

E.Q Trendwatch™

The plain and complex truth

*“How do you make poor people feel wealthy when wages are stagnant?
You give them cheap loans.”* --Michael Lewis, *The Big Short*



April was a wild month. Not only were there massive upheavals in the physical earth: earthquakes, volcanoes and tornadoes; but people: countries and institutions this month have been moving into a fresh wave of unease and flux. Whether it is the sovereign debt crisis in the EU, Greeks protesting in the streets, Tea Parties and bank closures in the USA, or the SEC versus Goldman Sachs, people are upset and the free world is struggling through uncomfortable revelations and changes.

The plain truth is that there are no easy fixes today. The global economy imploded in 2007 on the culmination of a decade long credit orgy. The deleveraging needed to restore the system back to reasonable health will be underway for several years. People everywhere are awaking from the daze of the past decade to realize that most are poorer than they thought. Many are just plain broke. And the safety systems seemed to fail us.

The tale of our present is a long and complex web. Many sides are complicit in fault. Our present begins with westerners wanting more and Asian people wanting more to eat.

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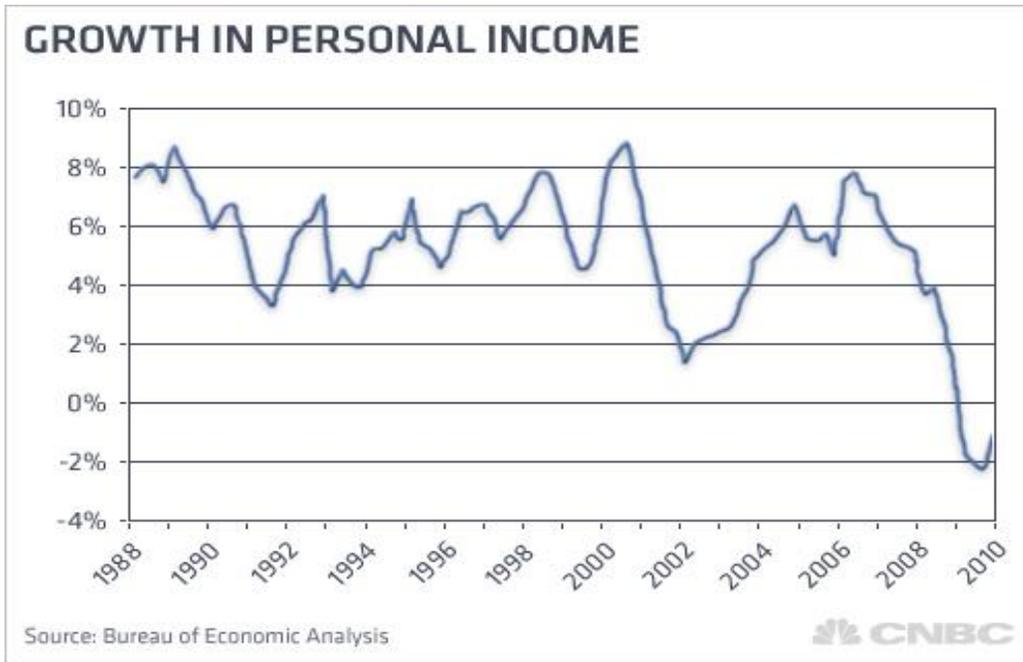
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Asians work for a fraction of western wages and their growth goals are not much impeded by environmental and employment standards. This makes their goods very cheap. The cheaper their goods, the more we bought. The more we bought, the more Asian governments fought to keep their prices low by pegging their currency to the US dollar. The more we bought the more our domestic jobs and wage gains disappeared as shown in this personal income chart since 1988.



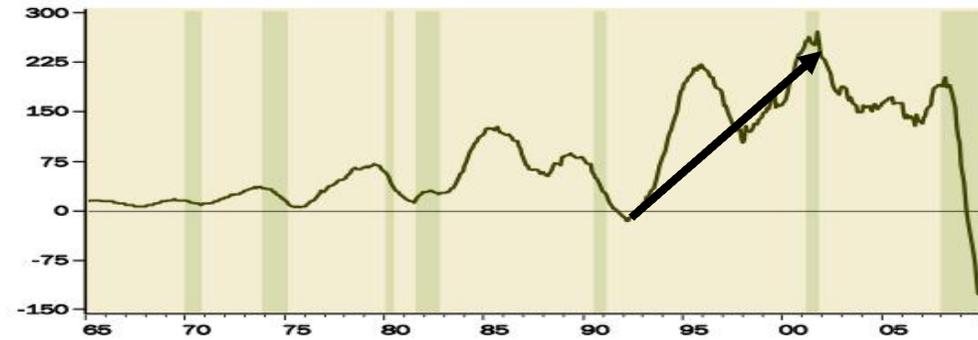
When the tech bubble burst in 2000, Western governments were not able to stem the exodus of jobs. So they needed other ways to keep the masses happy - easy credit was their answer. Our politicians looked to “creative finance” and bankers to help fund the aspirations of the masses. The magic ingredient to stretch available credit past traditional (rational) lending limits was financial derivatives.

