

E.Q Trendwatch™

Obama gets a warning shot

Paul Volcker Tells Obama To Go After the Banks



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President Obama received a political espresso this month when the democrats lost the Massachusetts Senate seat and their 60-40 supermajority. A democratic seat for 40 years under Ted Kennedy, the Massachusetts loss was an upset.

Apparently Americans are becoming disenchanted with their new President; his approval ratings have plummeted over the past few months. There is no doubt that he inherited tall orders and a difficult time. But it seems that working people, who were inspired by the hope of Obama, are starting to lose faith.

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We ourselves have been deeply troubled the past few months as we watched the new leader seemingly engulfed in a scrum of key bank advocates including “Tiny Tim” Geithner and Goldman Sachs alumni.

Time does fly. But for a man who ran on the mantra of ‘change’ there seems to be little of it in Obama’s first year. Perhaps the Massachusetts loss has now re-focused his mind on his ultimate political risk: losing the trust of the people who voted for him.

Not coincidentally, the day after the Massachusetts upset, Obama held a press conference to announce the first serious proposal for substantive bank reforms since the credit crisis started. Standing by the President’s side for the announcement was none other than the legendary former Federal Reserve Chairman “Tall Paul” Volcker. Standing at just over 6’7” and now 82 years old, Volcker famously led the US Federal Reserve from 1979-1987 when it pursued a restrictive and ultimately successful monetary policy to combat inflation during a notorious period of stagnant growth and stubborn unemployment. Volcker was succeeded as Federal Reserve chairman by “Easy Al” Greenspan in 1987.

Volcker’s tough actions are generally credited as key to leading a weak economy into an era of sustained prosperity through the 80’s and ‘90’s. Volcker offers Team Obama something that most of its other members lack: a track record for making tough unpopular decisions accepting short-term pain for longer-term gain.

A deliberate step, Obama proposed the “Volcker rule” to reinstate long-standing restrictions on banks similar to the Glass-Steagall Act which had separated traditional lending activities from speculative trading operations. Motivated by the pain of the Great Depression, the Glass-Steagall Act had protected the financial system for more than 60 years but was over-turned in 1990 at the urging of banks who said it placed undue restrictions on them, their leverage and opportunities for profit, (yes this was precisely the point). Nevertheless wisdom failed, the lobbyist succeeded and the rest is now our present.

Volcker had first proposed the need to reinstate Glass-Steagall when Obama was campaigning for the Oval office and announced Volcker as one of his key “financial advisors”. Unfortunately once Obama was elected, Tall Paul was back-benched and more Wall Street friendly characters were ushered to the fore. The ‘Volcker rule’ announcement last week was a carefully orchestrated signal to the public of a new arms-length intention between Obama and the bankers.

But actions will be harder than eloquent words. All choices from here will be painful:

“Those who spend more than they earn need to maintain excellent relations with their bankers. Over the past few decades, North American governments have become increasingly dependent on the kindness of lenders. Such support now forms the bedrock of our incredibly indebted nations. Spend-thrift leaders are repeatedly elected to help the masses spend our way to prosperity...a leader who suggests a life of restraint and paying down debt is, so far, unlikely to win the popular vote. The financial machine provides the products and the funding to support the vision of the have mores. And so the vested interests favour the continued borrowing and spending of today without worrying about tomorrow.”

--Juggling Dynamite, D. Park, p. 70. February 2007

Clearly, announcing tough proposals to re-order the banking system and getting new rules actually legislated are worlds apart. It will be some time before we know what actually comes of the recent proposals. But one thing is clear - after the fire storm that hit the world the past three years and the overhang that will linger for some time, the issue of financial reform is not going away. Government officials are stuck in a very tenuous spot. The public wants job creation, and fiscal restraint; and they are mad as hell at the bankers. If governments fail to deliver reform and growth it is likely to pack a dangerous blow to future election prospects. Politicians are all very nervous. In some countries they risk civil revolt.

The stock market takes the opportunity to sell off

The stock market seized the recent spate of rhetoric and political jostling as an excuse to take a much-deserved leg down. But as [John Hussman](#) so eloquently put it:

“...blaming last week’s decline on the proposed Volcker Rule, or on fears of Bernanke’s non-confirmation is like blaming a particular gust of wind for knocking a sideways nickel off of a flagpole. When the market is as extended as the current market has become, a thousand events can act as triggers for abrupt weakness, and it makes little sense to single out any particular one.”

