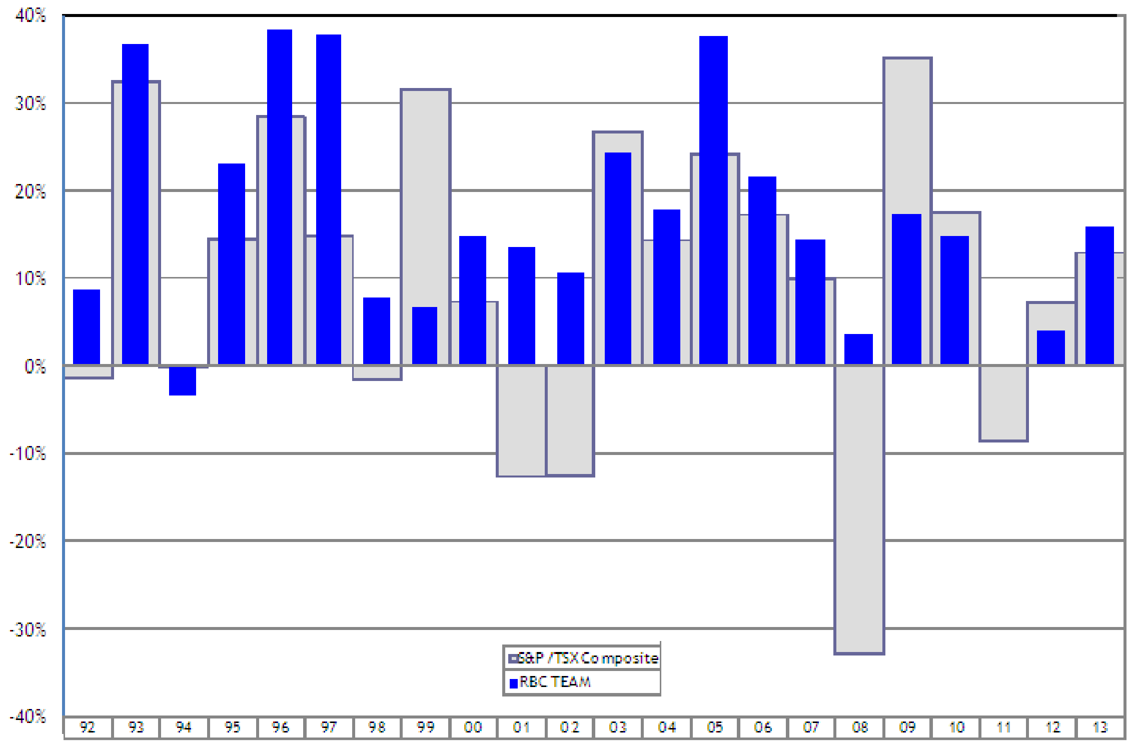
January 5th 2015

"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: 14,754
TSX 200 Day Moving Ave: 14,823
% Above/Below 200 Day Moving Ave: **-0.47%**
Levels for change: 100% stocks - **TSX 15,560** and 100% fixed income – **TSX 14,080**

Weekly Quote

"*You don't realize how easy this game is until you get up in that broadcasting booth"*

The great Mickey Mantle – *that goes for investing too!*

<u>The Bottom Line in 2015</u>

Standing up to be counted or *choosing to go right when everybody else is going left*…I believe investors are going to be called to make this type of decision in 2015.

Investors will have to make a serious decision…**are you a "buy and hold" investor…or are you a "tactical" investor**?

The extreme financial conditions we find ourselves in at the end of 2014 are historically unprecedented.

- Never have stock prices been as high as they are today on a nominal basis. (Stocks have only been this *expensive* once before in history when using more fundamental metrics of value – in 2000)
- Never in history have global interest rates been this low.
- Never has there been more cash floating around the world getting zero rates of return…and now sometimes a negative rate of return!
- Never has there been more global debt

The correct investor course of action during the past 6 years has been to ignore all of the above and buy US stocks. Managers who employed risk management techniques have underperformed. Why? Because the stock market in the US has basically ignored all negativity and gone straight up!

So why do I believe 2015 will be different?

