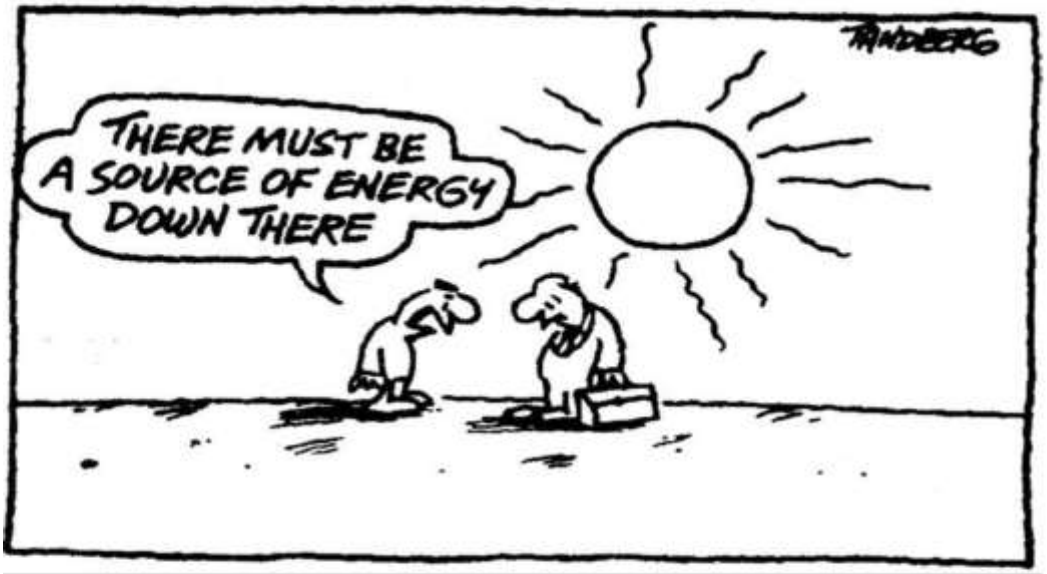
Real life needs active management

July 31, 2015, Issue 7

E.Q Trendwatch™

Good growth



> *"There's been a colossal misjudgement of future demand. That long boom made it especially difficult for people to expect anything otherwise. Many bought the big story about urbanization, instead of thinking how things could go bad."* -- Dali Yang, Professor at the University of Chicago, July 13, 2015

This month the Chinese government resorted to the next rash of desperate attempts to stop garishly valued financial markets from crashing. Officials banned short-selling, halted IPO's (fearing IPO's prompt selling of existing holdings), intermittently closed markets, banned large investors from selling positions, announced a government-directed fund to buy stocks, ordered corporations to buy back their own shares and sent out the police to question anyone who was talking about wanting to sell. When markets did re-open, about half the listed companies were frozen and not available for trading. A free market, this is not!

> *"One woman, who declined to give her name but said she is almost 80, invested RMB 20,000 ($3,200) when the market was at 5,000 points. "I've lost two thirds of my money," she said, her voice cracking. "I really want it back and when I get it, I will never invest in the stock market again…"Old people often don't understand economics," says Nie Riming, a pensions expert at the Shanghai Institute of Finance and Law. "They are easily duped."*
>
> – *The Financial Times, July 11, 2015*.

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Mario Draghi at the ECB famously said European central bankers would do "*whatever it takes*" to support bank profits. A world full of policymakers have followed suit. The past 5 years have witnessed the most epic phase of market intervention and financial juicing ever in human history. And it's not only participants in China who are at risk:

