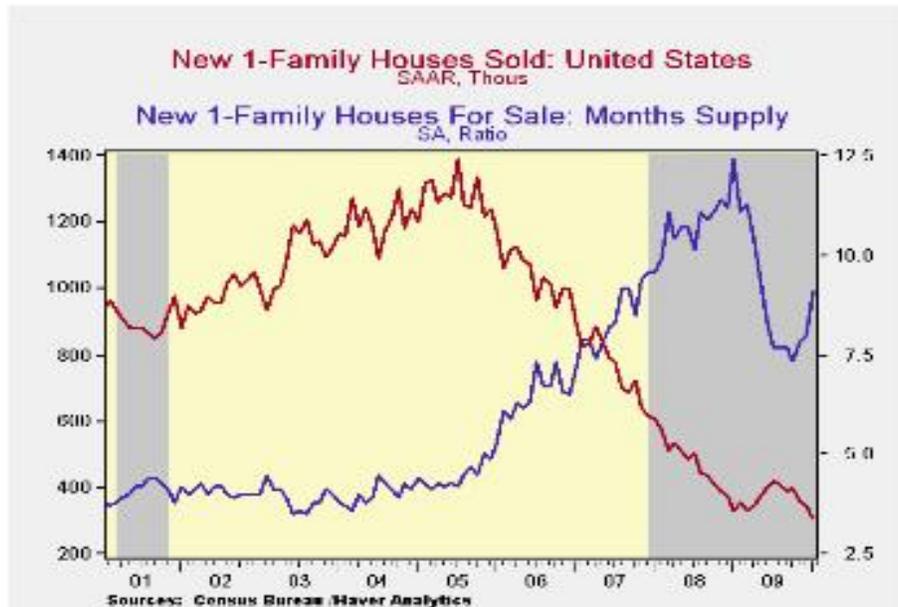


E.Q Trendwatch™

Rocks and hard places

February brought a fresh round of bad economic news. Most reports disappointed to the down side this month. Captured in the chart below, the starkest point is that the US housing market has not bottomed: the number of houses sold resumed its decline this month while the supply of properties for sale resumed its ascent. This is important because virtually every optimistic forecast over the past year has been premised on an expected stabilization in US housing prices in 2010. Without housing market stability the foundation for the promised economic recovery is not yet in place.

Unsold housing inventory still piling up



The unsold backlog of homes, rose to just over 9 months supply in February, and has now been steadily growing again since last October.

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And that’s not counting the “shadow inventory”: homes in default that are not yet on the market.



There are presently millions of additional homes in America where the owners have stopped paying the mortgages, but the banks have not yet completed foreclosure procedures to reclaim the property and re-list it for sale. Numbers suggest that these homes will roughly double the existing supply of properties looking for a buyer. Barring miracles, epic over-supply will necessarily place further downward pressure on property prices, bank earnings and consumer spending. Lower prices will eventually work down inventories. Eventually.

Consumers that spent by leveraging their homes 2002-2007 are now out of cash, under-employed and as reflected in the consumer confidence data this month, increasingly concerned about their future.

US Consumer confidence falls to a fresh low in February



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The U.S. Conference Board's consumer confidence expectations (red line above) ran out of steam in February, with a severe drop from 56.5 to 46.0. This marks the lowest level since April of last year. Even more alarming, the present conditions index (blue line) fell to its lowest level since February of 1983 with a reading of just 19.4 after 25.2 the prior month. A 10-point drop in consumer confidence in a single month has historically led to falling stock prices in the months that follow.

Poor future employment expectations hamper confidence



As shown in the chart above, jobs were seen as hard to get (blue line) by 47.7% of respondents and jobs were seen as plentiful (red) by only 3.6%. That was up just slightly from the series' historic low. Also at a record low was the percentage of respondents who saw business conditions as good. The percentage of consumers who thought business conditions were bad rose to 46.3%, off somewhat from its peak but also nearly the highest since 1983.

For a point of reference on the significance of job losses in this “great recession” (see how comparatively broad the grey recession stripes are in the charts above relative to the duration of previous recessions), we note that for the first time since the Great Depression the American economy has now seen zero job growth in ten full years.