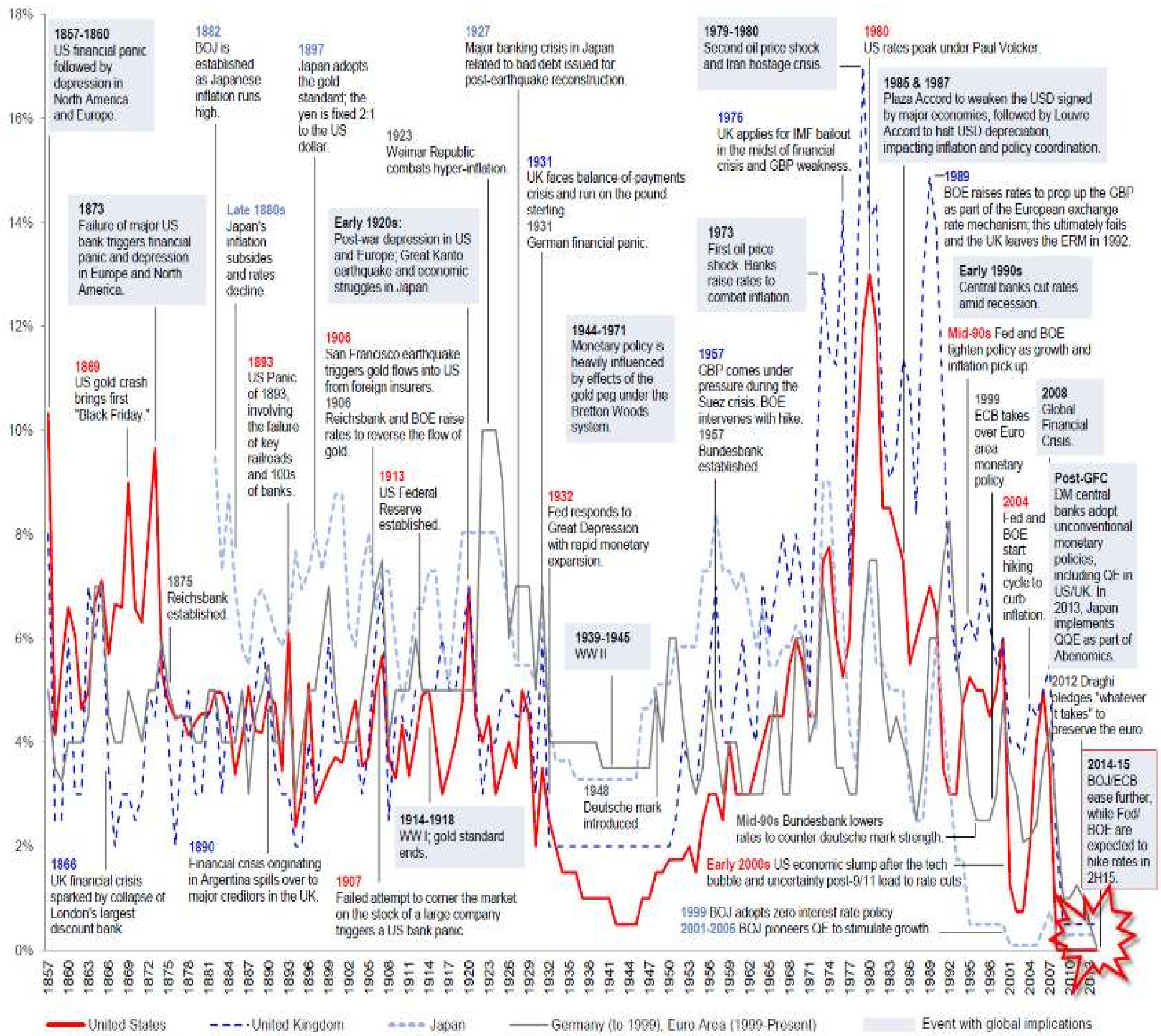
This is where my forecast begins!

<u>Bond Markets</u>

The crux of the financial markets resides in the bond markets. I cannot stress this point enough!

Interest rates were the greatest surprise in 2014 reaching never seen before low yields in most nations around the globe. Nine European countries and Japan have "negative" interest rates at present. How these insane interest rates unwind in the future is anybody's guess?

