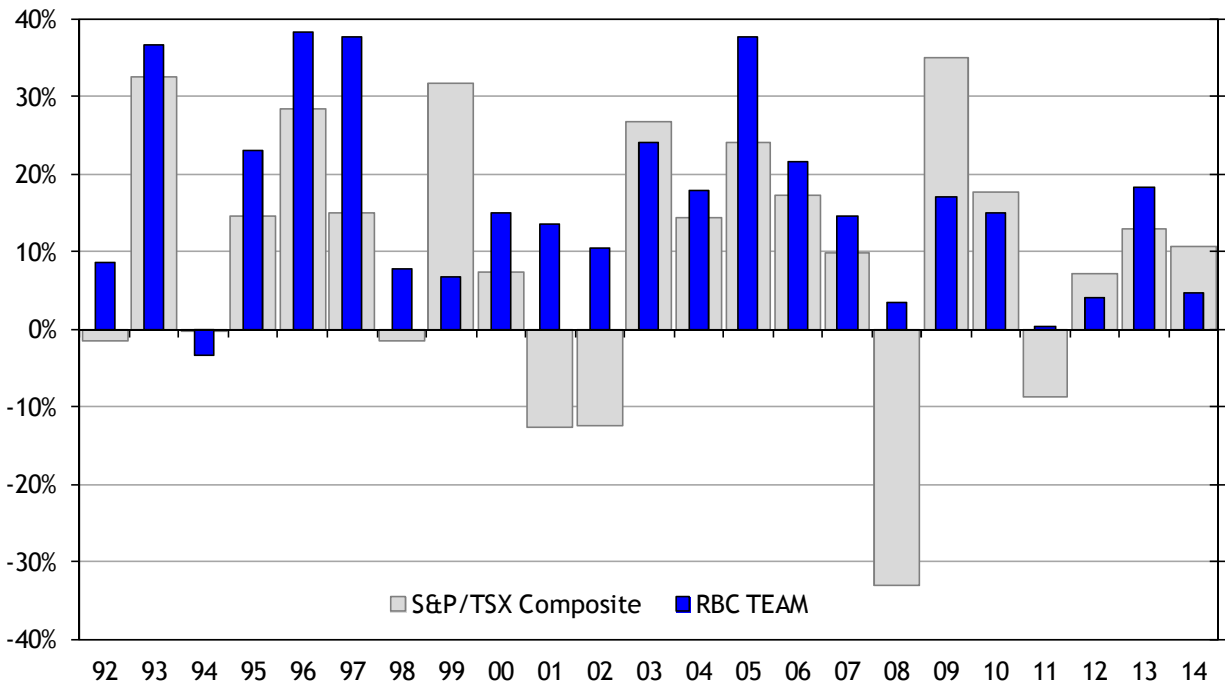


January 4th 2016

“Won2One” with Nick Foglietta

Tactical Equity Income Model Portfolio Record



Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: **0% Equities/ 100% Fixed Income**
S&P/TSX 60 Closing Value: 13,010
TSX 200 Day Moving Ave: 14,264
% Above/Below 200 Day Moving Ave: **8.72% Below**
Levels for change: 100% stocks - **TSX 14,977** and 100% fixed income – **TSX 13,550**

Weekly Quote

“Ah, but a man’s reach should exceed his grasp, or what’s a heaven for?”

Robert Browning – English Poet 1812 - 1889

2016 Forecast

Opening Remarks:

As we embark upon 2016, I believe investors are **severely underestimating the risk of financial market disruption**. Because of this fact, having a tactical (TEAM) approach to your investment portfolio becomes more and more valuable.

As Doug Kass of Seabreeze Partners loves to say:

1. Risk happens fast
2. The financial markets have no memory from day to day.

Both of these characteristics are associated with late cycle BULL markets. The real challenge is to get the timing right for the change in direction.

As shown in the 2015 review, there was not a lot of opportunity to make money in financial markets. There are always winners and losers, but the “breadth” of rising assets around the world was “narrow”.

And that is where we start looking into 2016.

My forecast is quite simple: **If the U.S. and Canada are presently at the early stages of a recession, then financial markets will have a rough ride this coming year. If the U.S. and Canada are going to skim along at between 1% and 2% growth, then 2016 will be a relatively flat year for stock markets.**

The expectation for individual segments of the financial markets will differ greatly between these two outcomes. Throughout the forecast I will allude to the recession/non-recession outcomes with different coloured chart lines.

The major driver of 2016 will, just as it was last year, be the U.S. dollar index. If we could get the U.S. currency forecast correct, I believe we would be well positioned in virtually any other financial market you could pick.

Hence, we will start with the forecast of the U.S. dollar index.

Currency Levels:

It was a banner year for the U.S. dollar in 2015. The “greenback” remained well bid based upon three specific influences:

