May 7-15 Financial Engineering is BACK!

Good Morning To All

The last time we heard so much about creative “financial engineering” was back in 2007 when it got rare use by the forward thinkers of that time (eg. neurologist Dr Michael Burry ….in the famous book-The Big Short) where it was used to reference the creation of the housing bubble. It also referred to the financial smoke and mirrors engineering feat required to justify giving a mortgage to the NINJA (no income, no jobs, no assets) applicant. This massive use-abuse of financial engineering (FE) was ignored by 99% of the investors at the time (as all were happy with climbing markets) and the housing-equity markets continued to race to record highs despite these warnings.

I think we are once again seeing the same early warnings from the very few forward looking investors in May 2015. There are references to the MULTIPLE financial engineering schemes being used today in three of the attachments listed below (Stan Drukenmiller, Stephan Roach and Tony Sagami) . The forward looking investor who is willing to separate from the herd should take notice of this I believe. But be WARNED—it’s a very lonely place when you go against the herd in a BULL market as outlined in the Big Short—it takes confidence, patience and tenacity!.

The risk today is that FE is at play in many more sectors of the economy than just the housing sector such as it was back in 2007:

-1. corp stock buy backs are one giant FE scheme—driven by short vision and CEO bonus pay—this will push markets higher but these CEOs are all buying high here recall!! It’s a fact that CEO’s are now buying more shares than the investing public!!

-2. similarly, junk bond issuance is another giant FE scheme that will not end well—when IR do rise there will be a massive rush to get out and these bond holders will see significant losses. Future generation investors will refer to these as NENJA companies (No Earnings, No Jobs and No assets) and wonder why investors ever bought these junk bonds…..well its because…

-3. GLOBAL government ZIRP (zero IR) and massive QE policies is another FE scheme that has forced investors and pension funds out of traditional bonds and into riskier investments (eg junk bonds)…this won’t end well

-4. Student debt is another FE scheme created by the wrong gov actions of making the wealthy rich and by weakening the middle class forcing students into "education purgatory"…this debt will bust down the road and could create real problems for financial institutions

-5 finally—one of the end results of this FE has been severe income inequality globally—I have no idea how this will be fixed??

So my take on this is that the smart guys are telling us that FE is as active today as it was in 2007 (even more so) and so its BUYER BEWARE

Okay—enough of a rant on FE—here are my thoughts on other economic issues followed by my Conclusion and then Plan of Action.

EARNINGS-REVENUES

The earnings season is about 70% done and Earnings are beating lowered expectations by about 70% BUT revenues are coming up weak esp. with the large multinationals.

The yoy EPS growth is at -0.4% (vs expected 4.2% back in January) and sales growth is -2.6% (vs expected 1.6% in Jan)

If we exclude energy then the earnings are better but revenues are still weak indicative of the continued weak economy

The trend in earnings and revenues is weakening and hence the reason for continued ZIRP and no IR hike yet…the optimist hopes its short term but the pessimist is concerned

GDP WAS WEAK

The first Quarter GDP was very weak at 0.2% (expected consensus was 1%) and many expect a negative number on the revised GDP. The party line is that this was a transient hit from cold weather, a west coast port strike and low oil. Most are calling for a rebound in GDP in the following quarters as the three prior issues are "cyclical" or transient issues. However the Atlanta Fed recently stated that the second quarter GDP will also be very weak at 0.9% (vs the consensus of 3.4%) but they were the closest on the Q1 call so this has my attention. If they are right again then that's very, very low growth….and just a hair away from recessionary numbers???...but we will see what happens in the second quarter

INVESTOR SENTIMENT

Almost all polls in April-May(retail investors, investment advisors, newsletter writers, fund managers etc.) are revealing tremendous bullish viewpoints (Dr. Ed Yardeni) but an interesting poll from the AAII (individual investors) reveals that the largest group of individual investors are now in the "neutral zone"---that's neither bearish nor bullish and at 47% is the largest reading since 2003 and now at 4 weeks above 45% making it the longest streak since 1989 according to Bespoke!!

I believe this is what is seen when investors suffer from "cerebral financial whiplash" where investors are dazed and confused from the multiple side effects of FE. Everyone is aware of the serious disconnect between the soaring markets and the tepid economy but can't resist remaining invested as they see the markets climb each month (Nasdaq now just reaching its 2000 high after 15 yrs.!) and are simply giving into the HERD REFELX. But they are getting fleeting frontal lobe input saying "if everyone is in who is left to buy?" And "isn't that a contrarian sell" their frontal lobe keeps telling them??

