Real life needs active management

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E.Q Trendwatch™

Speculating on recovery

“"Better-than-expected" is Wall Street's euphemism these days for "we're happier than we thought we'd be." But Wall Street is in the business of cheer leading, even when there's really nothing to cheer about. It wants investors to think positively, on the assumption that positive thinking can be a self-fulfilling prophesy: If investors begin putting more money into the market, then the market will automatically rise, leading more investors to put in more money -- until, that is, the rally ends because nothing has fundamentally changed in the real economy. Keep your eye on the real economy, where unemployment and underemployment keep rising. It's not as much fun as cheering and investing right now, but it's far safer.”

--Robert Reich US Secretary of Labour, July 24, 2009

Last week we received confirmation that second quarter GDP was still contracting in both Canada and the US. It is now widely speculated that the great recession of 2007-2009 will soon be ending. If the American recession does end this fall, it will mark the longest and deepest economic contraction since the 1930’s. To see the end of negative growth this cycle would be a great first step.

But stock markets typically don’t begin sustainable bull expansions until an economic recovery is apparent. Recoveries require a pick up in demand in the real economy that can increase revenues and GDP. So far evidence of a growth recovery is the key missing link in our picture.

The recent spate of less-bad earnings data has been born of companies slashing overhead to produce net income at any cost. This is the rational response of management struggling to stay afloat when revenues have fallen off a cliff. One of the painful after-shocks of deep cost cutting of course is the wake of unemployment and under-employment that it leaves

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behind. Unemployed people buy little. People concerned that they may become unemployed also buy less. It is for this reason that unemployment serves to prolong downturns and undermine the recovery.

Historically, in a typical recession the US economy has lost about 2 million permanent jobs. In this recession so far, 9 million full time jobs have been lost and 3 million people have been forced into part-time work. Traditionally there have been about 4 million people who are under-employed, meaning they are working part-time hours because they cannot find more work. This recession so far has 9 million Americans who report that they are looking but unable to find full-time hours. Under-employment in Canada has also more than doubled during this recession.

In treatment of the unemployment virus now sweeping the world, governments where ever possible have issued massive fiscal and monetary stimulus programs. In the short and perhaps medium term, this stimulus is highly likely to stimulate; at least somewhat. The hope (which we share) is that governments may stimulate consumption long enough to tide the economy over, to buy us some time, to allow business to survive and consumers to work enough to pull the world economy into eventual recovery.

Over the next 12 months we are reasonably optimistic about a recovery, especially given that only 1/3 of the US stimulus has so far made its way into the US economy and it is very likely that a second stimulus package will be announced this fall. At some point, the Feds will have their way. In the short and medium term, some consumption is bound to pick up.

Longer term we do see the risk of inflation. But over at least the next 12 months, we see continued price deflation. The hangover from the great credit boom of 2003-2007 has left a massive over-supply in most large consumables like housing, retail, and autos. Some of it will have to be destroyed or recycled. Price deflation will also act as a brake on economic recovery. So long as people see over-supply and expect prices to continue to fall, buyers are not eager to buy. Even employed people will put off purchases if they believe that prices will be lower a year from now. The less people buying, the more prices drop and so the spiral goes until massive inventory is worked down slowly over time.

What about the stock market?

Over the past 4 months a string of less bad economic data has inspired a seismic shift from despair to euphoria in a breath-taking price rally across most risk assets. The way prices spiked from

March to July, one might think that a strong and rapid economic recovery was now in the offing. We would love it if that were the case. If only we were speculators! But alas, we at VPIC are mandated as stewards of life savings; we are asked to make more sober assessments than "take a swig and pass it around." And so, although we have made some money year to date in corporate bonds and some equity exposure since February, the recent rally has been so parabolic and of circumspect quality and volume, that we have been so far unable to fully commit.

After a market has rallied so much so quickly, it is normal human behaviour to feel remorse that one has "missed out." This is where objective rules and measurements can greatly help psychological strength and overall perspective.

First, before we beat ourselves up too badly, it is worth noting that what we at VPIC have actually missed out on over the past 2 years is one of the most devastating wealth destruction cycles ever in human history.

