

# E.Q Trendwatch™

## Misplaced confidence



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Judging by the acorns that are hurling onto our deck this month, the fall is close at hand. It is a little sad to see our hemisphere tipping away from the sun again. But it has been a remarkably beautiful summer in our part of the world. We are grateful. Worse things can happen than a little winter, after all.

Last week we learned that US growth in the second quarter decelerated to an annual rate of 1.6% and less than half what the consensus was predicting only a few short months ago. Hoping for miracles, some market followers turned their focus to Ben Bernanke's speech at the Jackson Hole, Wyoming financial symposium for the Fed's next round of promises. We were thinking Ben should have plucked a quote from engineer Scotty's script in the old Star Trek series: "I'm not a bloody magician, Captain!"

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In a less political world, Bennie and the Feds would have said what realists already know: the Feds can't possibly fix the economy. They can't create the jobs that were lost the past few years. They can't make debt disappear. They cannot solve the housing downturn. Private business and workers are the only ones who will right our economic ship, and we will do so through hard work, innovation, perseverance, better habits and the passage of time. We have to stop looking to governments and bankers to pull rabbits out of hats. (After all, misplaced confidence there helped to create our problems in the first place). Collectively we need to get tough, get focused and get to work. And we might as well be patient. Recovery is going to take a few years. In the meantime, we will likely make a little less, spend a little less, bump up savings, and downsize where necessary, in order to adapt.

### **But seriously...what more can the central bank do?**

In the end the Fed Chairman promised to: "use all its tools...to promote the continuation of the economic recovery...the Federal Reserve remains committed to playing its part [Editor's underline] to help the US economy return [Editor's note: "return", as in we aren't there yet!] to sustained noninflationary growth."

In other words they are willing to do what they can. They are part of the team, but they are not in charge. With interest rates already forced down to next to nothing, the Fed can really only try to push them down a little further and hope that helps. They can continue to buy US Treasuries (QE) and other US bonds which supports their price and aims to keep yields (interest rates) artificially low. They have already been doing this for more than a year. They can pay banks literally zero on their reserve deposits (rather than the .25 presently) and hope that this forces banks, who are clinging to cash, to make more loans in the economy. But banks and consumers already have too many loans on their books. Banks need a business case for making more loans. Consumers have to want to borrow. In the present global downturn, neither of these is a given.

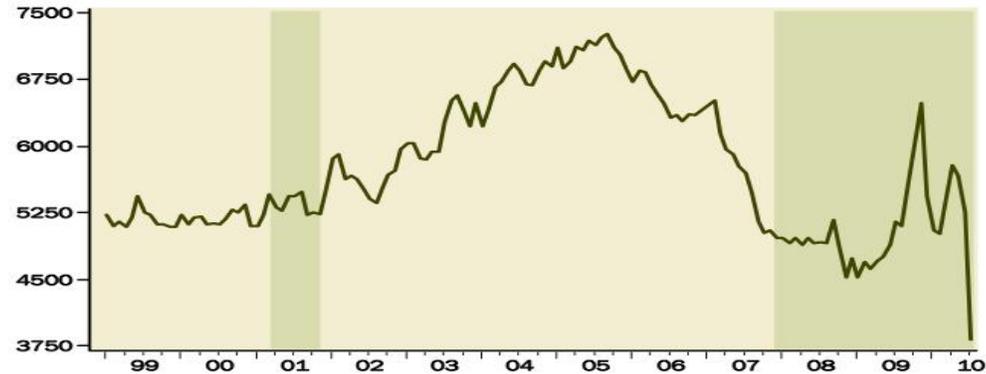
Two thirds into the third quarter of 2010, the consensus view of economists is that US economic growth in Q3 and Q4 will be at a 2.5% annual rate. In reality, it appears most likely that growth peaked in the first month of this quarter (April) and then moved back below 1%. Several indicators suggest that it may now be turning negative as we write. We will not get the first official read on Q3 GDP until the end of October, but the stock market today is pricing for growth north of 1.5% over the second half. There is risk here for considerable disappointment.

