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

RBC Wealth Management
Dominion Securities

March 2015 *Written by* ***Dr. Terry Curran, MD, CIM, Investment Advisor***

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The Investing Pendulum & Risk vs Reward

It is well recognized that equity markets repeatedly cycle from periods of undervaluation to periods of overvaluation driven mainly by changes in human psychology. I have written about these cycles many times over the years and have often used the analogy of an oscillating pendulum to describe the swings in human psychology. Last year I was fortunate enough to read Howard Marks book, "*The Most Important Thing*" in which two chapters were dedicated to the importance of being aware of these repetitive market cycles, and he also drew the analogy of an oscillating pendulum. The pendulum swing **reversal** is predictable and repetitive with the back swing representing market undervaluation (and fear) and the front swing representing over valuation (and greed).

Unlike Marks, I believe that most of the time the pendulum is in the mid-swing phase where frontal lobe logic and valuations prevail. However, perhaps 20 – 30% of the time we are in the back or front "over swing" territory where the non-logical temporal lobe is running the show. The arc of the pendulum swing varies in duration from cycle to cycle, which makes it difficult to know the exact time when the pendulum reverses direction, but the longer it remains at one of the extremes the stronger the likelihood that the reversal will be abrupt and unexpected.

It is therefore wise to be on alert when the pendulum is out of the mid-swing range as this is an important time for the savvy investor to be **tactical** (and not passive). When we are far out on the front swing the risks far outweigh the rewards and prudent investors focus on defense. Conversely, when we are far out on the back swing rewards far outweigh the risks and this is a time of aggressive offence.

In this newsletter I will review the current "*Reward Scenario*" followed by the "*Risk Scenario*" and then conclude on where I think we are on the pendulum swing in 2015.

A. THE REWARD SCENARIO

1. Global Central Banks Are Easing:

This is without a doubt one of the strongest tailwinds for equities in 2015. On the most recent count we have 28 out of the 34 global central banks in easing mode through a combination of either massive Quantitative Easing (QE) programs (e.g. ECB & Japan) and/or record low interest rates (*Ned Davis Research*). Even the US, which stopped QE several months ago still has record low interest rates. These aggressive central bank policies have driven US equity markets back to record highs and many expect a similar outcome in 2015, especially in the EU.

2. World's Largest Economy is Growing:

The US economy has now created 200,000 plus jobs per month for 12 consecutive months – the best run since 1995! The US unemployment rate is 5.5%, which is where the Fed considers "full employment" to be. The US economy has created

12 million jobs over the last 60 months, which is very strong. Additionally, the Leading Economic Indicators all point to further growth over the short to mid-term.

This has most economists believing that the Fed can now safely start normalizing (i.e. raising) interest rates in 2015 (?June) and that the US economy will keep growing. The optimists point out the tremendous benefit cheap gasoline will be for US consumers in 2015, which is a form of "tax reduction." Similarly, David Rosenberg just wrote that restaurant sales were up 11% in January 2015 over 2014 and he sees this as a reflection of the growing confidence and optimism felt by the US consumer.

The bottom line for the optimist is that the US economy should keep chugging along in 2015 as jobs are growing, interest rates are very low, and consumers now have extra cash because of cheap oil. They emphasize that 70% of the US economy is driven by the domestic consumer who is very happy these days and will likely keep spending in 2015.

3. The US Recession Risk is Low:

The other major potential reward in 2015 comes from the fact that the odds of a US recession "seems remote." My estimate is that 99.9% of economists/strategists are **not** calling for a recession in 2015. They argue that the 3 main provocateurs of recessions are one or more of: 1. high oil prices 2. high interest rates 3. or an inverted yield curve. None of these economic threats are in the cards for 2015. Although the US may see increased interest rates, the relative levels still remain very low and accommodating. The potential reward to "knowing" that there is no recession is that the odds of an equity bear market remain remote and so any 10 – 15% correction would be viewed as a buying opportunity for the optimistic bulls. (I will remind readers however that the prior 100 year success rate in accurately predicting recessions is remote!).