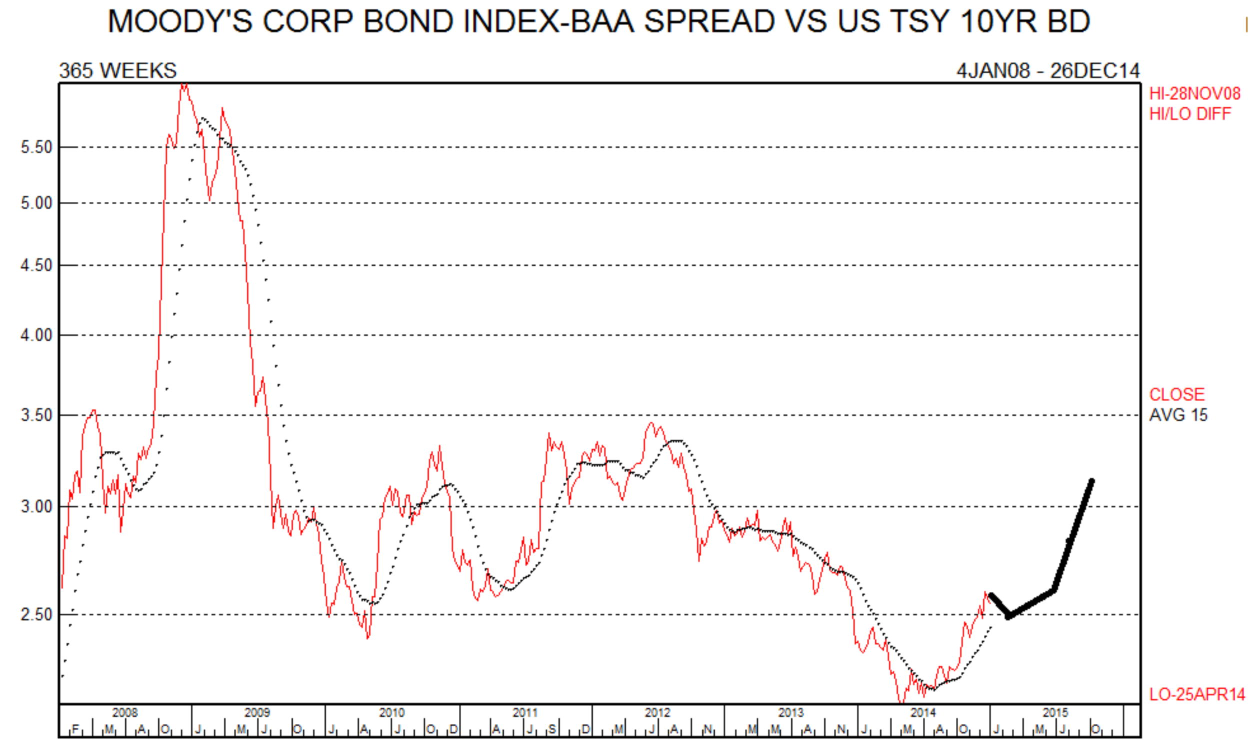
Below is the same chart I used in the 2014 recap showing the past 150 years of interest rates in the world's largest economies. Again, the captions are not the important part of this chart…just look at where the present day interest rates reside compared to the past 150 years!!



Will these yields begin to climb again? Will they stay suppressed due to low global inflation? The answer to that question would make you a lot of money in 2015 if you knew it right now!

My forecast is going to go off the board a little bit for 2015. **My expectation is for government bond yields in highly rated nations like the US and Canada to stay low…but I believe <u>we will see the yields on weaker quality corporate bonds rise</u>**.

The difference between the interest rate on the government bond and the lower quality corporate bond is called a **"spread"** in yield. The chart below shows how much "interest rate pickup" there is between a government bond and a "junk bond". The theme behind this chart is **the more risky the economy is perceived to be the higher the spread will be between the government and the corporate bond.**



The red line shows where the yield spread has already started to increase. Nothing compared to what happened a couple of years ago…but it bears watching.

As the **spreads on high yield bonds to get larger throughout the year** two major impacts will result:

- It will become more difficult for corporations to borrow money in the bond markets. This challenge in borrowing will, in turn, make it more expensive for companies to do corporate share buy-backs.

- More money will pour into the US dollar because the US economy will continue to be viewed as the strongest large economy in the industrialized world. Therefore, US government bonds will be viewed as "safer bets" corporate bonds will be viewed as growing in risk due to the exposure they have to global markets.

