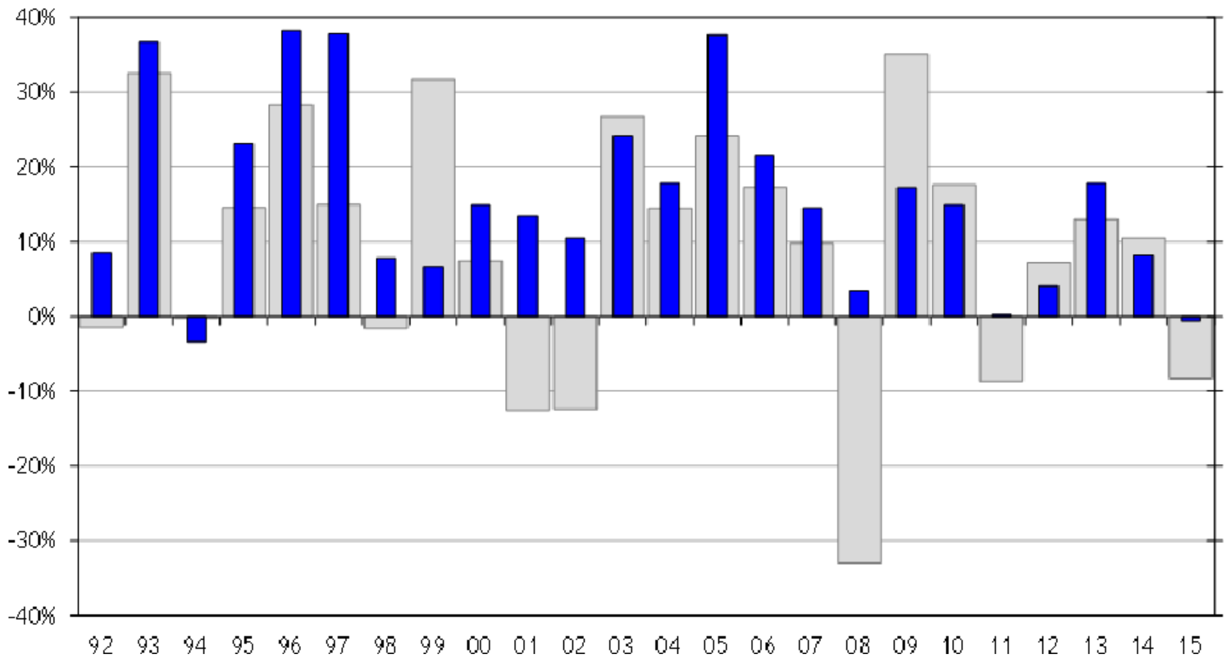
December 12th, 2016

"Won2One" with Nick Foglietta

Tactical Equity Income Model Portfolio Record



Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: 100% stocks
S&P/TSX 60 Closing Value: 15,313
TSX 200 Day Moving Ave: 14,274
% Above/Below 200 Day Moving Ave: **7.3% Above**
Levels for change: 50% stocks - **TSX 14,988** and 100% cash at – **TSX 13,560**

<u>*Weekly Quote*</u>

"Doing the right thing after doing the wrong thing is rarely painless"

- *Bill Fleckenstein speaking to the central banks of the world and their actions over the past 8 years*

"Hanging on Tight"

This week we begin the review of 2016 and consider what actually happened compared to what I expected at the beginning of the year. As I started to write this review I found myself thinking about the lyrics to the Pink Floyd song "*Money*" from the Dark Side of the Moon album. The song lyrics are below:

Money, get away
Get a good job with more pay and you're O.K.
Money, it's a gas
Grab that cash with both hands and make a stash
New car, caviar, four star daydream,
Think I'll buy me a football team

Money, get back
I'm all right, Jack, keep your hands off of my stack.
Money, it's a hit
Don't give me that do goody good bullshit
I'm in the hi-fidelity first class traveling set
And I think I need a Lear jet

Money, it's a crime
Share it fairly but don't take a slice of my pie
Money, so they say
Is the root of all evil today
But if you ask for a rise it's no surprise that they're giving none away

The line "*share it fairly, but don't take a slice of my pie*" was what resonated with me.