Secondly, we continue to be of the belief that we are perhaps half-way through a secular bear period that history will record as one of the most difficult ever. At the same time, within this lengthy period, we will continue to have shorter cyclical bull markets perhaps 2-3 years in length, which can only be rewarding so long as entry and exit points are very carefully managed.

Most important to lasting success will be the ability to capture a portion of up market cycles by buying where risk-reward is favourable and selling again when reward prospects turn for the worse.

At this point we do believe that an expansion will get underway in the next few months. And if the economic evidence continues to support this thesis, going forward we will use market price weakness as an opportunity to buy target assets in accordance with our rule set.

But first we need to see some volume and quality leadership.

A basic tenant of a durable bull cycle is that volume and participation of investors must expand with increasing prices. So far this rally has been lacking this key element. And so long as this continues, the recent rally is vulnerable to a potentially significant correction. Before there can be a more lasting bull market, a larger number of participants will need to buy in.

Institutional and conservative investors who manage large amounts of capital have to date largely watched this rally from the sidelines as traders and speculators have been partying like it's 1999 in late-cycle hot sectors from the last market peak (energy and commodities).

While financials did bounce in March they seemed to stall out in May and have done little since. *No lasting expansion is likely to materialize until the financial sector can lead.* So far, it has been the lower quality, more speculative companies that have attracted the most capital in this rally and this should give grounds for concern.

The chart below of the Canadian market 1998 to present, reveals the dramatic divergence between the price rally since March and the volume decline over the same period.

TSX: volume has been falling as prices have gone up- this is worrisome

Also important to note is that despite the parabolic spike since March, the TSX will have to gain a further 43% from here just to reclaim its prior cycle peak last summer.

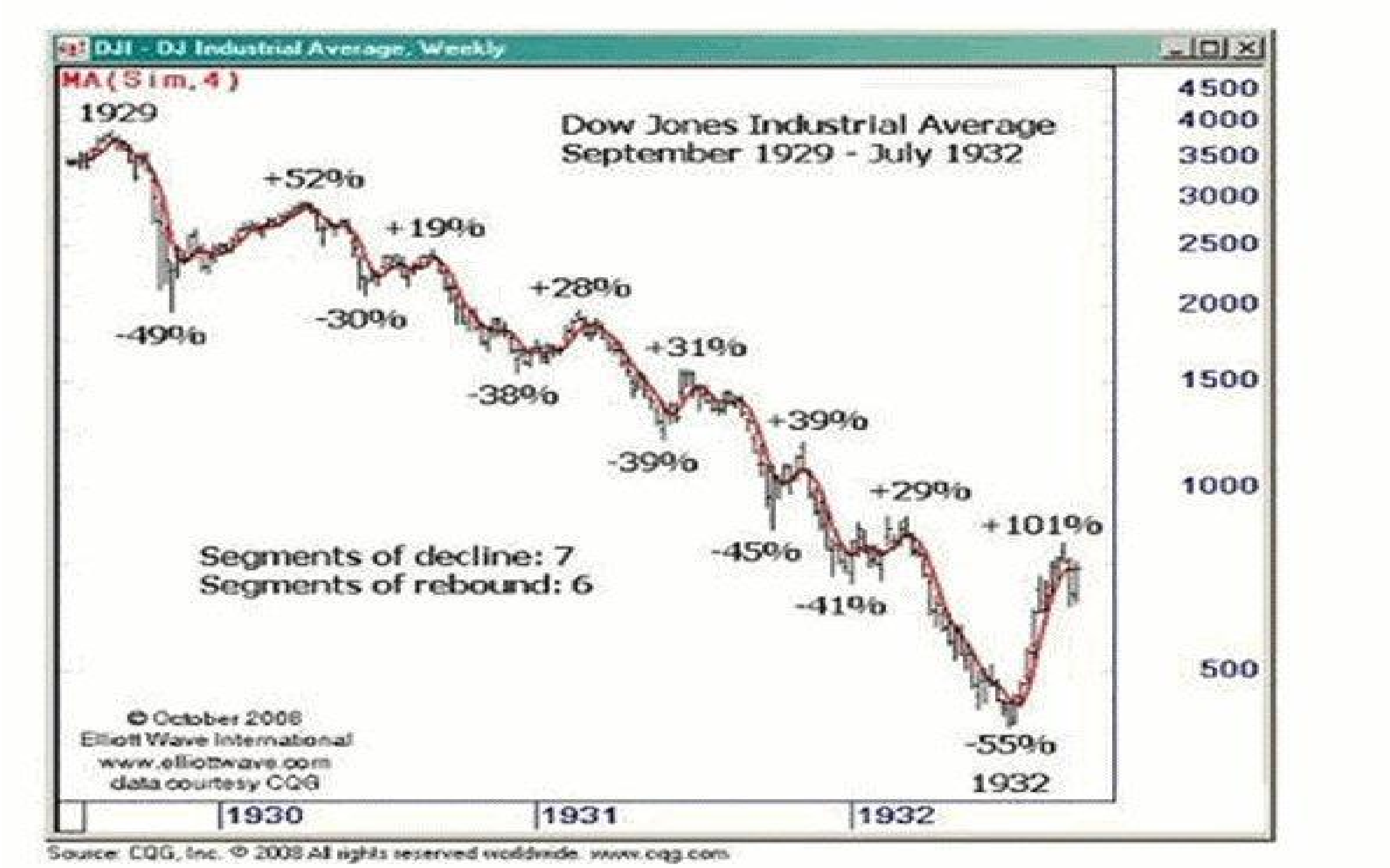
The same negative volume divergence is apparent with the S&P 500 shown below.