Once the "spread" on "high yield bonds" exceeds 3% my guess is stock buy backs will be impaired.

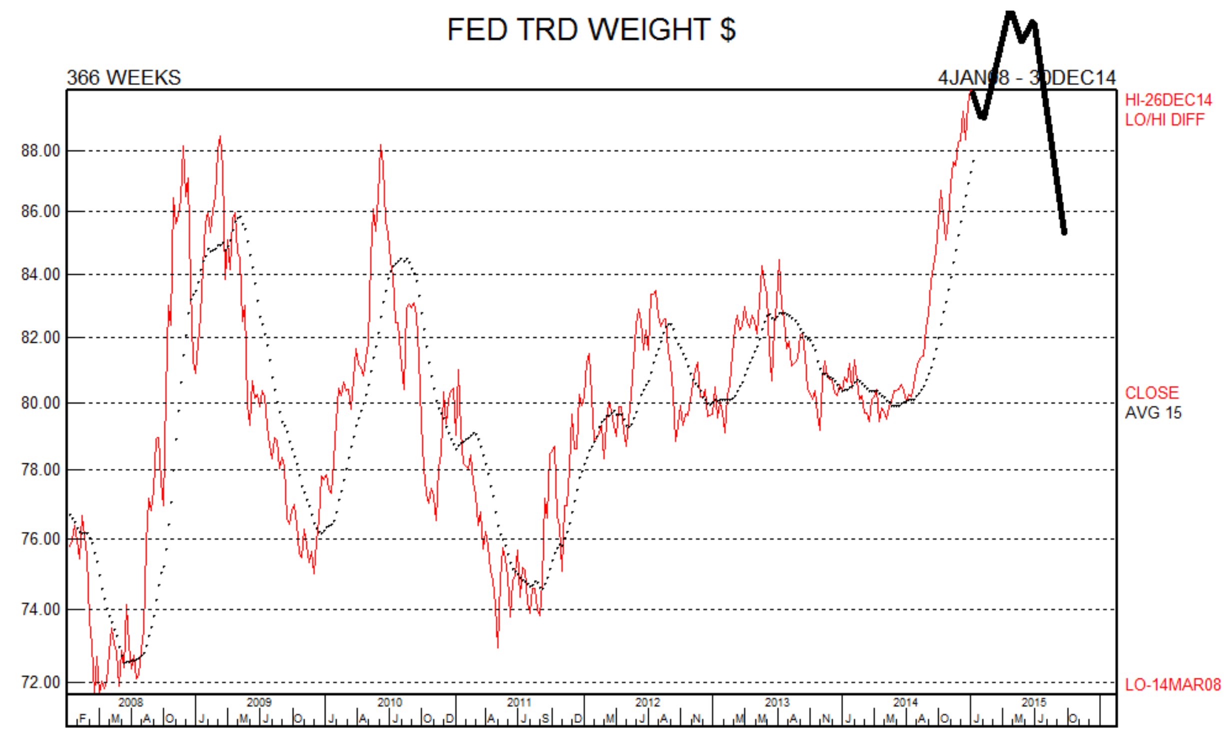
Bonds were the big surprise of 2014. I don't expect that to be the case again as long as you are not guessing the yields on bonds were going to rise dramatically…because they won't!

The financial area I look for surprises in for 2015 is the currency markets.

Currency Markets

Janet Yellen, Federal Reserve Board Chair, will get her wish to start raising interest rates in 2015. **The US will raise its short term FED funds rate off of the zero bound up to 0.5% in 2015, but it will not get any higher**. The reality will be that (a) the economy will not be strong enough to take any more increases than .5% and (b) the US dollar is going to continue to strengthen causing the FED to stay cautious about any further interest rate increases.

The US dollar rise is absolutely killing many economies around the globe…not to mention what it does to commodity prices.



But here is where I forecast a surprise.

By early fall in 2015 the FED is going to "blink" and not raise interest rates again after two increases over the spring and summer months. When the FED misses an interest rate move higher the US dollar is going to peak and start to decline sharply.

This is where things are going to get tricky.

My greatest concern for 2015 comes later in the year as markets digest the inability of the FED to raise interest rates any further. There is a huge difference in perception when the FED is "managing" the interest rates and when "interest rates are managing the FED".