Looking back at the year, the **political landscape of the globe shifted in seismic dimensions**. The recent shockers of Brexit and Donald Trump were "watershed" results thought highly unlikely 9 months ago.

If we go back as far as 2015 we can see the G8 leaders have changed dramatically. Stephen Harper…gone, David Cameron (UK)…gone, Matteo Renzi (Italy)…gone, Barack Obama…leaving, Francois Holland is already off the ballet in France, and I'd be willing to bet that Angel Merkel will lose in German this May. That basically leaves Shinzo Abe in Japan and Jean Claude Junker in the Eurozone. That is massive change!

So why all the change?

Lots of reasons, but a big reason is reflected in the lyric from the Pink Floyd song: **Share it fairly, but don't take a slice of my pie**. The masses feel that neither side of that lyric has been true for them in the last 20 years: **The pie has NOT been shared fairly AND slices of their pie have been taken!**

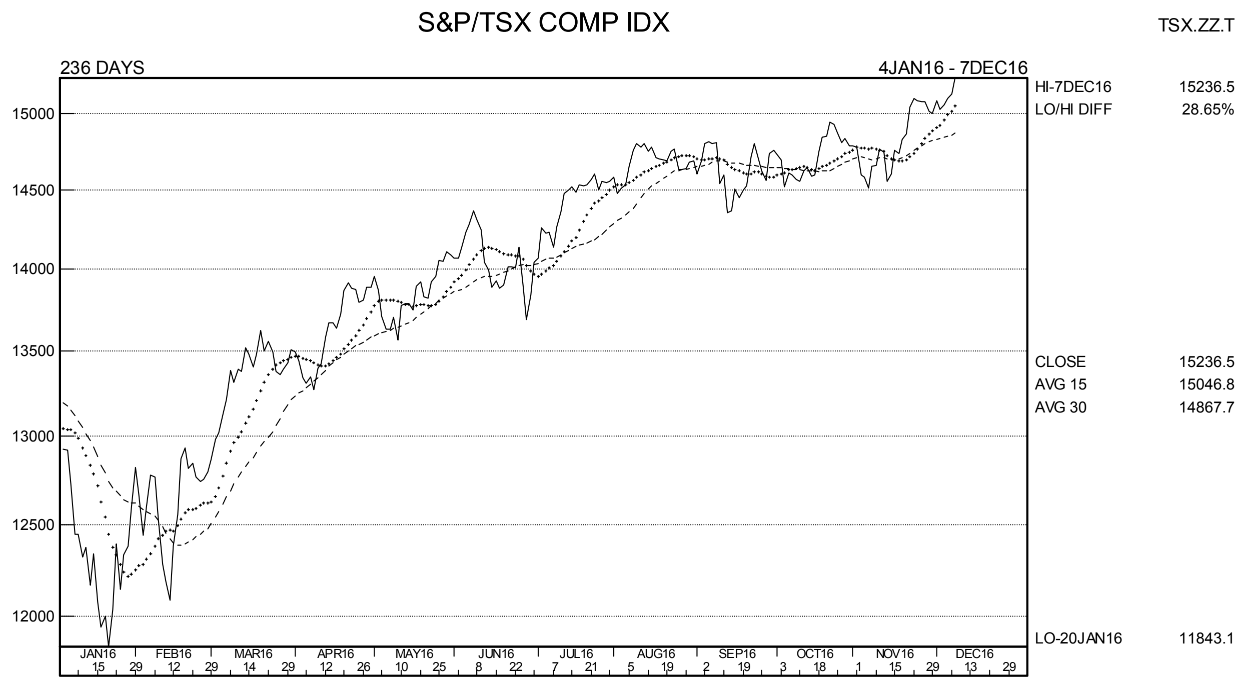
Can sharing the pie really be done fairly? Has the economic pie EVER been shared fairly? We could debate these questions, but it goes beyond the scope of my year-end review. So let's plow ahead by acknowledging what I believe to have been the defining anthem of 2016: *THROW THE BUMS OUT*! And the goal behind the political change…**to stop the inequality perceived to have spread around the world via elite-minded politicians and take back "my" share of the pie.**

Let's look back and see how the year unfolded.