The more credit derivatives they created, the more credit was available, and the more we were able to consume. The more we consumed, the more Asian governments collected our cash. The more cash they collected the more they had to recycle back into western assets and currencies and the more they bought our financial assets. The more they bought our financial assets, the more “liquidity” we had to lend to our consumers. Before the pistons blew on the world economy in 2007, our global imbalances seemed like a perfectly symbiotic relationship— both sides got most of what they wanted. But there is a limit to the amount of credit any one family or country can service. Something had to give.

The following chart captures the trend in consumer credit from 1965 to 2010. It is clear to see the large ramp up in leverage from 1993 to 2000, the rebound in 2005-2007 as the housing bubble and creative mortgage financing went into overdrive and then consumer credit plummeting even unto today.

CHART 2: SINCE THE START OF THE RECESSION, CONSUMER CREDIT HAS DECLINED BY \$129BLN

United States: Consumer Credit Outstanding
(18-month percent change, US\$ blns)



Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

During this time of the great leveraging, leverage architects otherwise known as “investment bankers”, came to be widely revered. They were consulted by governments as trusted and savvy advisors. The more our world economy became dependent on debt and ever-increasing leverage, the more we needed financial brokers to keep the proverbial ball rolling. The more debt we had, the more debt we needed, and the more ‘derivative’ solutions the credit magicians invented and sold. When the world ran out of prime borrowers, the magicians figured out ways to fabricate more borrowers through synthetic debt pools that created leverage on leverage on leverage. The credit derivatives market grew from **40 billion in 1996 to 62 trillion by 2008**, making credit derivatives larger than the entire global economy.

Cognitive dissonance?

In watching the Capitol Hill hearings against Goldman Sachs (“GS”) this month, we were reminded of how horrendously little the politicians had understood about the nature of the deal we all made with the credit devil over the past 10 years. Expressing revulsion at evidence that GS had been the self-interested creator of garbage debt derivatives that it had sold to pension funds with no remorse, some of the Senators were vexed and shocked. They declared Goldman no better than a common ‘bookie’.

We couldn’t help but think of the scene in the 1980’s movie Arthur, where an intoxicated Dudley Moore is dining with a young woman he had just met on the street. When she tells him of her terms for hire, he blurts out in disbelief, “You’re a hooker? I thought I was just doing great with you.” Arthur did not understand whom he was dealing with in the same way that governments misunderstood the role of the world’s investment bankers in the past decade. Ironically, this criticism was levelled at GS who had until recently been almost universally praised as the marvel of its peers. Indeed Goldman has a long history of revolving door employment between the company and positions in the American Treasury— back and forth. It is this cozy blur which has prompted some to dub GS “Government Sachs.’ We think it fair to say that this intimate relationship is also a key reason that insurer AIG was bailed out by the American government in 2008 in order that AIG could pay Goldman (and other banks) 100 cents on the dollar for the credit default insurance AIG had underwritten. But we digress.

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One of the defining moments of the GS hearings on Capital Hill April 25 was when Senator Carl Levin was asking Goldman CEO Lloyd Blankfein about the relationship and influence that Goldman and its peers may have had with the now infamous credit rating agencies. The structured products Goldman and others were underwriting were paying hundreds of millions in fees to the rating agencies to secure favourable credit ratings on each issue. (They are still collecting millions in fees from these extend and pretend structures today). Senator Levin asked Blankfein whether he realized how important the ratings given were to the marketability of each tranche: "I don't know," Blankfein said, "I never thought about it." Levin: "you never thought about it? Are you saying it never occurred to you that there were a whole host of pension funds and other institutional buyers that would only be able to purchase these instruments if they were rated AA or AAA?" Blankfein: "I'm saying I just never thought about it."