I believe the US dollar could travel a lot higher than present on the way to this moment in time…maybe gaining another 15% - 20%.

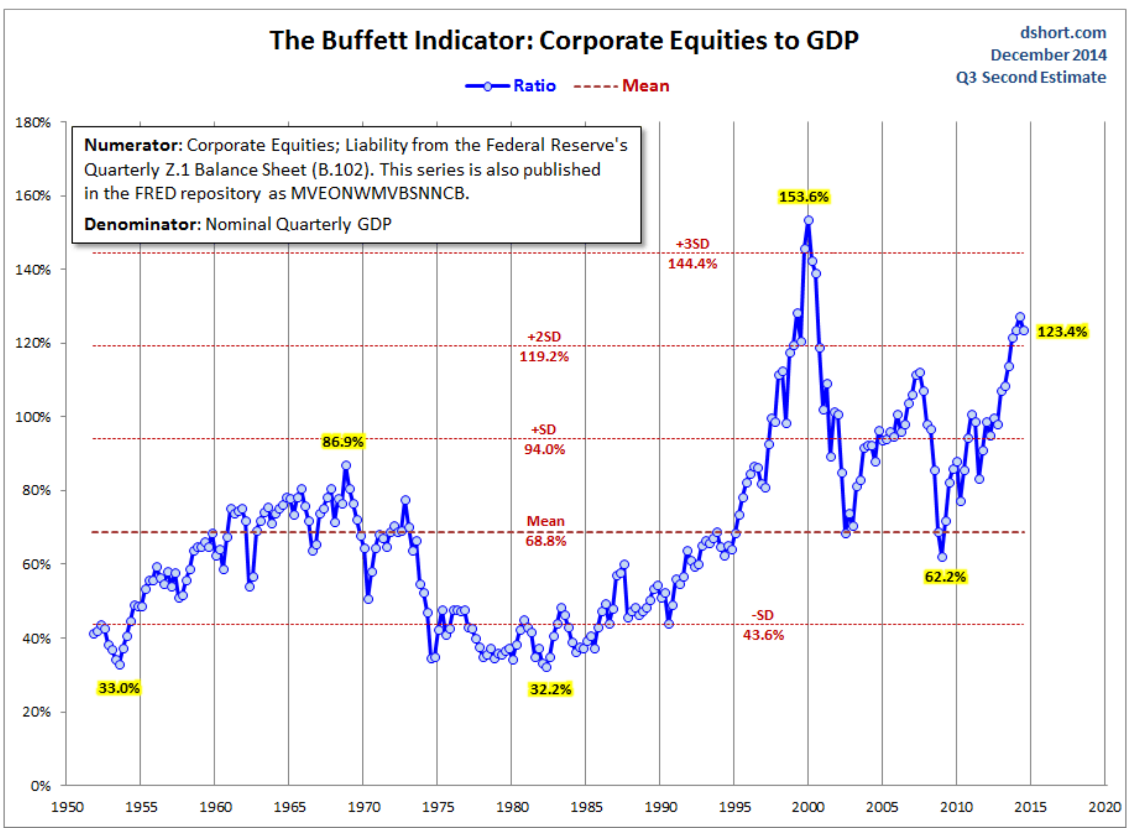
Personally, outside of an unexpected geopolitical type event, I see the US dollar level as the number one issue to be watched by investors in 2015.

Stock Markets

US stocks begin the year at all-time highs. Chinese stocks have jumped sharply in the past 4 months. Even with all the troubles in Europe, their stock markets are extremely elevated.