Review of 2016

The first chart is what the TSX index (Canadian stocks) managed to do during 2016.

The month of January was very negative for financial markets. The world was in a dither that we were slipping into a *global deflation* and stock prices were falling fast.

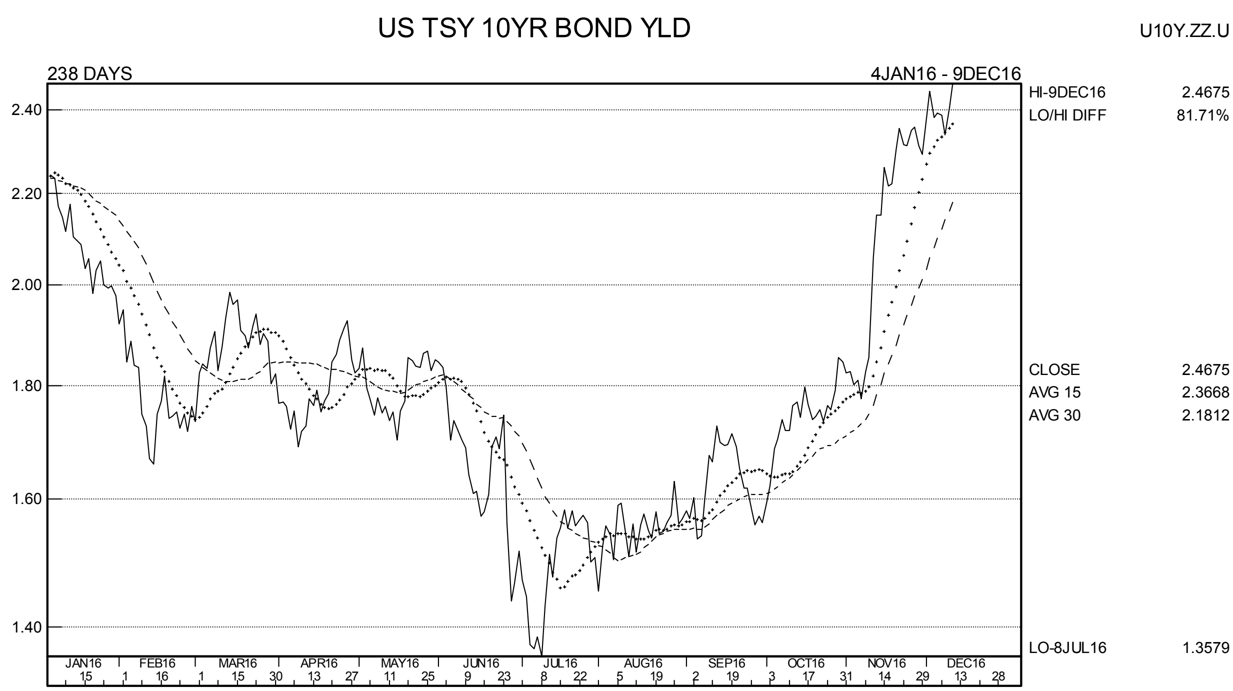


During the first two weeks of the year the TSX lost 8% of its value and there was talk of an imminent global recession. In the 2016 forecast (you can go back and look at the whole thing on my website) my TSX forecast was split into two: a recession based forecast and a non-recession based forecast.

The thinking was that stocks would bottom sometime during 2016 in both cases and then rally higher at the end of the year. Of course, now we know there was no US recession but growth was not very robust either.

Actually, the TSX forecast chart I used in the 2016 forecast (below) written in December 2015 was not too far off the mark. The “non-US recession” trend line in green is close to what transpired…at least until the Trump victory.