To us these lines from CEO Blankfein, a Harvard trained lawyer under oath, were reminiscent of the Clinton impeachment hearings and his now famous response also under oath, "I did not have sexual relations with that woman." One has to wonder: could this guy be for real? Could it possibly be true that Blankfein, the now fabulously wealthy son of a postal worker from the Bronx, could have become so far removed from his childhood roots, that he actually did not consider the devastation to public pension plans if they bought toxic mortgage pools under the assurance that they were low risk 'investments'? Could a person really become so detached as to forget the real life postal workers, teachers and firefighters of the world who are depending on pension promises to fund their old age?

Maybe. Maybe powerful, wealthy folks like Blankfein travel in one too many private jets. Maybe they lose touch with all sense of moral obligation and duty of care. Maybe they snap. Or, maybe they were born charming, charismatic, sociopaths from the outset. But one has to wonder: how is it so easy for our society to repeatedly fall in love with people so unworthy of our adoration and respect? Whatever the cause or psychological explanation, there is no doubt that the taxpayers of the world are now left to clean up this mess. And there is no doubt, that the credit bubble and financial crisis of the 2000's will go down in history as one of the most spectacular transfers of generational wealth from the so many to so few.

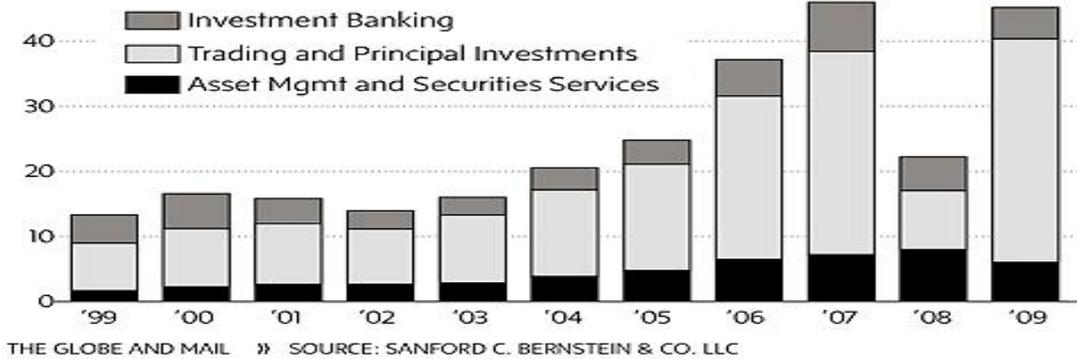
Where is Goldman Sachs leading this market next?

Goldman Sachs and the other large financial firms matter a great deal to the stock market. In many ways, the financials today are the market. They have always tended to lead the market cycle and over the past year this leadership has been true with a vengeance. Most interesting to us is that when you break down the revenue streams that produced the investment bank earnings in 2009, we find that more than 78% came from their own proprietary trading desks (25 year old traders swinging for the fences with levered capital). A miniscule 10% came from traditional lending and investment banking activities (didn't Blankfein call this 'God's work?'). The next chart shows the breakdown in revenues for Goldman Sachs over the past 10 years.

Trading up

In recent years, trading has grown to dominate Goldman Sachs' revenues.

\$50 billion (U.S.)



We also note that the trading revenue in 2009 looks most similar to the trading revenue they were generating in 2007 just before the stock market crashed. Risk seems to be back in vogue all right, and why not? When they win they win huge, and when they lose, the American taxpayer is thrown under the bus to bail them out.

As their trading desks have ramped up risk again this past year, Goldman has led the large financial stocks higher. **Over the past year, 40% of the S&P 500 earnings and 70% of the earnings growth have come from the financial sector itself.** This has been a huge reason for why the stock market has been able to rally so far so fast over the past year, even while the rest of the economy has been struggling to recover. We think it is also important to note that one of the huge aids to the sudden recovery of Goldman and other financials since 2009 was the industry's successful lobbying last spring that moved the Financial Accounting Standards Board (FASB) to suspend 'mark to market' accounting rules for the loan portfolios. In temporarily suspending this important, common sense, accounting rule, FASB has allowed the financial co's to pretend that their loan portfolios have not lost huge chunks of value. In still holding these compromised assets at "model" rather than market value on their books, the financials have so far avoided admitting their losses and writing off the bad debts. As a result they have been able to report massive paper profits and payout performance bonuses (government enabled) to their executives. (Again forgive us, we digress. This is just such a fascinating study of money and human behaviour!)

Getting to our point...

