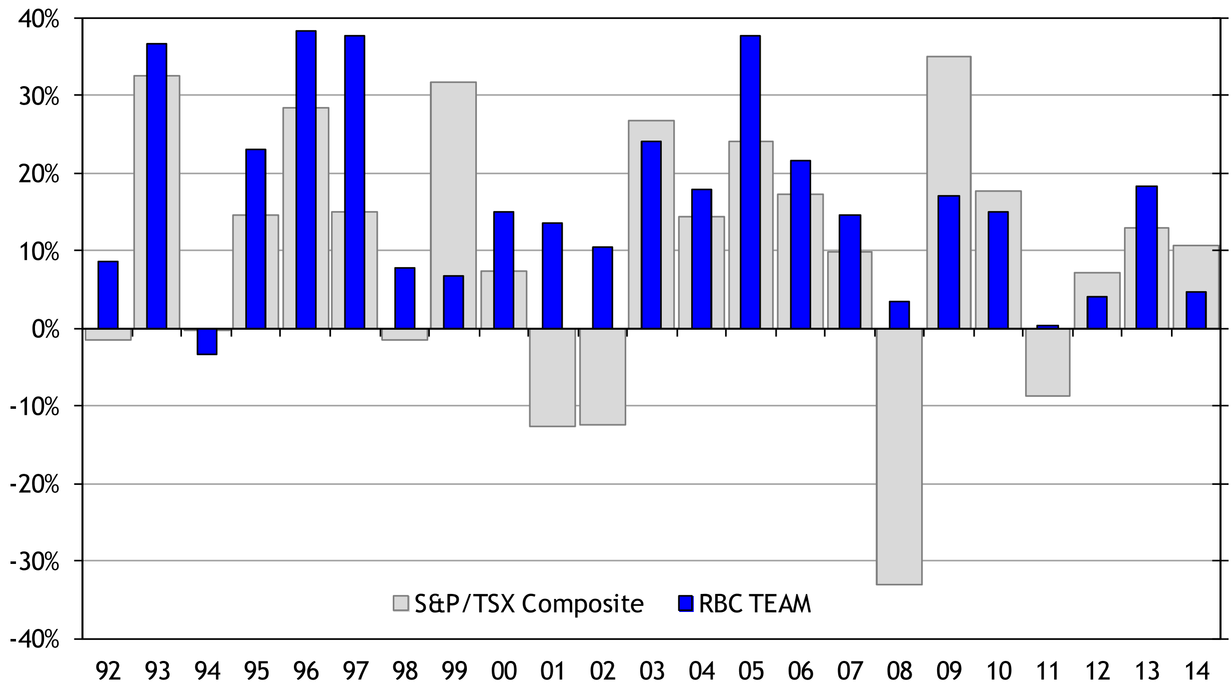
June 22nd 2015

"Won2One" with Nick Foglietta

Tactical Equity Income Model Portfolio Record



Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: **50%** Equities/ **50%** Fixed Income
S&P/TSX 60 Closing Value: 14,653
TSX 200 Day Moving Ave: 14,863
% Above/Below 200 Day Moving Ave: **1.40% Below**
Levels for change: 100% stocks - **TSX 15,633** and 100% fixed income – **TSX 14,144**

<u>*Weekly Quote*</u>

"*To be completely cured of reading newspapers…spend a year reading the previous week's newspapers."*

Nassim Nicholas Taleb, author of "*Antifragile"*

"Trickle Down Economics"

OK…I admit…that was a little bit mean!

"Reasonable Hypothetical"

Does the same crime committed by two separate individuals deserve different punishments depending upon who the perpetrator is and what their personal circumstances are?

A lawyer friend of mine used the term "**reasonable hypothetical**" when describing a case with which he was involved. A quick over-view of the case saw a person convicted of a crime and was sentenced to an appropriate time in prison. Given the circumstances surrounding the crime all agreed the punishment fit the crime.

But the judge was concerned the precedent set by the sentence may be too severe if the SAME CRIME WAS COMMITTED BY ANOTHER INDIVIDUAL whose personal circumstances were not as extreme.

