of tremendous investing asymmetry…

None of these observations confirm that the markets are going to correct or crash tomorrow, but it does bring to my attention the growing asymmetry between rising risk and lower rewards. If my hunch is right and most of the best gains are behind us then investors should now be razor focused on finding the optimal balance between defense and offense as we head into the second half of 2015. But let's first review the separate arguments for defense and offense and then conclude on our strategy.

A. Reasons for Defense

#1 RECORDS ABOUND!

I always think about stretching asymmetries when I see multiple economic / financial records being broken. This to me is a sign of pervasive emotional human behavior at work and often indicates we are late in the cycle and maybe close to a market top. Although these records don't define the exact time of the market top they do indicate to me that most of the easy money has been made and excessive greed may be at play.

Record Merger & Acquisitions (M&A)

Charles Schwab just announced that global M&A has surged to an 8 year high. For the US markets – this May saw $243 billion in M&A activity, which beats the two prior M&A record months – March 07 at $226 billion and Jan 2000 at $213 billion. Harvard professor R. Kropf has researched the last 6 M&A activity surges and recently warned that they "*always ended in a precipitous decline in equity prices.*" This makes sense as after all record M&A is the result of excessive CEO emotions and we know they often buy high like everyone else…

Record Share Buy Backs (SBB)

In 2014, S&P500 companies spent 95% of their operational margins on SBB and dividends! A recent **Financial Times** article by Edward Luce reported that this will be close to $1 trillion dollars in 2015 and 100% of operating margins. Luce noted that this strategy "works" in the short term by driving share prices up but the downside is the lack of dollars going into Cap Ex, innovation, and training skilled workers. This "short-termism" strategy now has CEO's buying more company shares than the investing public! The history on the timing of record SBB by CEO's is very poor as it often indicates a market top. Again, another sign of excessive human behavior.

Record Bond Issuances

Merrill Lynch just reported that over the last 4 months we have seen $100 billion/month in US bond issuances (to allow for record M&A activity) which is the largest streak ever! Stan Druckenmiller recently noted that corporate credit was at $3.5 trillion in 2007 and is now at an astounding $7 trillion! The scary part is that in 2007 - 28% of the bond issuances were B-rated (ie really, really junk) and now it's at 71%. He went on to say that he thought it "*was nuts*" that CEO's are issuing such vast amounts of corporate debt to fund share buy backs (and M&A).

Record Equity Market Streaks

This is now the 3rd largest bull market in history and if we don't get a recession until 2017 (as many are claiming) then it would make for the largest expansion ever! Additionally, over the last 6 years US equities have gained a whopping 250%. This tremendous 6 year percentage gain has only been seen twice before according to Pension Partners – in the 6 years leading up to 1987 and the 6 years leading up to 2000. Those were incredible streaks but both ended very poorly and asymmetry was very noticeable.

Additionally, Dana Lyons reported that we have only seen 4 other periods where we did not have a 10% correction over 3 years (ours now at 3.5 years) – the first ended in 1965/66 with a 23% decline, the second ended in August 1987 with a 30% decline, the third stalled in 1993 and then went through a sideways market for 4 years. The final streak ended slowly from April 06 to Oct 07, but this was the start of a very severe bear market. His point is that these market streaks are often followed by very painful corrections. So based on history, the odds are that at some point soon we could see some real pain in the equity markets.

Record Chinese Market

All of the Chinese stock markets (Shanghai Composite, Shenzhen, Chinext, etc) have exploded over the last year. The current valuations on many of these markets are looking very much like the NASDAQ 15 years ago. New retail account openings are booming with very inexperienced investors and the use of margin debt has quadrupled over the last year! Margin debt as a percentage of China's stock market capitalization is now **higher** than the record NYSE margin debt!

Recall, Beijing first joined the "record club" back in 2008-09 when it first deployed massive stimulus – **twice** the size of the US! But now China is once again in a very dark place. A surge in wages, a surge in labor strikes, plunging commodity prices and real estate prices have most analysts doubting the reported 7% GDP data. Based on electricity growth over the last year Professor Chris Balding at Peking University in Shenzhen believes GDP is in the 1-3% range. Record new stock market participants therefore must be expecting a repeat of the massive 2008-09 stimulus but I think these are very precarious times to be long China equity markets.

Other Records Previously Covered

- The record margin debt in the US (i.e. leverage use) continues to climb – now at 2.89% of GDP which is the highest ever.

- We have record student debt of $1.3 trillion in the US, of which 33% is held by the 30 – 39 year olds…our future home buyers.

- The record profit margins could be at risk on many fronts - as revenues stall (last quarter was very poor), wages increase and interest rates increase, margins will surely see pressure (and hence equities) as they revert to the mean.

- Record valuations on the Shiller P/E, Tobin Ratio, Buffett Indicator and P/S.

- 80% of IPO's are unprofitable these days just like 1999… says Stan Druckenmiller.

For the record folks – that's a lot of records!