> *"Investors today seem to be as myopic toward the risks of income investing as they were in 1989. MLPs, REITs, emerging market debt, and other income categories all seem to have risks that investors today are largely ignoring. One must remember that excess returns in the financial markets are always accompanied by excess risk. Yields that are abnormally high typically carry abnormally high risks as well, and a proper assessment of those risks should never be taken for granted.*
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> *The deflation of the global credit bubble remains our primary investment focus. The problems related to oil, Greece, Puerto Rico, China, Brazil, gold, and other credit-related investments should not be a surprise given the secular deflation of the global credit bubble. Yet, investors' unwillingness to accept the end of the 1998-2008 credit paradigm has caused considerable financial market volatility."*
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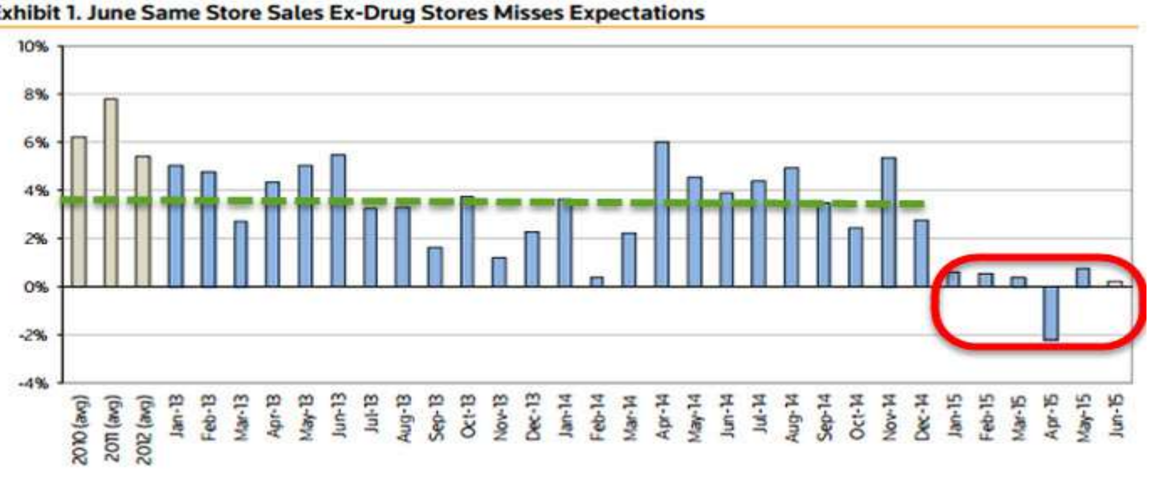
> --Richard Bernstein, July 14, 2015

Meanwhile the Chinese economy, the great growth hope for the bulls, continues to slow along with its appetite for commodities. As sales sputter in most countries, record levels of debt taken on in the boom are weights on spending. The gold and silver index (XAU) and broad commodities index (CRB) both fell to 2002 levels this month, while key industrial metals like copper and aluminum fell to six-year lows; iron ore hit its lowest price in more than a decade.

Compounding weak demand in developing countries, North American retail sales continue to disappoint. As shown below, US same store sales have been extremely weak through 2015.

Exhibit 1. June Same Store Sales Ex-Drug Stores Misses Expectations



Source: Thomson Reuters I/B/E/S estimates.

Weak retail demand has led to depressed wholesale sales and rising business inventories. As shown here, the gap between sales and inventory levels is now more extreme than during the 2008 recession.

US Industrial Production in June came in at a level seen at the start of the last 3 recessions.

Source: www.zerohedge.com

This underlines serious valuation problems for stocks. Rising inventory to sales ratios (inverted scale below in orange) suggest 12-month forward earnings estimates will fall further (plotted in blue since 1993).

Such disappointments could be more easily absorbed if stocks were trading at low multiples of expected earnings, but this is far from the case. As shown in the updated chart below from Crestmont Research, the price to earnings valuation for stocks today at 27 is second only to the tech peak in 2000 (blue line below).