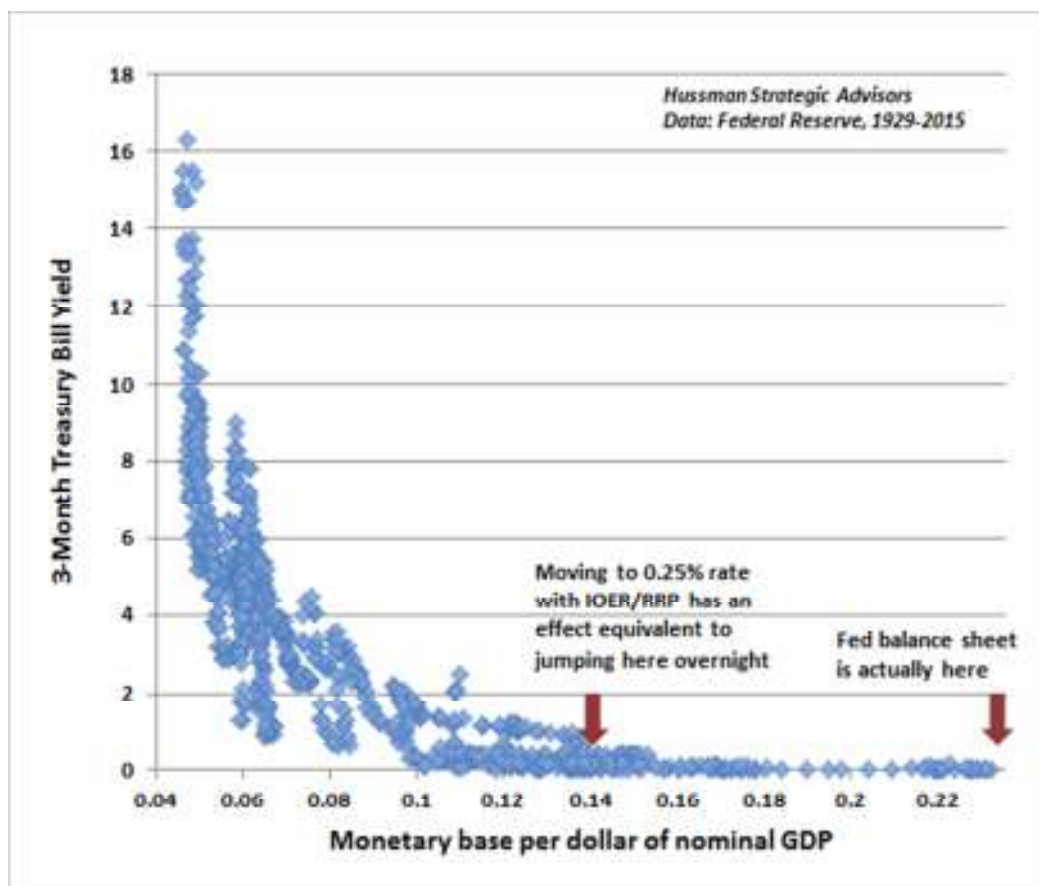
1. The U.S. Federal Reserve was able to “jawbone” its way through the year “threatening” to start raising interest rates, even though it took until December 16th to actually make the first 0.25% increase.

2. The U.S. economy looked to be on firmer footing than most other global economies.
3. Global debt levels continued to expand and the U.S. dollar is the basis for a rather large percentage of debt issuance around the world.

All three of these reasons for the rise in the U.S. currency in 2015 are in question for our 2016 forecast.

Let's start with the "threat to continue to move U.S. interest rates higher. **The fact that it took almost exactly one year from the first threat to raise interest rates to the actual first increase tells you how tentative the FED was in initiating any action.** The mathematical implications alone of just the 0.25% increase on December 16th are quite fascinating.

The chart below (John Hussman of the Hussman Funds Group) shows how stretched the U.S. FED balance sheet becomes by the tiny December increase.



The chart is saying that the effect of raising interest rates 0.25% is like decreasing the FED balance sheet from \$4 trillion to \$2.3 trillion. **Put another way, the 0.25%**

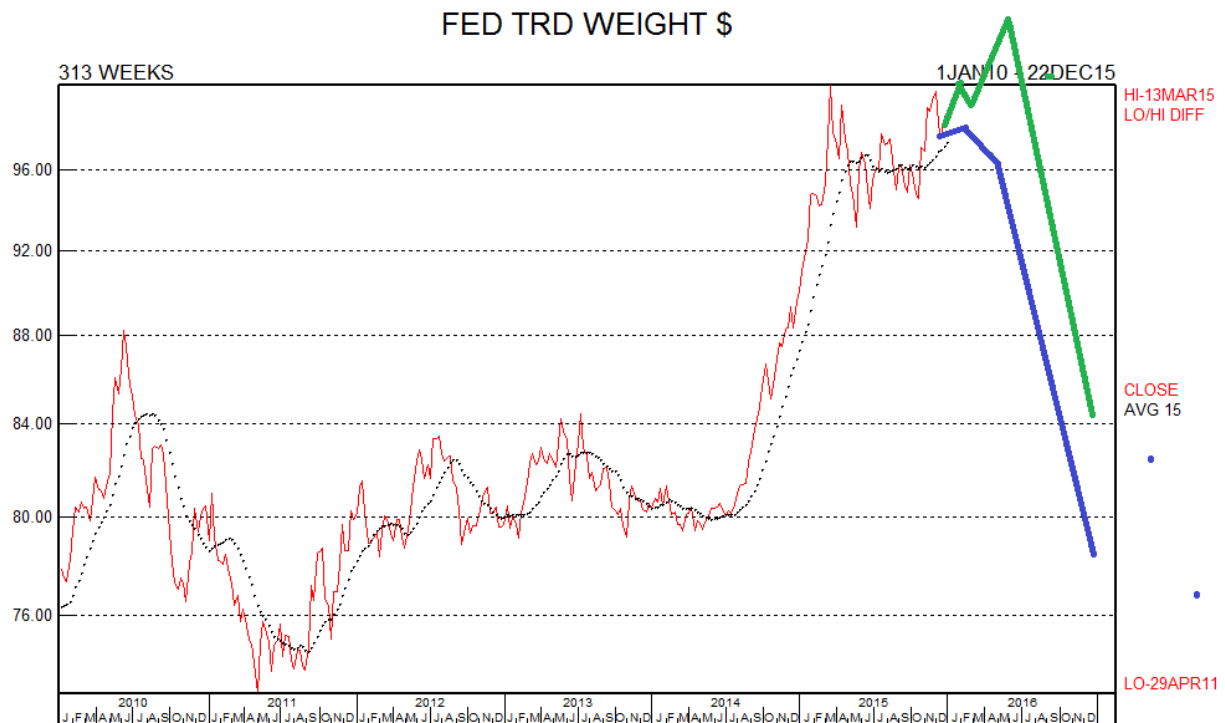
increase negates all three of the Quantitative Easing initiatives the FED used since the Great Recession in terms of balance sheet expansion. Hmmm?

