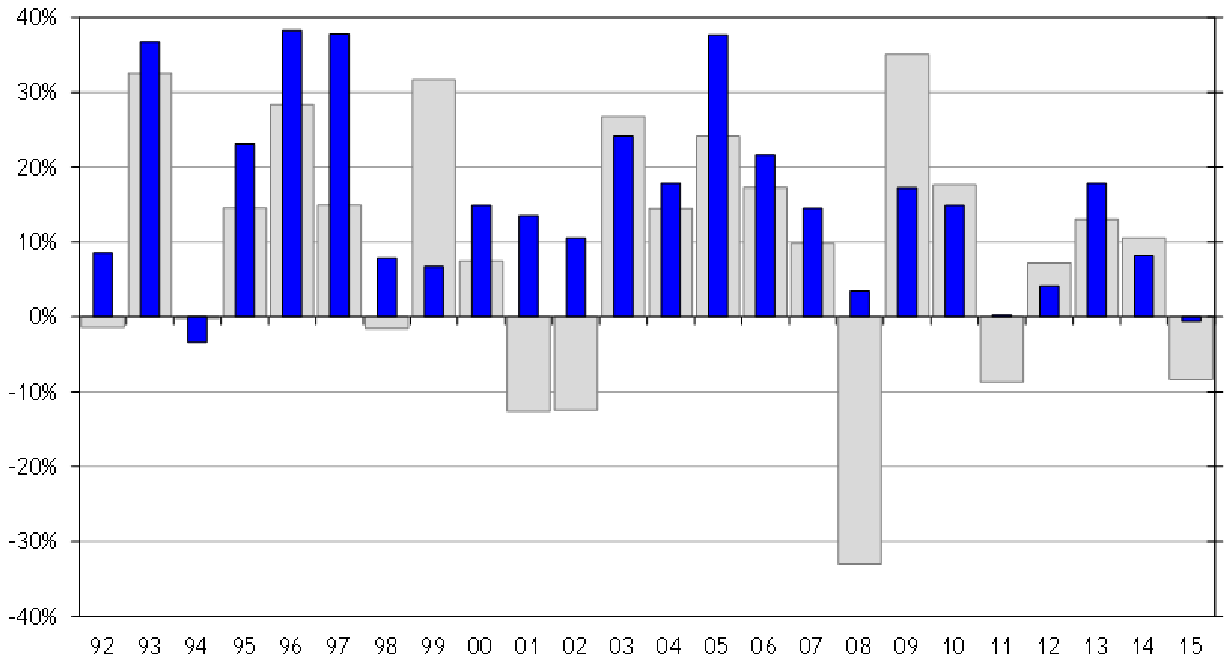
November 28th, 2016

"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: 15,075
TSX 200 Day Moving Ave: 14,139
% Above/Below 200 Day Moving Ave: **6.61% Above**

Levels for change: 50% stocks - **TSX 14,845** and 100% cash at – **TSX 13,432**

<u>*Weekly Quote*</u>

"What central banks have done has encouraged governments to believe the central banks have the economic situation under control."

Ultra-Easy Money: Digging the Hole Deeper? – William (Bill) White

Opening Thoughts

Financial markets continued to party based upon the belief that Donald Trump changes everything…although they didn't party quite as hard as in weeks before!