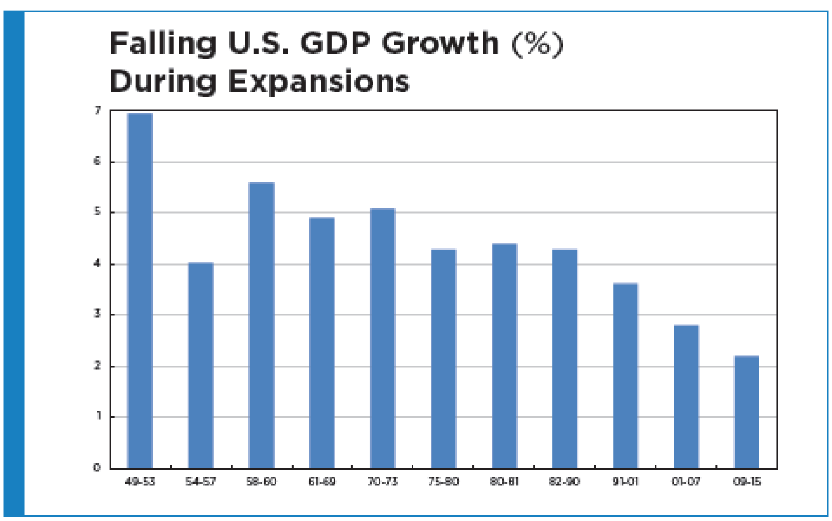
The “reasonable hypothetical” was the sentence was too punitive if the hypothetical “perp” was not as evil as the one the case sited.

As my friend was telling this story my mind was racing and thinking of all the parallels to what has been happening in the financial world the past 6 years**!** **Maybe the financial world has been overly influenced by leaders who are too concerned about the “reasonable hypothetical” outcomes of their actions? This means that, maybe the central banks should have tried to balance interest rates sooner and caused the banks some problems sooner, rather than letting borrowing and leverage get out of control to the point they are afraid to lift interest rates even 0.25%!**

Unfortunately, these mistakes are all in the past. As the old expression says, “*one can never know would have happened if we made different choices, we can only influence what will happen NOW!”* So let’s look at “now”…

Lakshman Achuthan from the Economic Cycle Research Institute (ECRI) published a report looking at how the US business cycle has shifted in past decades.

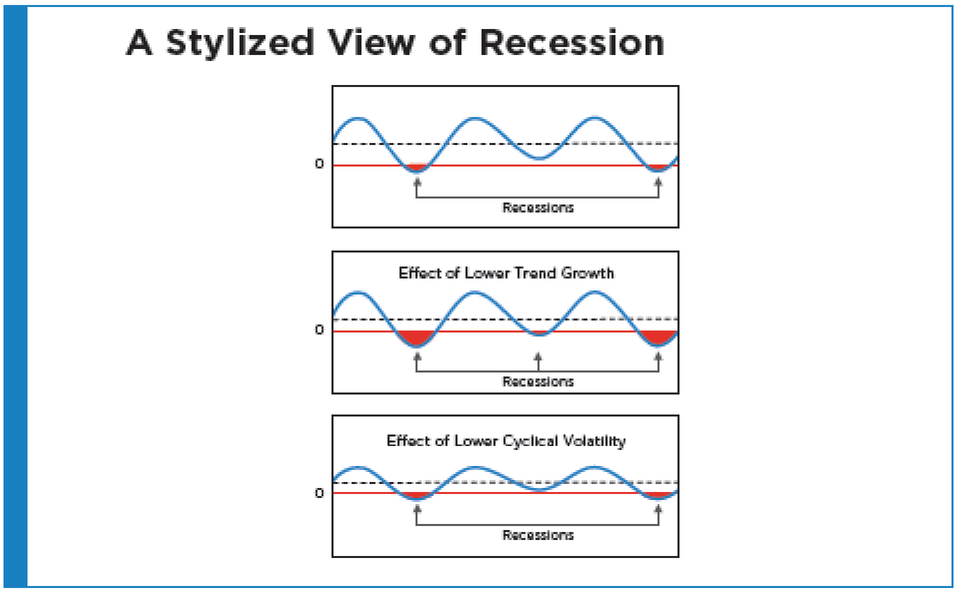
The chart below clearly shows the trend to slower growth during the recovery phases after recessions in the US since the 1950s.



The massive increase in debt since the early 1980s has been the main contributor to the slower growth. “Secular stagnation” is a global theme. The *glass half full* part of the story has been that secular stagnation has let interest rates fall for the past 40 years to the ridiculous low levels of today! The *glass half empty* part of the story has been the ability to carry larger and larger amounts of debt for the same interest costs.