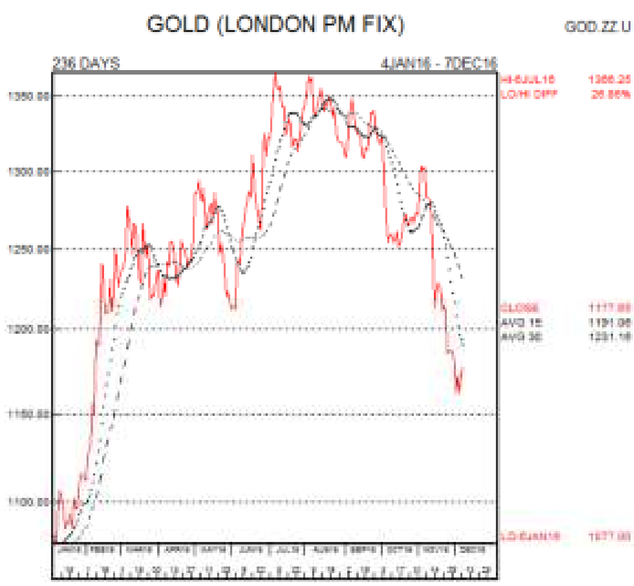
The TSX corrected into February 2016, bottomed, and then moved higher through the rest of the year. **The catalysts were a significant decline in interest rates and then the hope of economic recovery heading into the US election**.

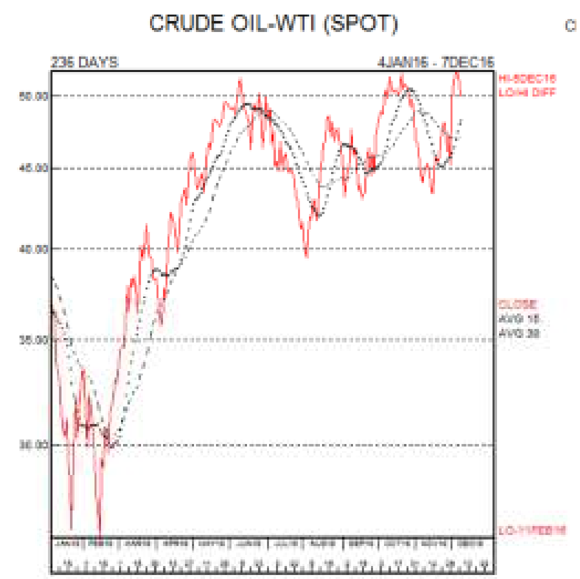


So even when earnings kept coming in lower and lower, the drop to historic lows in the summer of 2016 for longer term interest rates made stocks appear relatively cheap.

But as the summer interest rate lows were being made, the financial markets appeared to be at peak valuation. The feared recession was not coming…actually there were more signs of inflation than deflation. Earnings were starting to turn up. Interest rates looked like they were way too low for the economics of the summer of 2016. Strangely, the US FED kept talking down the economy so investors were basically "frozen" in a tight range.

A quick side note comes when looking at the Gold and Oil markets. The key to notice is how both commodities bottomed early in the year and rallied higher AS LONG AS INTEREST RATES KEPT GOING LOWER. Once longer term interest rates made their lows in July 2016, both commodities started to struggle. **This was an excellent early sign that deflation was no longer the biggest concern to financial markets**.





By late August, the attention of financial markets was directed towards the US FED and the US election. Donald Trump was making significant gains in the polls and as the calendar flipped to September, there were some that were picking him to win the US election. Financial markets were getting a little nervous about the possibility of President Trump and flattened out trading in very tight ranges.