### **Record low interest rates are not reviving housing**

As more money flowed into Treasury bonds this month it forced bond yields down further and pushed mortgage rates to their lowest level since Freddie Mac began tracking them in 1971. Those hoping this would stimulate more borrowing were disappointed. It turns out that low rates, after years of low rates, have vanishing returns. After a few quarters of rescue efforts from governments around the world, the housing market is now in its next leg of price decline. As captured in this next chart: record low rates have produced record low home sales. It seems that governments can lead debt-weary consumers to credit, but they cannot make them consume.

**CHART 2: LOOK AT WHAT RECORD LOW MORTGAGE RATES PRODUCED; RECORD LOW SALES**

**United States: Total Existing Home Sales**  
(thousands, seasonally adjusted at an annual rate)

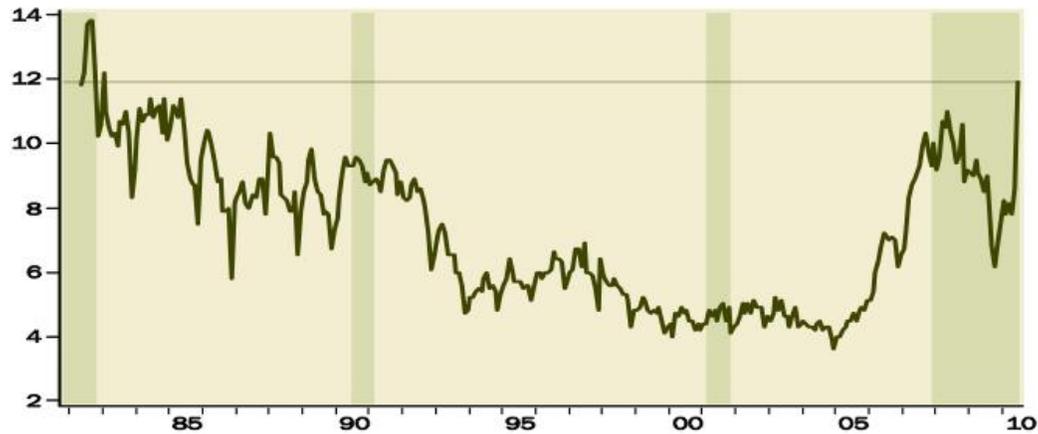


Shaded region represent periods of U.S. recession  
Source: Haver Analytics, Gluskin Sheff

And although the build rate has plummeted from a bubble peak of 2,000,000 units in January 2006 to less than 300,000 units today, the supply of US homes for sale is presently at a 27-year high. (See next chart). There are still way too many houses, and way too little demand to put a floor under prices any time soon. It will take several more years and lower prices before the existing supply can be absorbed by normal household growth.

**CHART 3: HOUSING INVENTORY SKYROCKETED TO A 27-YEAR HIGH**

**United States: Months' Supply of Single-Family Homes on the Market**  
(number of months)



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

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## Low rates and decreased risk appetite are still fuelling the bond rally

As shown in this next chart of the 20 year US Treasury, the bond rally that took off in April of this year is so far still alive and well. We have made some impressive capital gains on our bond holdings this year, and we are always on alert for the inevitable end of this trend. But so far it is showing no signs of weakness just yet. As aging boomers around the world increasingly turn away from unrewarding stock markets they have been looking to bonds as a place to stash savings and collect some (albeit modest) income. Really, after repeatedly negative experiences over the past 11 years, who can blame investors for feeling a little “risk averse” with their savings.



## Stock prices are still relatively too high

As shown in the next chart of price data collected by Robert Schiller for the S&P 500 Index and its predecessors, in terms of relative earnings (P/E multiple), even after massive declines since 2007, stocks today are more expensive than they have been over most of the past 130 years. We would need a further 17% decline just to get back to the historical mean valuation.