Why would we expect the economic dynamics of a 2% GDP recovery to be the same as the dynamics of a 4% or 5% recovery? Those are massive differences in magnitude in an $18 trillion economy! Is there a structural difference we should be looking for between these recovery rates? Maybe the business cycle of the recovery is different too?

The following graphic is the key to what I am trying to communicate.



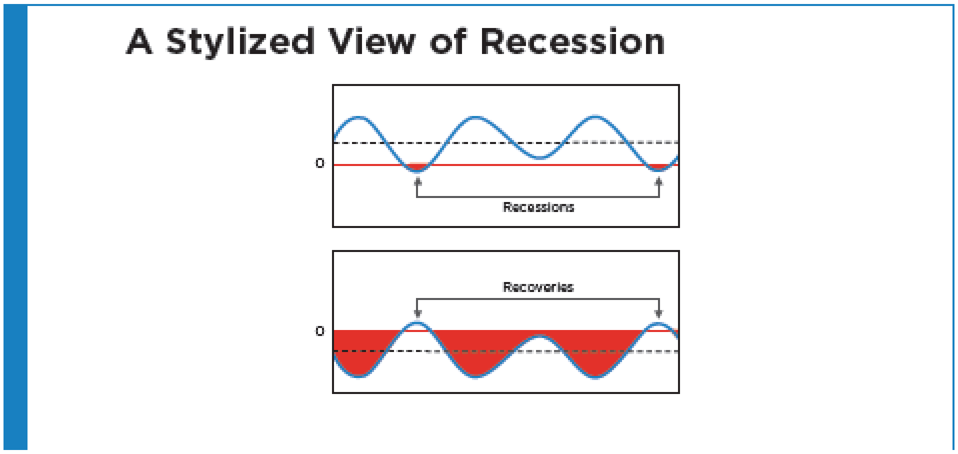
The blue wave line is a proxy for the peak and trough of the GDP growth for a given economic business cycle. In the early 1950s the peak growth rate might have been around 8% and the low for the cycle at 0%. (With a cycle average of 5% growth).

But maybe the "reasonable hypothetical" no longer applies? **What we are considering in the three charts above is the possibility that the whole global economic cycle has shifted down (lower peaks and lower troughs) AND the business cycle has less amplitude from peak to trough and back to peak again.**

(If you are interested in more details about this research please email me and I will forward the full report.)

For the next few paragraphs I am going to assume the ECRI research is correct and **<u>we live in a slower growth economy with less difference between peak and trough growth rate</u>**.

The first question I want to pose…what if we keep employing higher levels of debt to try and balance out the business cycle? (It appears this is the ONLY solution considered by central banks at the present time.)



We may end up in a business cycle that looks more like the lower peak to trough GDP graphic? I'm not sure how a highly leveraged economy could exist in a state of negative growth, but the concept needs to be considered by our leaders.

The next question I want to pose…what happens to commodity prices if this analysis is true?

The chart below shows the surpluses in global oil production vs. oil utilization.

Notice, we have never seen the builds in crude oil stocks in the last 30 years we have seen in the past 1 ½ years. The possibility that high debt levels slow the global economy enough to impair commodity absorption is real.

It is too early to tell if any of this is what our future holds. As I like to say…we are just looking for clues.

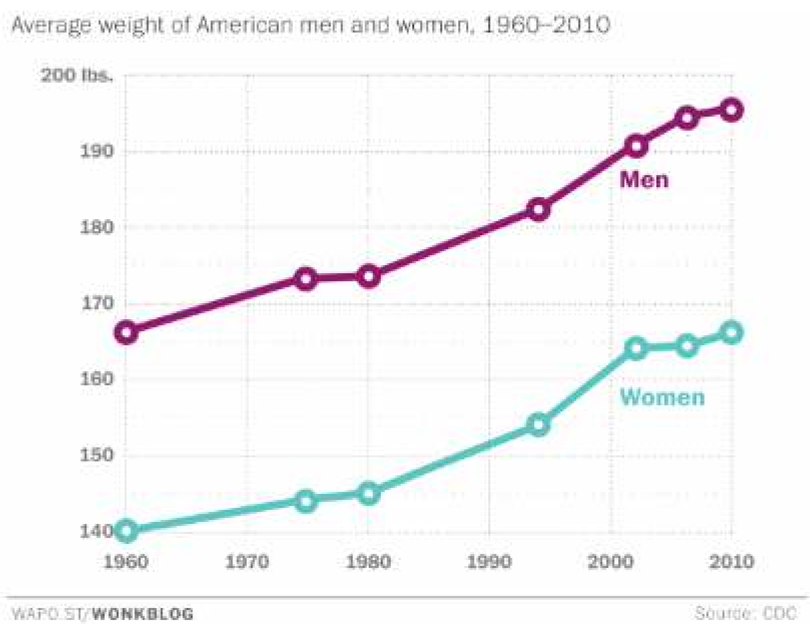
But the "reasonable hypothetical" approach to managing the global financial system is running out of chances to show it is the correct approach. I believe we need our leaders to embrace policies that benefit a greater proportion of society. So far, politicians and central banks have resisted these broader policies. We will see what happens going forward.