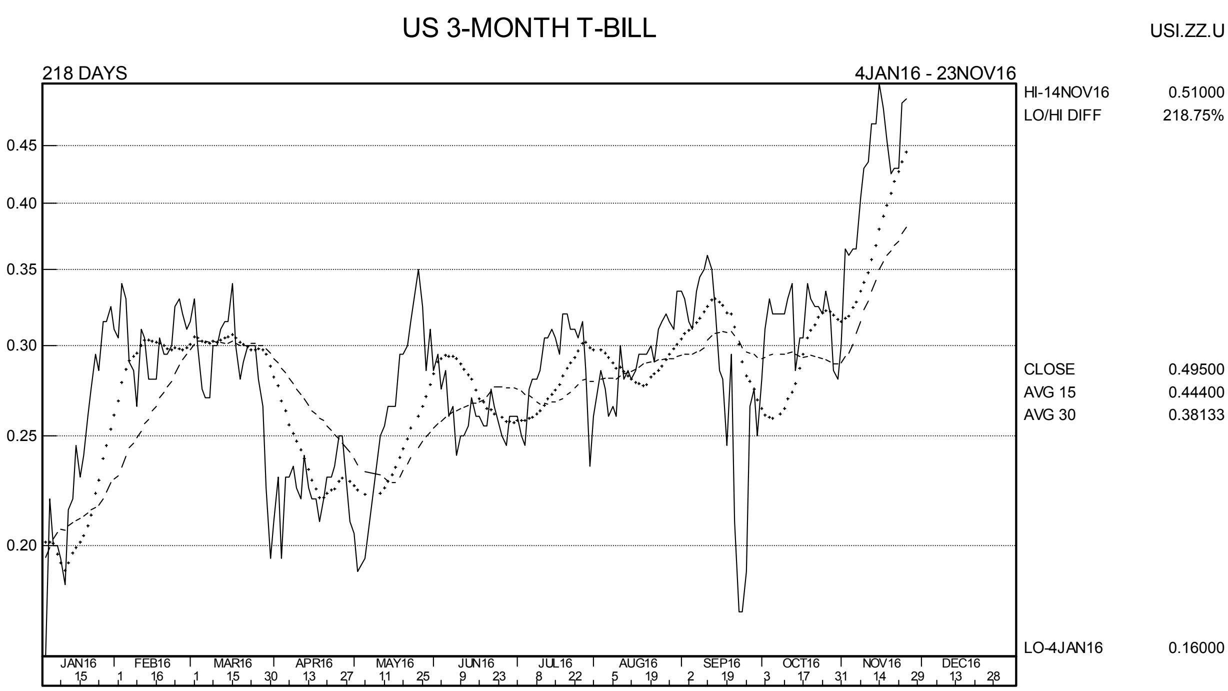
The comment this week is touching on where the global central banks fit into the picture now that **financial markets have taken it upon themselves to raise interest rates**.

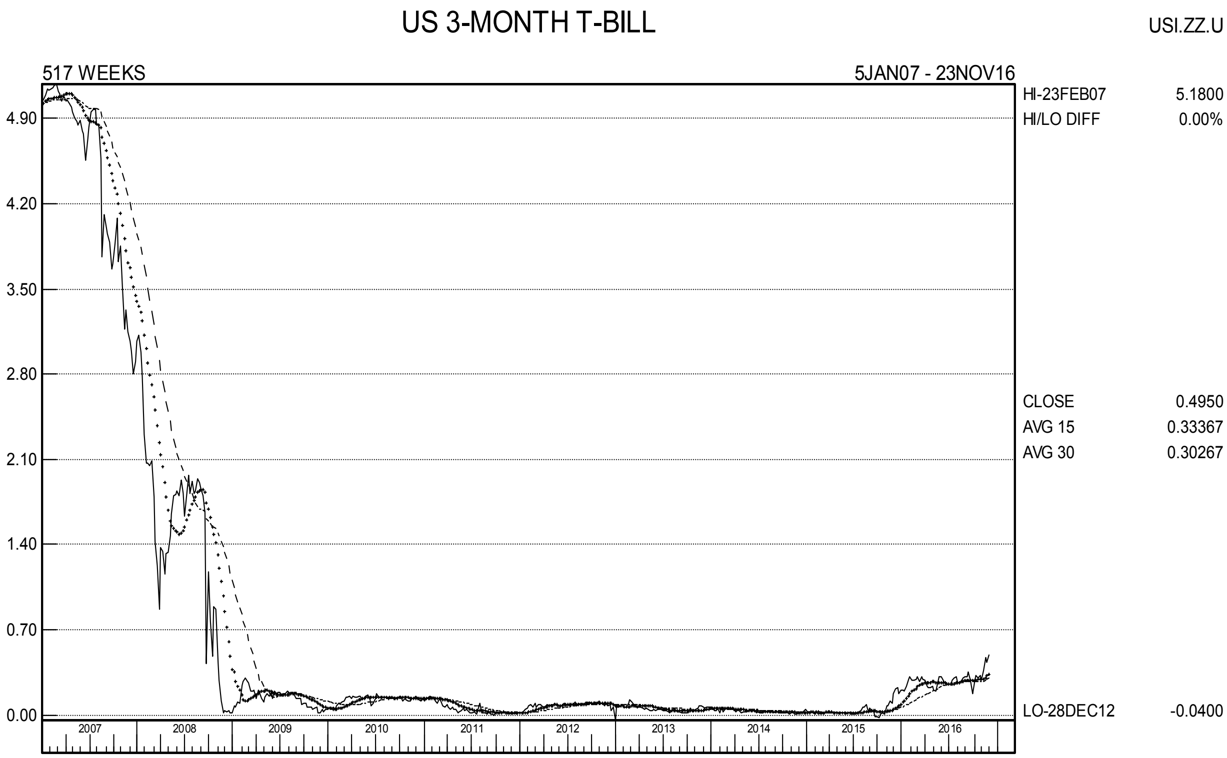
My goal is to bring to your attention two points:

1. **Central banks have been factored out of the equations by the bond markets** – what this means is as MARKET interest rates go beyond the levels the central banks are holding them at it no longer matters what the central banks decide to do at their meetings UNTIL THEY CATCH UP TO THE MARKET INTEREST RATES.
2. Consider the question **"At what level do interest rates start to impact asset prices?"**

Central Banks Have Been Relegated to the Cheap Seats

Let me show you two charts depicting short term US interest rates. Chart 1 shows the US 90 day Treasury bill yield for the calendar year. Chart 2 goes back to 2007 before the financial crisis.





It is really hard to believe the Federal Reserve let the asset bubbles develop for as long as they have without starting to normalize interest rates! They left the interest rates at zero for 7 years.

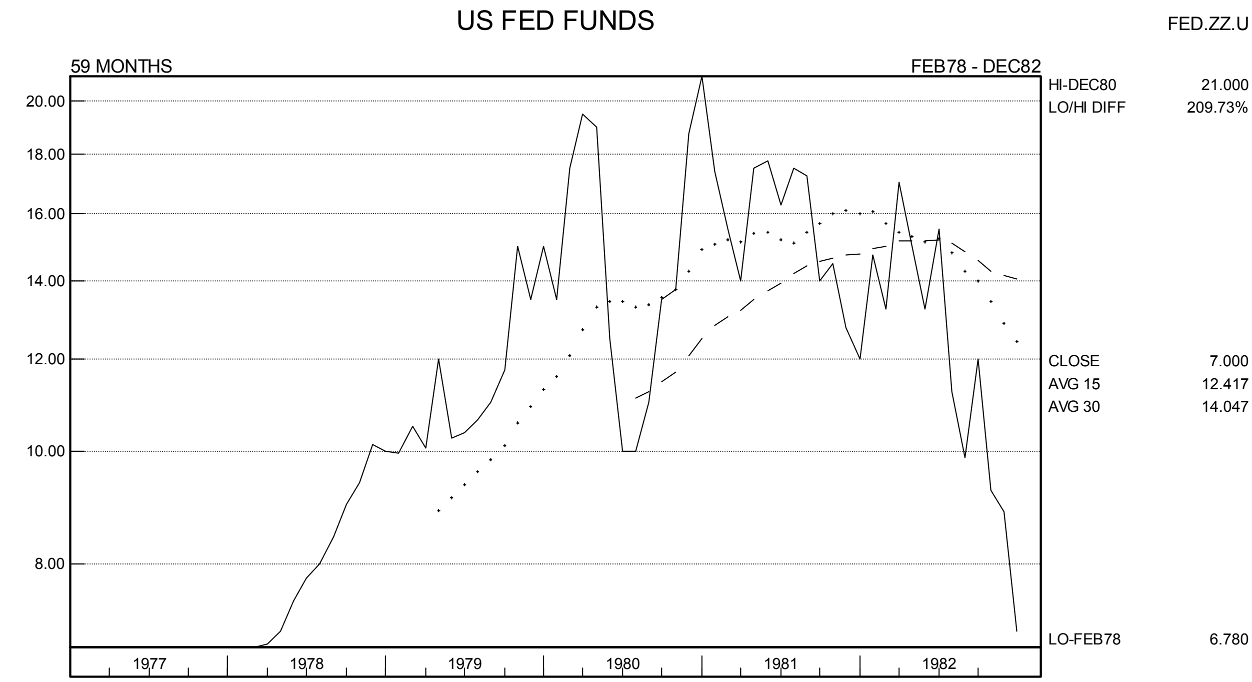
Since the US election, interest rates have been moving higher. Ironically, the markets have done already what the FED has been afraid to do for all those years…raise short term interest rates!

