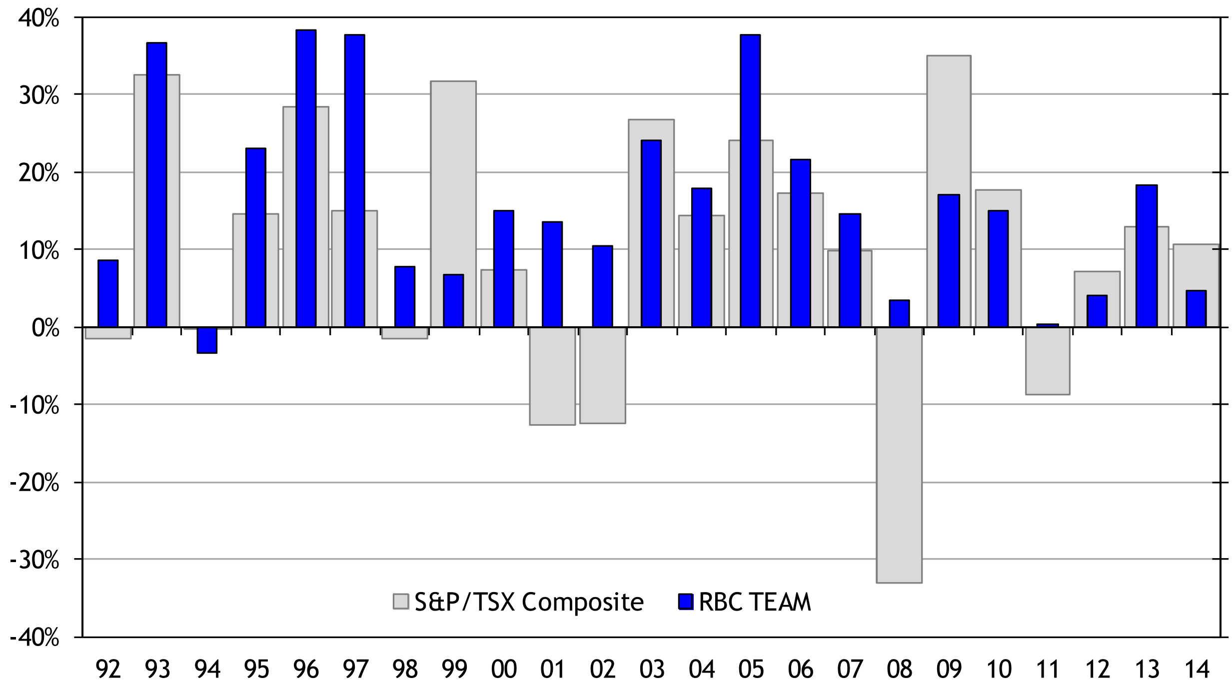
April 20th 2015

"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: 15,360
TSX 200 Day Moving Ave: 14,930
% Above/Below 200 Day Moving Ave: **2.88%**
Levels for change: 100% stocks - **TSX 15,675** and 100% fixed income – **TSX 14,184**

Weekly Quote

"We are paying attention to a possible transition from banks rejecting depositors to depositors rejecting banks" – David Einhorn, Greenlight Capital

Preamble to Negative Interest Rate Editorial

Before you read the main body of the weekly editorial, let me add a bit of a "reality check" to the discussion.

What **normal investor** is going to buy a bond for 2 years that "pays" an interest rate of negative 0.27% (-0.27%)? Or what investor is going to buy a 10 year bond that pays 0.078%? Answer: NOBODY!

Yet, in Germany, these are the present day yields for German government bonds!

Negative interest rates are present in 2/3 of European countries as are 10 year bond yields of less than 0.35%.

The editorial below will help you understand how the world got to this point and why it is happening. **But, as you are reading, you need to step back from the "academic answers" to these conditions and ask yourself where this is all leading to?**

Can German bond yields stay at 0.078% forever? Can countries keep devaluing their currencies against their neighbours currencies indefinitely?

Please try to read the thoughts below in the context of more than a few months in time. I continually hear investors (professional and retail) say how they "*will ride the stock markets as long as they are rising, and then get out near the top*."

Fine, but rarely do I hear these investors speak to how they are going to make this determination of a "top". The comments are spoken like a person who talks about buying earthquake insurance for their home…it's a good idea…but never actually buy the policy because it is too expensive.

These comments are not meant to be BEARISH or negative. They are meant to counter the near limitless line of BS I hear about why things are going to just "normalize" in the future without any pain or dislocation.

Folks, the world had its chance for normalization in the 2008-2009 recession. The stage was set for true financial "amnesty" on a global basis IF our leaders would have had the guts to choose it. They did not make this choice!