A full 6 months ago in October, we noted that Goldman shares seemed to be running out of buyers. The price stalled and rolled over. Knowing how vital the GS leadership had been to buoying the overall stock market, we wondered aloud, where could Goldman be leading the stock market next? The next chart is of the Goldman share price from its peak in October 2007 to the end of April 2010.



There are two things that really stand out in the above GS chart for us. One is the fact that share price has now failed three times at the overhead resistance it established in May 2008. Most recently it failed to break through again at the beginning of April and even before the SEC announced its charges of fraud against the firm. The second thing which we find noteworthy in this same chart, is the volume line indicated at the bottom. The volume of Goldman shares traded fell off significantly as the price soared from March to October 2009. The large volume spikes since then have been on down days not up. As we have previously written, this waning pattern the past year has been evident in the overall stock market as well, and has been one of the features causing us (and others) to question the sustainability of this rally.

Another barometer of risk appetite: the Chinese stock market has fallen year to date

The other poster child for global recovery hopes this past year has been of course, China. Chinese shares doubled in value from March to December 2009. Then they stalled and have been declining since. As shown in this next chart, the Chinese market has now failed three times to break through the overhead resistance established in May 2008. The Shanghai composite has now fallen 20% from its interim high last year. This should give pause to perma-bulls and especially to the commodity sensitive Canadian stock market in particular. The Chinese market has typically led commodity prices by about 4 months. Shanghai's downturn since December raises concerns for the Canadian market near term. By our best estimate, based on several metrics, the Canadian market is at least 25% over-valued at present levels.



Which brings us next to the Euro zone

As we all recall governments around the globe stepped in to “save” the financial system last spring. They did this by spending hundreds of billions of taxpayer dollars and issuing tons of fresh debt. Through their emergency intervention, governments were able to suspend the de-leveraging cycle of the great recession of 2007-2009. It is not a final fix. Debts were transferred from consumers and banks on to governments. The net effect is that excessive credit has not been paid off or written down so much as it as been transferred from one party to another. The debt is still within the system.

The irony in this is that while governments stepped in to save banks, banks are in fact large holders of government bonds (debt). The plot thickens. With so many banks needing bailouts, governments’ offering to save them was rather like Titanic passengers offering each other their deck chairs. Governments now need bailouts of their own in order to avoid default on their debt. This threatens to put already battered bank balance sheets under further duress. **So governments are being called on to bail out other governments.** Round and round our credit crisis goes.

As shown in the next chart, banks in Germany and France alone are estimated to have a combined exposure of \$119 billion to Greece and \$909 billion to the other four countries, according to data from the Bank for International Settlements. Overall, European banks have \$253 billion in Greece and \$2.1 trillion in the Portugal, Ireland, Greece and Spain “the PIGS”.

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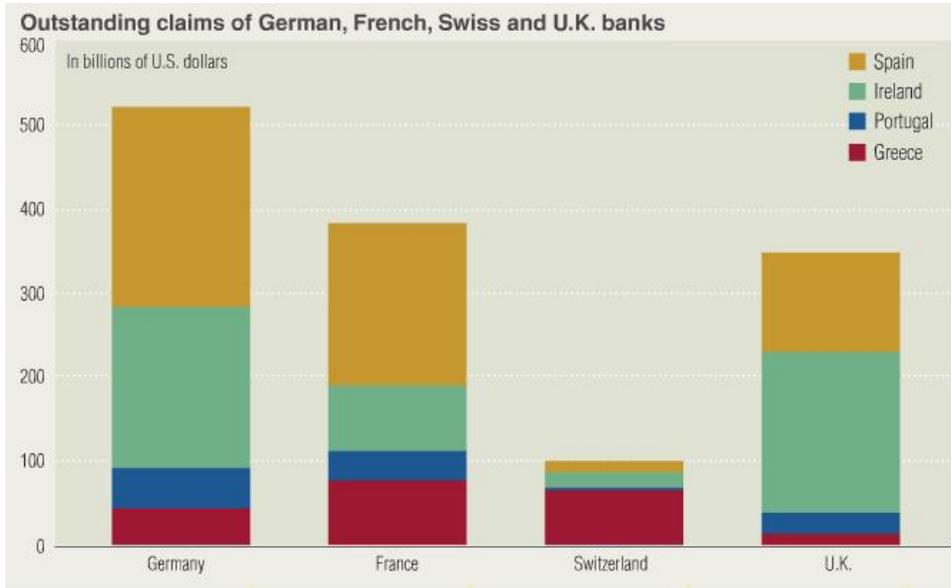


Chart from Societe Generale SA via Bloomberg Finance L.P

If we believed that the world could not afford the collapse of a few key banks, one has to think that sovereign defaults pose a much greater systemic risk. Beyond emergency intervention that will add more debt to already indebted nations, it is really unclear what the longer-term solution will be. Like individuals, over-indebted countries must cut down their expenses to less than their revenue and ramp up their income. Increasing revenue or GDP is extremely hard to do amid tepid global growth and while many nations are cutting back on their government spending and having to slash their work force, wages and pensions and social programs. This is why wise people will tell you that high levels of debt are always eventually a bad thing!