## Relative price to earnings of the S&P 500 1880 to present

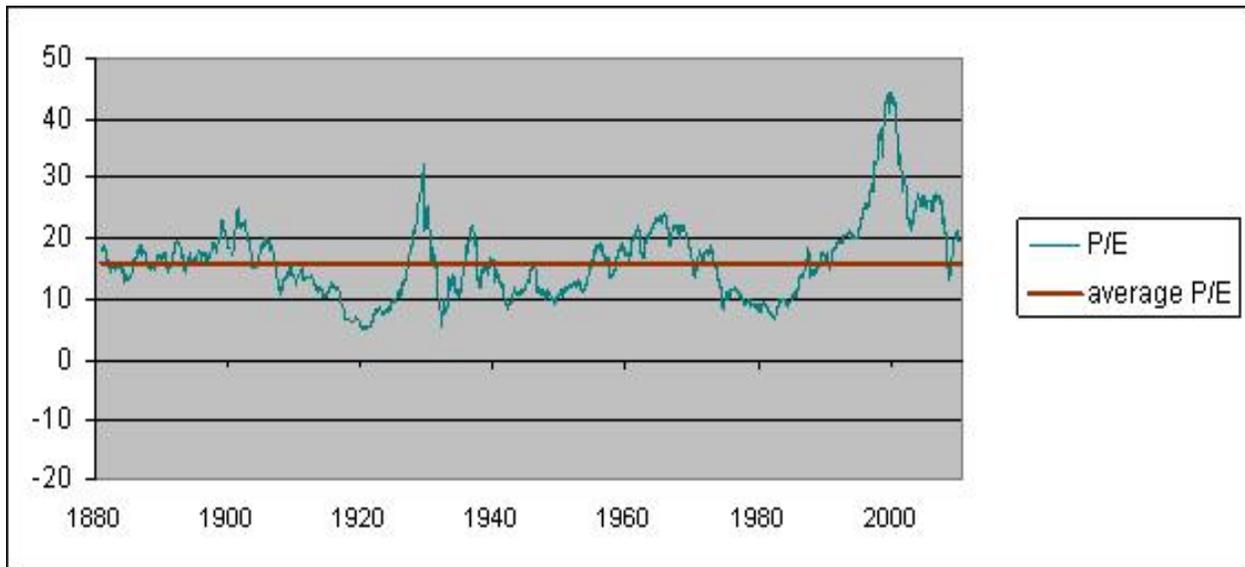


Chart from [www.ftalphaville.ft.com](http://www.ftalphaville.ft.com)

It is important to note however that in every period where stock valuations have heavily over-shot the mean to the upside in the past (1900, 1929, 1940, 1966, 1999) they have then spent many years where values move back below mean. Just returning to the mean (red line above) has never been enough to correct periods of over-valuation. Typically valuations have spent 13-20 years below the red line before the next secular bull phase begins. So although stocks touched the mean for a few short weeks in March 2009, it is highly unlikely that such a short decline will be the final low for stock values ahead. Distasteful as this may seem to those wanting big upside ahead over the next 5-10 years history suggests we have further downside to go before equilibrium is restored to the long-term averages.