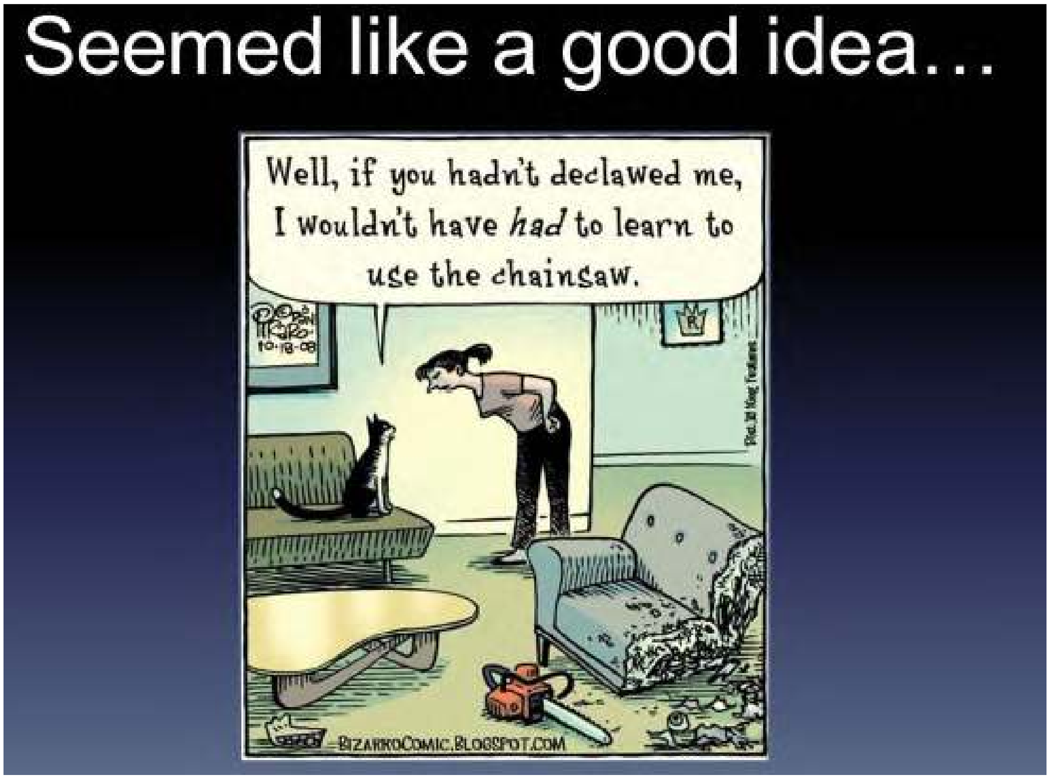
Feel free to ask me questions about the editorial this week. Don't be afraid to Google what the terms of the "Solvency II Directive" are all about.

We are trying to navigate this challenging time together. I do my best to keep abreast with all that is changing in the world…and it is a challenge!

Please don't bury your head in the sand…stay informed!

“The Growing Disease of Negative Interest Rates

As interest rates in many countries around the world drop **below zero**, an entire new financial mindset is taking hold. Investors have been forced to vacate many of their favourite “safe” investments and add risk to try and make a “reasonable” rate of return.



At first, there was some vision being applied to the never before attempted concept of intentionally crashing down interest rates. **The goal was to make it cheap for people to borrow money and stimulate the economy while giving the bankrupt banks a braid-dead easy way to make profits**.

The hope was in two or three years the economy would be rolling again and the banks would be recapitalized and nobody would really care that the Central Banks “*declawed”* citizens in the process. Politicians decided *the needs of the few outweighed the needs of the many…*at least in the short term!

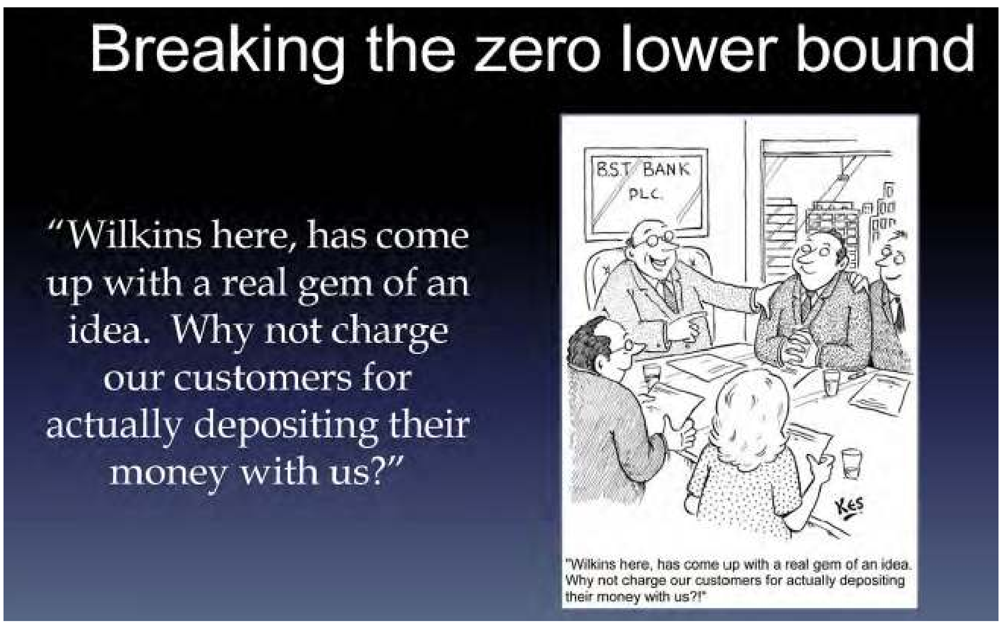
But as the cartoon above alludes to, sometimes the best laid plans don’t lead to the desired results.