#2 MASSIVE GLOBAL DEBT IS A HEADWIND

It's not just the surging US corporate debt and student debt that has my attention – it's the global debt. Global debt stood at 245% of GDP in 2000, 269% in 2007 and is now at 290%! A recent McKinsey Report stated that global debt increased by 33% over the last 7 years to a whopping $57 trillion. US corporate debt alone was $3.5 trillion in 2007 and is now $7 trillion (Stan Druckenmiller) as corporations rush to lock in low interest rates to pursue aggressive share buy backs and M&A activity (this is a form of CEO "Financial Engineering" in my books).

Dr. Lacey Hunt has repeatedly written about the negative economic effects of chronic high debt. For example – we see weak US GDP growth:

2011 GDP was 1.7%, 2012 was 2.3%, 2013 was 2.2%, 2014 was 2.4% and 2015 thus far is -0.2%. He says monetary policy (i.e. ZIRP) is not effective during these high debt times so countries resort to currency depreciation amongst other desperate measures to stimulate growth. In aggregate, this hurts global trade (as all can't depreciate at once) and we are seeing this with the recent weak global trade growth at 2.3% y-o-y versus the usual 5 – 10%. Dr. Hunt believes low interest rates are here for a long time and long bonds are the place to be for the rest of 2015, which is certainly a minority call.

#3 THE HERD IS ALL IN

There is much speculation as to whether the majority of investors (i.e. "the herd") are already invested in equities or if there is a large percentage still sitting on the sidelines? I see repeated references to this market being "the most hated bull market ever." Sentiment opinion surveys such as the American Association of Individual Investors (AAII) reveal that the percentage of investors who are bullish is at very low levels and the percentage who are undecided (neutral) is very high. This is supposed to be a contrarian reason to buy equities as it infers that investors are not buying.

However, a more factual representation of what investors "*are doing*" rather than what they "*are saying*" paints a better picture. The most recent quarterly Federal Reserve Z.1 report tells us that the percentage of household financial assets invested in stocks is at the **same levels** as the 2007 peak! This data makes more sense to me – we have had a 6.5 year bull market with no 10% correction in 3.5 years, margin debt is at record highs and the NASDAQ just hit a 15 year high! This tells me that the herd is all in…no matter what investors are saying on surveys! Going against the "Herd Reflex" is very difficult because we are hard wired to stick with the herd, but my rule of thumb is to try to do the opposite of what the herd is doing especially when we are this late in the cycle.

#4 EQUITY MARKETS & RECESSIONS

A major bull market argument is that because there is virtually no recession risk over the next 6 – 12 months, most investors will see any 10% equity decline as a buying opportunity. David Rosenberg has repeatedly argued that we do not get equity bear markets (i.e. declines greater than 20%) without recessions, so he is advocating to "*buy the dips*". He also argues that we never see recessions without at least a flattening and most often an inversion of the yield curve (i.e. short term rates higher than long term). The yield curve currently remains steep.

But here are some points to ponder before jumping completely onto this wagon:

- Jeremy Siegel in "*Stocks for the Long Run*" referenced 5 bear stock markets with losses of 20%+ and **no** recession.

- Most recently we saw a 15% drop in 2010 and a 19% drop in 2011 despite steep yield curves. Both of these drops occurred after the QE1 and QE2 were stopped. I also note that since QE3 was stopped in late 2014 equity markets have been weak and trading sideways…

- And on the "yield curve theory"… in May - Switzerland brought a 10 year government bond to market with a **negative** yield!!! Investors therefore paid the government to hold their money – that's rare. Until just recently, 50% of all EU government bond yields were negative! The point is that these are very "uncharted and manipulated" waters for bonds and one wonders if the recession "yield curve indicator" applies in 2015?

- Many also believe that equity markets do not experience a serious correction or recession until 2 years after the first interest rate hike (*D. Rosenberg, Scott Minerd*). But Lance Roberts has noted that central banks typically raise interest rates when GDP growth is good, wage growth is booming, and inflation is showing its head. But we are not seeing any of these in 2015 and yet we may see IR rise!? He looked and found only 3 prior times where the Fed started tightening when we had similar weak growth. His work revealed that we had a recession within 3 – 9 months after the first IR hike under these 3 similar circumstances! So based on history, if the Fed raises rates in

September we could see trouble by December 2015…and equity markets are always 6 months forward looking remember …

- Finally – an IMF study on recession predictions in 63 countries concluded that *"the record failed to predict recessions is virtually unblemished."* So it's wise to be a little skeptical when 99% of economists say there is no recession.

  To me the Fed tightening actually began 8 months ago with the stoppage of QE3. I think the risks will become very elevated in September if we see rising IR at a time of tepid GDP growth, weak wage growth, weak sales growth and record profit margins! The Fed has backed itself into a corner here and so the risk of a "taper tantrum" repeat in Sept-Oct is very high I believe.