So what does this chart have to do with the U.S. dollar?

...Quite a bit actually. You see, if the FED did not have such a megalomaniacal view of itself it would have realized it needed to start bleeding the liquidity off of its balance sheet BEFORE it raised interest rates for the first time. By skipping this step, the FED is trying to “*have its cake and eat it too*”! The methods of bleeding off the balance sheet are time consuming and require actual market bids from “non FED controlled entities”...and the FED hates suspense! Therefore, a shortcut was chosen where the Fed Funds rate was simply increased...in effect, the U.S. Fed’s first major blunder!

The impact in taking this short cut is continued support for the U.S. dollar valuation in the short term. (3 to 6 months) But the longer term looks much murkier.

Now look at the chart below with my forecast for the U.S. dollar with consideration to the above comments. (Hopefully, this will be easier to follow.)



The **green** line traces the expected trend for the US dollar index if the U.S. economy is NOT entering a recession at the beginning of 2016. In this scenario, U.S. inflation continues to creep higher and the U.S. economy will still be perceived as the “*cleanest shirt in the dirty laundry basket*”. Here I would also expect:

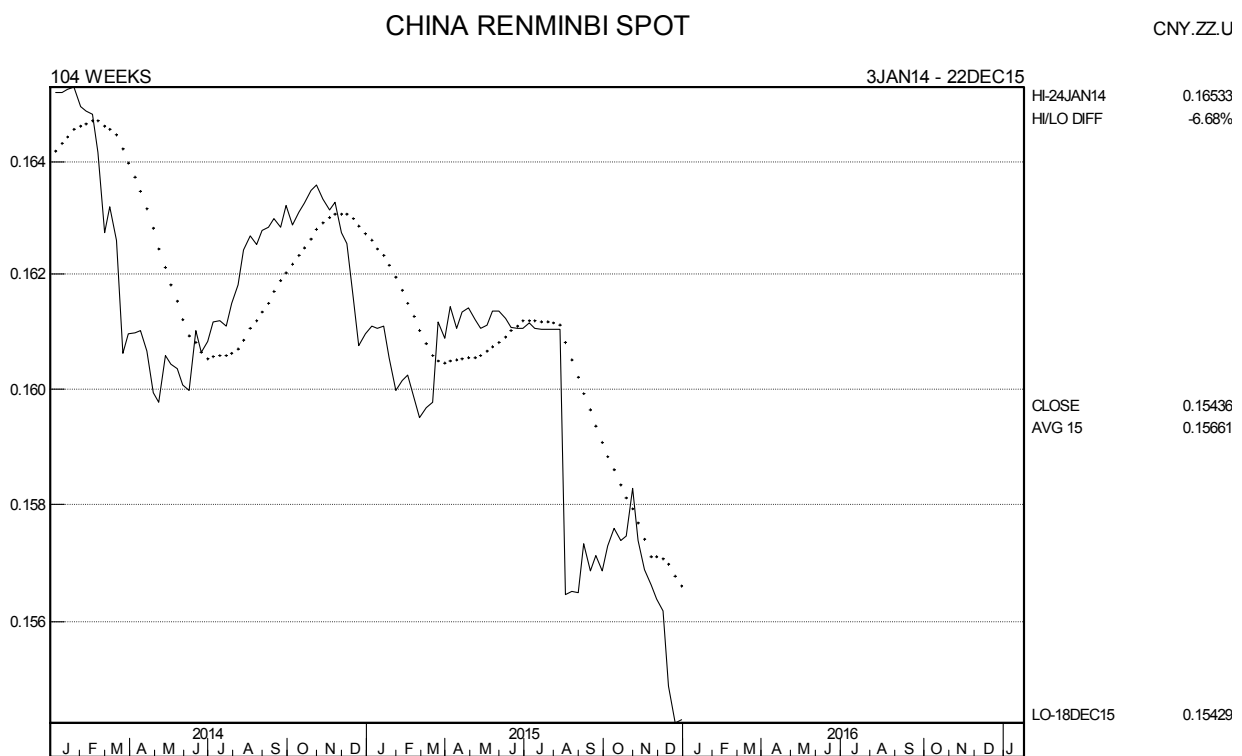
- Lower commodity prices for the first half of 2016

- The Canadian dollar sliding to \$0.67 U.S.
- Stock prices in both the US and Canada to stay “range-bound”.

The **blue** line represents the recessionary trend for the U.S. dollar. In this scenario, FED inflation targets remain elusive and the U.S. dollar index slides early in 2016. Here I would expect:

- Higher commodity prices, especially precious metals.
- Strong recovery in Oil and Materials company shares.
- The Canadian dollar to recover to the \$0.83 U.S. level.
- U.S. stock prices to decline significantly. Canadian stocks prices to decline moderately.

The other significant currency story in the world remains the Chinese Yuan. The Yuan has been declining vs. the U.S. dollar for just about two years now. The past 6 months have seen two sharp declines.



