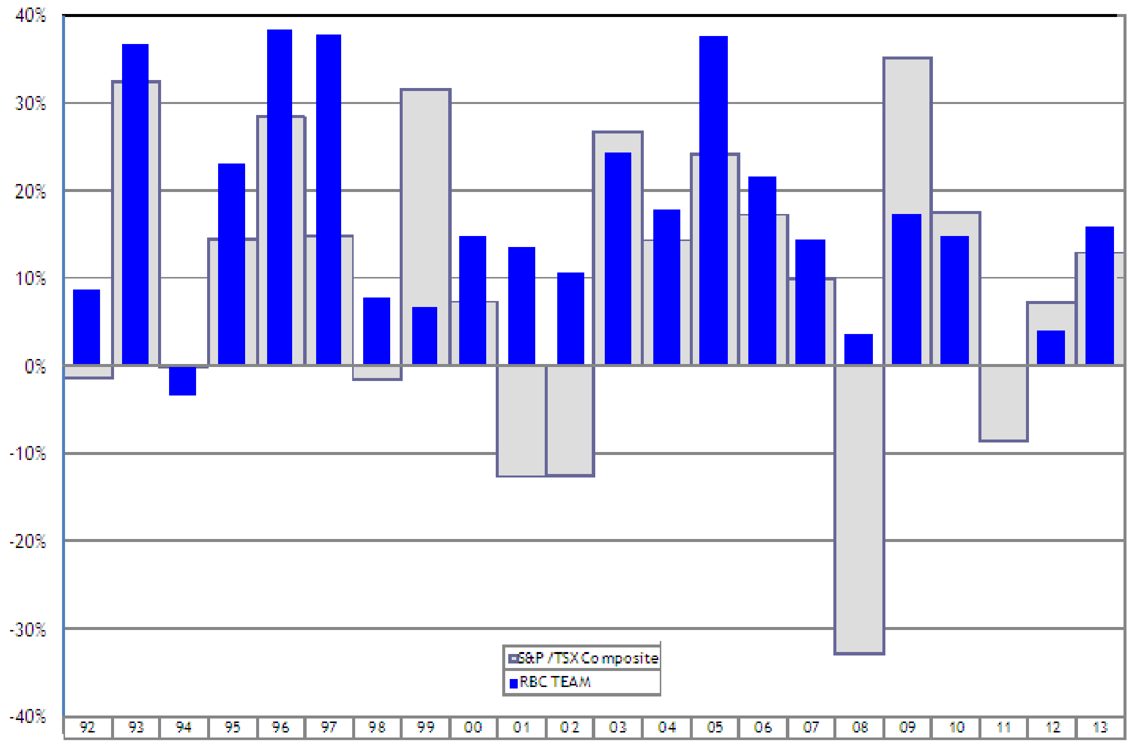
December 28th, 2014

"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: 14,609
TSX 200 Day Moving Ave: 14,812
% Above/Below 200 Day Moving Ave: **-1.37%**
Levels for change: 100% stocks - **TSX 15,550** and 100% fixed income – **TSX 14,070**

Weekly Quote

"It's best for the country to do away with democracy and laws…we should hold no snap elections".

Greek Prime Minister TV interview quote, December 28th 2014

2014 in Review

My hope is that each of you remembers the board game "Clue". Let me jar your memory a little bit… *It was "Miss Scarlett" in the "kitchen" with the "lead pipe".*