And now after more than six years of financially repressive Central Bank policies, the best plans to move forward for the global economy are less than clear.

A few of the things I saw this week in the news:

1. JP Morgan plans to return $100 billion to customers as it costs them money to hold the funds even when they pay the customers NOTHING!
2. Bank customers in Europe are being "asked" to switch deposits into securities that the bank can hold in custody. This keeps the banks from having to account for the funds as a liability.
3. Banks are asking customers to buy US Treasury bonds rather than hold deposits.
4. Banks are switching customer assets from "physical positions" to synthetic, derivative based securities.

Negative interest rates really do change the face of the financial system. (I found the following slide a little too close to home!)



Why I think the cartoon above is so interesting is because it is nearing a reality in some counties around the world. So how would you feel if your bank said to you, "*we will no longer pay you zero interest on your savings, actually we will charge you to leave them in the bank*"?

I agree…people are NOT going to pay a fee to deposit with a bank…they will take their money out of the bank as cash, or gold, or something else!

If people actually take their money out en mass, the financial world would go crazy in fairly short notice…you want to know why?

Just think back to the Christmas movie "*It's a Wonderful Life*". George Bailey (Jimmy Stewart) is leaving on his honeymoon and he sees a run on *The Bailey Building and*

Loan. George stops the cab and goes into his office to see the majority of his depositors demanding their savings out of their accounts.

Of course, the *Bailey Building and Loan* can't give everybody their money back at once because, as George Bailey so aptly describes, their deposits are the mortgage financing for all of the people who live in "*Bailey Park"* subdivision.

At least in the movie the leverage on assets at the *Bailey Building and Loan* was reasonable! The banks today are leveraged at many multiples greater than George Bailey's family business! There clearly would not be enough money for depositors to retrieve from the banking system today.

So far, I have been having a bit of fun with you…but now you need to put on your thinking caps because the next section of what I am writing is deadly serious!

Many people have asked me, "Why in the world do these interest rates even go negative…who is buying these negative yielding bonds?"

The financial crisis spawned a policy named **Solvency II**. It was created with the goal of rewarding insurance and pension fund companies for **minimizing risk**.

Solvency II gave government bonds the lowest risk rating of any asset holding. Therefore, it encouraged financial institutions to hold government bonds. (See chart below…charges shown are before "re-credits" and "adjustments")

Asset class - rating - duration	Solvency II standalone charge	Solvency II all-in charge
Money market	0.9%	0.8%
Corporate debt A 5 years	7.0%	4.3%
Corporate debt A 10 years	10.5%	3.9%
EU Government debt 10 years	0.0%	-2.1%
Residential mortgage loan, 10yrs, 80% LTV	0.0%	-2.1%
Covered bond AAA 5 years	3.5%	2.6%
Real estate	25.0%	13.9%
Equity type 1 (EU/OECD listed equities)	39.0%	23.4%

Ok…here comes the key concept. **Solvency II never anticipated negative interest rates**. When bond yields go negative the normal "human" response is to sell the bond and go to cash. Why? **Because this trade maximizes the rate of return, lowers the duration risk in the portfolio, lowers the market risk in the portfolio, and even eliminates credit risk as governments can default**!

But the crazy mathematical calculations of Solvency II above make it so the institution chooses NOT to sell the bonds for all the valid reasons above.

This is because the insurance company has to pay a Solvency II charge of 0.32% to hold cash as opposed to receiving a credit of 0.84% for holding the riskier negatively yielding bond! Make sure you are get this…Solvency II makes the insurance company or pension fund PAY 0.32% for holding cash, but the Solvency II fund PAYS them 0.84% to hold a bond that yields -0.25%. (A net profit of 0.59%)

Taken to its logical conclusion…**Insurance companies and pensions funds in Europe are going to keep buying negatively yielding bonds for as long as cash yields less than the Solvency II directive charges them to hold cash.**

That means this could last a while longer than any of us think!

Please understand that negative interest rates create incredible distortions to the financial system. These distortions are now adding risk to the banking system, not reducing it.

Bottom line: Complicated is an understatement in today's financial world. If you send me a question, I will do my best to find the answer most suited to it. A lot of what I find tends to be someone else's opinion and I don't like to use those answers unless they are both credible and don't have a biased interest in the outcome from the policy.

This leaves me with few options most of the time. That said, don't hesitate to ask your questions.

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.