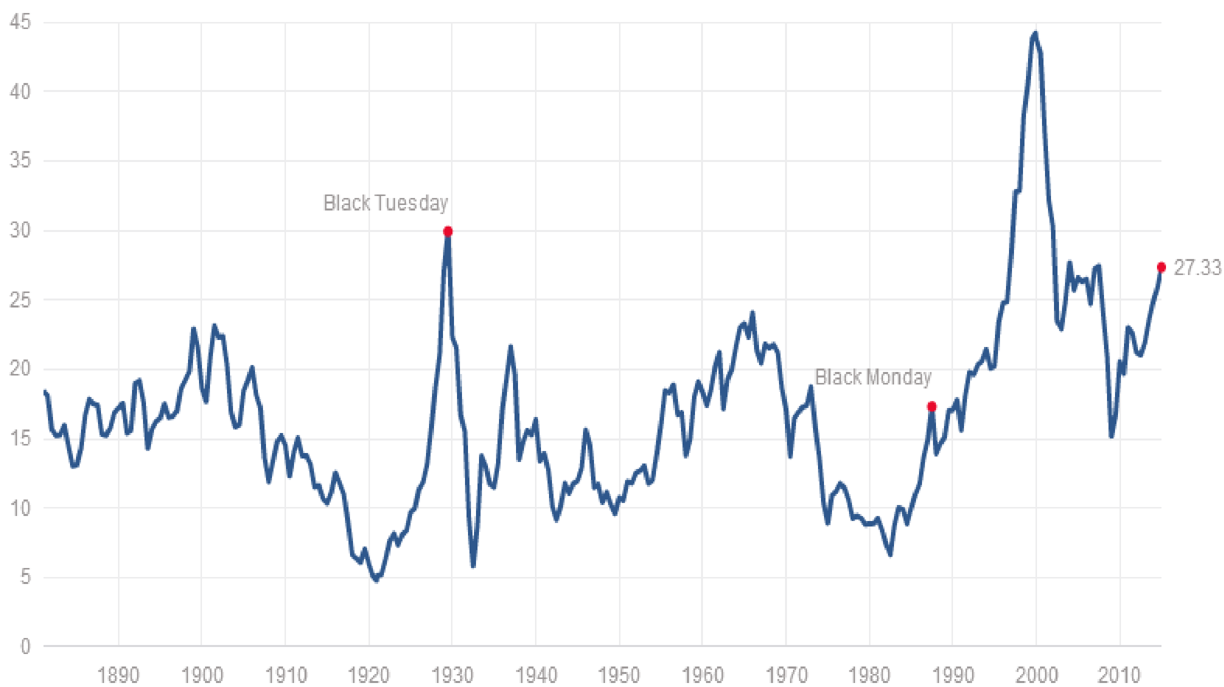
Let's spend some time on valuation and set the stage for a forecast.

The first chart is Warren Buffett's favourite chart for assessing broad US stock market valuation. It correlates **GDP to the overall valuation of stocks**. (Hat tip to Doug Short of dshort.com)



Clearly US stocks are not cheap on a historical basis…but why should they be? Interest rates are so low, the FED has chased savers into riskier choices to try and make a rate of return on their money.

Here is one more respected US stock market valuation tool. The “Shiller P/E” ratio is good because it uses a less volatile earnings stream to generate its number.

