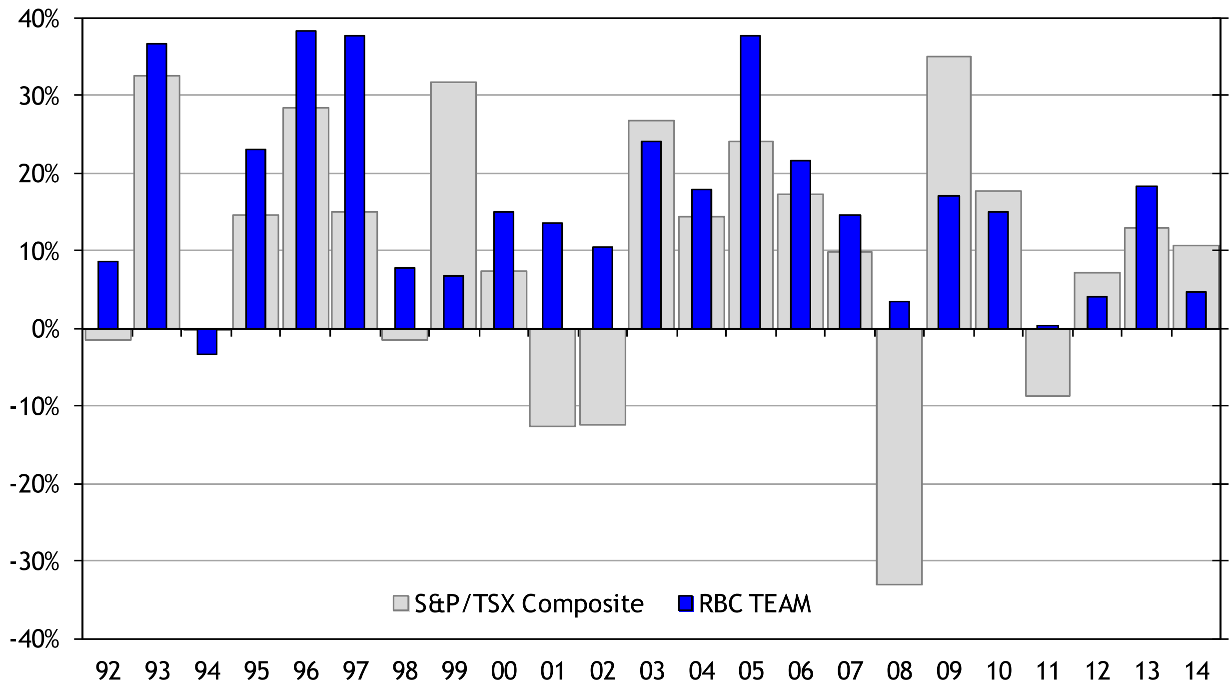
June 1st 2015

"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: 15,014
TSX 200 Day Moving Ave: 14,915
% Above/Below 200 Day Moving Ave: **0.66%**
Levels for change: 100% stocks - **TSX 15,660** and 100% fixed income – **TSX 14,169**

Weekly Quote

"If you can't trust the data…what is a data dependent Fed supposed to do?" –

Stockcats blog – May 29th 2015 in reaction to the -0.7% US GDP number that analysts are saying "just isn't right".

Not Equal and Opposite Reactions

Some “big picture” thoughts to start this week.

Interest rates have steadily declined for 35 years now. Short term interest rates have been held at or close to zero for the last 6 years in a large number of the world’s developed economies.

The objective for using a zero interest rate policy (ZIRP) was to incite asset growth, and to encourage economic “trickle down growth” as a result of the asset growth.

Inflation measures lack “meaningful” inflation targets for the real economy. Inflation statistics has been over-manipulated and bear little resemblance to the experience of the average consumer.

So now consider the problem our central banking community around the world faces. **Lowering interest rates and printing money was supposed to spur on asset growth, followed by economic growth. It succeeded in asset growth, but the economic growth did not follow as expected.** The action created the first desired response but not the second.