4. The EU Could Surprise On The Upside:

Now that the ECB has finally committed to QE, many believe that we will see EU economic and stock market growth like we did in the US. The ECB QE program is substantial in size at 11.3% of GDP ($65 billion/month) versus the 9.3% of GDP that was seen with the US QE3. This is a very large tailwind for the EU economy/markets because of the low interest rates associated with QE, which encourages lending, borrowing, and spending, and also the associated currency devaluation. The euro now trades at its lowest level in 12 years, which is a great aid for EU exporters going forward.

If we saw EU growth in 2015 this would be a big positive surprise for the global economy and stock markets.

5. The TINA Factor:

One of the main arguments for equities (especially dividend equities) is that **T**here **I**s **N**o **A**lternative. Bond yields are desperately low and overall bond returns are at risk when IR do start to rise. Cash is giving zero returns and Hedge Funds had a terrible year in 2014. Gold stocks have also been pulverized over the rising US dollar and lack of inflation. This leaves very few options for investors, which makes equities look attractive "relatively" speaking. The optimist will also tell you that equities do very well historically when IR and inflation are this low and one can hardly argue with the result over the last 6 years. This argument, of course, encourages the emotional Herd Reflex where all participants join the equity wagon, and herd momentum is a powerful force as we all know, e.g. 1998, 1999. This could be a big factor in 2015!?

B. THE RISK SCENARIO

1. Valuations Are Frothy:

This was covered in the January Newsletter, but needs to be **repeated**. From virtually every perspective US equities are now very rich and even frothy. Even the overly optimistic forward P/E for the S&P500 now trades at 17.6x 2015 earnings estimates. That's almost 400 bp above the 10 year average of 13.9x! The more stable and reliable retrospective valuation measures such as the Shiller CAPE ratio (which uses the last 10 years average earnings) is now at an eye popping 27.9x. That's only been higher twice before in history and in fact since 1871 has only traded above the 27x level **5.5%** of the time! (Yikes!)

What's scary is that most expect the P/E to become even more elevated as US earnings are not just slowing but expected to contract over the next two quarters. *FactSet* just recently released its 2015 estimates for S&P earnings growth at 2.9% – that's down from the estimate of 8.2% growth in January! That's a huge drop. The consensus is for earnings to contract -4.6% y-o-y in Q1 and then -1.5% in Q2. The last time we saw negative back to back quarters like this was 2009! This is a rare event in equity "bull" markets. A major problem for US companies in 2015 will be the strong US dollar as 45% of S&P500 revenues come from overseas. This is a hindrance for these earnings once translated back into US dollars and also makes US exports expensive, which hurts sales. I believe that this hindrance has not been fully appreciated by investors.

So although high valuations do not tell us when markets might correct, multiple studies have shown that:

#1 – market returns over the next 1 – 5 years will be very low from these levels (as there now needs to be a payback period), and…

#2 – when markets correct from these levels it is often quite severe.

These are two major risks for investors who are 100% long equities in 2015. It also concerns me when *TrimTabs* reports that 95% of the US corporate spending in 2015 will go to stock buy backs and dividends in 2015. That does not sound like a lasting nor profitable strategy?

We also know that we see recessions every 4 – 5 years and have not seen one now in over 6 years. It is important to realize that 99% of economists/strategists never accurately predict recessions. For these reasons, I see 2015 as a very risky time to be 100% long equities – especially in the US.

<u>2. The Bond Message:</u>

In general, bond yields are driven by inflation and interest rate expectations. Right now we are seeing record low bond yields globally and most bond yield curves (the spread between 10 year and 2 year) are flattening. This implies weak inflation globally and tepid economic growth and if either of these were rising we would expect the forward looking bond yields to be rising, not dropping. Yields are so low in the EU that we now have 5 year government yields as being **negative** in 6 EU countries! That's rare!