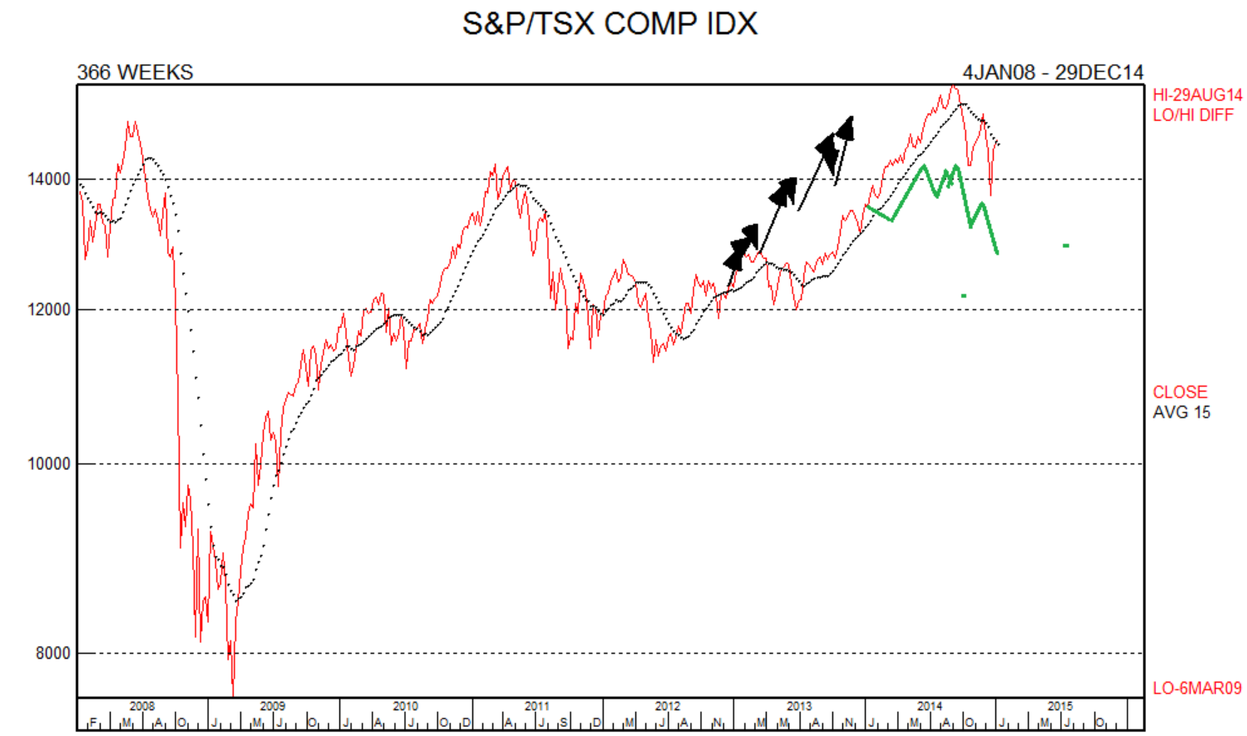


Some may take solace in the fact that stocks aren’t as expensive as they were in 2000 or in 1929…I won’t be one of those people.

Momentum is the best thing going for US stocks as we start 2015. And on a day to day basis, I prefer to have momentum on my side! My forecast doesn’t include US stocks each year but I will make one comment: **If corporate bond spreads keep growing making corporate buy backs of US stocks a challenge, US stocks will weaken. How much really depends on a ton of variables that I can’t even begin to list in a short report like this one. Technically, the TEAM Modeling will pick up on this change if it occurs relatively early.**

The Canadian stock market is the one I do forecast each year. The chart below includes both my 2013 and 2014 forecasts for the TSX.

(The black arrows represent my 2013 forecast made at the end of 2012. The green line represents my 2014 forecast made at the end of 2013.)



The good news is that last year I had the shape of the trading year pegged pretty close…but my forecast was always about 1000 points less than what the TSX was actually trading at. At year end the TSX closed about 1100 points higher than what I was forecasting.

The funny thing was that I "overestimated" the TSX in 2013 and "underestimated" the TSX in 2014.

Looking forward into 2015 my view on Canadian stocks is much more constructive on a **valuation basis** than that of the US.

Canada's central bank has simply not screwed around nearly as much as the US FED. And when the FED "blinks" and stops raising interest rates next summer…I believe that will mark the point where the TSX outperforms the US stock indexes.

So at the clear risk of looking like a complete fool, I will do a stock market index forecast for the TSX. The theme behind this chart is a somewhat weaker TSX to start the year, but a strong rally at the end of the year that coincides with the change in FED policy in the US.

The overall TSX forecast for rate of return is something around “flat”, for the year. **The trick will be to find a place to get “overweight” in the commodity sector…mainly oil stocks, at some time during the second or third quarter of 2015.**

Weakness at the beginning of the year is not something I am too worried about…it should be perceived as the “setup” to the commodity based opportunity to come.

It should pay to follow the TEAM Model allocations and to stay underweight stocks the first half of the year and then overweight the second half. My hope is that, even though the TSX will end the year “flat”, TEAM will be able to realize a 6% - 8% rate of return by “buying low” later in the year!

Miscellaneous Thoughts – “Black Swans” and “New Opportunities”

- **General Global Geopolitical** – the world is a fragile place. Financial repression in most developed nations has created an insecure middle class. Income inequality is at extreme levels. A disruptive geopolitical situation is something that cannot be taken off the table in 2015…and maybe it even gets elevated!

- **China/Japan Crash** – these two countries have crazy financials backing their economies. They have been precarious for years…neither is more or less precarious today than before. But, if for some reason, one or both hit a tipping point and imploded the financial world would change quickly. We need to keep an eye on these two giants.

