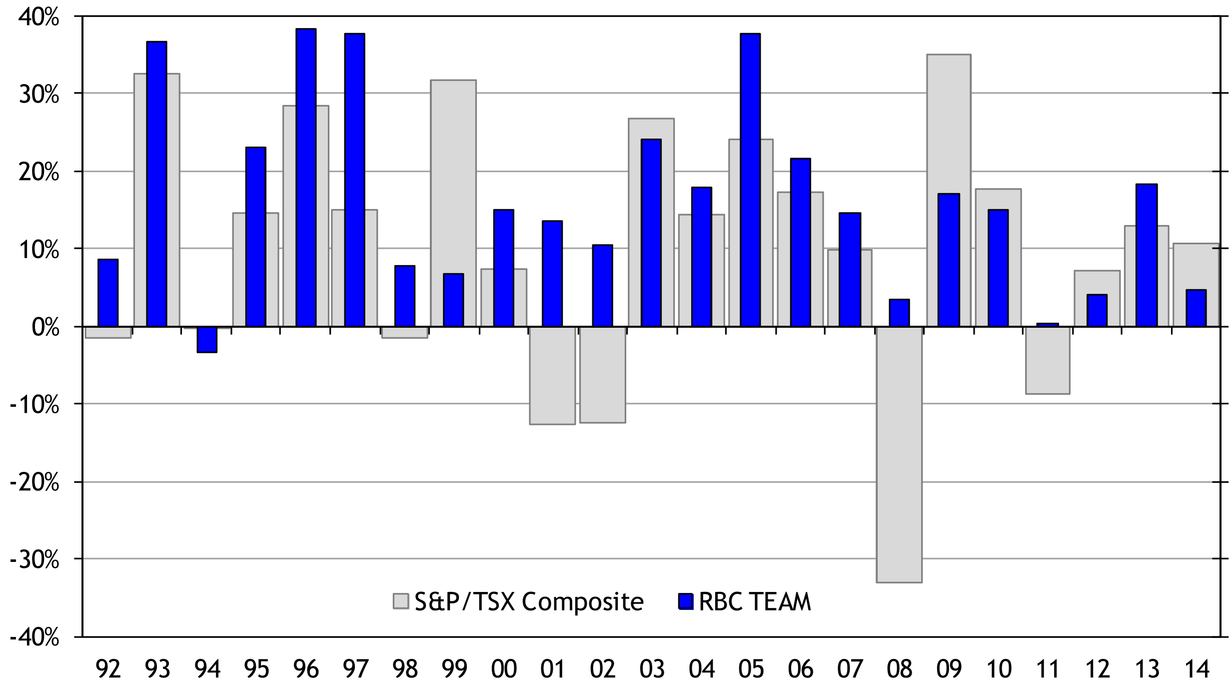
October 19th 2015

"Won2One" with Nick Foglietta

Tactical Equity Income Model Portfolio Record



Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: **0%** Equities/ 10**0%** Fixed Income
S&P/TSX 60 Closing Value: 13,838
TSX 200 Day Moving Ave: 14,582
% Above/Below 200 Day Moving Ave: **5.10% Below**
Levels for change: 100% stocks - **TSX 15,324** and 100% fixed income – **TSX 13,865**

Weekly Quote

"I'm your top prime cut of meat, I'm your choice…I wanna be elected."

Artist - Alice Cooper; song - "Elected" from Billion Dollar Babies (1973)

Looking Past the Election

If you are like most people I know, you feel it is nice to come to the end of the election campaign period and move on.

The modern day campaign is low on substance and high on hype and hyperbole. Even if a leader wants to stay on topic with real election issues, inevitably the media will make the campaign a circus.

The election is going to be close. A minority government appears to be very likely…we will know in about 24 hours time if this projection holds true.

My guess is the results of the 2015 Federal election will have the largest financial impact in the currency markets. The Canadian dollar could see some sharp swings in the coming few days. Beyond the currency, I foresee little impact from the Canadian election in financial markets.

Why is this?

Mainly because most of the pathways our leaders have to choose from going forward have been predetermined for them by past political and central bank actions. The ability to act boldly looks much easier to accomplish on the campaign trail than in real life after the ballots are cast and counted.

Let me use a couple of excerpts from Lacy Hunt's (a former US FED economist, now bond manager) third quarter commentary to drive the point home.

Global debt has increased from 219% of global GDP in 2008 at the peak of the economic cycle to 265% today! That's a numerical growth in debt of over $60 trillion. At the same time, GDP has only grown by $12 trillion.

As debt levels surge, the ability to grow shrinks. There are lots of fancy formulas that tell you how much of a difference certain debt growth rates mathematically impact GDP…but for today just understand…MORE DEBT = LESS ABILITY TO GROW.