It is rather intuitive why the decline in the Yuan is a big deal to the U.S. The amount of trade between the U.S. and China is massive! This is a sleeper story to keep an eye on in 2016.

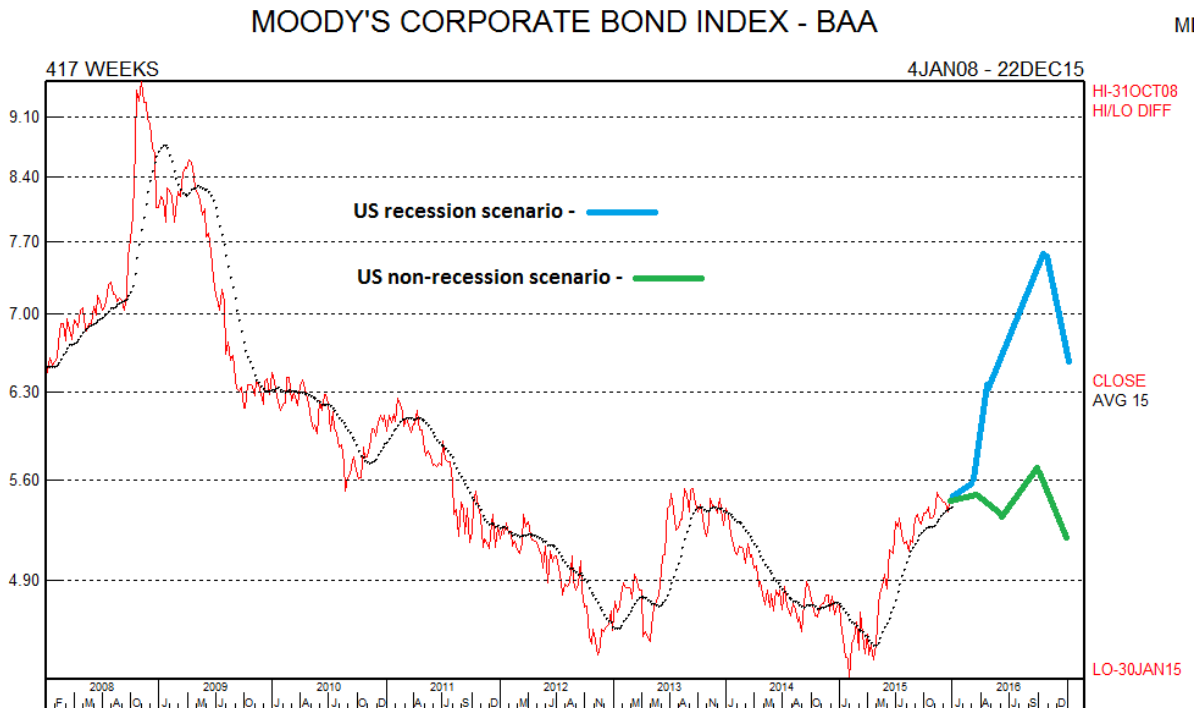
Bond Markets:

I am sticking with my directional forecast from 2015 in 2016. **Both Canadian and U.S. treasury bonds will hover around all-time lows (Canadian yields likely falling slightly more) but lower quality bonds will continue to rise in yield.**

I am adding one other prediction to the bond market equation: **I believe the U.S. yield curve will “flatten” in the first half of the year and then the front end of the U.S. curve will fall back to near zero percent.**

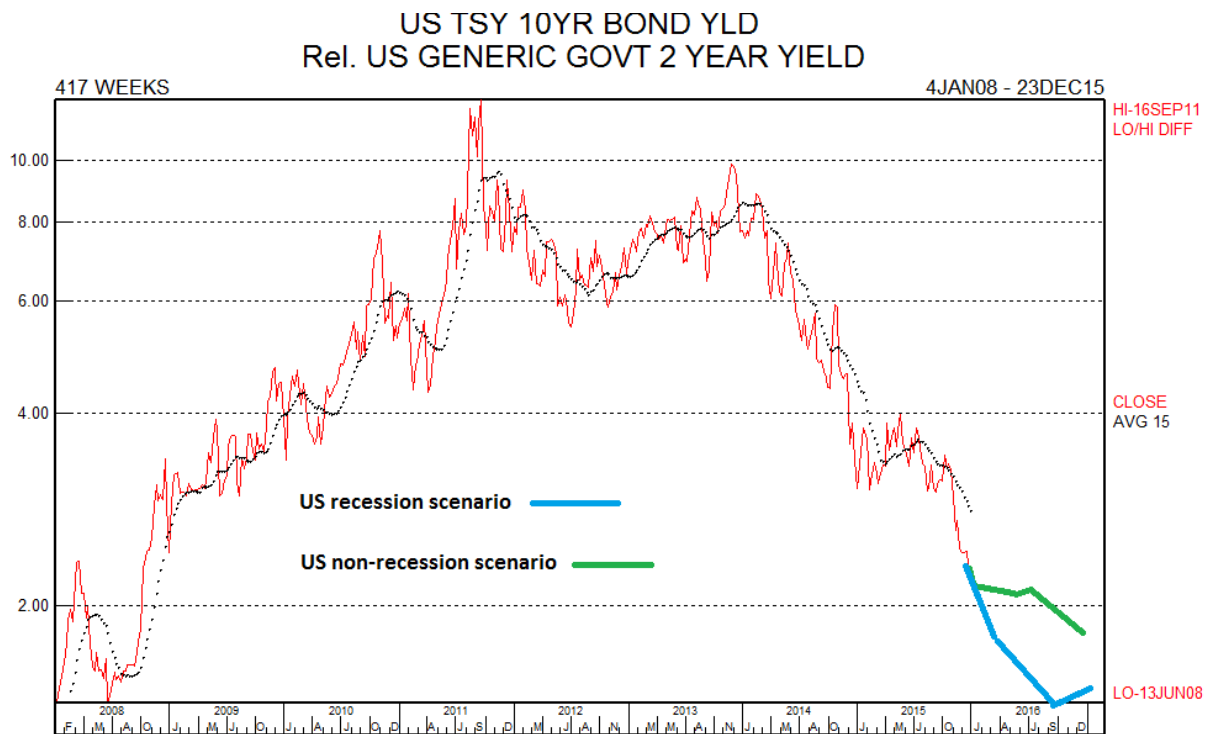
This is the section that most of my readers just skip over. Talking about bonds is about as popular as talking about the “intricacies of painting a house”. So rather than spend a lot of time writing about why I expect the above results I will just put two graphs showing what I expect and then we can move on to more interesting topics!