If the central banks admit defeat and reverse their policies, they will not achieve the opposite reaction (lower asset prices and higher economic growth). The will actually get the worst of all worlds: Lower asset prices and lower economic activity. This is important to remember; the opposite action will not create the reverse reaction…it will actually create a “double negative” economic outcome.

Hence, the incredible amount of concern over the first interest rate hike in the US is well justified.

There have been many smart people who predicted the present outcome of soft economic growth due to the artificial central bank stimuli. This misallocation of capital due to artificial economic stimulation is not new to the global financial world. History is littered with classic examples that ultimately end in a great reset of asset prices. But how it specifically happens is rarely the same!

So consider these thoughts: The central banks are left with two options.

1. Continue on with interest rate manipulation, over-indebted country bailouts, exponential growth of new debt and the likes which only cause themselves and others to continue to misallocate capital.
2. Change interest rate policy and begin some sort of “slow reset” on the misallocated capital and stop the malinvestment that presently is occurring.

This week we are going to start toying with some of these ideas. What if the FED decides to raise interest rates without the “cover” of better than 3% GDP growth?

Let’s start the weekly comment on this thought!

My guess is that the Central Banks have successfully “anesthetized” the stock and bond markets so that they basically run on “autopilot”. Weak GDP, Greece having troubles, sloppy earnings reports, don’t seem to move the markets one way or the other for long.

How long this situation exists is anyone’s guess?

Funny thing though, now I find myself wishing that I had been dead wrong about these central banks. I wish their policies had worked and the economies of the world had truly recovered. Ironically, now I actually FEAR that someday the central banks may be viewed for what they really are…**cheap facsimiles of the Wizard of Oz hiding behind a curtain blustering and blowing out great prognostications even though they are mere mortals who know little more than we do!**

And what about the “average Joe”? He has gone about his toil, even though his wages have not kept up to inflation. He has borrowed money (because it was easy to do) to make up for his lack of wage increases. He has been lured into a sense that “interest rates will stay low forever and there is always another credit line to be secured somewhere”.

And what about the “average retired Joe”? The one that saved and kept a good portion of his money is safe, interest yielding investments. He didn’t ask for much…just a simple retired life while he was healthy. “Retired Joe” has seen his purchasing power decimated by both low interest rates and very low upticks on pension incomes.

Volumes of trade on asset markets have dried up substantially since last summer. The anesthetized markets feel “comfortable” in the range they trade. Two weeks ago we looked at range trading strategies for investments.

As the “June summer doldrums” begin, what could happen to make a difference to the markets? See below…..

Could We See a June Interest Rate Hike in the US?

If you have not heard of a “double seasonal adjustment” before don’t feel bad. Most economists who have PhDs had not heard of one until a couple of weeks ago!