Two key moments came in the run up to the US election:

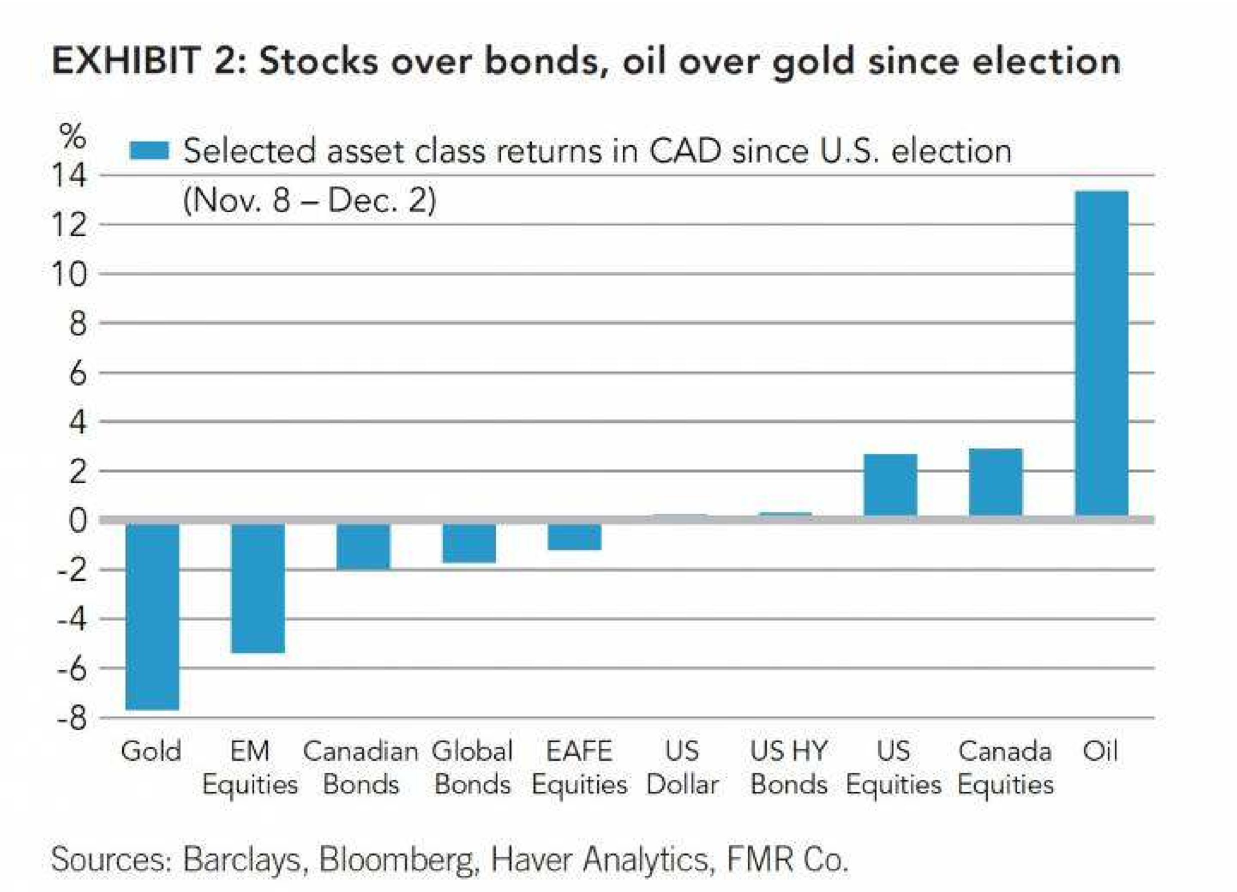
1. The first debate where Donald Trump looked absolutely horrific and out of his league when compared to Hillary Clinton. (The polls started to show Hillary as a landslide winner after that debate.
2. Donald Trump's unbelievable work ethic and stamina that just never gave up. He kept pounding home his same message and called himself "a movement" no

matter what the media dug up on him and tried to paint him as. Donald stuck to his script…and let the cards fall.

Financial markets did very little in the run up to the election. **And then the world changed!**

After November 8th 2916

Let me begin with a chart of a number of asset classes and how they have behaved since the election of Donald Trump on November 8th **in Canadian dollars.**



(Just for the record, Oil was influenced much more by the OPEC decision than by the Trump election win.)

Here is another factoid that might get you thinking. On December 8th the US media was loud and proud announcing that the stock market rally in America had created more than $1 trillion in market value. Ok…that is true. But let me add one piece of information to that factoid. **The cumulative value of US government bonds lost $2.7 trillion over the same time period as interest rates went higher.**

You see, there are about 15 times more investment quality bonds outstanding than stocks!