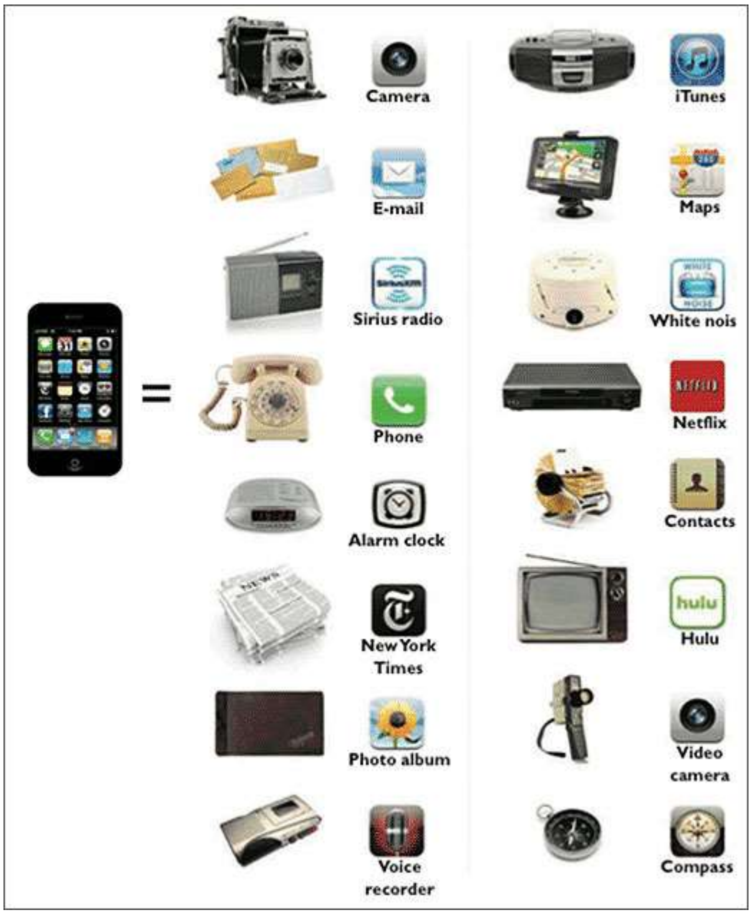
And as compared with the 3 other secular bear cycles of the past century (black, yellow and red lines above) sustained price gains based on valuation expansion from here (pink line) would be unprecedented. The best hope for bulls is that valuations would hover near current levels for years as earnings growth catches up to present forecasts (in brown). The most likely case is that valuations will mean revert toward the lows that marked the end of previous secular bears (purple line below) somewhere in the 5 to 8 P/E area.

Near-term this is not great news for commodity-centric producers like Canada.

The world is already awash in resource assets and it will take several years for current growth trends to absorb. At the same time, the last few years of QE-enabled free-flowing corporate credit has incented producers to continue ramping up supply.

While the indebted world grows slower (disinflationary), the Internet and global information sharing are enabling a rapid evolution to smarter technology and efficiency that reduces resource inputs for the growth that is happening. The below graphic from a recent article by Jesse Ausubel of the Program for the Human Environment at Rockefeller University, demonstrates the point well. (See: Nature Rebounds for an encouraging take on the upside of less human consumption and waste).

Just one poignant example, the smart phone has consolidated dozens of consumer goods into one handheld device, reducing spending while sending tons of old electronics to recycling. It has also enabled developing countries to bypass traditional buildout needed for cable and phone lines and go straight to wireless.



The credit bubble enabled a flurry of unprecedented discretionary spending. With less money now to waste and a focus on debt-reduction, an undersaved and aging population are interested in downsizing and spending less. Efficiency is the new passion.

Commodities are being reclaimed and recycled all over the world. Western trash is shipped to developing countries that use cheap labor to harvest valuable constituents like copper and aluminum, paper and plastic. It's a win-win for everyone except raw material producers.

And then there is energy.

Not only are appliances and equipment using less power by the day, but the array of alternative energies is leaping with new sources and systems being unveiled each month: biomass, momentum, thermal, wave, tidal, wind, solar. All are aimed at feeding smart grids and batteries that are already fueling vehicles and generators. The energy revolution underway in the world is the next secular boom for global growth. It is very exciting.

For a few billion people in developing countries, building out conventional infrastructure is impossibly expensive. But alternative energy like solar and wind are enabling a leapfrog of traditional systems straight to on-site generation of individual energy solutions. Solar power is also being used to pump water in the way that windmills traditionally have in Holland.

In order to survive and thrive, it is imperative that companies, countries and individuals see the new trends and innovations as the answers not the enemy. Alternative energy systems are the next big 'job creator'. General Electric, CEO, Jeffrey Immelt recently explained that he sees GE as an energy innovator. Not one particular type of energy, but a company that helps to develop and supply smart energy equipment of many kinds in the world. Traditional suppliers, investors and consumers must also evolve their thinking if they are to prosper. Humanity is presently moving away from the epoch of centralized energy to a new epoch of personalized energy.

For those who may have missed the links on the blog this month, we highly recommend you invest 20 minutes to watch the TedTalk from Harvard professor and inventor Daniel G. Nocera, the world's leading researcher in renewable energy at the molecular level. In 2011, Nocera won Time Magazine's innovator of the year award for the 'artificial leaf', a hand-sized solar fuel process that captures many of the elements of photosynthesis to create energy and clean water for individual consumption. You can find the direct link on YouTube here. The revolution in energy is shifting many of the current status quo ideas and powers in the world.