From present levels the S&P has to make back a further 55% in order to recover its peak value of nearly two years ago in October 2007.

Another important observation to be made from these longer charts is that today the TSX is still trading below the level it reached in March of 2000 and the S&P 500 is now back at the level first reached in 1998. So lest anyone obsess over what they may have "missed since March", it should be useful to realize that one could have missed the last 10 years or so of equity investing and be much further ahead today than those that have been fully invested throughout.

In addition one must understand that we are in the midst of a market cycle eerily reminiscent of those found during the great secular bears of 1920-1939 and 1960-1982. A review of the price action of the stock market during these prior secular periods ought to give thoughtful people some reason for care.

The Dow 30 Index: bear market rallies and contractions September 1929 to July 1932



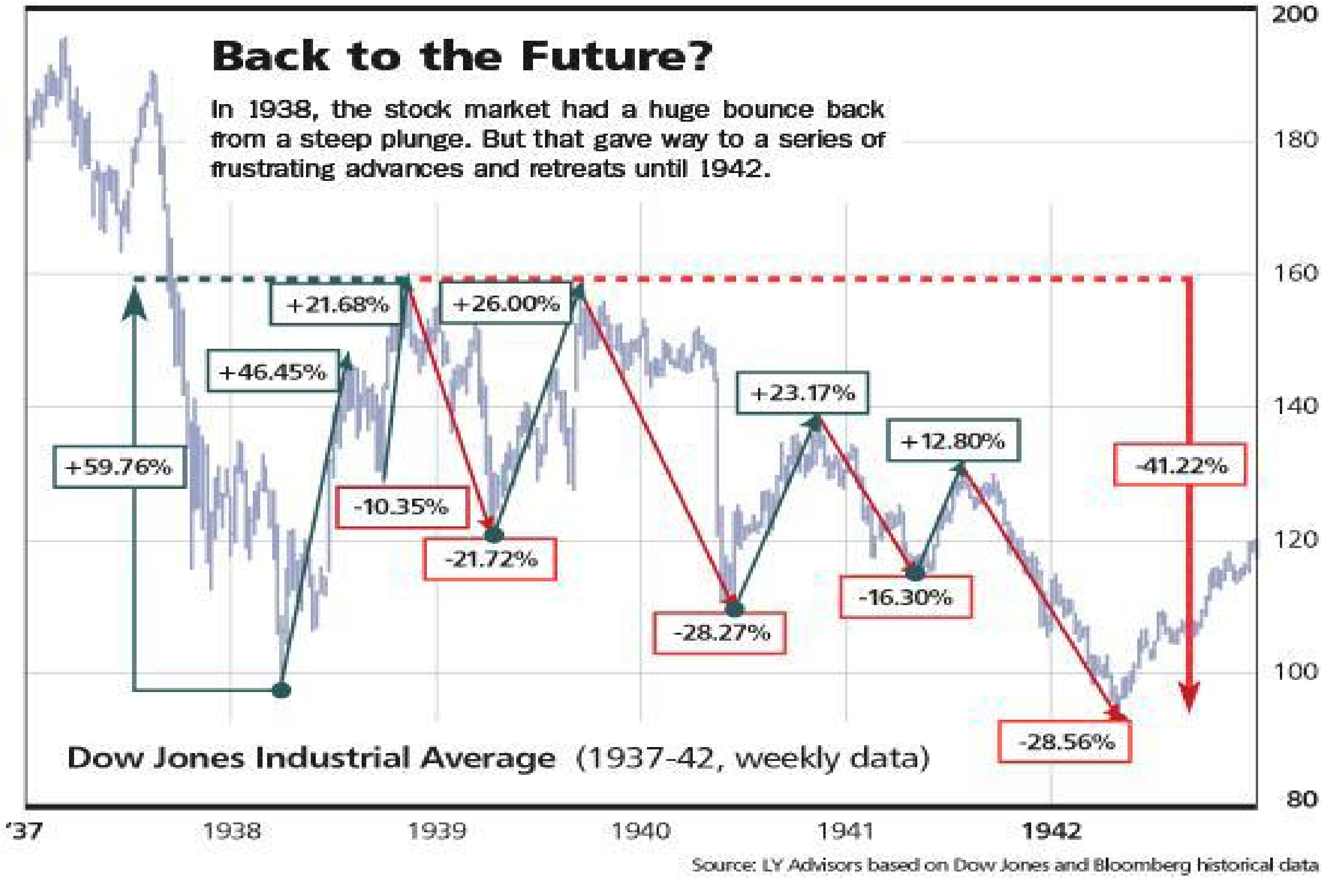
50-year market commentator Richard Russell reminded his readers of the risk in secular bear periods in one of his newsletters last week:

> *"Probably the most famous bear market correction occurred after the 1929 crash. The crash took the Dow from 381 in September 1929, to 198 in October of 1929. From there, an amazing bear market rally carried the Dow to 294 in April 1930.*

Thinking the 1929-30 rally was a resumption of the bull market, traders and investors piled into the market. When the bear market rally finally crumbled, the losses sustained were even worse than those seen during the 1929 crash. ..Remember that following a bear market down-leg, a correction may recoup up to 66% or more of the ground lost during the preceding bear market leg. Because we have not experienced a classic bear market bottom during the bear market so far, I would be particularly cautious about playing the recent "bull signal".”

-Richard Russell, Dow Theory Letters, July 29, 2009

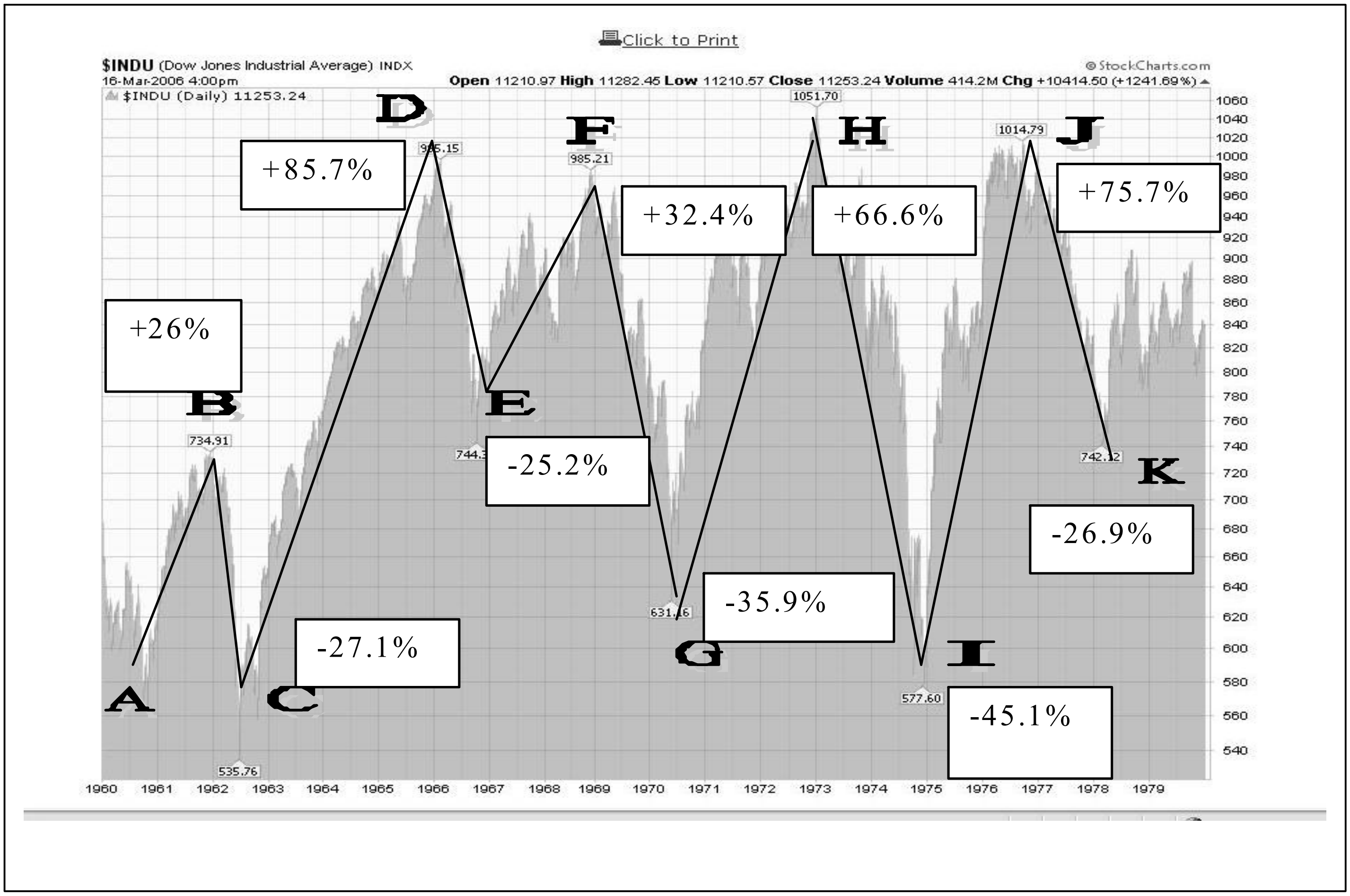
And then there was the Dow from 1937 to 1943.



We included the above chart in last May’s newsletter, but we thought it was worth a second glance given the remarkable similarity between the rally since March and the one experienced in 1938.

The 1920's to '40 were plagued by deflation, while the 1960's-80 were plagued by inflation and yet both periods saw secular bear markets with remarkably similar price action.

Here was the Dow 1960-1982 during that secular bear:



The art of prosperity and wealth preservation during these lengthy, challenging periods has always been patience, care and diligent risk management throughout. These are truly times when tortoises can prevail and hares can be utterly undone.

The cost of being wrong