First, a chart of low quality bond yield expectations:



The key in the chart above is to notice that only a recession brings out more significant pain in the high yield bond markets!

The chart below plots the US 10 year yield vs. the 2 year yield. **A falling trend signals a rising chance of recession as the two yields get closer together, or flatten.**



A single comment again. In both, a U.S. recession and no recession, I see the yield curve flattening some more. But I see a **significant** flattening if the U.S. does go into recession.

Why does flattening matter?

Yield flattening is bad for the financial sector. So we want to watch how the bond markets trade early in 2016 and vary our bank stock holdings accordingly.

Stock Markets:

The TEAM model ends the year BEARISH of Canadian stocks, NEUTRAL European stocks, and NEUTRAL the U.S. markets. Ironically, my personal sentiment is almost exactly the opposite of what TEAM is presently allocating looking forward for 2016.

I believe the two main variables that impact stock market values and, hence, my 2016 forecast are:

1. The U.S. and Canada recession/no recession call.
2. The possibility of growing terrorist activity on American soil.

Obviously, I have no way of forecasting terrorist action so I will leave that point out of the discussion. But the recession/no recession call is really important to stock markets.

Low interest rates have literally manhandled investors into stock and real estate investments over the past 7 years. Investors are over-confident that “nothing can go wrong and the U.S. Federal Reserve can solve all problems”. The result: ALL ASSET MARKETS ARE EXPENSIVE RELATIVE TO HISTORICAL VALUATIONS.

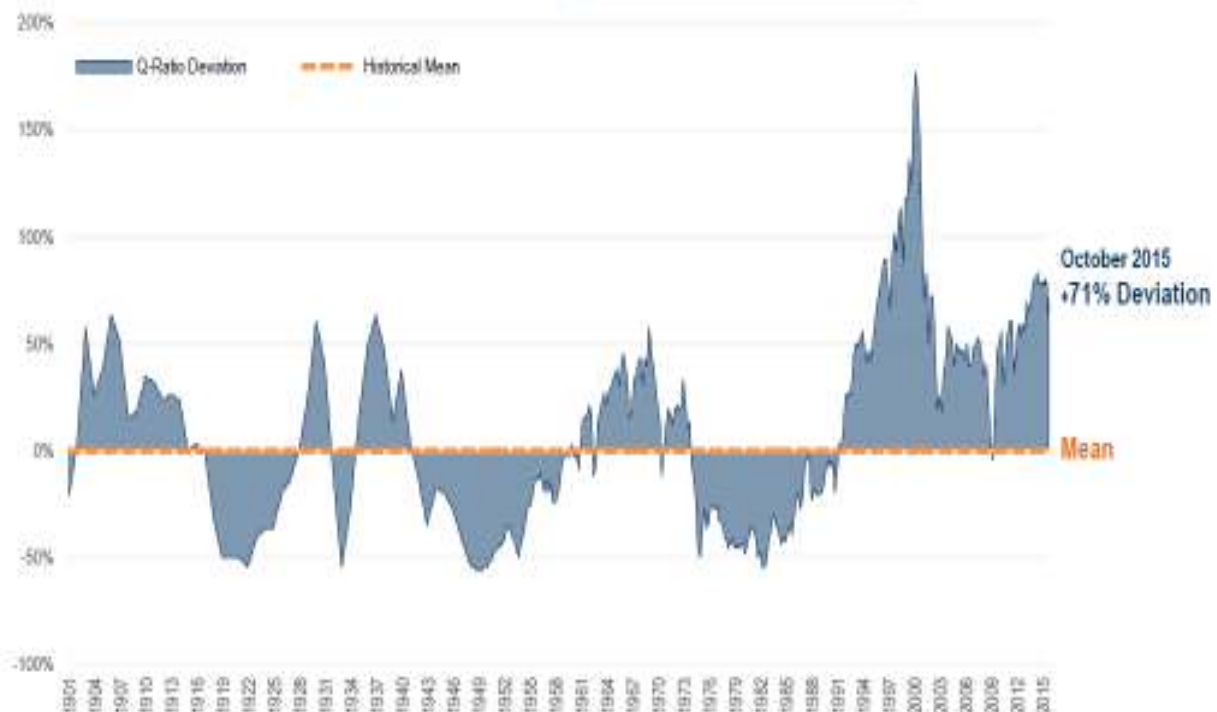
The BULLS say this doesn't matter because interest rates are low.... (Do you see anything circular in that logic?)