Canada in particular has much work to do in transforming our economy and diversifying our revenue streams away from hard assets and 'dirty' fuels. Having committed all the classic errors of wasting money and opportunity during our most recent boom decade (2001-2011), we are now left with a steep road to climb. But necessity is the mother of invention and the present cash crunch will undoubtedly force consolidation and creative destruction for antiquated managers, models and political PACs.

Some observers note the world's debt levels and slow growth today and see little catalyst for improvement. We are not among them. After 7 years of destructive monetary decisions in the world, we see endless room for improvement!

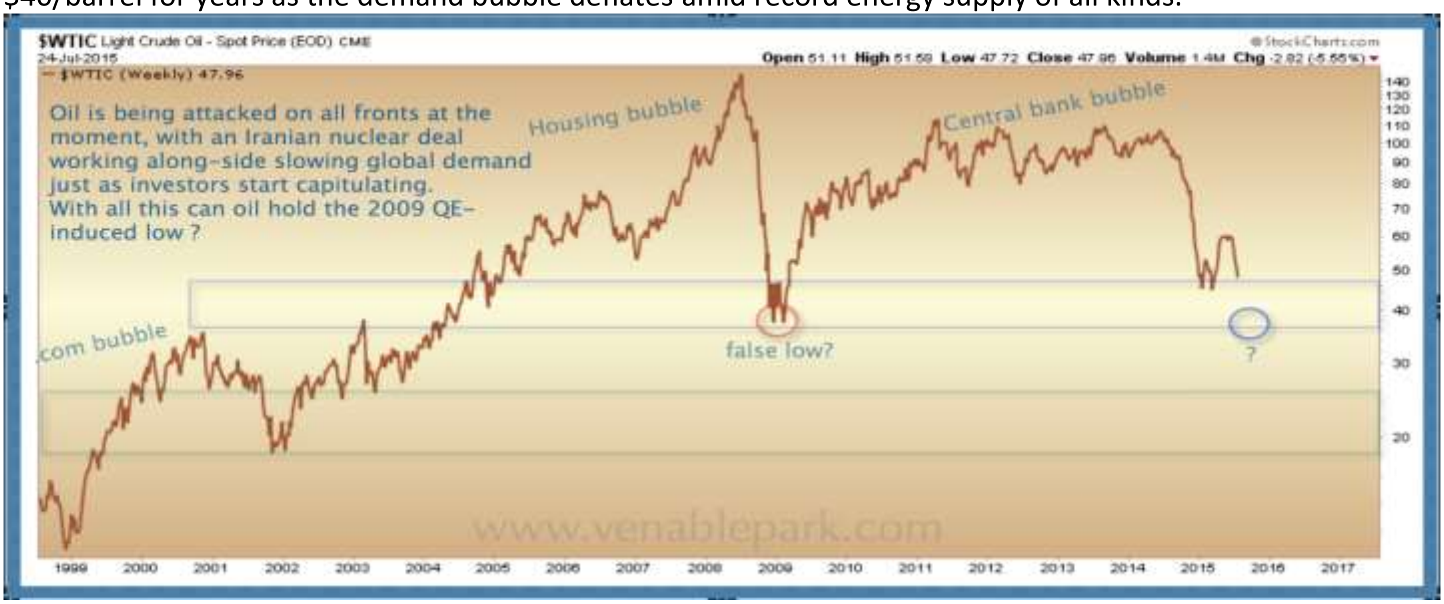
<u>We at VPIC came into the 2000's suspecting that the secular boom from 1982 to 2000 would be followed by a 15 to 20 year period of financial conditions equal and opposite in the other direction</u>. We were so convinced of this probability, that we devised a new asset management approach, quit our jobs at the bank, and founded

our own firm to manage risk for clients. We are now 15 years through this secular bear period. So far so good, but as the Irish would say, *"we'll be grateful ta see the back"* of this cycle. To date, less deleveraging has been accomplished than rational minds would have hoped. QE experiments since 2010 have managed to extend leverage beyond even our wildest fears, and have delayed the financial healing needed to launch the next secular boom for investment markets.