Check out the chart below showing leading economic nations and how their debt to GDP ratio has steadily grown.

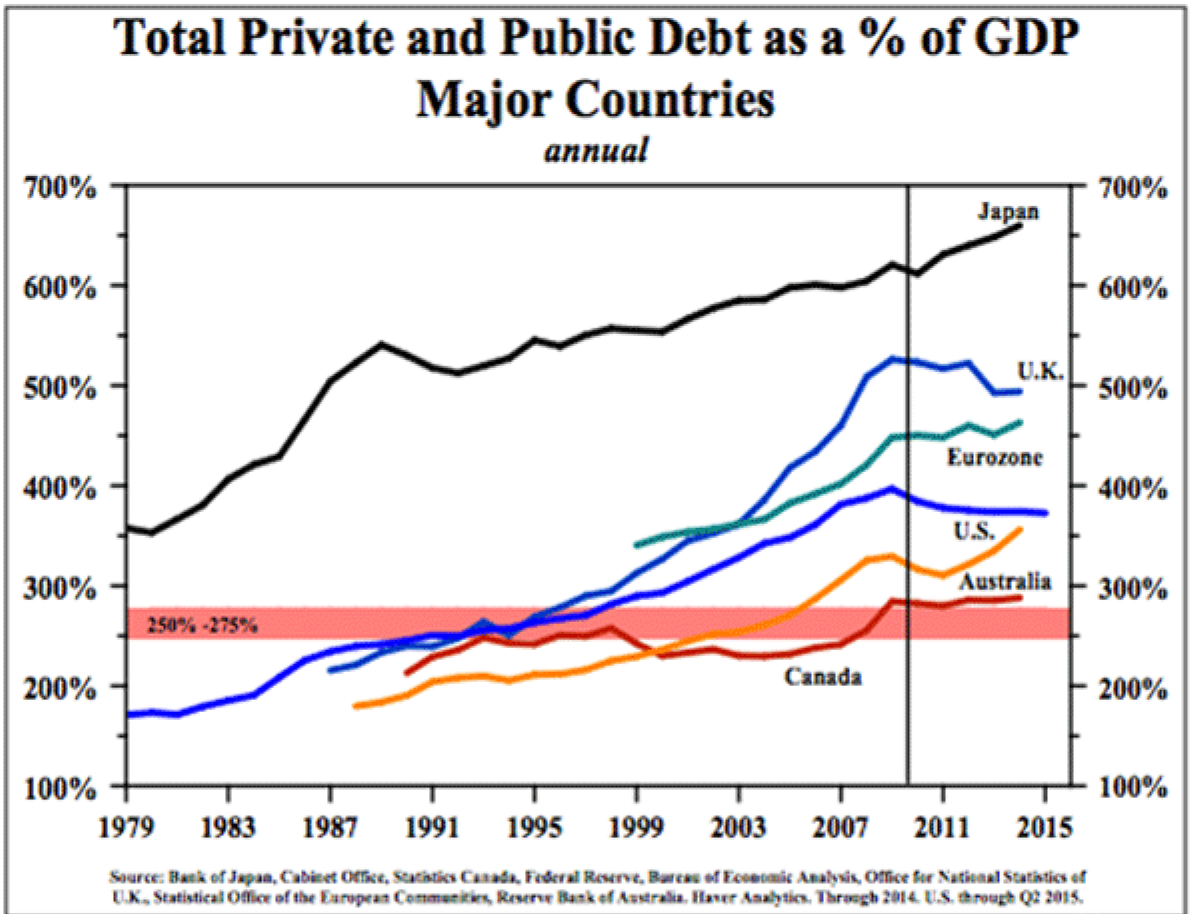


Chart 1

The pink coloured band in the 250% - 275% range is a “point of no return” type assessment of sovereign debt. It is not like more debt can’t be added…obviously because Japan would have long ago blown up if that were true…**but it represents a level where debt is curtailing the ability to grow the economy.**

So I pose the question: What does it mean when the entire world exists above the 250% - 275% range?

It means a lot of things that are beyond what I want to talk about today…but it definitely means that whoever wins the election today has a lot fewer policy choices to make an economic impact in our country than a leader who won an election in the 1960s!

One last comment about the election.

Justin Trudeau has employed the most popular election platform of the present age. He promises change through more debt…or as I like to call it “helicopter money.” (Helicopter money is a term coined by former US Fed Chairman Ben Bernanke in his 2002 speech explaining why DEFLATION could never happen in the United States. In extreme conditions…the FED could simply give money to the citizens for them to spend and, thereby, stop a deflationary spiral. The economists of the day drew graphics of Ben S. Bernanke throwing cash out of a helicopter over a busy downtown street.)