Could all of this be why the S&P 500 has gone nowhere now for 5 months?



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Two months into 2010, equity markets closed February with slightly negative returns year-to-date and are still hovering at the same levels reached last October.

The Canadian stock market seems to have stalled out too



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Our readers will recall that we have been increasingly concerned about weak technical supports to the stock market rally since May. While share prices continued to climb from June to October they rose on ever declining support on several key metrics. Not that such little details trouble the heads of the many perpetually bullish commentators. But for those of us who strive to keep our wits about us, the decoupling of price from underlying support presents ominous capital risk. Some other ‘thinking’ risk analysts have noted similar concerns. Economist David Rosenberg made the following observation this week:

“...from our lens, all we see is a major roller-coaster ride in a stock market that has done diddly-squat for nearly six months now. It’s called a topping formation and to make matters more unnerving, rallies have been on low-volume and sell-offs consistently on high volume and the huge number of distribution days we have endured, sad to say, is symptomatic of a bear market not a bull market.”

–David Rosenberg, February 25, 2010

Only time will tell whether the October to March market stall turns out to be an interim topping pattern before the next corrective leg down. However, as shown in this next chart of copper prices, it appears abundantly fair to say that the odds of “price reconciliation” are mounting with each passing day. Where 2009 was the year of government spending-driven demand and inventory rebuilding, 2010 is shaping up as a year of soaring excess supply. To help demonstrate this point, we offer the following chart of copper.

Copper price (blue) vs. inventories and Chinese demand since 2008



Source: Bloomberg Finance L.P. via Ian Farrell

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As western consumers imploded with the debt bubble, copper prices plummeted from a high of \$4.00 a pound in 2007 to a low of 1.38 in early 2008. Determined to support its export dependent economy, the Chinese government turned on the monetary spigots to literally insist on continued “growth”.

It is hard to imagine the extent of their commitment to this goal. China is a state planned economy. This means that Party officials simply pick a growth target and demand that the economy achieve it. They do this by forcing capital into their monetary system. The government sets lending targets for banks to meet. They set revenue targets for provinces and state run companies to attain--at all costs. This may sound brave and ambitious; in fact it is ridiculous, unsustainable, and doomed to eventually fail in burst bubbles and epic waste.

Over the past year, local-government officials scrambling to meet stipulated targets have wasted endless stimulus funds by replacing infrastructure that was already like new. As an example, State media complained in May 2009 that party chiefs in Jianyang, Sichuan province, decided to boost the local economy by rebuilding a bridge that was in such good condition it had emerged unscathed a year earlier from the earthquake that killed 70,000 people. The so-called Bridge of Strength withstood a demolition crew that tried to blast it to pieces with dynamite. They finally prevailed-- rebuilding a bridge that didn't need building in the first place.

For an illuminating assessment of the bubble that is China, we suggest you take a moment to look at the slide presentation [The mother of all Black Swans](#) by analyst Vitaliy Katsenelson.

While mandated spending spurred a couple of quarters of commodity demand in 2009, inventories are now up to the rafters while consumption demand has virtually flat-lined since October. With prices this over-extended again, we suspect that the downside from here may be considerably lower indeed.

Over-inflated commodity prices (again) present the likelihood of fresh weakness for commodity-linked markets and currencies such as the Canadian dollar. Sound familiar? We can't help feeling like its some kind of sick Groundhog Day. This was precisely the largest risk facing the Canadian stock and commodity markets in early 2008, only two years ago just before our markets had a major melt down wiping out 50% of Canadian stock values and upwards to 70% off commodities like oil and copper. In a normal cycle we would not expect to be back to this level of price risk for Canada until late in an expansion some 4-5 years from the last downturn. However thanks to all of the extraordinary efforts of governments to force false demand and 'growth' we are back at this point of price euphoria and risk less than 1 year after the last implosion.

Canadian dollar still looks over-bought relative to the rebounding US dollar



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As we had expected, the US dollar has continued to rebound this month against a basket of foreign currencies, and particularly as against the Euro. Although at a more muted pace than against the Euro, the US dollar has also made gains as against the Canadian dollar as shown in the chart above. From a low of .71 on the US/C\$ index in October 2009, the US dollar has now rebounded to .86 as against the Canadian dollar. If this rebound trend for the Greenback is able to continue we are anticipating a buy within the not too distant future.