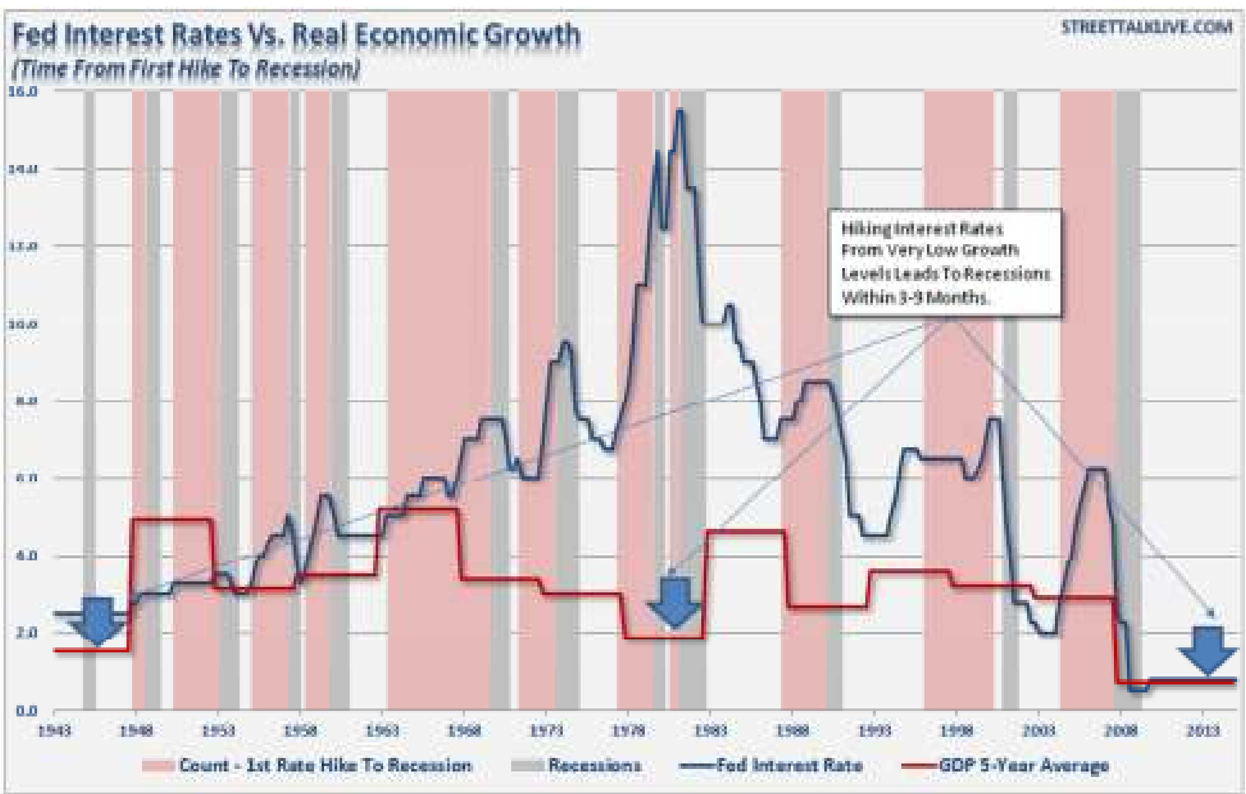
The Bureau of Labor and Statistics (BLS) decided that the tradition way of measuring economic growth in the US is no longer “right” so they introduced the new concept in May 2015. And guess what? The initial calculation for **GDP growth goes from 0.2% up to 1.4% in the US when you introduce the new calculation!**

For the most part, it’s just playing with numbers. I mean, you don’t create anymore actual economic activity by labeling the economy with a different growth rate.

So I ask you the question…why are the FEDs bothering to do this?

Let me speculate in one direction with this question. **If the US FED really wants to raise interest rates they need enough economic activity to justify their choice to raise…maybe the FED is more anxious to raise interest rates than we think!**

Before I go further, please look at the chart below show FED interest rate cycles and growth.



A few notes about the chart above:

1. The average number of quarters from the first interest rate hike to the next recession is 11…or 33 months.
2. The average 5 year real economic growth rate was 3.08%

3. The median number of quarters from the first interest rate hike to the next recession is 10…or 30 months.

But here is an important detail. **There have only been two previous historical points where real economic growth was below 2% at the time of the first interest rate hike by the US Federal Reserve.** (They were 1948 and 1980…both marked on the chart above by blue arrows.)

Obviously, the extremely low level of interest rates is going to magnify the severity of the hike in the next interest rate cycle. (If you raise a 5% rate by 0.5% you have only increased interest rates by 10%. But if you raise a 0.25% rate by 0.5% you have "trebled" the interest rate!).

So back to the changes in FED growth rate calculations.

Clearly, the GDP calculation change gives the FED a bit more "cover" to raise interest rates without looking like the Franklin D. Roosevelt government during the mid-1930s. He raised rates too soon and created the "second economic dip" of the Great Depression.