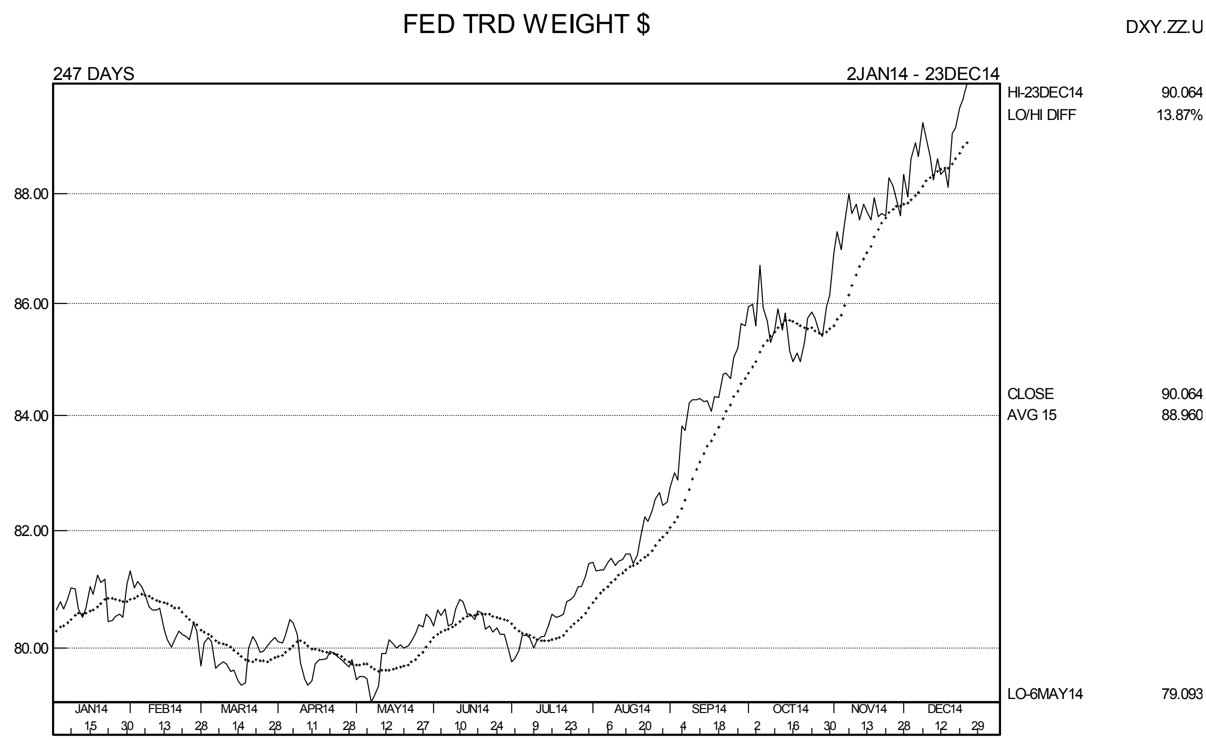
The game was introduced by Anthony E. Pratt in 1949 in the UK and is themed around a murder mystery. The objective of the game is for the participants to deduce the "*murderer*", "*room the murder was committed in*", and "*weapon of choice*" by asking other players if they hold one of the playing cards for the three variables defined above. Once someone correctly ascertains the three variables (murderer, room and weapon) the game is over.

The game consists of "strategy" and "counter-strategy" and usually leads players to numerous false deductions before it is complete. Those mistakes are what make the game fun to play!

Timeless game…still popular today!

Financial markets mimicked what I would refer to as a "game of Clue" in 2014. **As the year started, the expectation was that interest rates would start to rise due to the "healed global economy thanks to six years of central bank intervention.**"

But a funny thing happened on the way to the economic recovery of 2014…the **US dollar** took off to the upside and started to play havoc with a great number of different markets and asset classes.



Precious metals were already "seriously bruised" and the group got beat up even worse. For the first six months of the year analysts kept saying "*who needs gold when the global economy is on the verge of recovery?"* Easy story to tell…makes the central bankers feel good too!

But by the summer things got weird. Russia decided to cause a little diversion in Ukraine…Europe was economically weakening not strengthening…and China was weakening too.

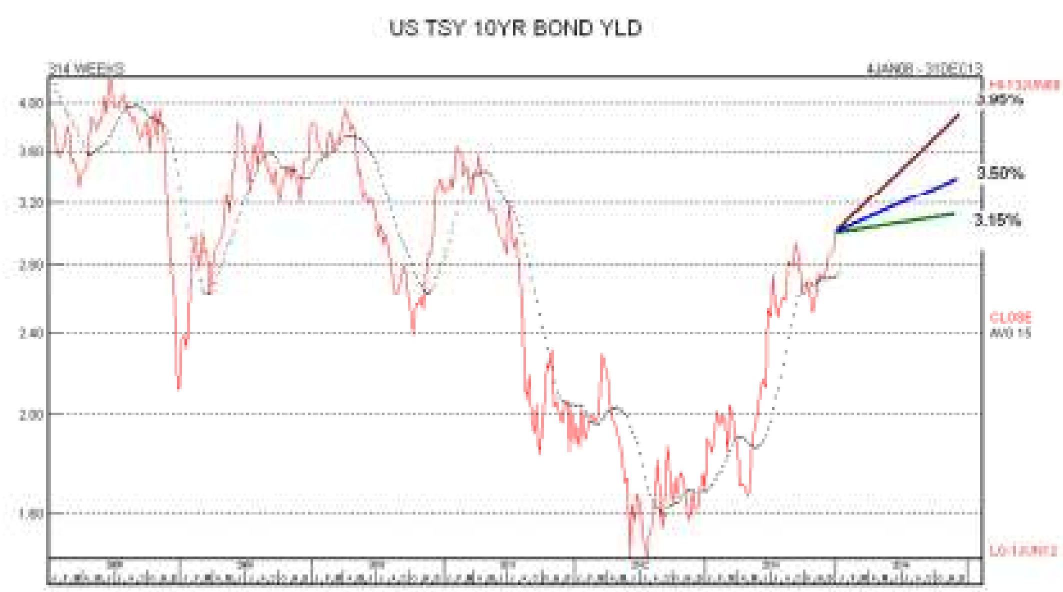
By September, the world witnessed the beginning of what would turn out to be a 40% decline in oil prices. (Matching the 3 year decline in gold in 3 months!) The Goldman Sachs report from July highlighting the triumphs of "quantitative easing" was now being replaced by reports fearing "***negative interest rates across many European nations and new calls for global deflation.***"