### 2010 now eroding the 2009 rally gains

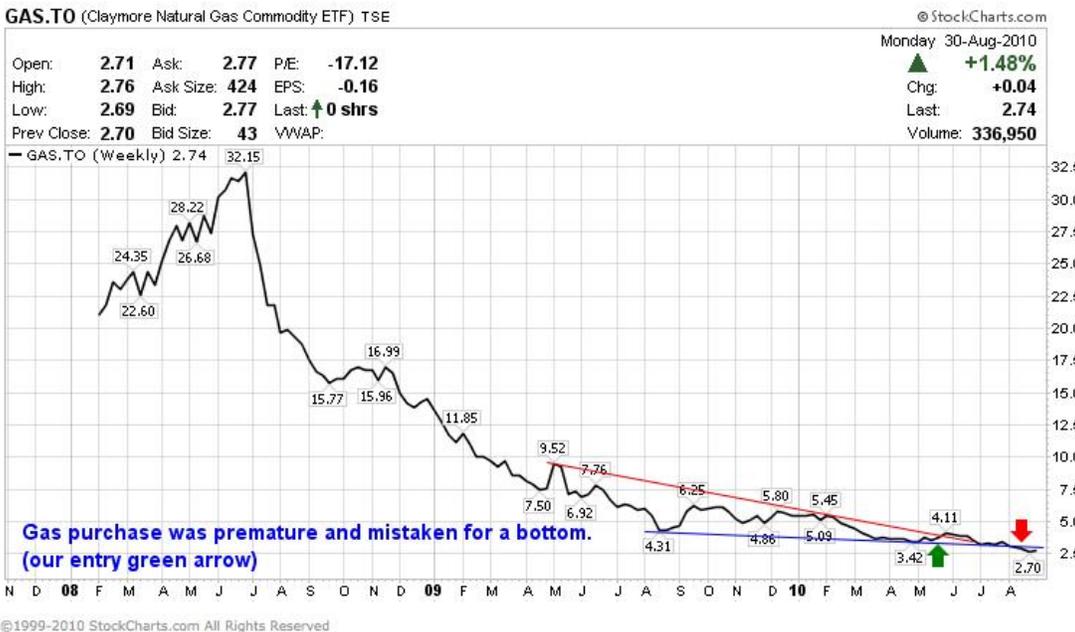
At the end of August stock markets around the globe have lost money year to date and are all now well below their long-term moving averages. This on-going contraction in 2010 is now eroding the gains which took place in the recovery rally during the final 9 months of 2009. Down trends are evident pretty much everywhere around the world and resemble the pattern shown in this next weekly close chart of the S&P 500. At this point we are still thinking a test of the 800 to 950 range on the S&P may be sufficient to initiate the next bear market rally. There is no assurance that this would be a permanent or lasting bottom, but it may prove interim support that could be traded with a reasonable probability of success.



The downtrend in world assets is also playing out in commodity markets. This month sectors, even long beleaguered Natural Gas, broke support triggering a sell in our work. A re-entry point may well present ahead, but for now we will wait this contraction out on the sidelines. As our friend Dennis Gartman says:

“You have no idea how low, low can go.” We have learned over the years to not argue with our sell rules.

**“Bad Gas” alright**



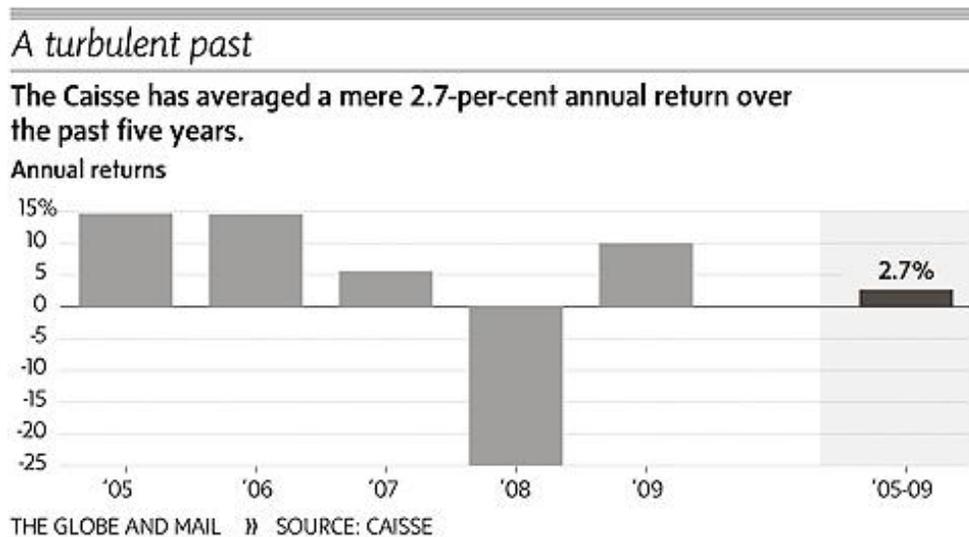
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### More pension managers starting to face facts