The Euro zone represents about 30% of the world's GDP and it has been a key area of demand for global goods over the past year. Increasing instability there is likely to further contract available credit and be a drag on world demand.

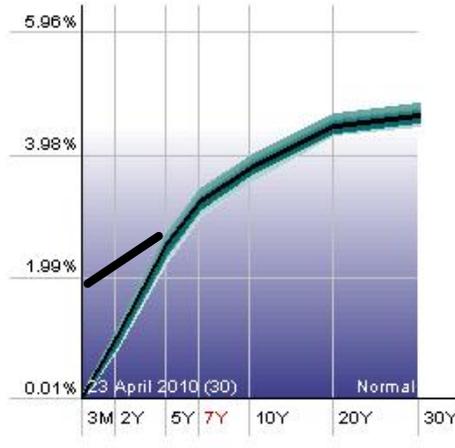
True north heavily indebted

Froth in the Canadian housing market and soaring consumer debt levels are finally becoming a more mainstream topic these days. As our readers will know we have been sounding the alarms on this front for many months (we do tend to be early to worry in these matters). We will not spend further ink on this issue here. What is most relevant for today is the realization that Canadian interest rates are now on the rise. Mortgage rates at all the major banks increased this month. The Bank of Canada has been hinting that hikes in the bank rate are likely to start by June. (Although we still think it likely that they may start hiking and then have to pause or back track again if the recovery slows down). In any event, anticipating increasing rates at the short end, the Canadian bond market has been selling off existing bonds of less than 3 years. This caused us to receive a sell in our work on Canadian (but not yet US) short-term bonds this month. Our largest holding in this category has been the XSB, an ETF of Canadian bonds 1-3 years. Although these units were paying us an income of 3.6%, our concern is always in wanting to protect the capital first. So we have sold the XSB and will await an opportunity to buy it back in the future when prices are more likely to be supportive. This next chart shows the risk at the front end of the yield curve today, where short-term bonds have become over-priced.

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Bond prices at the short end appear over-valued. Yields at the front end of the curve appear to be moving up from government-depressed levels to meet the black line below around 2%. This would mean a continued decline in value for short bonds over the near term. At the same time yields on the longer end of curve have been selling off and are looking more attractive of late. We will look for an opportunity to reallocate some fixed income into the longer end of the yield curve as it flattens out and rates become more attractive. Moving away from the lowest interest rates in a century will be much appreciated by all of us!

Dynamic Yield Curve



We are also watching Natural Gas for a possible near term buy:



The above chart is of the Claymore Natural Gas ETF. This sector was devastated from a high of 32.35 in June 2008 to a low of 3.42 of late. The price has been building a base since last September, and we would not be surprised to see it

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break out as a buy in our work shortly. Technically, several of our indicators on gas have been turning up. Fundamentally, there are also arguments in favour of Nat Gas and especially with the US seeking cleaner, domestic energy to support US employment rather than foreign oil. As a sector this would be a relatively small holding in our accounts, but a recovery even back to support in the 5.88 range would be a worthwhile gain.

In keeping with the roll over in other risk assets, we note the Canadian dollar losing steam of late



After running back to par against the US dollar this month, we note that the Canadian dollar index sold off on significant volume over the last week of April. The US dollar has been strongly gaining against the Euro of late (makes sense amid the Euro turmoil), but we have been patiently waiting for the world to notice that the Canadian dollar has become significantly over-priced the past several months as “hot money” traded into the Loonie. Perhaps that time of recognition is now upon us. A weaker Loonie is needed to help struggling Canadian exports. Lest we forget: a growth recovery cannot survive on our own indebted consumers forever.

And now comes May...let's get outside and breathe the air!

Quotes of the Month:

"When I get ready to talk to people, I spend two thirds of the time thinking what they want to hear and one third thinking about what I want to say." --Abraham Lincoln 1809-1865, 16th President of the United States

"Pennies do not come from heaven. They have to be earned here on earth." –Margaret Thatcher

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