Longer term bond yields perpetuated the deflationary fears by dropping to 700 year lows in a number of European nations.

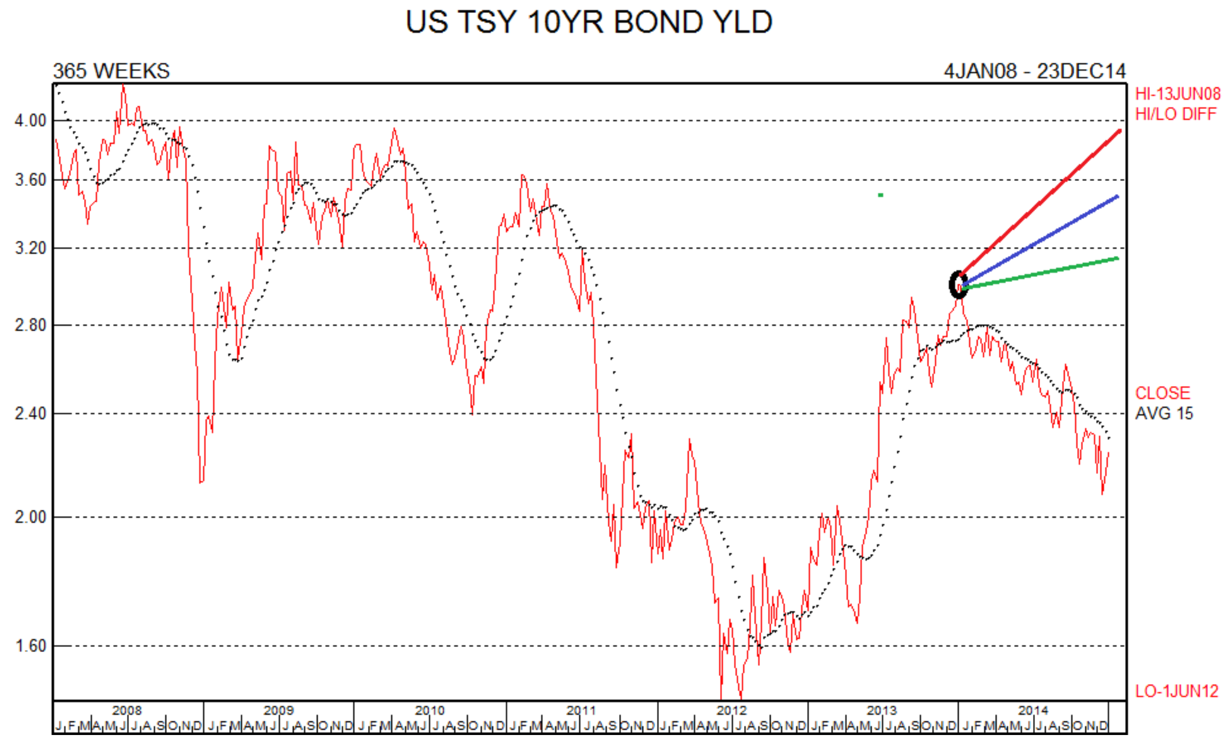
Just like in the game of "Clue" what everybody was deducing to be a sure pick as the "guilty party" early in the game turned out to be nothing more than an illusion as the game progressed. The players (central banks) had to go back to the drawing board and figure again.