Weight Gain in America

A few weeks past I wrote about looking into some themes for investing in trends in society.

Obesity was on the list of trends.

Below is a chart showing the average weight of American men and women from 1910 to 1960.



The chart clearly shows that the "pounds are piling on" across America. Even our language lexicon has shifted to using words like "big-boned", "heavyset", "solid", "plump", "heft", "stout", "portly" or "pudgy"…instead of FAT.

It all adds up to making it easier to not face the truth!

But our hearts don't care about the lexicon we use to describe our "weightiness". Those extra pounds equal extra strain on our circulatory systems and, eventually, more heart disease.

There are three different ways an investor can view the “Fat America” theme:

1. Buy health care companies specific to heart disease.
2. Buy restaurant companies. (not a positive theme, but it might work.)
3. Buy healthy grocery store companies.

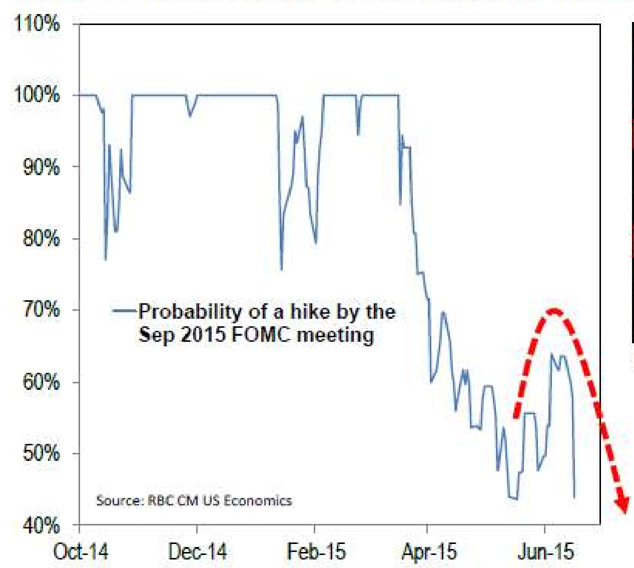
One of the other thoughts I have had about this theme is that when the next recession eventually comes around people usually “tighten their belts” both figuratively and physically. I would expect people to dine out less and focus on themes that “cost less and get us back to core values.” Weight loss could very easily become a core value to be sought after by Americans and become an excellent investment theme for the next economic cycle.

One Last Table…

On the topic of the US raising interest rates, last week saw the Federal Reserve once again decide to do nothing with short term interest rates.

The table below shows economists’ **expectations** as to when the first US interest rate hike will happen and the FEDs assumptions for some key economic data into the next couple of years.

The Less-Hawkish-Than-Expected Fed Statement



FOMC Economic Projections (June 15, 2015)

	Central Tendency			
Variable	2015	2016	2017	Longer run
Change in real GDP	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5	2.0 to 2.3
March projection	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4	2.0 to 2.3
Unemployment rate	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1	5.0 to 5.2
March projection	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1	5.0 to 5.2
PCE inflation	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0	2
March projection	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0	2
Core PCE inflation3	1.3 to 1.4	1.6 to 1.9	1.9 to 2.0	
March projection	1.3 to 1.4	1.5 to 1.9	1.8 to 2.0	

Source: Federal Reserve

I highlighted both GDP expectations and Personal Consumption Expenditures (PCE) inflation in red on the right hand side. I still think the FED is wishful thinking on the GDP side and may be too low on the inflation side…we will see.

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.