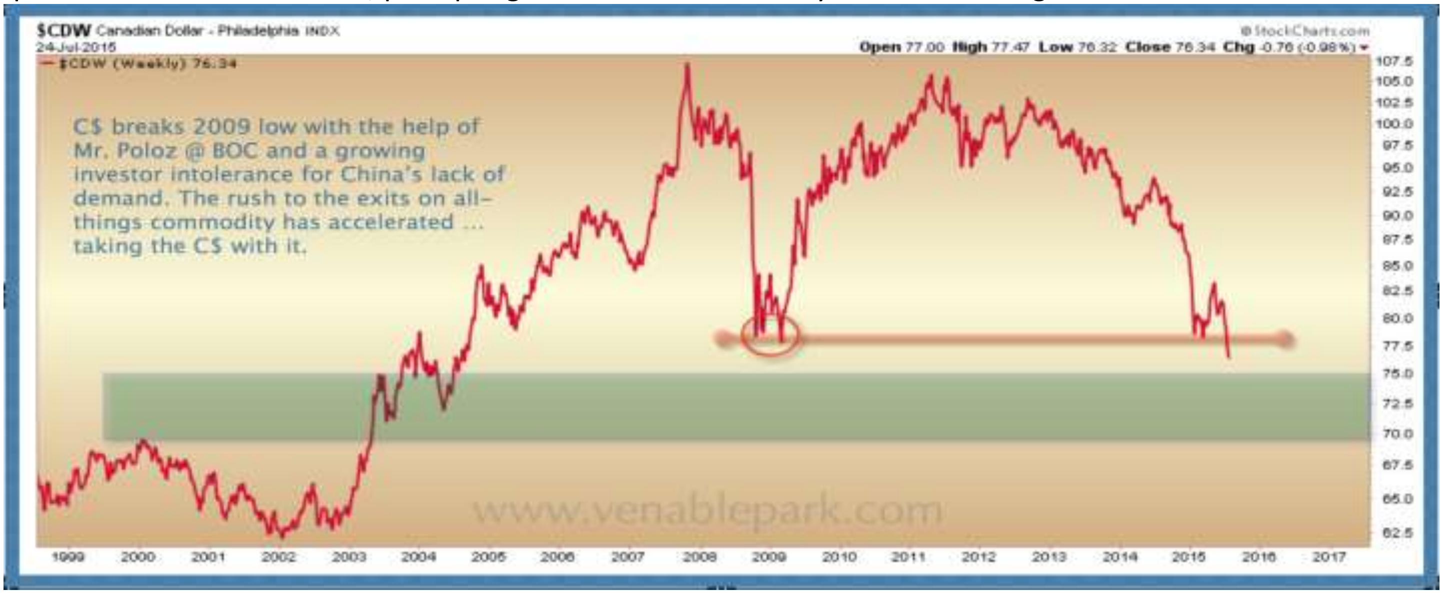
Secular bears begin with irrational exuberance and outrageous valuations and end in pessimism and asset liquidation that presents uncommon investment opportunity. We clearly are not there yet, but we are headed in the right direction. Monetary magicians are increasingly being revealed as old world hacks, reckless at best, maniacal and criminal at worst. We see much reason to be optimistic that the current rash of egregious excesses will be cleansed by the third, and likely final phase, of this secular bear market. Whether it be rationalizing oil economies, an unravelling bubble in China, or global disgust over the EU's public raping of Greece, confidence in policymakers is waning and asset prices are wobbling all over the world. The seeds of the next secular boom have already been planted. *'Good'* growth--*that adds to, rather than detracts from, the health and financial strength of its customers*--is the holy grail of a sustainable economy - and it is coming.

> *"Those who support [the latest Greek deal] are merely covering up their own inability to make money other than by riding the coattails of central banks. Unfortunately, believing you can solve a debt crisis with more debt is unlikely to prove to be a profitable investment strategy in the long run. The Greece deal may have removed the last excuse the Fed has to delay an already too-long delayed rise in interest rates. Investors need to start realizing that central banks and policy makers in general have made a mess of things. If they don't move quickly to hedge their risks, they will be making their own walks of shame before long."* -Michael Lewitt, July 13, 2015

WTIC since 1999: secular bull in oil began in 1999 and ended in 2008. Crude could now trade below $40/barrel for years as the demand bubble deflates amid record energy supply of all kinds.



Canadian dollar index (CDW) 1999-2015: weakening with oil since 2008. Canadian economy saw a second quarter of contraction in Q2, prompting the BOC to cut rates by .25—weakening the C$ below 2009 levels.