I bet you're not surprised that they could not come up with any new ideas! Quantitative easing forever baby!

Below is a chart I used in my December 30th 2013 year end editorial. Just look at what my interest rate expectations were for the 10 year bond a year ago.



Now let's look at what actually happened!



Not even close Nick!

The downward move for the US 10 year bond yield (and global interest rates as a group) was by far the greatest surprise in 2014. The "bond bubble" that was supposed to burst in 2014 not only did NOT burst, but actually grew…and by a whole lot!

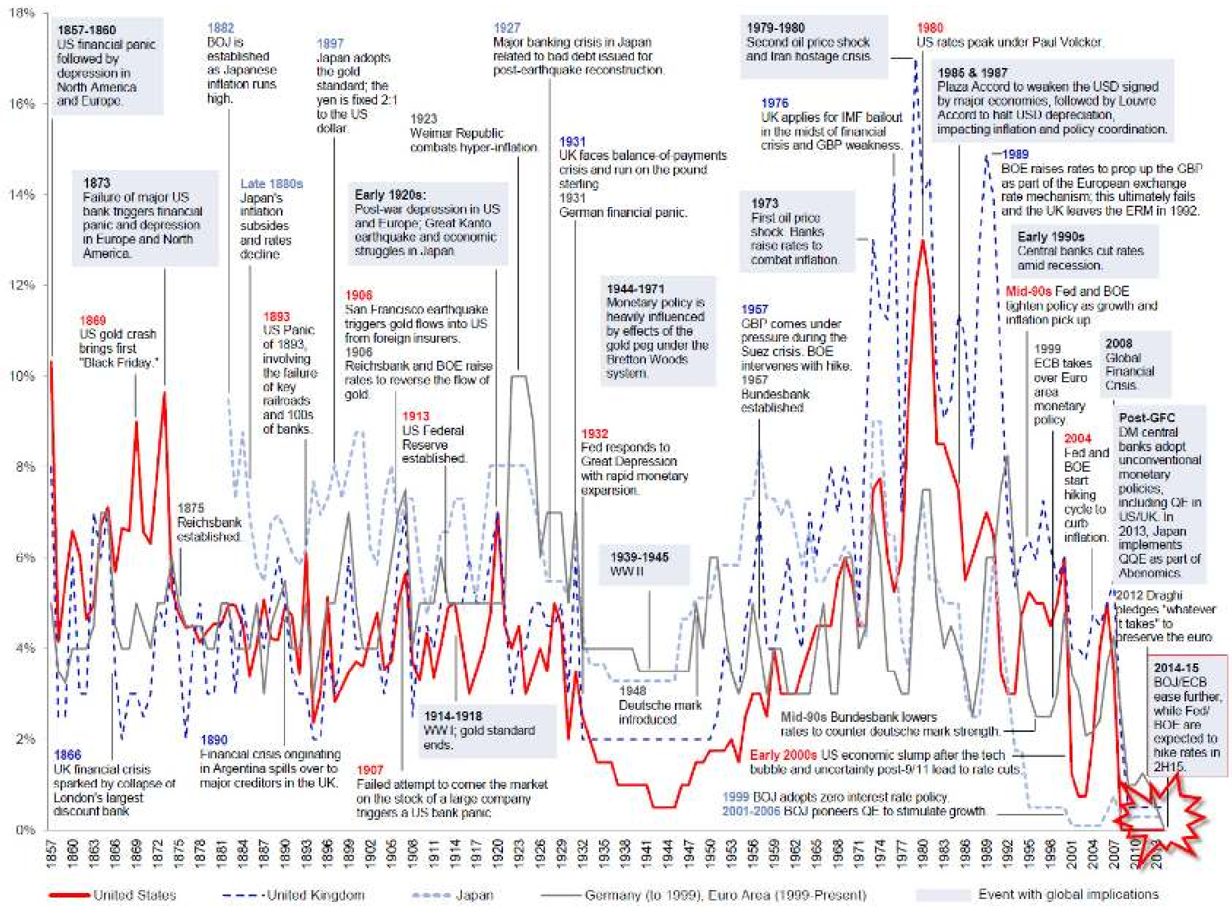
Let's spend a bit more time on this bond bubble concept. Interest rates have to go up…right? They can't go any lower…agree?

Well, yes and no!

Yes, interest rates have to go up. **They will rise when all of the global Quantitative Easing has done its "inflationary duty" and destroyed the currencies of nations employing the insane financial policy.** But that does not mean that interest rates will not go lower (and become even more negative in many countries) before the higher rates come!