Let's establish one fact about the U.S. stock market leading into 2016: **American stocks are not CHEAP!** (See following two 100 year charts.)

THE EQUITY Q RATIO

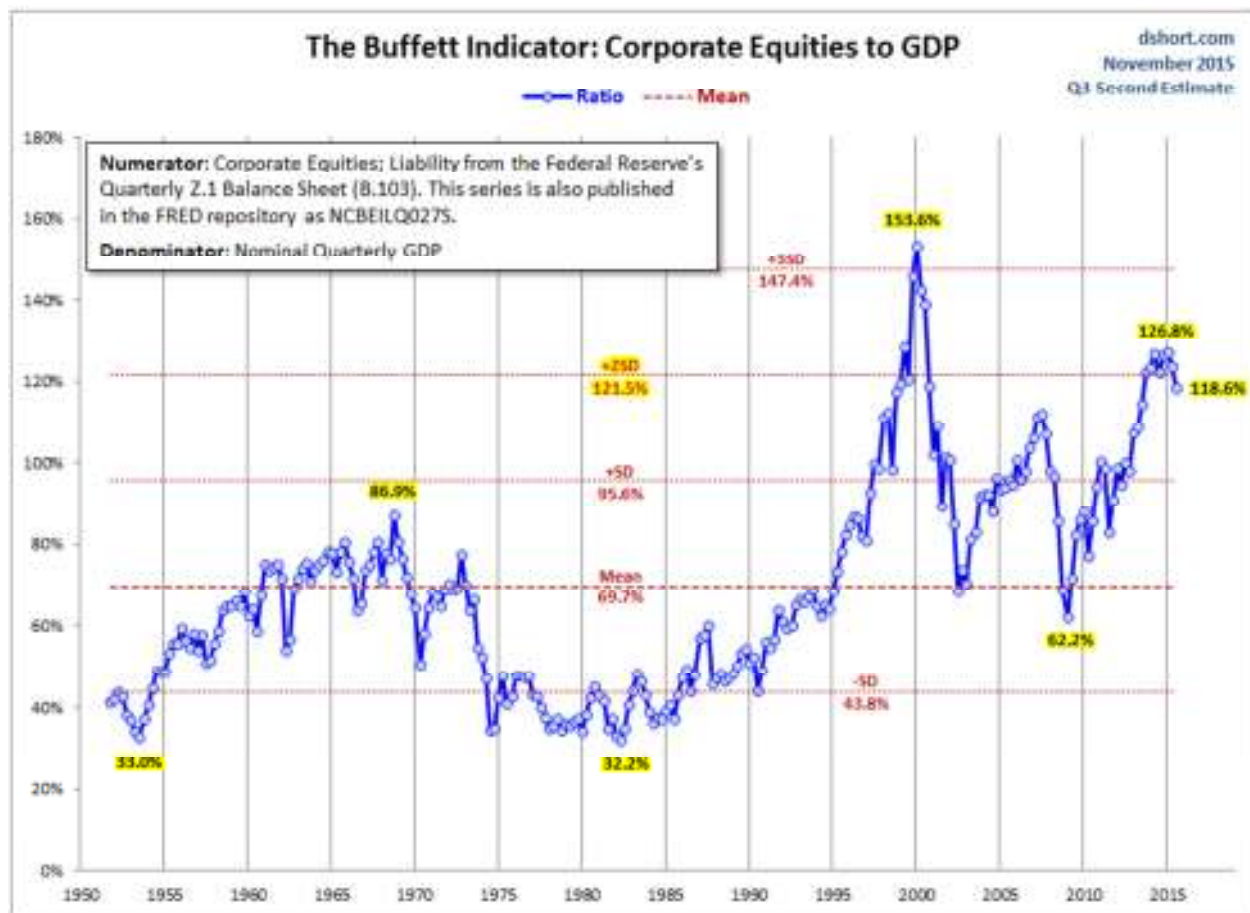
Aggregate Prices of Capital versus Tangible Replacement Value
1901 – present, deviation from geometric mean

$$Q \approx \frac{\text{Value}}{IC} = \frac{ROIC - g}{WACC - g}$$



To read the above chart: **The higher the ratio, the further ahead the stock market is priced relative to the reality of the “underlying capital”.** The U.S. stock market is declining off the second highest “Q ratio” in history! **The fact it is declining already is important to note!**

The next chart is the “Warren Buffett Indicator”. I used this chart last week in the annual review and last year in the 2015 forecast. It really is a derivation off of the first chart, but likely is slightly more “user friendly”. (Note, it is also in decline already.)



Let me summarize in point form what I am specifically forecasting for stock prices:

Canada:

- Canada has an excellent chance of outperforming the US in either of the two variables outlined at the beginning of this section of the editorial. In a recession scenario, I believe the US is much more richly valued than Canada and simply has more room to fall.
- In the possible higher terrorism scenario, I believe the possibility of Oil and Gold outperforming industrials and tech is significant. This would offer an edge to Canadian stocks over the U.S.
- If 2016 turns out to be "more of the same of the past 7 years" with low interest rates, 1% - 2% growth and more global Quantitative Easing Initiatives emanating from who knows which countries, then I think Canada and the U.S. both have mid-single digit positive rates of return. (5% - 7.5%)

United States:

- The most BULLISH case for the U.S. stock market is that nothing changes in terms of the global financial “bubble”. Interest rates stay low, real estate keeps going up, and governments keep printing money. The U.S. Fed has already fired a warning shot over the bow for the “status quo” crowd by lifting the interest rate on December 16th by ¼ of a percent. It may not sound like much but it’s a change in direction.
- In the case of either a recession or terrorist activity on U.S. soil I believe American stocks have substantial downside. (30% - 40% possibly). And with no way to lower interest rates from the present low levels, the world would be faced with negative interest rates and outrageous Quantitative Easing.
- A tactical approach is imperative in U.S. stock markets in 2016.