There is no doubt that the bond markets have been seriously manipulated by Central Banks with ZIRP (zero interest rate policy) and QE but you would be foolish to totally ignore the bond market message of predicting weak global growth. My take is that with such weak global growth and already zero interest rates, many economies would be at risk if there was a major unforeseen economic event in 2015. What would the government "rescue strategy" be when IR are already zero?

<u>3. The Slowing Global Economy:</u>

Although many believe that the US can "decouple" from the slowing global economy, it certainly is a risk in 2015.

Although the ECB is just starting its QE there are concerns that we may not see the same "benefits" as in the US. For starters, the ECB did not recapitalize its banks like the US did, and so bank lending has been a problem. There is also the "transmission mechanism" which may not be as strong in the EU with QE as many of the small-medium businesses borrow from the banks and not in the bond market, as in the US. So lowering interest rates and yields may not help these businesses access credit if the banks are not lending money. Unemployment rates in the EU remain very high at 11.3% and youth unemployment in many countries is at 50%. The EU also has a larger demographic problem than the US and finally the largest headwind is that the EU still has its flawed monetary union that remains a work in progress, e.g. Greece.

Then we have the Chinese economy, which is also in slowing mode. The 2014 GDP growth rate of 7.4% was the slowest in 24 years. Additionally, the government has just lowered its 2015 target to 7%. Gary Shilling says that based on electricity use, China's GDP is running at about 4.3%! This is supported by the weakening Baltic Dry Index (tracks cargo rates for dry commodities and is a good proxy for commodity use), which is down 50% over the last 12 months and now the lowest in 29 years. This is reflected in the multi-year lows in many commodities such as copper, iron ore, and coal.

The Chinese government has a very fine balancing act ahead. It wants to wean its economy away from excessive shadow bank lending (for real estate projects) and massive government spending on quasi-infrastructure projects towards a more domestic consumer based economy. This is better in the long run, but in the short term we will see lots of volatility and risk in the Chinese equity markets. The bottom line is that China will not be providing the global economic support in 2015 that we saw in 2008 – 2010! In fact, if there is a hard landing it would be a hindrance.

So the question remains as to whether the US can remain the solo global engine in 2015 with such slow global growth from the EU, China, and Japan??

It's a concern for me when we see *FactSet* projections of US 2015 profit growth being lowered from 8.2% in January to 2.9% in March – that type of dramatic reduction spells risk for me! This plus the rapid rise in the US dollar will be a very strong headwind for the US economy in 2015.

4. Global Deflation Risk:

Gary Shilling says that "*26 of the world's 34 major economies are in or close to deflation*." The headline US CPI for January came in at 0.05% y-o-y and the core CPI (minus energy and food) was 1.65%. The headline CPI was the lowest since October 2009. The January **core** Producer Price Index (PPI is a wholesale price index) went negative in January and is a sign of lurking deflation.

We are also seeing global deflation numbers in the EU and China. Global deflation is a very unusual backdrop for bull markets.

The risk with deflation is that it becomes embedded, which leads to lower consumer spending, lower retail sales, and subsequent job losses. Persistent deflation crushes economies and stock markets, and one only has to look at Japan's 20 years of deflation to see the serious side effects. This is something that will need to be followed carefully going forward.

5. Risk From The Middle Class:

This is perhaps the most controversial risk for the economy in 2015. Although we are seeing "tremendous" job growth, and personal debt levels in the US have been falling for years, there are several aspects to the US middle class that do not look healthy to me.

Several studies have shown that much of the benefits of this QE induced recovery has gone to the wealthy and bypassed the much larger middle class. A 2012 study by economist E. Wolff revealed that the top 5% of the US citizens now own 89% of the US wealth, which is mostly focused around equities and real estate ownership. And it's not just a US phenomenon – a more recent 2014 Oxfam report stated that "*85 of the richest people in the world have accumulated as much wealth as half the world's population*." These elite 85 multibillionaires have fortunes equivalent to the "wealth" of 3.5 billion people !!?