Canada is not the only commodity-centric currency that has been taking a drubbing. The Brazil real, Norway krone, Mexico peso, South Africa rand, Aussie and New Zealand dollars have all been plunging against the rising greenback, as resource economies grapple with the shock of plunging export revenues.

Shown here since 2006, Canadian banks, REITS and the S&P 500 are all likely to follow the TSX lower to re-couple with both the loonie (red), Venture resource exchange (green), CRB commodity index (brown) and gold shares (black) that are all now back or below where they bottomed in the 2009 contraction cycle.

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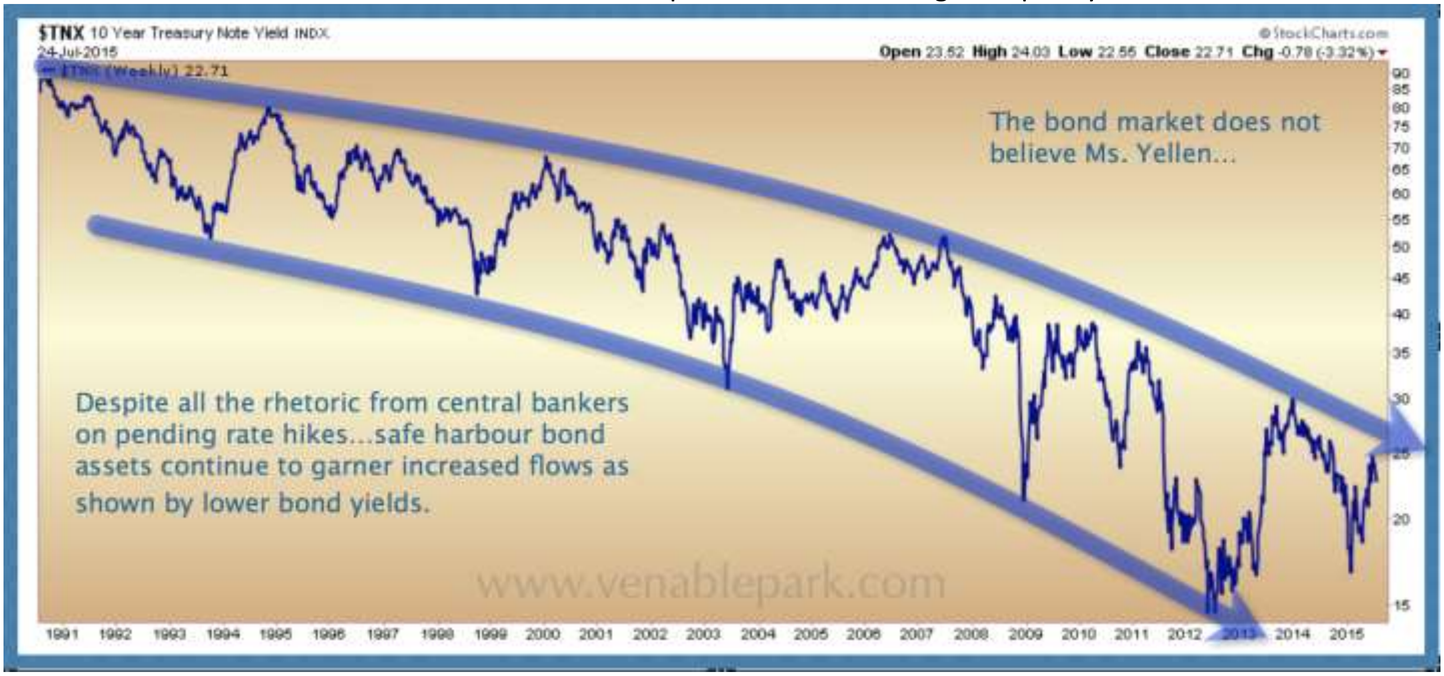
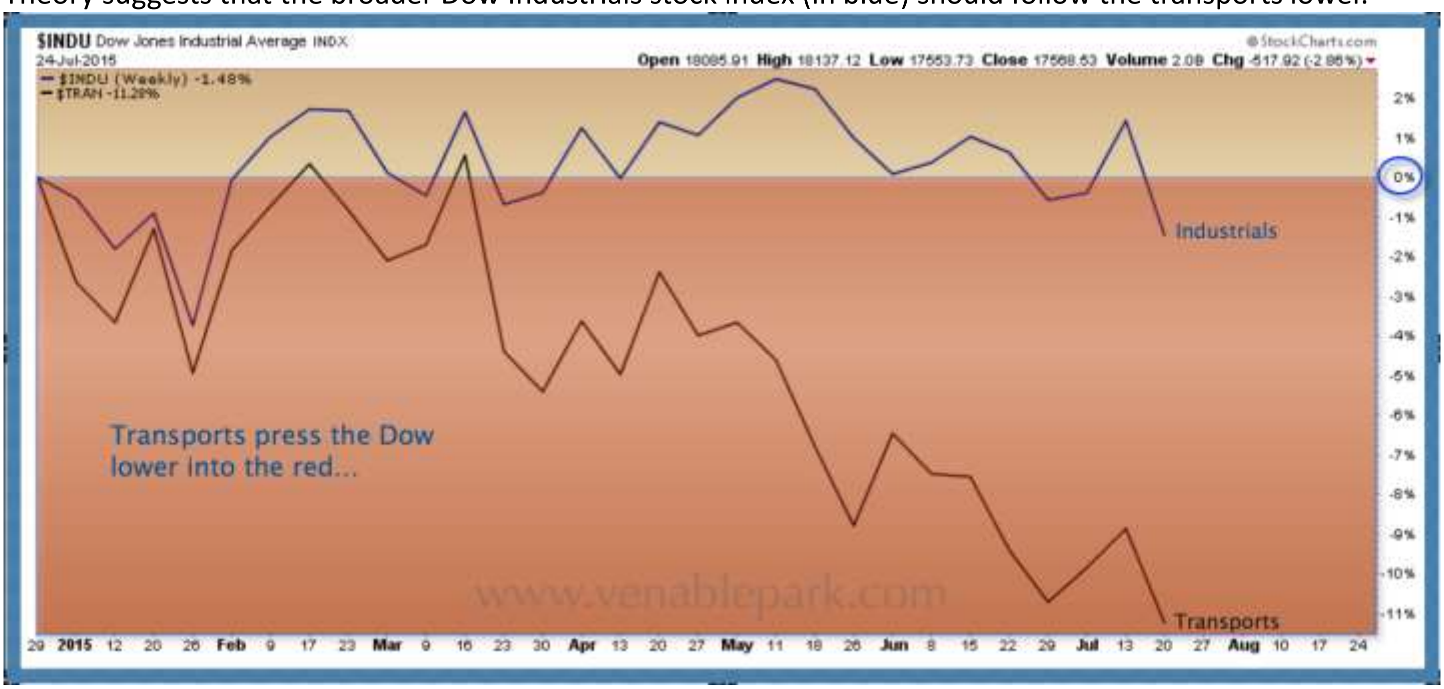
North American interest rates still in downward channel as deflation dominates the dreams of central bankers: As shown below since 1990, the barometer US 10 year Treasury yield remains well within the downward channel in tact since the credit crisis erupted in 2007. The highest quality bonds are in demand.