Stock, commodity and high yield debt markets the past several months have been pricing in a miraculous economic recovery and quick cure to the world’s leverage/debt driven economic woes. This month the weight of the evidence against such an outcome seemed to finally hit a tipping point:

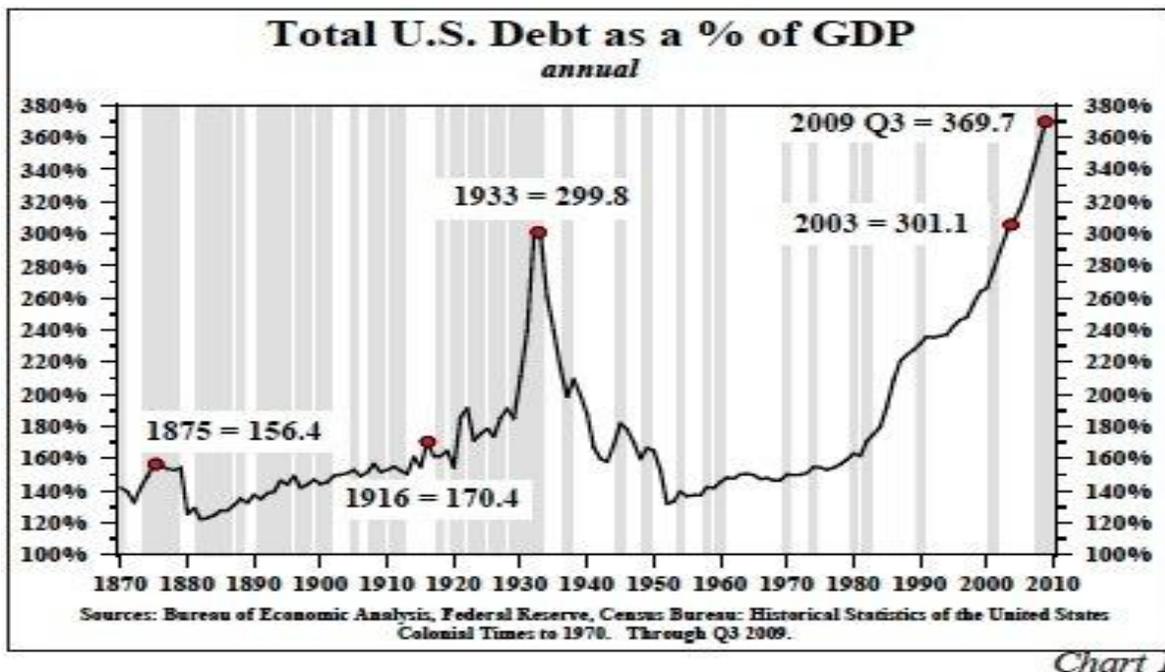
as many prices broke down through key technical supports on soaring (2 x the average) volume.

Losses have been almost universal across the world this month. The Shanghai Composite Index lead the way with a drop of more than 10%, closing below its 200 day moving average for the first time since 2007.

This week we at VPIC confirmed sell signals on our technical metrics for all but one of our equity holdings (Canadian REITS-have held up this week, although we suspect they too may break down shortly). We have learned over the years not to argue with our sell signals and so we sold, quite content to take rather remarkable profits on positions that we bought just last February. We suspect that after 10 months of rebound interlude, the primary trend of this bear market may now be re-asserting itself. That said we should expect to still see some periods of rebound in the days or weeks ahead. The issue here is that the rising trend lines that began last March and supported this rally into January have now been broken and support has now become over-head resistance. Humble caution is in order. Here, here.

The truth is that ‘debt disease’ is not cured quickly:

As shown in the chart below since 1870, US total Debt (government + private) as a percentage of Gross Domestic Product (GDP) is now at an all time high of more than 370%; even higher than the all time high achieved on this metric in 1933.