Weakness in the Canadian dollar would eventually be supportive of a recovery in demand for Canadian exports and so helpful to the Canadian economy. Actually a strengthening US dollar is supportive of a recovery for most other countries; most of who benefit from exports to America. So hopefully the US\$ will continue to find some legs for a while; the Canadian government—now slipping into mounting deficits—is praying for it!

Meanwhile our concern about increasing household debt in Canada continues to mount. It seems that our recently frothy housing markets have elongated a perilous trend in Canadian spending habits courtesy of more and more debt. The below chart of personal lines of credit in Canada since 2008 captures the concerning trend with a 39% increase in line of credit balances over the past 21 months. These trends have ended badly in the rest of the world. The longer this goes on, the harder our economic pain will be. Why oh why can't we humans learn from the mistakes of others?

This line of credit is still going the wrong direction in Canada!



A decade ago, many rich countries were running small budget surpluses. The recent global recession has seen a surge towards deficits as governments increased their spending to counter the drop in private-sector demand and the fall in tax revenues. As economies eventually pull out of recession, government spending will have to be cut. Hopefully tax revenues will rise from increasing revenue. No doubt there will be tax increases. But paying off debts will be a long and tedious task for households and countries and will weigh on the global economy for a few years to come.

Savers today: rocks and hard places

In secular bear climates like this one, a focus on income paying assets rather than pure capital gain plays is generally defensive and prudent. Presently, with interest rates at 70-year lows (!) and cash equivalents earning less than 1%, there is an obvious impetus to look to higher risk instruments like dividend paying equities to provide income. *If only it could be that simple.* Thanks to the big spike up in the past year, dividend-paying stocks and higher yielding bonds are once again generally over-priced and full of risk to investment capital today.

Governments have been holding interest rates at virtually zero for over a year now to try and prevent asset prices (real estate, bonds, stocks) from fulfilling their necessary destiny toward price correction. In the end they won't be successful. Secular bear periods serve to take economies and asset prices from periods of dramatic over-supply and over-valuation to periods of under-supply and attractive valuation. This is the natural self-correcting mechanism that has played out repeatedly through market history. No government has ever been able to stop the correction process, but given human aversion to short term pain, many have tried and have frequently succeeded in elongating the pain.

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What world governments have achieved in 2009 was to temporarily re-inflate some asset bubbles through increased debt. This served to temporarily suspend the secular bear market with a dramatic spike up in some prices. But they have done so at the expense of savers. They have done so at the expense of those who have amassed large parts of our life fortune already and seek to preserve our capital. They have encouraged asset speculators at the expense of investors.

So what is a careful investor to do? We stick to our discipline. We keep taking rational measurements and we don't allow our pension capital to fall down the slippery slope of speculation. Here is what the father of value investing Ben Graham had to say about this in 1949:

“The individual investor should act consistently as an investor and not as a speculator. This means that he should be able to justify every purchase he makes and each price he pays by impersonal, objective reasoning that satisfies him that he is getting more than his money's worth for his purchase.”
--Benjamin Graham (1894-1976)

When there is little that satisfies our criteria, we have to wait and we have to be content to collect whatever income flows from guaranteed rates while we wait. Impatience is a plague. Less risk, no debt, and where necessary—less spending are the keys to surviving in tact through these once in a lifetime conditions.

So far 2010 has arrived as a year to batten down the hatches again. We can see attractive opportunities coming; but they are not here yet. While the storm in world markets abated in 2009 we believe that it has not yet passed. As boring as it may seem, we will opt for safe over sorry.

Quotes of the Month:

“All of the great leaders have had one characteristic in common: it was the willingness to confront unequivocally the major anxiety of their people in their time. This, and not much else, is the essence of leadership.”
--John Kenneth Galbraith (1908-2006)

“Our bravest and best lessons are not learned through success, but through misadventure.”
--Amos Bronson Alcott (1799-1888)

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