There are so many of these types of factoids racing around that I will just stop there so I don't get your thoughts too far off topic. Main point: **The amount of financial disruption that Donald Trump's victory represents is off the charts…let alone how unpredictable he is a person. Just don't lock yourself into any one view. Stay flexible and attentive**.

The main challenge in the "Trump era" of investing is for Canadian investors to translate the implied, but unstated, Trump policy expectations over to a Canadian portfolio.

The only opinion I hold with conviction at this point in time is a stronger US dollar vs. the Canadian dollar. The latest pullback of might be a good opportunity to look at this strategy. Below is comment from one of the Canadian hedge fund managers I follow:

"We have increased our U.S. dollar overweight, notably against the Canadian dollar.

The rationale here is two-fold. One, while recent developments favour tighter U.S. monetary policy, the reverse is probably true for Canada – stronger U.S. demand won't help Canadian exporters much if U.S. market access is reduced, and higher longer-term interest rates are a greater threat to Canada's more leveraged household sector. This reinforces the view that the balance of risks looks to be tilted towards a weaker Canadian dollar ahead, even from already-cheap levels.

Conclusion

For investors, 2016 never really started until November 8th. Markets have made such sharp reversals since the US election and portfolio managers have had to work hard to keep up with the new trends.

The revenge of the middle class on the political elites has broadened to a global scale. But the jury remains out as to how much the middle class will actually gain from their "extreme voting" exercises in the UK, US, and Italy. When I look at the people that Donald Trump is choosing for leadership positions I still see a lot of "*Goldman Sachs exposure*"…that was supposed to be Hillary Clinton's beat! Maybe the fairest way to state the issue is to take the political angle away from what Trump is promising: **Can there be a strong working class again in the western world given the rapid rate of technological change and increases in "artificial intelligence"**? Who knows?

This will be the first year since 1999 that I will not try to write a 2017 Forecast edition for my blog. Reason: I have no idea what I would write…maybe that says something in itself given what 2000 brought in the way of financial changes.

So I am going to sign off with a couple of charts and some point for thoughts as we look into the next year.

1. **The stock markets and the bond markets are on a collision course as we look into 2017**. Interest rates will not keep rising along with stocks. One of the two are wrong right now…we just don't know which one!
2. **Artificially low interest rates and extreme monetary policy has carried the day for more than 8 years**. The changes since November 8th in markets are signaling the end of the BULL market in bond prices that started in 1981 and ended in July 2016. (Chart of US 10 year bond yield – 1981 peak and 2016 bottom)

3. **Asset valuations are at extreme levels around the world**. Stocks and real estate prices require low interest rates to support their valuations. It will be key to see if interest markets co-operate with asset prices. We need to spend a few moments on this theme. Think of valuations like this…*if you can get only 1.5% on a fixed income investment OR a 2.5% - 3% dividend yield on stocks you will likely choose to take <u>some</u> risk with <u>some</u> money to buy stocks. Your behaviour will be reinforced as the stocks go higher in PRICE (not value) so you might choose to keep buying stocks with more of your money. After 8 years of this behaviour, stocks are pricey. (See chart (A) below).* ***Now, what if you could get 3% - 4% on your fixed income investments again****? Maybe you decide to sell some stocks and buy some fixed income back?*

The real estate relationship to higher interest rates is much easier to understand…higher interest rates equal higher mortgage payments…which equals less house able to be purchased for the same payment. **The question becomes "how high do interest rates need to go to change investor's behaviour in both of these asset markets?** (See chart (B) below – Nanaimo RE prices)