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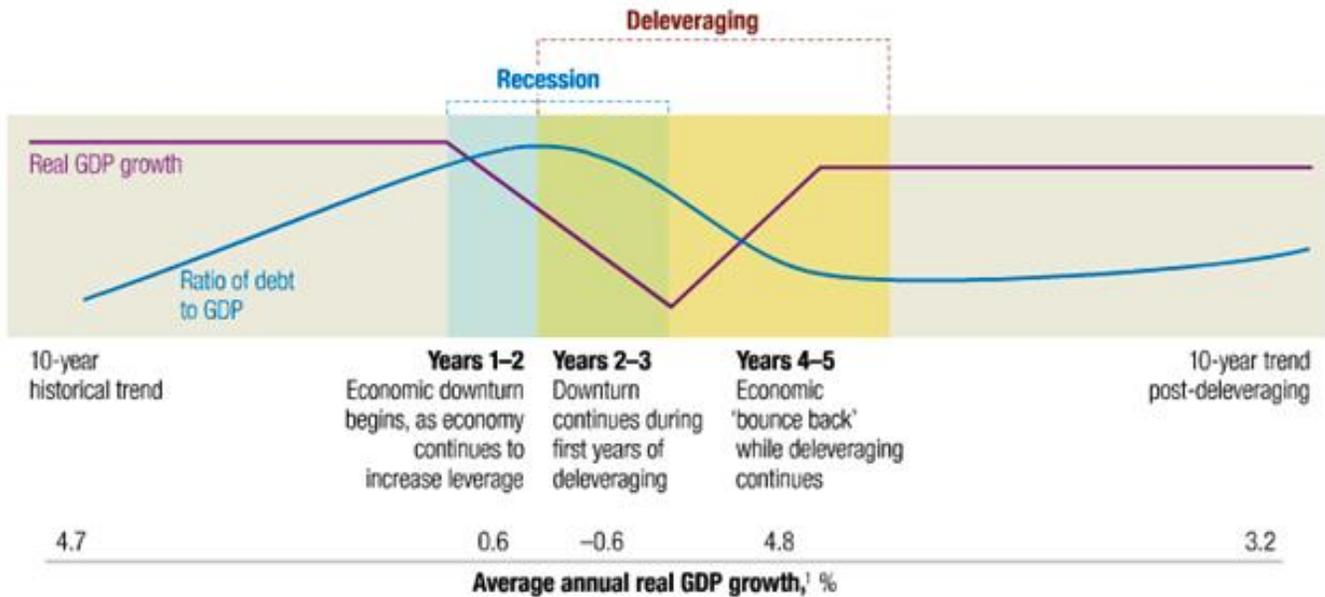
This month, independent global think tank, the McKinsey Global Institute released a detailed report: *“Debt and deleveraging: the global credit bubble and its economic consequences”* based on a study of 45 previous deleveraging periods since 1930. McKinsey compiled an extensive fact base on ten mature and four emerging economies. Their analysis adds greater perspective to the picture of how leverage grew around the world before the crisis, and how the process of reducing it could unfold. Their conclusion is that more than 3 years after this credit crisis began to unravel: the **“deleveraging process has barely begun”**.

Some of their key findings:

- *Leverage levels are still very high in some sectors of several countries—and this is a global problem, not just a U.S. one. (see debt/GDP levels of other major economies via chart ahead)*
- *Empirically, a long period of deleveraging nearly always follows a major financial crisis.*
- *Deleveraging episodes are painful, lasting six to seven years on average and reducing the ratio of debt to GDP by 25 percent. GDP typically contracts during the first several years and then recovers.*
- *If history is a guide, many years of debt reduction are expected in specific sectors of some of the world’s largest economies, and this process will exert a significant drag on GDP growth.*
- *The right tools could have identified the unsustainable build-up of leverage in pockets of several economies in the years leading up to the crisis. Policy makers should work to develop a more robust system for tracking leverage at a granular level across countries and over time. One needs to look at specific metrics such as the growth of leverage, and the borrowers' ability to service debt if there is a disruption to income or rise in interest rates. MGI found that sufficiently granular data do not exist today.*
- *Coping with pockets of deleveraging is also a challenge for business executives. The process portends a prolonged period in which credit is less available and more costly, altering the viability of some of business models and changing the attractiveness of different types of investments. In historic episodes, private investment was often quite low for the duration of deleveraging. Today, the household sectors of several countries have a high likelihood of deleveraging. If this happens, consumption growth will likely be slower than the pre-crisis trend, and spending patterns will shift. Consumer-facing businesses have already seen a shift in spending toward value-oriented goods and away from luxury goods and this new pattern may persist while households repair their balance sheets. Business leaders will need flexibility to respond to such shifts.*