The next chart is the key chart to my 2014 year in review. (It is busy so look carefully)

What you are looking at is the short term interest rate for the US, UK, Japan, and Germany for the past 150 years. Obviously, this time frame spans world wars, a "depression", economic booms, and anything else you can think of.



Just look at the far right hand margin as to where global interest rates reside today. With full disclosure in mind, when I was on vacation last week I sat and looked at this chart (over coffee on the lanai) for more than an hour. Let me be absolutely blunt: **If the global economy was truly recovering would the interest rates of the world look anything like the chart above?**

Please consider a few more observations and questions that came to me:

1. There is absolutely NOTHING normal about our interest rates today.
2. How many other asset class prices are screwed up because of these ridiculously low interest rates?
3. How long can such interest rates continue to stay in place?
4. If you were viewing the same chart in 2030 do you think this chart could stay in a flat line out until this date?
5. Why would anyone buy an investment with such a low return?

And the big one

6. What happens when these interest rates finally go higher again?

We will tackle some of these thoughts in my 2015 forecast that I will publish in January. But this chart certainly gets the ball rolling!

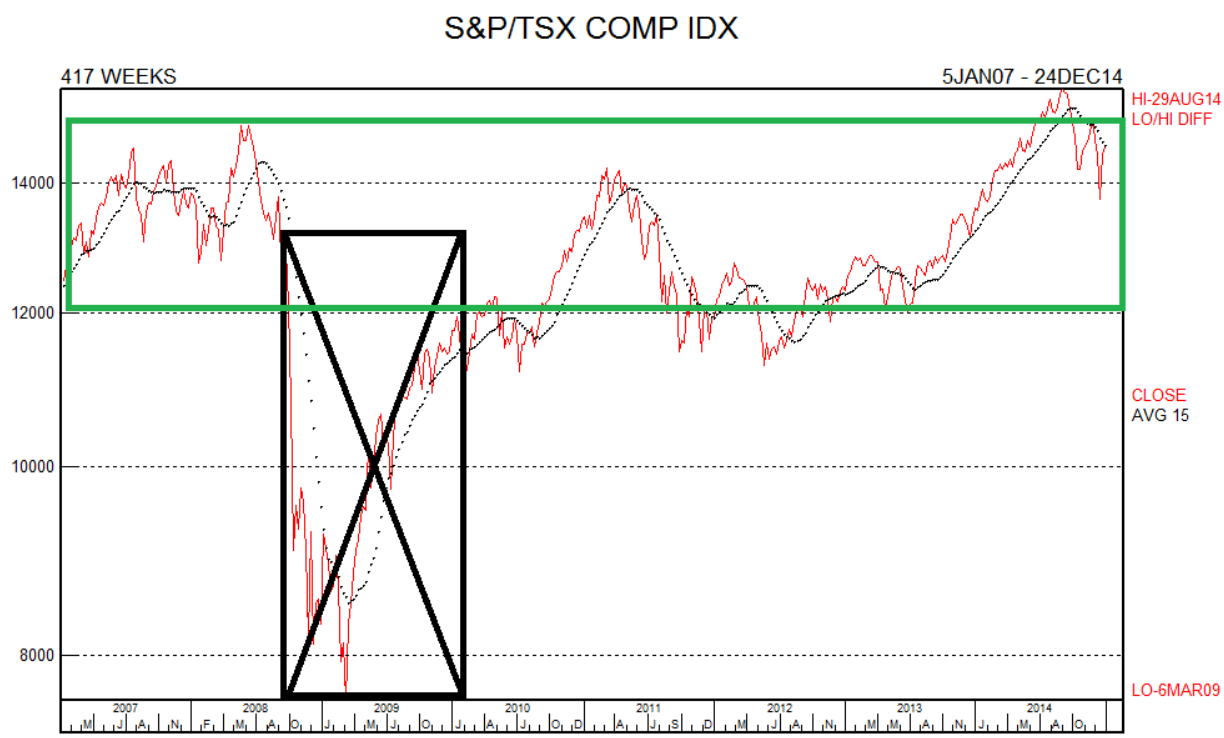
The rest of the financial markets basically took their cue from the happenings in the bond and currency markets.

For the review section I will restrict my stock market recaps to just the US and Canada. They are a pretty good representation of the “bifurcated” stock markets of the world so they will suffice for our analysis.