Many argue that part of the blame for this slow global recovery since 2009 (slowest ever, recall) is growing income-wealth inequality, and I would agree.

Back in the US – although we have seen 12 million jobs created since 2009, many forget that the working age population in the US has also increased by 12 million over that period. It is also disturbing that the Participation Rate (PR is a measure of employed and those looking) continues to decline (now the lowest since 1972) as even though there was great job creation in February and the unemployment rate declined to 5.5% - a major factor behind these numbers was that another 178,000 people left the workforce. There are now 92,898,000 US citizens not working, or not being counted as working. That's not a healthy economy in my mind.

It is also disturbing that the PR for those over age 55 continues to climb, but yet declines for the 25 – 55 age group? Doug Short recently reported that 1 in 3 aged 65 – 69 year olds are working and 1 in 5 aged 70 – 75 year olds in the US. Yes, these are jobs, but the reality is that the economy needs 25 – 55 year olds working as these are the ones who spend and consume.

I want to accept the headline numbers as being indicative of a robust jobs recovery, but these unusual job facts concern me. If the US middle class can't afford to spend (even with cheap oil prices) then the US economy is at risk. I believe that the tepid US retail sales and poor wage growth are a reflection of the very weak US middle class and this has me worried and risk adverse. This is especially so when the US Fed is about to embark on higher IR at a time of record high valuations.

CONCLUSION

"***Ignoring cycles and extrapolating trends is one of the most dangerous things investors can do***" (Howard Marks on Cycles & Pendulums)

The oscillating market cycles will always occur simply because of the emotional temporal lobe! "*If we invested just using the logical frontal lobe then the markets would be efficient most of the time and stay in the mid swing of the pendulum arc*" (Dr. Terry Curran). But for a variety of emotional reasons the pendulum **always** goes into the extreme area of the swing with every economic/market cycle! I have referred to this accentuated emotional phenomenon as the **Herd Reflex** in multiple prior writings. I currently believe that we are out on the extreme front swing of the pendulum arc where the risks outweigh the rewards. In fact, I think it's going to get even more extreme (overvalued) as we move into 2015.

I believe that 2015 has all the conditions for another **speculative** US stock bubble. Equity investors globally will be attracted to the US as it is the best (only?) global growth engine. Currency investors will be attracted to the US because of the continued strength in the US dollar (especially if IR do go up). Bond investors will also be attracted because of the higher relative bond yields, versus Europe and Japan. Additionally, we have great investor momentum (i.e. Herd Reflex) with no 10% correction in over 3 years and record high US markets. We are also in the very favorable "seasonal period" and the Presidential Year 3. In other words, the emotional Herd Reflex is now in full play (i.e. all temporal and no frontal) as risk aversion is non-existent and most investors have already joined the "emotional" party. I fully expect this momentum to continue into 2015 with markets achieving new highs into April-May.

Recall, however, that it is often not a change in fundamentals that alters the direction of the pendulum but rather a change in investor psychology. Recognition that fundamentals **do matter** often takes hold – and this frequently occurs once the majority of the herd are out on the extreme swing and the logical frontal lobe starts to challenge the emotional temporal lobe.

Because the equity markets are already very rich and the Herd Reflex is in full gallop, the risks now far **outweigh** the rewards from my viewpoint. Consequently, I will be taking advantage of these high equity valuations by selling high over the next few months and raising more cash. I will also continue with our *Defensive Investing Strategy* (covered in the *Curran't Generic News Report*) which appeals to my frontal lobe thinking that now is a good time to be tactical and defensive.

I will close with another quote from Howard Marks book… "*most important, in the late stages of the great bull markets, people become willing to pay* *prices for stocks that assume the good times will go on ad infinitum!!*" It is at these times that the wise and patient investor must step away from the herd and recognize the extreme pendulum swing and focus on tactical defense. That's where we are folks!

**** 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***

OR…

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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