The following chart is their picture of the multi-year “process” of deleveraging an economy:

Illustration of impact of deleveraging on GDP growth



¹For “belt tightening” scenario (historically, the most common path). This scenario involves a prolonged period of austerity when most countries experience some growth in credit, but at a pace far below pre-crisis rates of growth and slower than nominal GDP growth.

Source: International Monetary Fund (IMF); McKinsey Global Institute analysis

If the historical pattern holds this time, the world economy would just now be entering year 2-3 of the cycle shown above and we should expect that economic growth will continue to contract for another year or so. In this environment inflation is unlikely to pick up and governments will want to hold interest rates low for some time.

As we discussed last month, although deleveraging of the consumer has been underway in several countries for the past 2 years, that debt has not actually disappeared. Rather it has so far been just transferred on to financial institutions in the form of bad loans and on to governments in the form of increased debt caused by deficit spending, bail-outs and plunging tax revenue.

As captured in this next chart, the US is not alone in its plight, most developed countries are now suffering from heavy multiples of debt to GDP—conservative Canada is at 259%.

Developing countries like India, Brazil and China remain about half as indebted as more developed

nations and although they are heavily dependent on foreign demand for their growth, coming into this crisis with less debt means they are better able to finance stimulus spending now.

2009 total debt to GDP for key countries

Country	2009 Total Debt (% of GDP)
India	129
Brazil	142
China	159
Canada	259
Germany	285
United States	300
United Kingdom	466
Japan	471

Source: McKinsey Global Institute

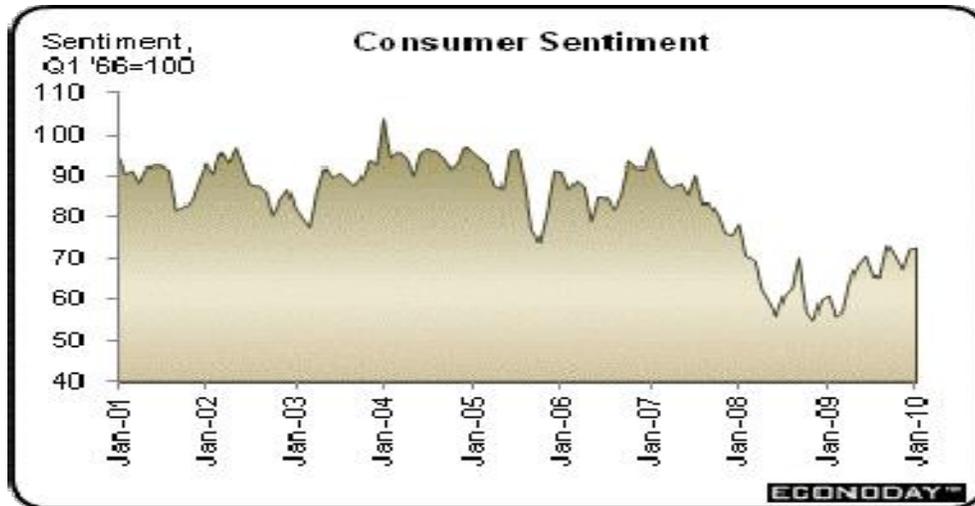
Chart 2

In addition there are some countries (such as Canada and Australia) where the consumer is still adding to their debt levels at this point. The McKinsey report named Spain, the UK, South Korea and Canada along with the US, as being the top five economies with the highest likelihood of deleveraging over the next several years.

Main Street will be hurting for some time

Despite all the strong words and massive fiscal spending, as shown in the next chart, two years into this economic downturn consumer sentiment on Main Street is still far worse than the last recessionary period.