<u>Canadian Stocks</u>

The TSX has almost completely lost its resemblance to the US stock market**. I believe this is a good thing because its shape is much more closely aligned with the economic reality of the past 6 years.**

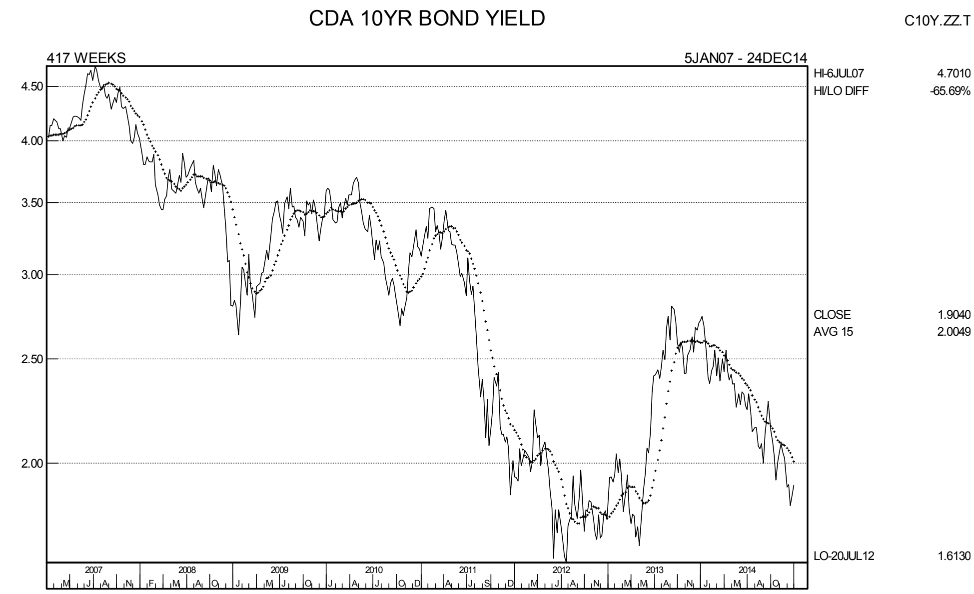
The chart below is of the past 8 years for the TSX Composite Index.



Mentally, I want you to forget about the big decline shown in the black box that occurred between September 2008 until the end of 2009. Just pretend you can’t see it! Now let your eyes focus on the green box that represents a sideways trend in the Canadian stock market over the past 8 years.

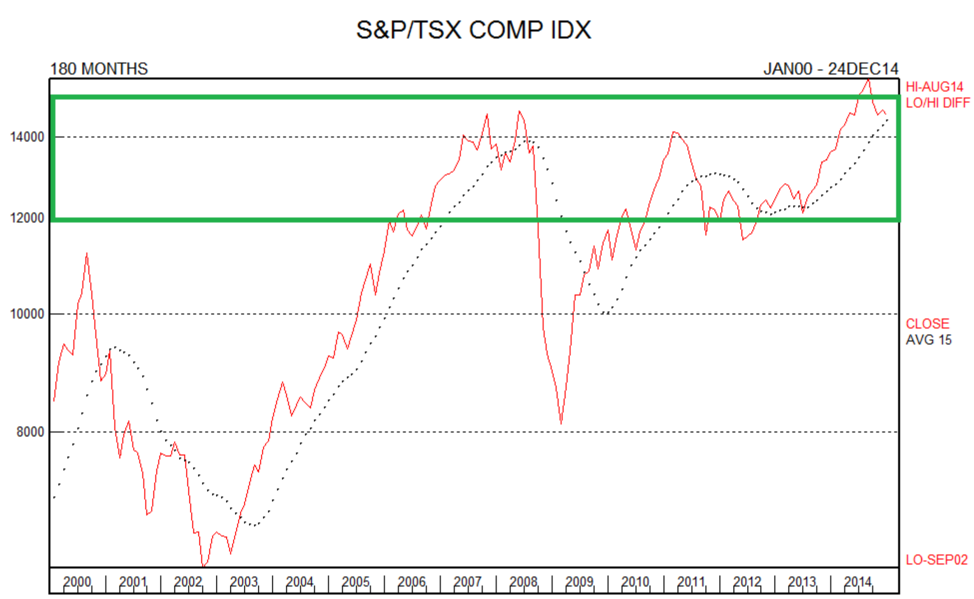
Interesting way to reconcile the TSX, isn’t it?