Of course, Justin is going to give people jobs and make the people work for the money by building infrastructure and other government projects…but it will all be created by our country going further into debt to fund the projects.

Hey, when it comes to our governments printing money and handing it over to banks or to people…I support the latter. But the time to have done the "helicopter money" move was about 8 years ago AFTER THE LAST RECESSION.

My fear today centers around the possibility of a continued drop in our currency if helicopter money were to be employed.

First we will see what the election results bring…then we can discuss these ideas further.

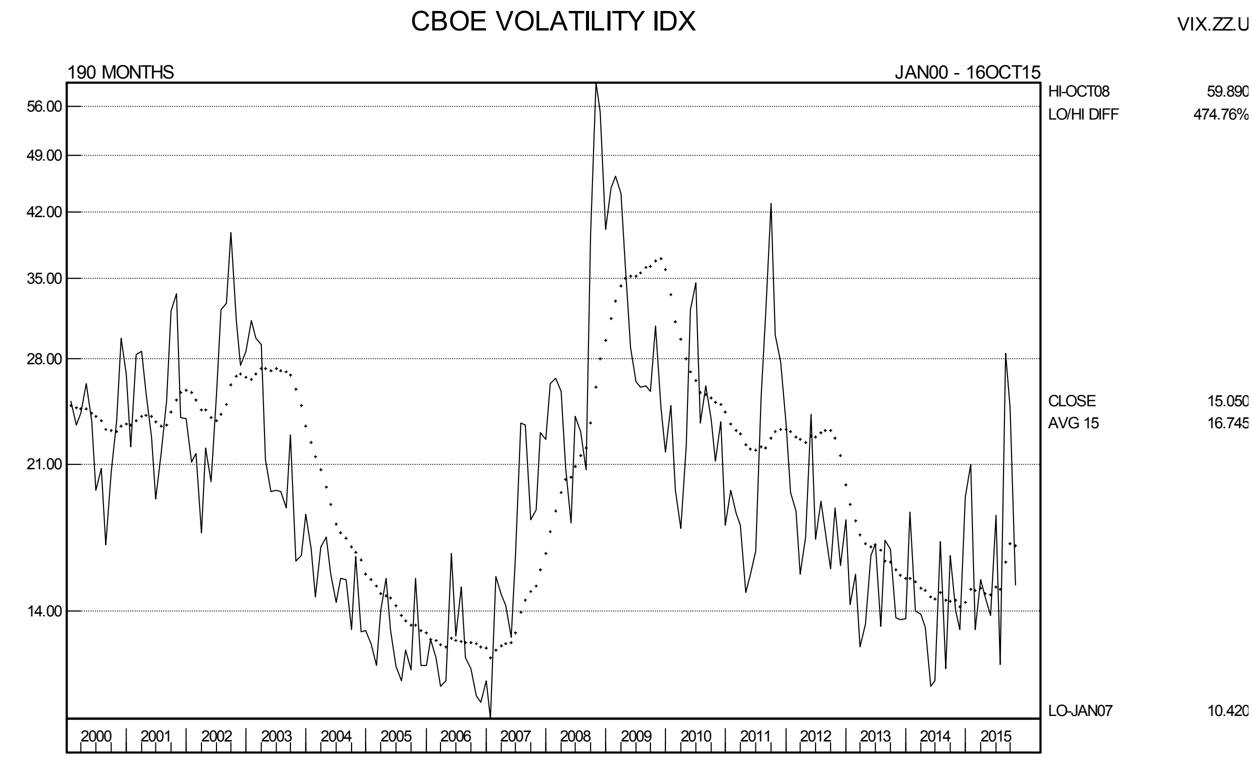
"Vix-termination" and "Skewed"

Nobody will ever be able to accuse me of not being curious as to why certain relationships exist in the world. Correlation and causation captured my attention as a student and continue to fascinate me decades later.

On the surface, financial correlations are different than many life-type correlations. Since finance is completely mathematically founded, one would tend to believe that correlations and causations would be better supported.

In reality, I would argue they are about the same. I say all of this because the two charts I am about to show you are behaving strangely in the present time.

The first chart is of the Volatility Index (VIX). The VIX is a correlation of option premiums used to gauge the amount of volatility in a market.