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Present poor sentiment can be directly linked to the fact that after unprecedented government injections into the financial system, unemployment levels remain high and rising. The ratio of Americans working today as a percentage of the population is still falling, now at the lowest levels since 1983. With no job growth likely for perhaps another year, we can expect employment ratios to drop through at least 2010; and to stay low for probably a few years. (See chart below)

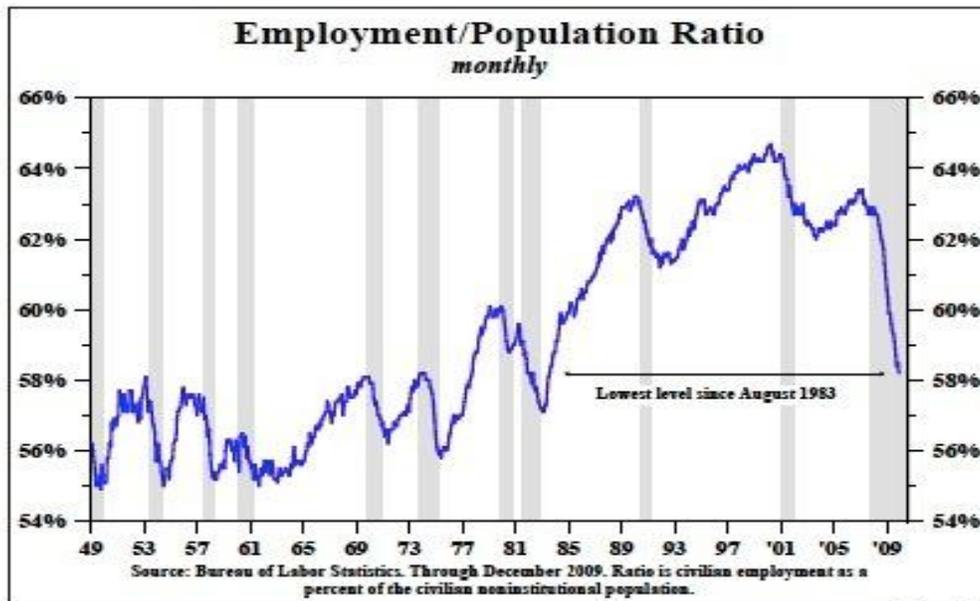
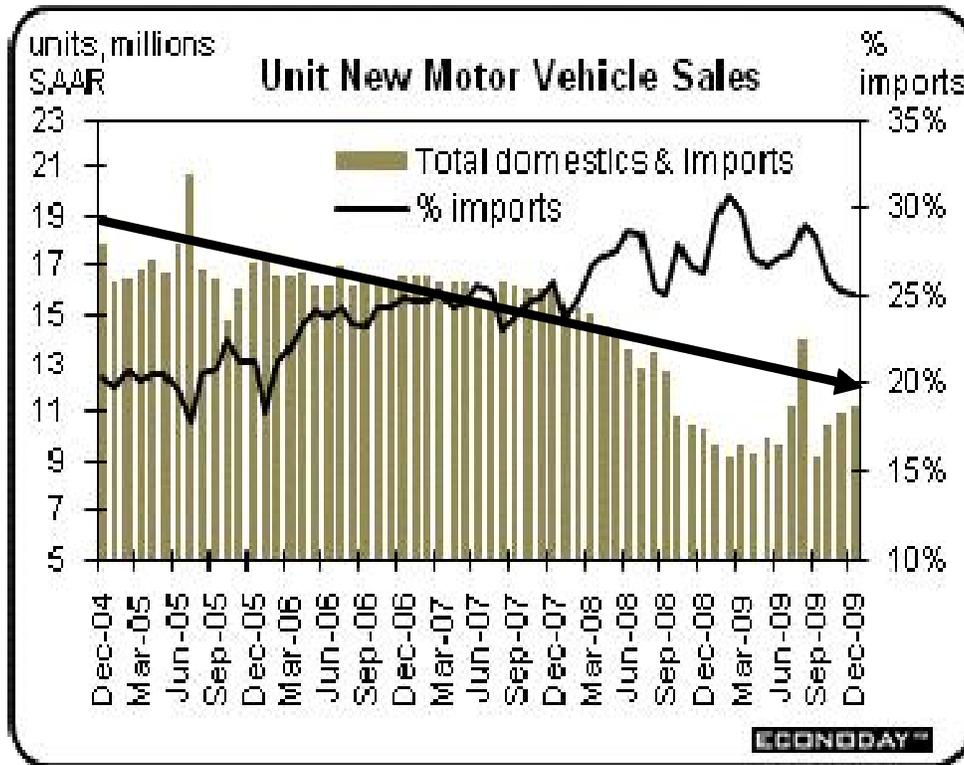