But now consider what happened with interest rates during the same time period. They are much lower than they were 8 years ago! That should have pushed stock prices higher.



The two sub-indices of the Canadian stock market that did well in this environment were the banks and the utility sectors. (The oils were there too until September 2014 came around.) We will watch these two sectors closely in 2015 to make sure they continue to hold up nicely.

Just for fun, let's look at a 15 year view of the TSX. This one includes both the top of the "Technology bubble" and the "housing bubble"…I will use the same green box to make my point.

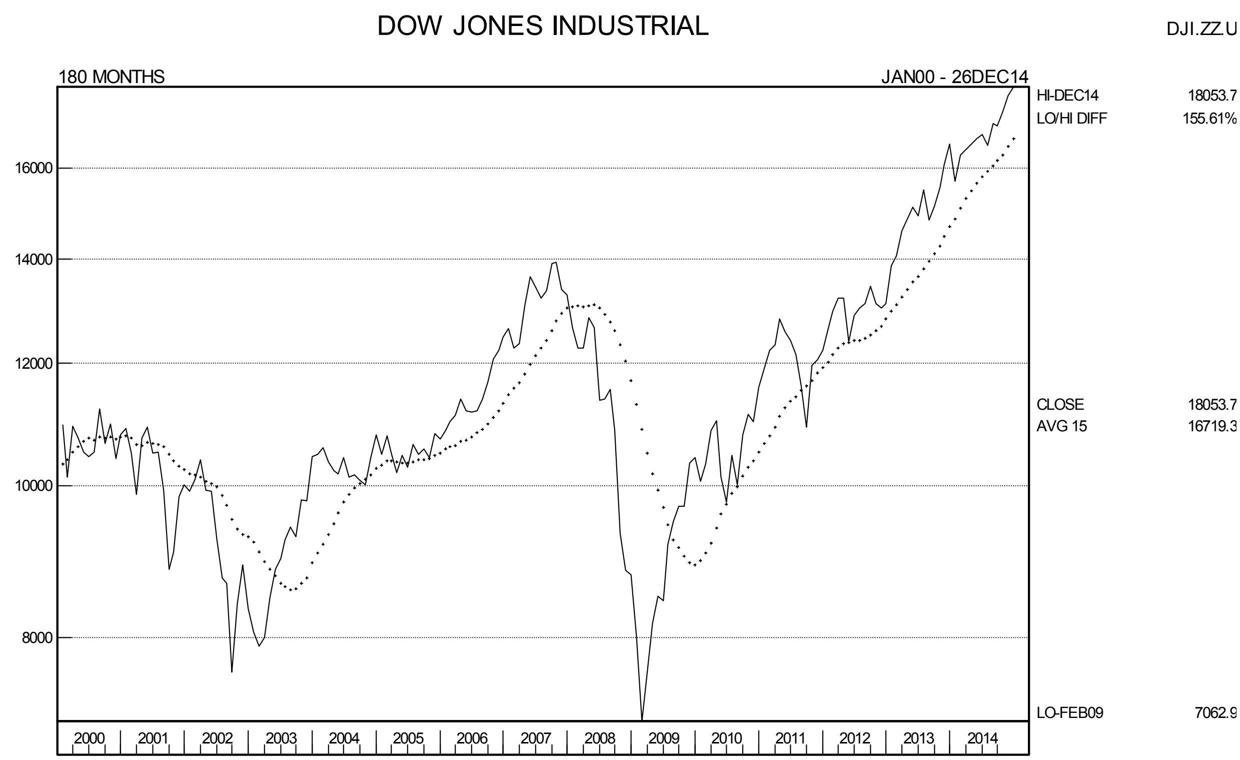


You can draw your own conclusions to the charts above. What amazes me is the incredible difference in government and central bank involvement over the last 15 years…attested to by the incredible increase in the amount of debt that has been created. It seems we pretend to believe government manipulation is normal!

The logical question that follows: *Was the result worth the cost?*

<u>*US Stocks*</u>

A vibrantly different picture is shown when we view the US stock market. US stocks have simply outperformed virtually the entire planets stock markets!