Transportation stocks (in red below) are confirming the plunge in global demand over the past year. Dow Theory suggests that the broader Dow Industrials stock index (in blue) should follow the transports lower.



As we write, many markets and assets are negative for the year. The Canadian TSX is well below where it was in 2008. Many corporate bonds and preferred shares have also been falling as commodity prices tumbled further this month. The secular bear is still in motion. Meanwhile our high quality fixed income and US dollar holdings have continued to steadily gain in value. We remain defensive and confident that unsustainable conditions will end and excellent value will be plentiful.

How can it be August already?? Remember to have some fun everyday. Quotes of the month:

> *"We've had to learn not to listen a lot to our critics. If we listened to people telling us that what we're doing is stupid, we would have stopped years ago."* **--**Patrick Sullivan, psychiatric geneticist (2015)
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> *"If you look at the Chinese financial system, you look at shadow banking, you look at the amount of leverage, you look at how desperately they worked to keep the stock market up. It looks worse to me than 2007 in the U.S."* –Bill Ackerman, **Pershing** Square Capital, July 15, 2015
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> *"All things are subject to interpretation. Whichever interpretation prevails at a given time is a function of power not truth*." --Friedrich Nietzsche, German philosopher (1844-1900)
>
> *"Example is not the main thing influencing others. It is the only thing."* –Albert Schweitzer (1875-1965)

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