Emerging Markets:

- A single comment here; emerging stocks are an area that really interests me AFTER THE NEXT RECESSION ENDS. I think these markets will get beat up badly if/when the U.S. has its next recession, but I think there will be an incredible opportunity in emerging markets in the next market cycle. ETFs are the easiest way to garner this exposure in your portfolio at a reasonable price.

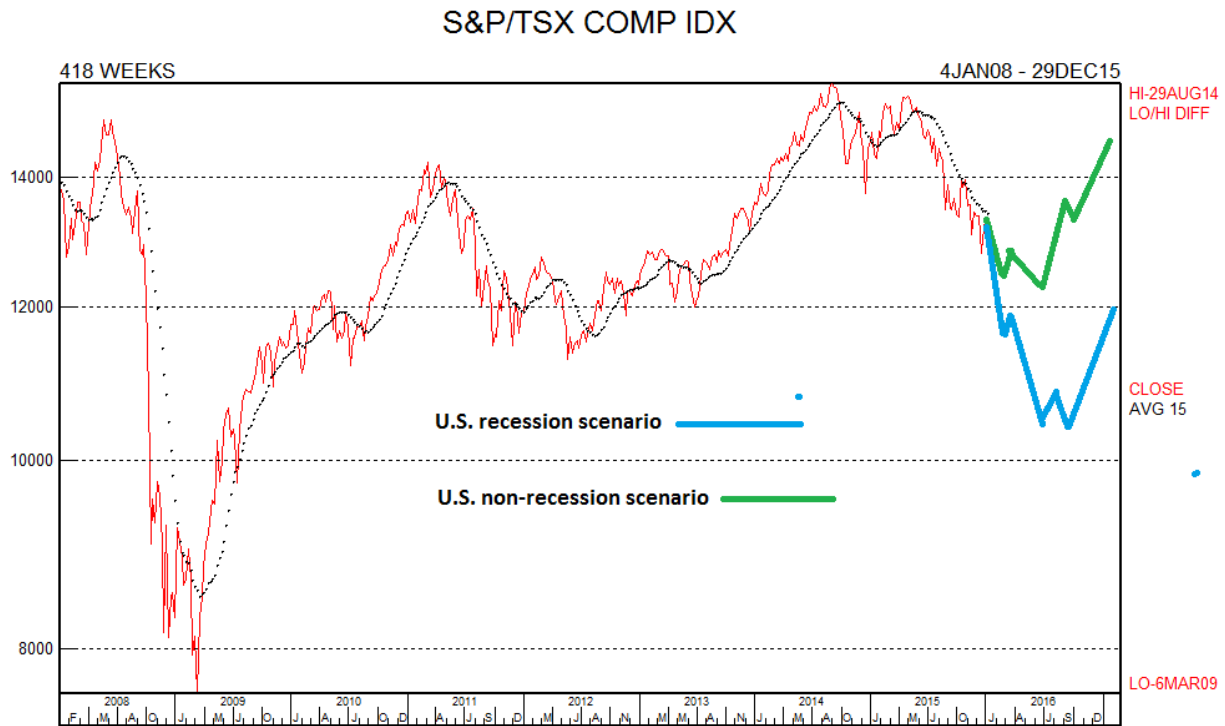
Dividend Stocks:

- **Quality of the dividend** is going to matter in 2016. What this means is that companies that have weaker fundamentals and balance sheets, even if they have generous dividends, are likely to underperform well supported dividends.
- If all goes well, and interest rates in the U.S. are increased by another 0.5% in 2016, **corporate buy backs** will fade. This lack of ability to buy back stock will hopefully make quality dividend policy even more sought after by investors helping dividend stocks.

Preferred Shares:

- As I have been saying for a few months now. Preferred shares are likely a good investment to consider in 2016. Many of you hold preferred shares that are below what you paid for them. Keep holding them....they pay good returns and should increase in value during 2016 in the “status quo” scenario.

With all that said, here is a chart of my expectations for Canadian stocks in 2016:



The TEAM model will handle this transition to protect our assets and allow us to participate in a potential market recovery. **Remember, it has been 100% in cash since September 1st 2015!**

Odds and Ends:

- Terrorism/Cyberterrorism

The greatest “black swan” risk I perceive to all that is written above is the possibility of terrorism/cyberterrorism, especially on U.S. soil. Economic numbers are already in slow down mode around the world. A serious and frightening terrorist event (or set of events) could be the straw that breaks the camel’s back economically. I know we are conditioned to believe a terrorist event “dip” in market prices is always temporary and to be bought. But for 2016 I would be careful with that one...

- China/Japan Crash

Last year concerns over the Quantitative Easing in China and Japan filled my “worry closet” enough to be the #2 concern in my 2015 forecast. I am not as concerned this year but the fact that the U.S. Fed is raising interest rates actually makes the risks surrounding China and Japan even more acute. (Note the chart of the Chinese Renminbi earlier in the report.)

The debt levels are so extreme in China and Japan that, if a tipping point is reached, the rate of change in financial markets could be rapid!

- “Unicorns”

A “unicorn” is a private company that is valued at more than \$1 billion U.S. The valuation is set by private equity investors. The following chart lists the **ESTIMATED** most valuable “unicorn” companies. (Estimated is the key word because the value is based off of the last time someone invested money in the private company. Note the dates on the right side of the page...a lot has changed in markets since many of those valuations.)