Reasons for Offense

#1 A LOW RECESSION RISK

As stated previously, most economists believe there is a very low risk of a recession over the next 6 – 12 months. D. Rosenberg is adamant that we never get recessions without a flattening/inverted yield curve – "*it has always been such and no it's not different this time*" he recently stated. In fact, the yield curve typically inverts about 1.5 years before the recession and currently it remains steep. Also, supporting the low recession risk is the latest Conference Board Leading Economic Indicator (LEI) which increased 7% last month over improving building permits and low jobless claims. As well, the recent NFIB small business survey was also very positive towards future sales and job hiring.

We have many now referring to 2015 as being in the economic "sweet spot" or "goldilocks economy" with low but steady 2 – 3% GDP, low 1 – 2% core inflation and continued low IR. Our own RBC strategists have referred to this period as the "no boom – no bust" period. Famed hedge fund billionaire, Ray Dalio, says we are only midway through this cycle, and he is one very smart investor.

The bottom line for the recession watchers is that all is clear and any 10 – 15% pull back should be used as a buying opportunity. I agree that (90% of the time) this is a very good argument, but I also think because of the "uncharted and manipulated waters" it is prudent to keep an open mind based on the previous comments.

#2 HOUSING IS IMPROVING

There is no doubt that US housing is showing signs of steady improvement especially over the last couple of months. The Leading Lumber Futures market has been on a tear indicating strong demand in the near term. Many other housing indicators are also very positive:

- Pending house sales are at the highest in 9 years

- Housing starts surged 20% in April to the best level since 2007 (though slightly weaker in May)

- New home sales are at a 7 year high

- US existing home sales are at a 5.5 year high

- Housing permits last month were the best since 2007

- The National Home Builders Housing Market Index (a home builders survey) just hit a 10 year high

Additionally, there is ample room for new housing to continue to improve based on housing starts per population. In 2000 housing starts were 10/1,000 civilians and now it's only 4/1,000 civilians. We also have a very large cohort of millennials that will need homes over the next 5 – 10 yrs. Housing might carry the torch from the ailing oil and gas sector, which has fumbled over $60 oil. A surge in housing would be very positive for the economy and could help elevate equity markets into 2016. I will be watching this very carefully going forward as it is the one area of the economy that could push me towards more offense.

<u>#3 DON'T FIGHT THE CENTRAL BANKS</u>

This has been covered before in the ***Curran't Generic News Report*** and remains a large tailwind for many markets, but especially Europe (with maybe some Greek hesitation…again). We are taking advantage of this in all portfolios.

<u>#4 A REPEAT OF THE 98 – 2000 BUBBLE</u>

There are many tailwinds that could allow for another enormous equity bubble with markets climbing higher into 2016, eg. continued massive share buy backs, continued global ZIRP (zero interest rate policy), persistent low inflation, global QE programs, continued record M&A activity and the TINA factor (there is no alternative), etc. These factors could undoubtedly encourage yet another huge "Herd Reflex" and push markets much higher as they did in 1998-1999 and 2006-07 **despite** the fact that most knew about the extreme asymmetry, i.e. emotions won over fundamentals. This would create many challenges for prudent investors, however, especially those who study history.

CONCLUSION

From this discussion you can see several reasons for tilting both towards offense as well as defense. As stated in the introduction, finding the right balance between offense and defense is mainly dictated by your **strategic** asset mix decision, which is based on your risk profile and time horizon.

However, there are times when one should consider tilting this balance based on where we are on the risk vs reward spectrum. I think we have reached one of those times, where more **defense** is needed. Before we get into my current strategy I would like to reveal some recent comments from much wiser and seasoned investors:

- Howard Marks June 16/15 - "*It's the job of investors to strike a proper balance between offense and defense. Today I see it's important to pay more attention to loss prevention than to the pursuit of gain.*"

- Prem Watsa of Fairfax Financial is sitting on $5.7 billion in cash or 22% of the total investment portfolio.

- Mohamed El Eran - "*there is a massive gap right now between asset prices and fundamentals*" and so he is mostly in cash as of May 2015.

- Hedge fund billionaire Julian Robertson on the next correction "*we can certainly see a 2008 like market crash because the bigger the bubble gets the bigger the bust.*"

- Warren Buffet's recent CNBC interview – "*we have not seen this movie before*"… "*this is a very unusual situation and I don't know how it plays out.*"

- Peter Briger CEO of Fortress Investment Group – "*the world seems very strange and very manipulated, very hard to draw conclusions*" … "*today all the easy money has been made*"… "*the whole world is expensive right now.*"

When I review the market positives and negatives I am compelled to tilt towards defense over offense. However, it is important to remain invested, but because the odds are strongly tilted towards increasing risk and away from rewards, my focus is on **defensive investing**. It is because of this investing asymmetry that I remain tactical with a higher exposure to cash and cash substitute positions. As covered in my recent ***Curran't Generic News Report*** to clients, I see escalating Financial Engineering schemes as active now as the 2007 era and this has me very concerned. I think this is a time for patience, discipline, and much common sense.

I will finish with comments from Sir John Templeton "*the secret to my success is that I buy when everyone is selling and I sell when everyone is buying.*" I wonder what Sir John would be doing today where both retail and CEO buying activity are at all time record highs?

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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
sharon.velisek@rbc.com
val.rybka@rbc.com