Without burdening this review with too much detail, I ask the same question of the US stock market as I did with the Canadian stock market: *Was the result worth the cost?*

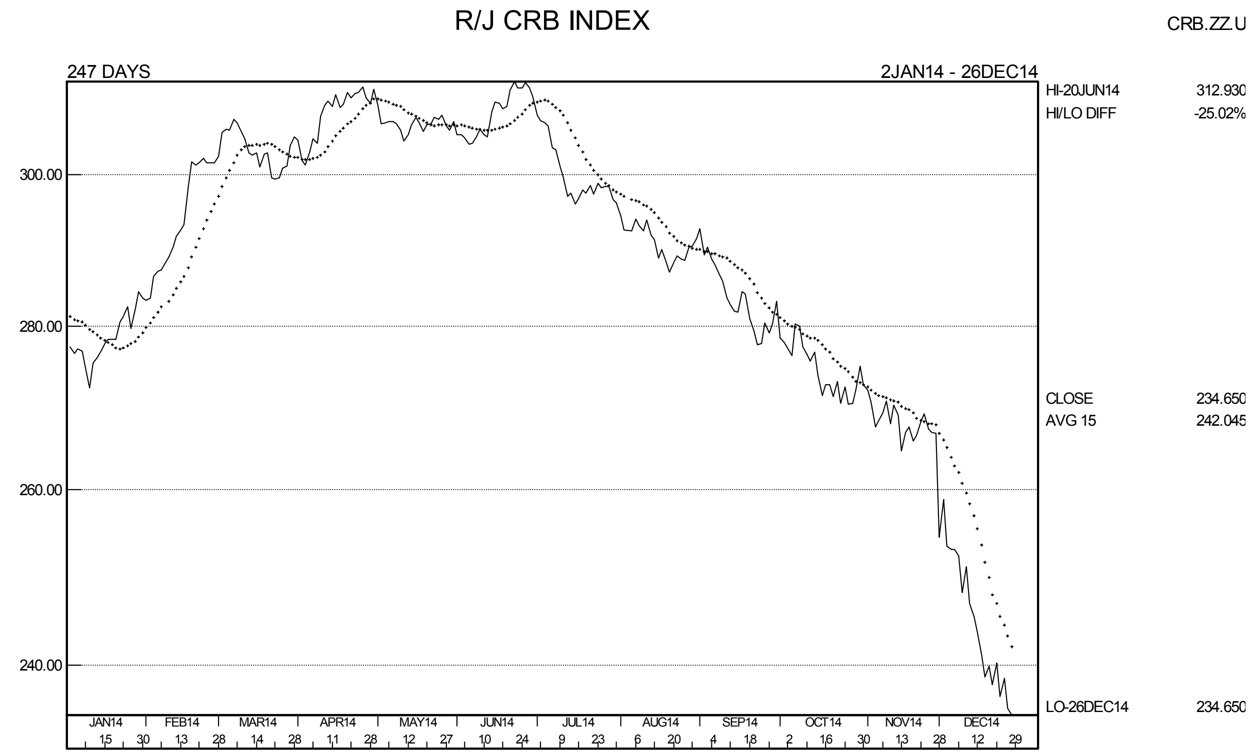
Obviously, a better result in that the US stock market has performed much better than the Canadian…but the cost has been, at the very least, an order of magnitude greater than in Canada.

Friends, it all comes back to what I referenced as the key chart in this report. **If interest rates around the world can stay at zero, the bubble in stocks and real estate can be supported. If anything disrupts the interest rate markets and they start to go higher…all bets are off!**

Commodity Markets

Commodity markets suffered a lot of pain in 2014. At first the reasoning in the media for the weakness was the weakening Chinese economy. But by September, the media was abuzz with stories about “global deflation”.

Below is a chart of a basket of commodity prices all rolled into one trend line.



(Just so you know, energy is 39%, agriculture is 41%, precious metals 7%, and base metals 13%)

In this case I think a picture is worth a thousand words, so to speak.

So ask yourself again, does this chart look like a global economy that has solved its problems and on its way to getting “normal” again?

Let’s back up the weakening commodities chart above with one more chart that defines global Gross Domestic Product (GDP) growth alongside global stock prices.

Weakening commodity prices should be no surprise when one views the state of global GDP growth.

In summary, 2014 was a simple year for US investors if they just "*closed their eyes, clicked the heels of their red shoes together, and said there is no place like home*" three times. **But if you took any time at all to look at the way financial markets correlated together you came away thoroughly confused!**

The extremes mentioned above will likely get more extreme for the start of 2015, but I expect the financial theatre will remain volatile and we will remain on guard for a change in direction in coming months.

…and with that we will look forward to 2015. I will publish a report the first week of January taking the themes from this report and looking forward as to what may happen.