Lack of price discovery: Theranos remains the 14th largest unicorn

All Companies as of December 2015

Select a company to read a full profile.

Company	Latest Valuation 	Total Equity Funding	Last Valuation
Uber	\$51.0 billion	\$7.4 billion	August 2015
Xiaomi	\$46.0 billion	\$1.4 billion	December 2014
Airbnb	\$25.5 billion	\$2.3 billion	June 2015
Palantir	\$20.0 billion	\$1.9 billion	October 2015
Snapchat	\$16.0 billion	\$1.2 billion	May 2015
Didi Kuaidi	\$16.0 billion	\$4.0 billion	September 2015
Flipkart	\$15.0 billion	\$3.0 billion	April 2015
China Internet Plus	\$15.0 billion	\$2.5 billion	October 2015
SpaceX	\$12.0 billion	\$1.1 billion	January 2015
Pinterest	\$11.0 billion	\$1.3 billion	February 2015
Dropbox	\$10.0 billion	\$607 million	January 2014
WeWork	\$10.0 billion	\$969 million	June 2015
Lufax	\$9.6 billion	\$488 million	March 2015
Theranos	\$9.0 billion	\$750 million	February 2014
Spotify	\$8.5 billion	\$1.0 billion	April 2015
DJI	\$8.0 billion	\$105 million	May 2015
Zhong An Online	\$8.0 billion	\$934 million	June 2015
Stripe	\$5.0 billion	\$290 million	July 2015

Those are some hefty valuations for a list of companies that make no profits. I mention these “unicorns” because they are representative of the “valuation froth” of stock

markets. As a wise man once told me...*take it all in as input, not to be judged*. If “unicorn valuations” continue to sink, that may be a sign of underlying market concerns by the “big boy” investors.

- “Stagflation”

For the older readers of my comments, the term “stagflation” probably elicits some mixed feelings.

I actually believe a period of “stagflation” may be one of the more BULLISH outcomes we may encounter in 2016. The traditional definition of stagflation is a period of **slow economic growth, rising prices, slowing GDP and high unemployment**.

The present financial condition does not include the “high unemployment” by percentage. But I would argue we have high “under-employment” which loosely translates to the same situation.

If we assume a “stagflationary” outcome for 2016 then I believe we can assume a better year for the Canadian dollar and for commodity based stocks.

Much like the recession/non-recession call earlier in the 2016 forecast, it is too early to tell if “stagflation” has much of a chance of becoming a reality. It does make sense to consider the possibility of “stagflation” on our list of possibilities though.

Summary of 2016 Forecast

The broad message from the year end reading it took to pull together the 2016 forecast: **Both the BULLS and BEARS were disappointed by the financial market outcomes of the year.** A couple of truly “strained optimists” decided to report rates of return over a three year period to make the point the BULL market in stocks still had a head of steam...seemed to miss the point.

The financial markets remind me of a spoiled teenager living with her parents. Time goes by and, as the condition of the child grows worse, the parents continue giving in to her demands and feed her more of the same excesses that led to her problems in the first place. **The circular set of conditions that led to the spoiled kid in the first place is now firmly engrained.**

There have been opportunities to return to better grounded policies in which to spur on true economic demand. But as laid out in the preceding forecast, these opportunities were ignored and the “short term easy Band-Aid solution” (QE) was chosen at the first sign of difficulty. (Just like the parents above.)

This means that 2016 begins almost exactly like 2015...except for two conditions.

1. The extremes gaps between the financial economy and the real economy have grown wider during the year.
2. The U.S. Fed has raised interest rates for the first time in the past 10.5 years.

The key to 2016 continues to be the U.S. dollar index. The status quo of the financial markets remains the same if the U.S. dollar index keeps going higher. **If the U.S. dollar starts to weaken, then investors will need to look for different asset classes to succeed in 2016.**

To keep things simple I have used a “recession/no recession” theme to the 2016 forecast. But there are many things that could work to change the direction of the U.S. dollar index. I really don’t care what happens that changes the direction. I am focused on watching for the change itself.

What is my best piece of advice for 2016? **Pay attention to what is happening in the world and how it relates to your money.** I know you think your financial advisor, planner, or banker is doing this on your behalf. I can tell you that confidence is misplaced. Not because the people in those jobs are being underhanded or lazy. No, the reason is because they are listening to all the same analysts who are all singing the same tune. “Don’t Worry, Be Happy!” Just like in 2007/2008.

There is a decent chance “Don’t Worry, Be Happy” is the right song to listen to and simply holding on to your investments and collecting the dividends during a status quo year will work out. But there has been a growing risk for the past 7 years that a “buy and hold” strategy will get burned.

“Buy and hold” Canadian investors lost last year with the TSX falling 11.1%. Tactical investors held a huge advantage in Canada in 2015 both in the “rate of return” column and in the “peace of mind” column.

I truly doubt there is any path back to “normalization” in the financial world **where interest rates reflect a premium paid over the actual inflation rate.** The U.S. Fed has started a process that they say leads to “normalization”. I can tell you today they will never make it!

2016 will be all about watching for the inflection point where the U.S. Fed gives up on its threat to push interest rates higher.

Index rate of returns are likely to be, at best, mid-single digit this coming year. But for investors who watch and are not afraid to act, I believe an opportunity to redeploy cash on the sidelines looms and the chance for 8% - 12% returns.

Welcome to the investment conditions of 2016 and the conclusion of Bubble 3.0.

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.

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