As money managers we are constantly faced with the cost of being “wrong.” There are two distinct aspects to this. If we miss out on some of a market rally, there is a risk that some clients will be unhappy and decide that we are not doing a good job. We always run the risk that some of these clients will fire us. This is what is known as career risk. Ideally, we would like to keep this number low, but we accept that career risk is a necessary part of managing wealth properly. For us, the cost of looking wrong in the short-term, pales dramatically in comparison to the real cost of being wrong- repeated capital loss.

Given that we must make our risk-management decisions in real time rather than with the luxury of hindsight, we resolved years ago to err in favour of capital preservation first. As hard as this can be at times like now when the market seems to run ahead, we take solace from the fact that over the longer-term our method has served us and our clients very well.

That said, Tech is starting to out-perform the market

We have said for a long time that together with financials, the tech sector leads going into an economic expansion and strength in this early cyclical is one of the more meaningful indicators that the economy may be turning up.

Semiconductors (shown below) lead Tech; Tech leads the market into an expansion.

The above weekly chart of the Semi-conductor Index is showing some promise. If volume can pick up, this would be an important data point in favour of an economic recovery.

We will watch carefully for further evidence in support of this thesis, and where reasonable we will buy price weakness as an opportunity to add further quality assets to our portfolios.

We will have a better sense of the next market phase as this summer ends and more people come back to a greater focus on business. Best wishes for more sun in August!

Sometimes you just have to shake your head and smile:

Quote of the Month:

"*The second mouse gets the cheese."* –author unknown

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