As volumes in stock and bond markets have slowed to a trickle…I believe the most important variable to watch going forward is when the US FED will begin to raise interest rates.

There are always the lists of possible "surprises" that may cause a change to markets, but the timing of the first interest rate increase remains the most "actionable" of variables to watch for.

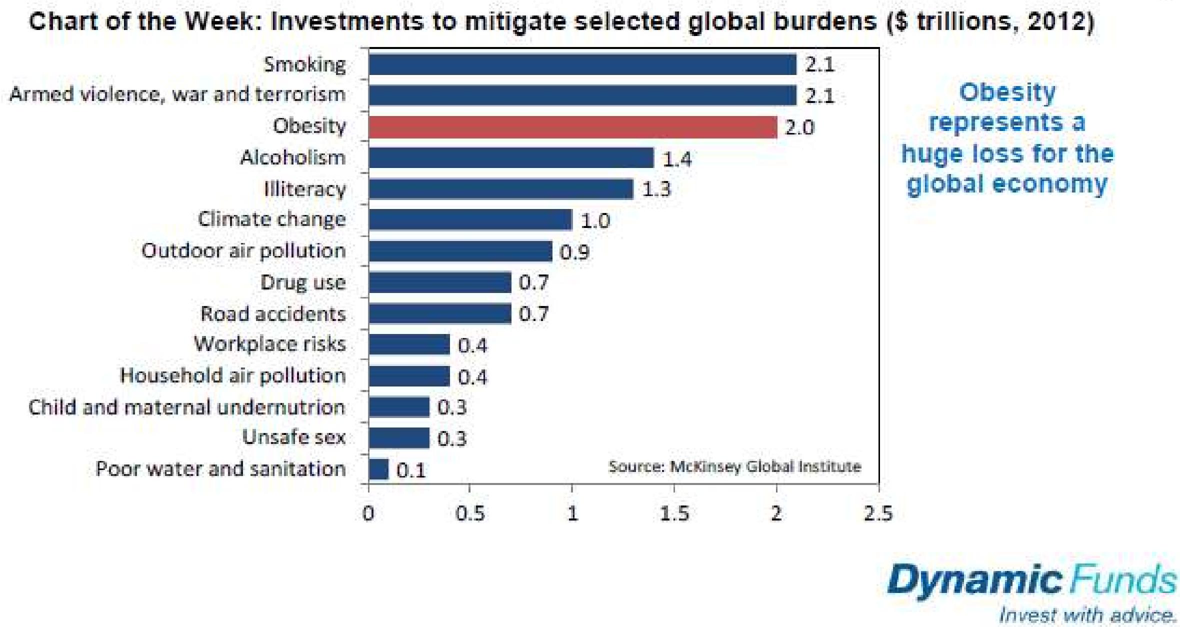
Mid June is the next time the FED is scheduled to discuss raising interest rates. Only 1 out of 37 economists surveyed expect the US FED to raise the interest rate at this meeting. With the -.7% revision in Q1 GDP it would be tough for the FED to do…but you never know?

How to Invest in "Positive Change" for the Future

A number of clients (and acquaintances) have wondered how to pick out investment themes that would "fix some problem the world faces."

Clearly we have lots of problems in the world…***what could a person put some money into that might make a difference and be a good investment***?

The chart below outlines the staggering costs of many of our problems.



The sheer size of these issues is amazing when viewed in terms of economic burden. It is also interesting when you look at the magnitude of some areas compared to others. For example, I would not have guessed that "drug use and alcoholism" were only equal to "smoking".

…and when referenced with "armed violence, war and terrorism" I think "obesity" stands out as a much larger cost economically than most of us think!

Finding investments that are working to change these world problems is an exciting and positive theme.

If these themes catch your attention and you are interested in this type of investment activity, please feel free to give me a call and we can chat about it.

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.