- **Eurozone Challenges** – The head central banker in Europe, Mario Draghi has talked until he is blue in the face using expressions like “financial bazooka”, “whatever it takes”, “totally committed” to explain how committed Europe is to Quantitative Easing. He just hasn’t pulled the trigger. Europe continues to weaken…maybe 2015 is Draghi’s year…maybe not!

- **Gold** – Gold prices have been trading with a different bias since September 2014. For the past 3 years gold seemed to find a reason to decline. Many of those reasons did not even make sense to me! All of a sudden in September, gold has a great reason to decline…a rising US dollar. But it doesn’t go down…gold actually starts to go up! If investors get the sense in 2015 that the FED no longer controls interest rates, gold could look very good. **Gold presents a high risk/high return opportunity in 2015.** We will watch it closely!

- **Oil Prices** – for Canadian investors, stabilization in Oil represents the most lucrative investment opportunity close to home. Oil’s slide is not done yet…but when the FED blinks I believe Oil could come back with a vengeance. Create a shopping list and watch for a technical turn in oil much like the one we have already seen in Gold.

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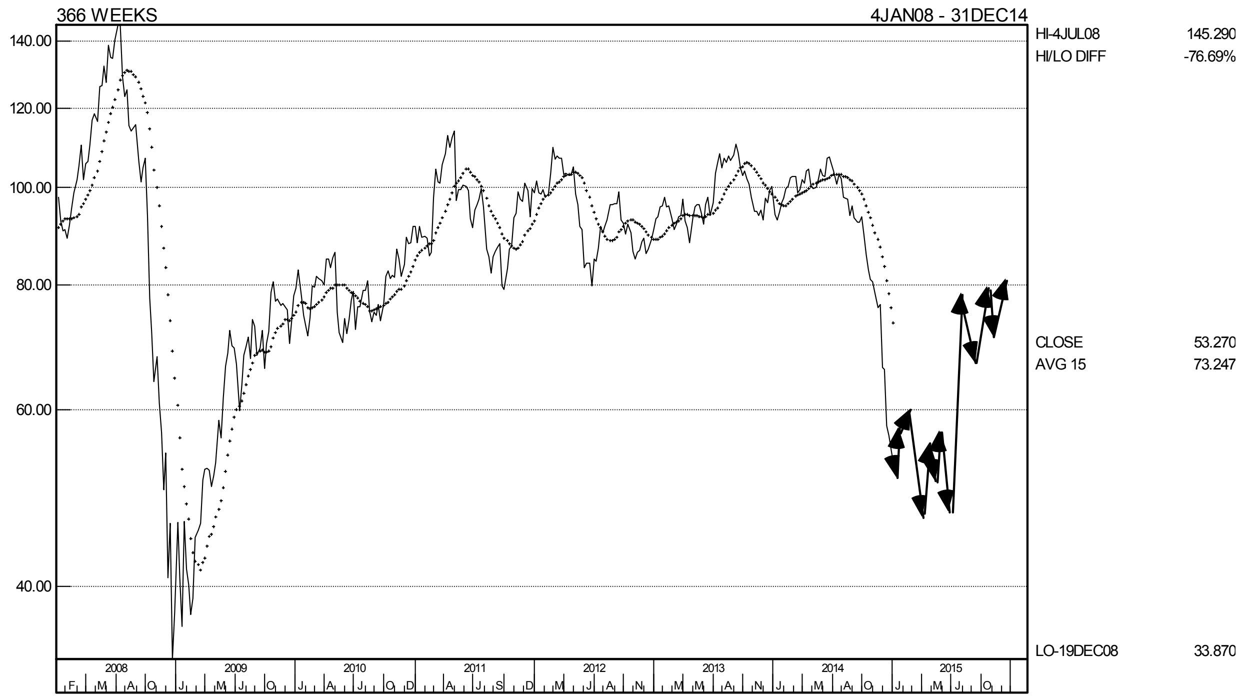

Summary

We begin 2015 with a neutral bias for Canada and a BULLISH bias for the US stock markets. Somehow, that feels about right to me for now.

In a sentence I believe 2015 is a year that **"*anything can happen".***

Please interpret that to mean that in a world of leverage and debt financial markets change very quickly. Let's stay on top of what is going on and be prepared to change our investment choices depending upon what happens.

Thank you again for taking the time to read this report and please feel free to comment!

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.