This month another one of Canada’s largest pension funds changed course. After losing heavily in bad markets over the past decade, the Caisse board admitted that pushing for double digit returns was getting them no where fast. The Globe and Mail ran with the story “Chastened Caisse seeks new balance”:

*“After suffering a \$40-billion loss in 2008, the Quebec pension fund manager, under CEO Michael Sabia, has worked hard to reduce risk... Fourteen months had passed since Michael Sabia strode into the CEO’s office, charged with turning around one of Quebec’s key financial institutions after a series of disasters...replacing most of the Caisse’s executive team and installing new risk controls. His urgent goal: to protect the Caisse, which manages the assets of 25 provincial funds, including the Quebec Pension Plan, against the type of surprises that led to a \$40-billion loss in 2008 and wiped out a quarter of its portfolio.”*

The below table of investment returns for The Caisse over the past 5 years resembles the experience of the majority of investors and professional managers.



The results also offer a veritable commercial (for our approach at VPIC) for why volatile returns and constant allocations to market risk do not pay during secular bear markets. Drawdown years like 2008 are huge, regular occurrences that wipe out years of investment capital in one fell swoop. This is especially dangerous because few of us amass our savings in a steady, even, annual stream. Most earn, inherit or trigger large lump sums, and often in our later years. When this happens to occur just before a negative market year it typically takes years to grow the capital back. Real-life people simply don’t have the time or the nerves to wait that long.

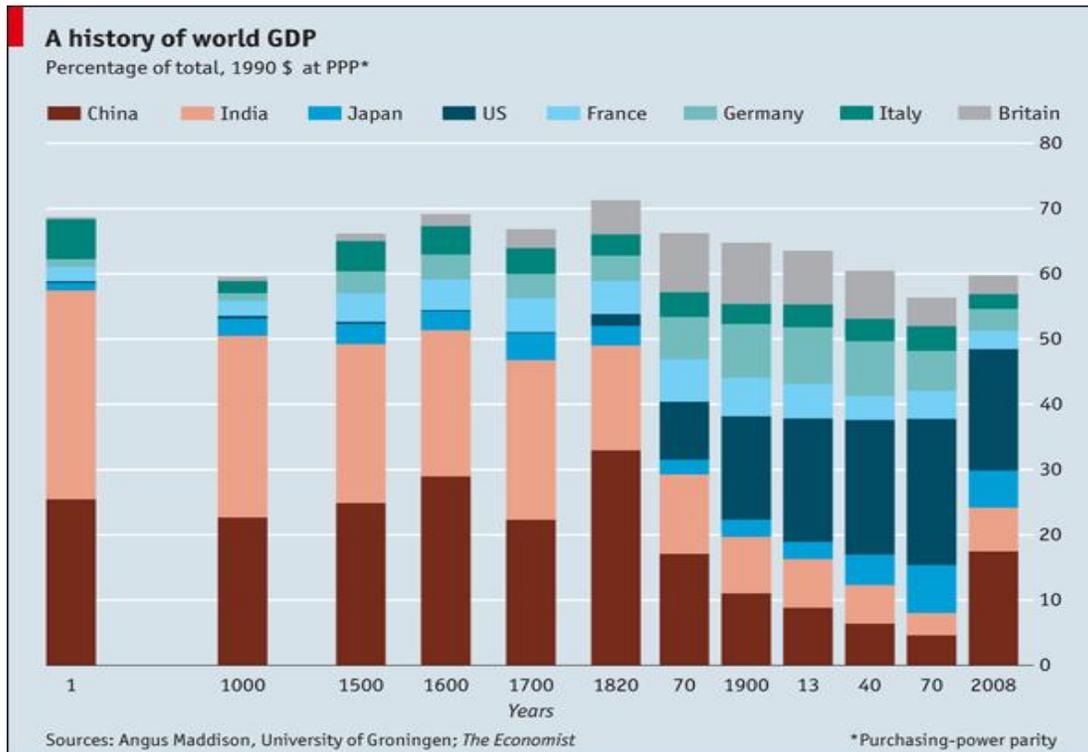
The challenge for pensions today is aggravated since the bulk of their beneficiaries are moving towards retirement and starting to draw income. There is a relatively smaller pool of workers still contributing capital at the same time that investment returns have been below levels anticipated. This confluence of factors means that pensions today actually have a shorter time horizon and lower risk tolerance than 20 years ago, when the boomers were younger and equity markets were still racking up above-average returns. What a difference a decade makes! The new executives at the Caisse seem to be finally catching on as Chief Investment Officer Lescure told the Globe this month:

*“I think that the best way of enhancing long-term returns—not only for the Caisse, but for a lot of investors—is to avoid a year like 2008 ever happening again. Because a year like that can wipe out long-term returns big time. Sometimes mitigating risk is a good way of enhancing return.”*

Our thoughts: Amen. They are finally starting to see the light.

**Chinese economy overtakes Japan as world’s second largest GDP in Q2**

Another story of note this month was that China overtook Japan to become the world’s second biggest economy in Q2 2010 at market exchange rates. China mega-bulls were out in full regale gasping about the insatiable demand of China and how it will inevitably over-take the US as the world’s largest economy. Based on a more accurate measure however, in purchasing-power parity terms, (which describes the tendency for long-term exchange rate movements to reflect long-term changes in relative price levels between countries) shown in the chart below, China and India have in fact been the biggest economies in the world for almost all of the past 2,000 years.



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The issue here is not whether China has a lot of population, it clearly does. The question is always one of relative incremental growth based on increasing consumption. To increase demand in a sustainable trend, consumption behaviour (not just money supply injected by governments) needs to expand. This will take years to build in China, especially where the population is aging and the one child policy has left a significant divot in the productive workforce (consumers) of the future.

### **Dog days of summer moving to an end**

So we come to the end of August with our bond holdings still gaining and world stock markets (which we don't hold) still falling year to date in 2010. The next few months are promising to be an extra-volatile chapter. It is likely that the economic data will continue to come in below expectations for the third and possibly the fourth quarter. The stock market will eventually process and price this reality. For those of us patiently waiting with our buy lists and cash at the ready we look forward to more realistic prices ahead. It is possible they could present us with another good interim entry point to add back some income-paying equities to our portfolios before the end of the year. Yes, we are still likely to be in this secular bear for 5-10 more years, but at this point, we are simply looking for the next interim cyclical expansion that can be traded with some good probability of success. It is coming; it's not a question of if – only when. We know what we want, and we know at what levels. We just can't tell how long that will take.

### **Our beloved assistant, Colleen, is getting married**



(Left to right is Cory, Beth, Beth's husband Paul, Colleen, her spouse to be Trevor, Wendy, Wendy's husband Darren, and Danielle.)

Colleen is getting married on September 24 to a lovely man named Trevor. Congratulations Colleen and Trevor! To celebrate we had a little office party in their honour this month. We include here a snap of the “crew” taken on our deck.

Best wishes for a fabulous fall!

**Quotes of the Month:**

"Live so that you wouldn't be ashamed to sell the family parrot to the town gossip."

*—Will Rogers 1879-1935, Comedian and Actor*

"The indispensable first step to getting the things you want out of life is this: decide what you want."

*--Ben Stein Attorney, Author, Actor and Commentator*

"Achievement seems to be connected with action. Successful men and women keep moving. They make mistakes, but they don't quit."

*—Conrad Hilton, 1887-1979, Founder of Hilton Hotels*

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