Chart A

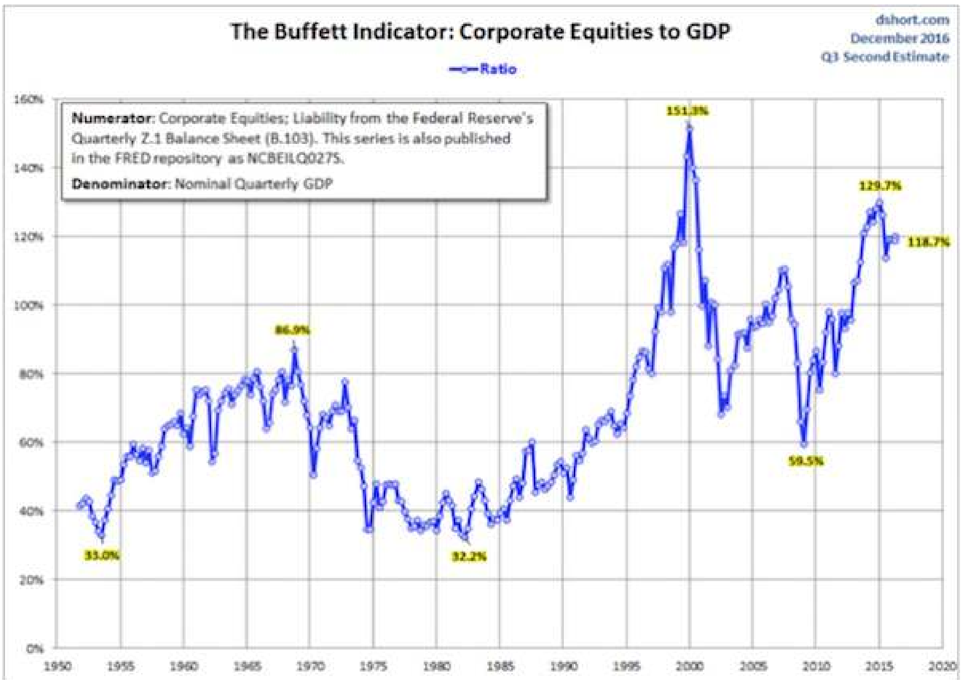
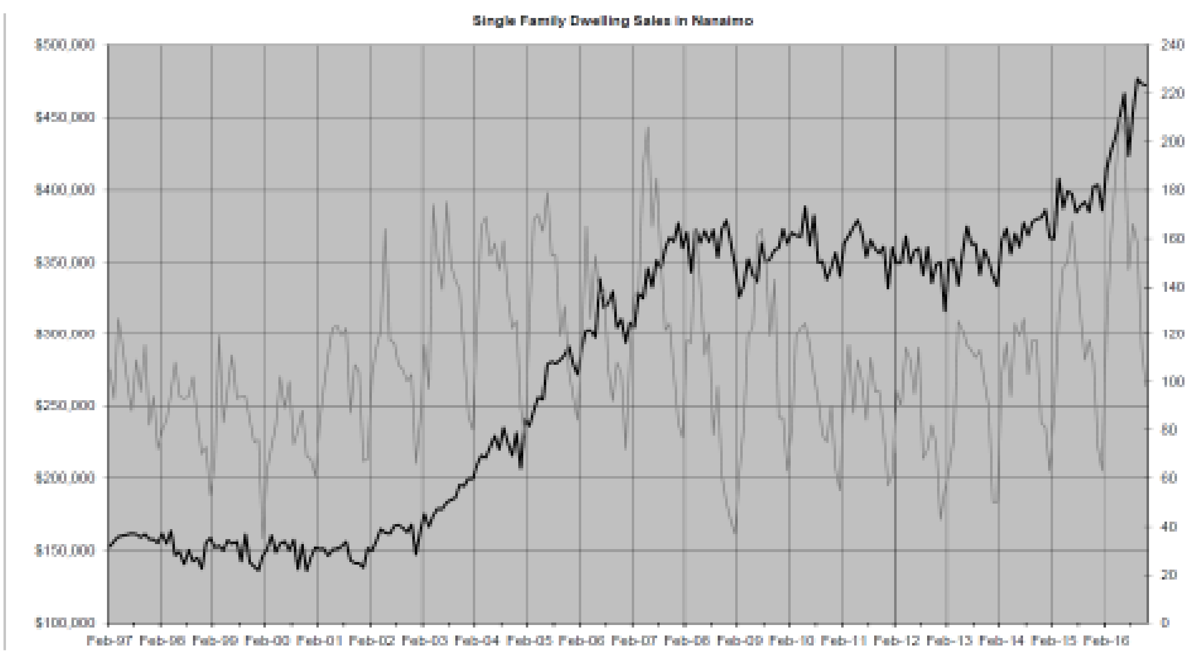
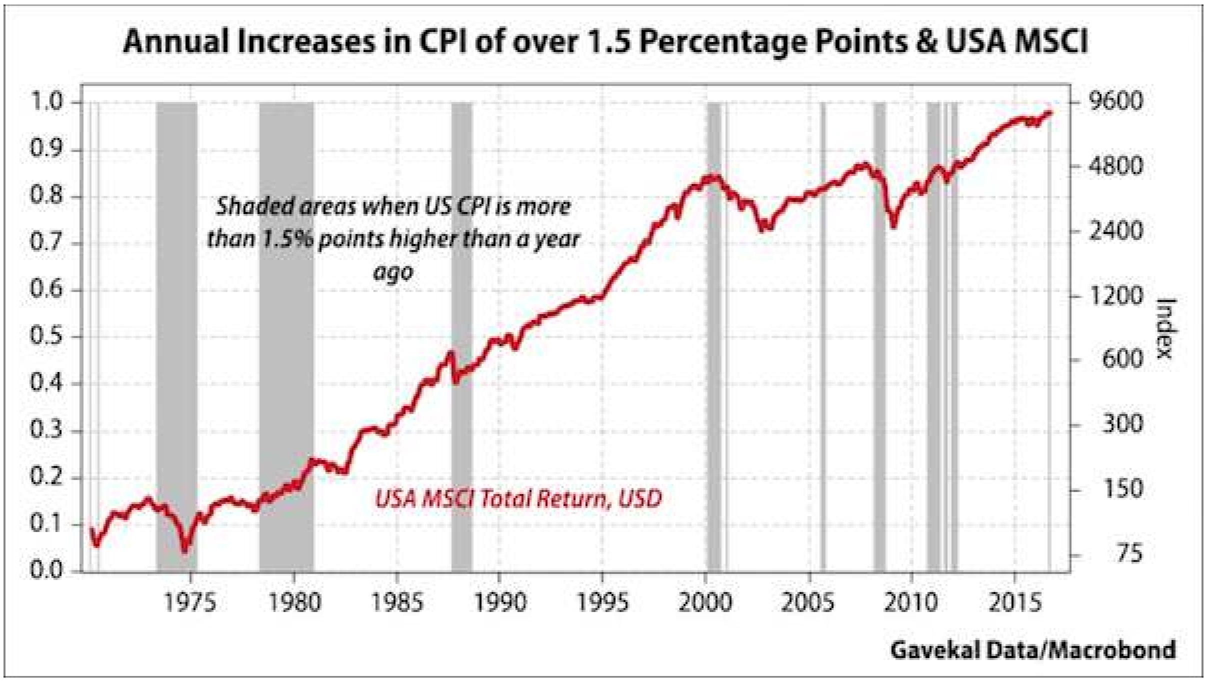


Chart B



4. **Inflation is rising for the first time in a long time**. November 8th represents a fascinating turn for "inflation expectations." The FED is behind the curve already when it comes to interest rates. The FED will raise interest rates by 0.25% this week but that still leaves them behind the curve. We will see how aggressive the get in 2017…my guess…not aggressive enough!



The chart above shows the last quarter of 2016 has been the first quarter with a higher than 1.5% consumer price index (CPI) increase since 2012. This will get more interesting in 2017!

5. **Risk happens fast**! Ironically, I used this quote from Doug Kass last year, yet most of the risk happens fast was very difficult to invest around. The night Donald Trump won the election the Dow Industrial Index market fluctuated from down 1000 points to up 900 in 3 days. Brexit was the same type of thing over a longer period of time. Investors are confident that asset prices are securely supported at lofty levels. **Please maintain your vigilance.**

Feel free to touch base to talk about any of the themes in this report.

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