Well thanks to Financial Engineering 101---it's the CEOs and Corp that are buying here (Dr Ed Yardeni says Corp now the biggest buyers with massive buybacks in 2015) which adds more froth to an already frothy market and has created serious confusion for investors. They know that based on valuations the markets are frothy and their "gut" tells them to run based on the memories from 2000 and 2008 BUT they see the markets climbing higher and so with 4 major Central Banks telling them that "we have your backs" they remain invested….so they have resorted to the default TINA Factor (there is no alternative) which is a very scary way to invest as it uses zero frontal lobe input!

INTEREST RATES

I have no idea when IR will rise in the US. I know it's very hard to raise rates when the GDP data is so weak and when the EU has negative rates….my bet is that IR will stay lower and longer than most

expect…I am big on demographics and most of the job creation in the US has been in the 55 + age group and these guys are NOT INFLATIONARY so my bet is low inflation for a long while and so IR will stay low.

The risk to this viewpoint is if we see wage inflation (some evidence that it's rising recently) and /or if housing rebounds…this would lead to higher inflation and then rates would move higher which could hurt both bonds and equities in my opinion

BOND INVESTING

This is where the biggest FE bubble is and any one investing in long duration bonds or high yielding junk bonds are really at risk. One needs to be very careful with their fixed income exposure..

But the very bright Dr Stacy Hunt says long bonds are the place to be in 2015 as he sees continued deflation and massive global debt as a head wind to growth and on the opposite view point is David Rosenberg who says they are dangerous….uncharted times folks always create opposite views

Stan Drukenmiller recently pointed out the risks in the Junk Bond market and I agree with this…in 2006 B rated bonds issued were at 28% and in 2014 it was 71%...caution on junk bonds folks (and we are)

CURRENCY ISSUES

Since the beginning of 2015 we have seen 22 Central Banks globally ease monetary policy so as to lower their currencies and boost exports. This is the main reason that we saw such a rapid rise in the US dollar (as it is on the rate hike path) but many now believe that the US $ has peaked and we are seeing the US dollar now decline somewhat which is a bonus for oil and other US $ based commodities

I Suspect that the Euro will continue to decline with continued QE—Stan Drukenmiller says this trend will last another 1-2 yrs.…I plan to add more EU positions going forward to avail of QE and the equity gains that should come that way if the EU markets repeat the pattern of the US markets i.e. don't fight the FED

WHATS THE RECESSION RISK?

Recessions are always associated with equity bear markets and 20%+ market declines so knowing the risk of a recession is always important for investors. Currently 99.9% of economist-strategist see NO recession over the next year. So the current party line is if we see any corrections they will only be in the 10-20% range and then followed by a rapid rebound making them buying opps.

David Rosenberg recently stated that the next recession is 2-3 years away simply based on the fact that they mostly occur after IR hikes and then only 2-3 years after the hikes commence. But Lance Roberts did an excellent rebuttal on this pointing out that we have never been here before with the combination of: record low GDP, record high markets and record low wage growth and the FED about to raise rates!!! So extrapolating from the past for today's economic environment is wrong here (and I agree). Additionally the three times that were marginally similar to 2015 saw recessions within 3-9 months after the first rate hike he stresses!!

The additional point I will make is that 99.9% of the time economist's do NOT get the recession call correct…so its worrisome that 99.9% see no recession in the next year

EU EQUITIES

Based on what happened in the US with QE 1-2 and 3 the bet is that EU equities will move higher from here. In fact the surge could be even greater than the US equity surge for the simple matter that at least in the US bond holders could get 1-3% returns in bonds over the last few years whereas in the EU most bonds are now at NEGATIVE yields—70% of EU equities now have div yields higher than their bond yields!!!! CRAZY and UNCHARTED…but it means that while the madness lasts money will flow rapidly out of bonds and into EU equities—we are taking advantage of this trend

MARKET POSITIVES (and the CURRAN RISK)

The main stimulus for higher markets going forward are:

#1. The consensus is No recession risk in 2015 so then every 5-10% pull back is viewed as a buying opp

#2. Global Central banks stimulating with ZIRP and printing $ forcing investors out of fixed income and into equity and real estate—this is a BIG positive for markets and a big risk for sitting in cash—famed Hedge Fund investor David Tepper has just referenced this as a major positive for markets in 2015

3. Continued Massive Corp buybacks—markets don't need retail investors buying when Corporations are buying this much stock…$1 trillion expected in 2015 on stock buy backs and div—but this is a short term strategy as it does not benefit revenues or future growth and history has repeatedly shown us that CEOs buy the most right at the market top!!