The truth of the matter, when the Federal Reserve moves to raise interest rates 0.25% in December they will not even be matching what the bond markets have already priced in. Hence, the FED will not be leading….they will be following!

The FED is used to being the lead dog on the “interest rate sled team”…not “wheel dogs”. As a group, Central Bankers like to see themselves as “masters of the universe”. Therefore, a continued rise in interest rates could become quite a change of pace for investors and the central banks.

The mid 1970s saw a period where central bankers fell “behind the curve” on interest rates. Inflation expectations became so ingrained that it required Paul Volker (FED chairman at the time) to lift interest rates all the way to 20% in order to finally stamp out the inflation fire.

(Below: FED funds rate 1977 to 1983)



Clearly, interest rates would not have to go up nearly as much in 2017 as they did in the 1970s to play havoc with government debt interest obligations…let alone the average consumer's financial situation! It is wise to remember that inflation fears are not totally mathematical in nature. Human psychology plays a huge part in the process.

These are early days and, maybe, the increase interest rates are transient in nature. We will have to wait and see. But the world is no place for high interest rates anymore so we had best keep our eyes open!

At What Level Do Higher Interest Rates Begin to Impact Asset Prices?

The question I asked myself before I wondered about the level where interest rates begin to impact asset prices was "*how high do I believe interest rates will move in the present cycle?"*

Since there is no way to answer the first question I decided to look try and look at where higher interest rates start to "hurt" more than "help" the economy.

Let me use some extremely simple math to outline how this question should be framed. I could use the average size mortgage or the amount of provincial debt to make the same point, but I am going to use the US government debt because it is so easy to go back in time and find out exactly how large it was at specific dates.

When aforementioned FED Chairman Paul Volker raised interest rates to 20% in the early 1980s the US debt level stood at $1 trillion[1]. Therefore, at a 20% interest rate the interest owing was $200 billion.

In 2008, the US debt level stood at $11 trillion. Therefore at 4% prevailing interest rates the interest owing was $440 billion.

In 2016, the US debt level stands at $20 trillion and, therefore, at 0.5% the interest owing is only $100 billion.

Ok…now reverse the math above. The debt level is going to explode higher under Trump (not that it didn't explode higher under Obama). By the end of 2017, the US debt will be in the $22 trillion range. If the Federal reserve does ONLY what it says it will do and raise interest rates 4 times (4 x .25% = 1.0%) the effective rate on short term US debt will be 1.5%. **Therefore, $22 trillion at 1.5% will amount to $330 billion in interest.**

So first, do I think 1.5% is enough to scare off the BULLS in the real estate and stock markets? No…I don't think so. I believe the narrative will be how great everything is healing and how bad bonds suck so just keep buying stocks under this scenario.

But the chance of an overshoot to the upside on inflation targets is significant.

<u>And here is the key in my mind, the financial markets will not wait until the FED acts on what it is seeing…the financial markets will be "the lead dog" and keep pounding interest rates higher based on INFLATION EXPECTATIONS, not the FED actions!</u>

My guess, the math surrounding the actual interest owing is important but less important than the INFLATION EXPECTATIONS of financial markets.

So if we don't know how high interest rates might go OR what level will cause the financial markets to "puke" what am I watching for?

- The US bank stocks – US banks have been on a tear to the upside. If they reverse while interest rates are rising it will be a great first signal interest rates are worrying asset price investors.
- Emerging stock and bond markets – when the US catches a cold the emerging markets go into cardiac arrest. Significant weakness in these markets matters.
- US home building and mortgage companies – they were the epicenter in the last melt down…I doubt that to be true this time…but they won't go unscathed either.

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[1] www.usdebtclock.org figures

Conclusion

The number of variables in the possible outcomes for financial markets around the globe greatly increased when Donald Trump won the US Presidency. These are VERY early days. Watch for clues and be ready to act!

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