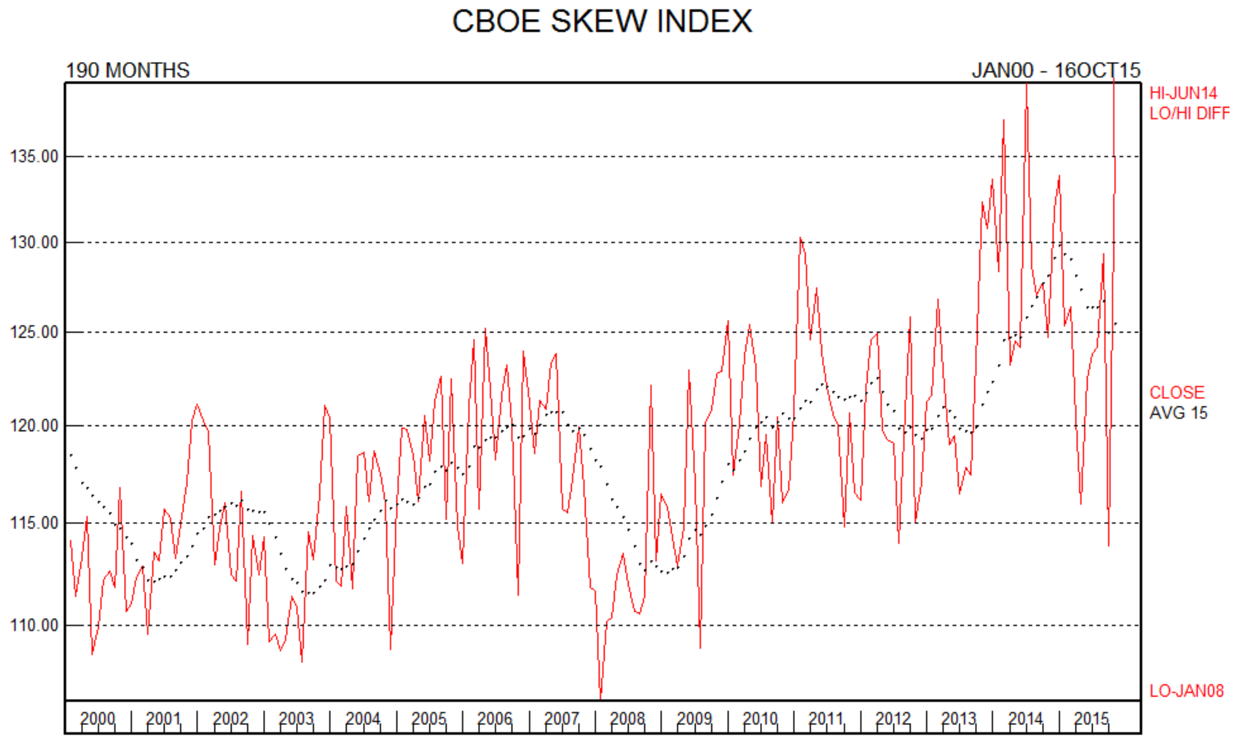
As you can see in the chart above, as the S&P 500 was making its low last month, the VIX was elevated. During October, as stocks recovered, the VIX came back down to more “peaceful” levels. This is normal behaviour and would be completely predictable.

OK…here is where it gets confusing. The next chart I am showing is of “Skew”. Skew is an indication of option contract activity on the basis of strike price and underlying price.

Under normal market conditions we expect a greater amount of options activity to be centered around the strike price of the underlying. This creates a “low skew” reading. But at certain times there can be large positions traded further away from the strike price of the option. This will elevate the skew.

Let me use a quick example before I show the chart. Let’s again use the S&P 500. It is trading at roughly the 2000 index level. It would be normal to expect most of the options trade on the S&P to be between 1950 and 2050. The further in either direction we go from the 2000 level the fewer options we would expect to be traded.

But in the present, we are seeing huge volumes of options trading down at “Black Swan” levels. Options in the S&P 500 have large volumes in the 1750 level and even lower than that! Hence, we get the chart below:



There are a number of reasons I can think of as to why this would happen. A couple of reasonable reasons…and a couple scary reasons...

1. **There are more "Black Swan" type hedge funds in the world today**. These funds make a constant bet on a "fat tail" event that is very unlikely to happen. In essence, they lose a little bit of money every day. But if something crazy happens in the underlying market they are betting in…they make a massive profit on their bets. These funds could simply be more active than usual to create a high skew.

2. **Regular hedge funds are buying more insurance than usual**. Hedge funds have underperformed the markets on a global basis the past 3 years. They are trying to cover all of the bases.

3. **Investors really are still worried about a large dislocation in the stock markets and therefore, feel the need for insurance against such a decline**.

4. **Someone big knows something we don't know and is making bets ahead of such an event**.

Each of the above statements could be true. We have no way of telling if any, all, or none of them is true. The first two don't worry me…the second two obviously do!

My job is to monitor the investment climate of financial markets to try and ascertain the risk/return profile of our investment choices. These are tough markets…and relationships like the VIX vs. Skew don't help when they start acting weird.

May you live in interesting times!

About the author: Nick Foglietta is a Vice President, Investment Advisor at RBC Wealth Management in Nanaimo, B.C., Canada. He has been managing money since 1988.