So this is a risk to sitting in cash these days…watching the markets charge higher

SECTORS-COUNTRIES THAT ARE CHEAP and on my RADAR

Energy is the top of the list here followed by small caps and so we are adding these in some newer accounts.

Emerging Markets are cheap but could get cheaper depending on the US dollar—China is a tuff one—despite its enormous run over the last year its still 27% below its 2007 peak

Europe is still cheap vs the US and has just started its QE so that's where most of my current focus is – we will gain with equity performance and most likely on currency exchange performance

CONCLUSION

I continue to believe that the risk in todays markets far out weigh the rewards!

The risks are multiple but no 10% correction in 3.5 years is RARE and in the past when the markets corrected after such abnormally long runs the magnitude was in the -20% range ++ (Dana Lyons)…I will cover this more in the next NeuroApproach Newsletter. I also know that when markets corrected in the past from such frothy levels the magnitude was -30%++ (Doug Short)…again more on this later in our news letter.

So the simple KISS principal is two fold--- the RISK level is very, very high and we are in very uncharted waters. Warren Buffet just stated in a CNBC interview that "we have not seen this movie before" and

that “this is a very unusual situation and I don’t know how it plays out”. The KISS principal forces me to focus on defense!

The CURRAN RISK to defense is that equity markets can climb higher into 2015-2016 because of unprecedented global ZIRP and global QE policies. This is especially true in the EU which is just getting started with its asset inflation policies. This is the one market where I am willing to take some risk and invest and we have/will be taking advantage of this but in most other markets I will remain defensive.

So it comes down to whether I want to be 100% long equities with clients money in an already frothy bubble (that could get frothier) or focus on defense and leave some short term gains on the table??? I am choosing the later.

I also know that we have very bright guys like Julian Robertson saying that the next correction “could be as bad as 2008” and Mohamed El-Erain is mostly in cash!!

These are very rare times folks from many-many perspectives—global QE, global debt, G7 demographics etc and so I will continue to stick with my repetitive (and maybe boring) Defensive Investing Strategy that was implemented 18 months ago BUT this has allowed decent gains over this time despite our reasonable degree of defense. It’s just too hard for my frontal brain to accept being 100% long equities here when the disconnect between asset prices and valuations/fundamentals is so great.

DEFENSIVE INVESTING STRATEGY STILL IN PLAY

1. Remain tactically invested but with a low beta focus—better down side protection for the future correction

2. Equity focus is dividend paying (to benefit from the demographic boom) and dividend growing stocks

3. Equity focus is value stocks and value countries right now—Europe and select Emerging Markets

4. Health care is also a focus for demographic reasons and future M&A activity

5. Maintain good exposure to “select” fixed income positions—stay away from long bonds and most junk bonds

6. Be tactical and maintain a high cash and “cash substitute” position

7. Be ready for IR hikes—both on the fixed income side eg. short duration and the equity side eg. dividend growers

8. Welcome any major correction ie. don’t fear it and be ready to act when it happens depsite the negative media coverage

On other topics:

-our energy stock Keyera did a stock split last month so u will now see 2x the number of shares in ur portfolio

-Teva is taking a run at Mylan…sure wish I had kept Mylan as a core position!!!!….but this new super power will be a big company and ready to compete in the "biosimilar" field which is set to explode for generics

-the TFSA (tax free savings accounts) limit was just increased from $5500 per year to $10,000 per year and will start in 2015—so as soon as it passes legislation in June the max amount you can contribute is now $41,000. Please ask your accountant about this as some accountants don't want the cash coming out of the Inc. just for the TFSA but would rather leave it in the Inc.…other accountants say take it out of Inc.….the logic may now change as the recent Small Buss Tax rate has decreased from 11% to 9% on the first $500,000 of qualifying active bus income

-also the new budget proposes to lower the minimal withdrawal for your RIF starting at age 71 from 7.38% to 5.28%

That's about it –very long and I apologize but lots to cover when times are so uncertain and uncharted!

Terry

ATTACHMENT OVERVIEW

1. China vs US concrete use
2. Eric Parnell re Fin Engineering
3. The brilliant Stan Druckenmiller
4. The brilliant Ray Dalio
5. Fin Times re share buybacks looting the future!
6. Stephen Roach –excellent read on Fin Engineering
7. REITS vs Condos—who wins
8. US Energy slide
9. Technical stuff

10. US Inc hoarding cash and more on Buybacks

11. CFNAI—weakness

12. Mohamed El-Erian and why he has so much cash

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