Chart 5

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People who are worried about their income and don't have savings don't buy cars, houses and other big-ticket items. They also don't shop, travel and eat out as often:

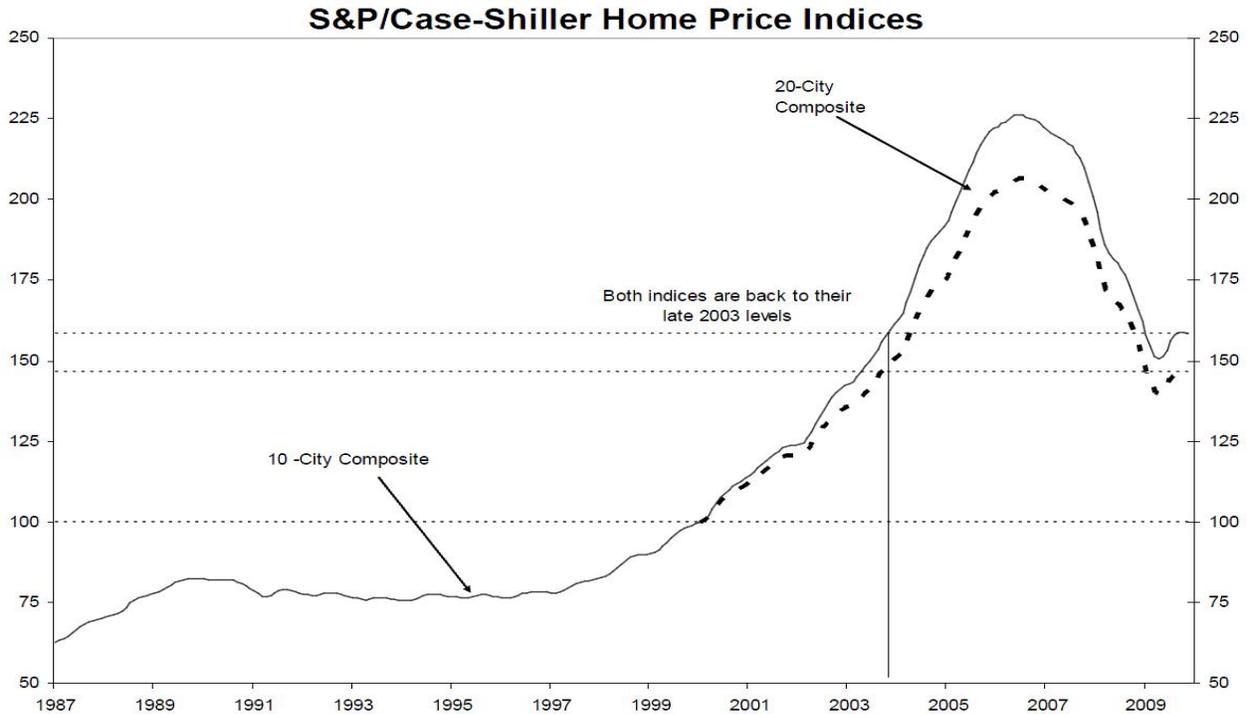


Despite all the high hopes about programs like “cash for clunkers”, as shown in the chart above, motor vehicle sales have not rebounded to previous levels and are presently lower than in 1994. Meanwhile Americans are buying more imported cars than ever before, presumably motivated by a search for greater fuel efficiency. (Who can blame them for that?)

US Housing prices are still falling-- at a slower pace—but still falling.

This month's Case-Shiller release showed that to the end of November, US home prices were still declining year over year, now back at levels seen in 2003-- 7 years ago. And declines are not likely finished yet, with key metrics suggesting another 10-15% decline in home prices may be still in order.

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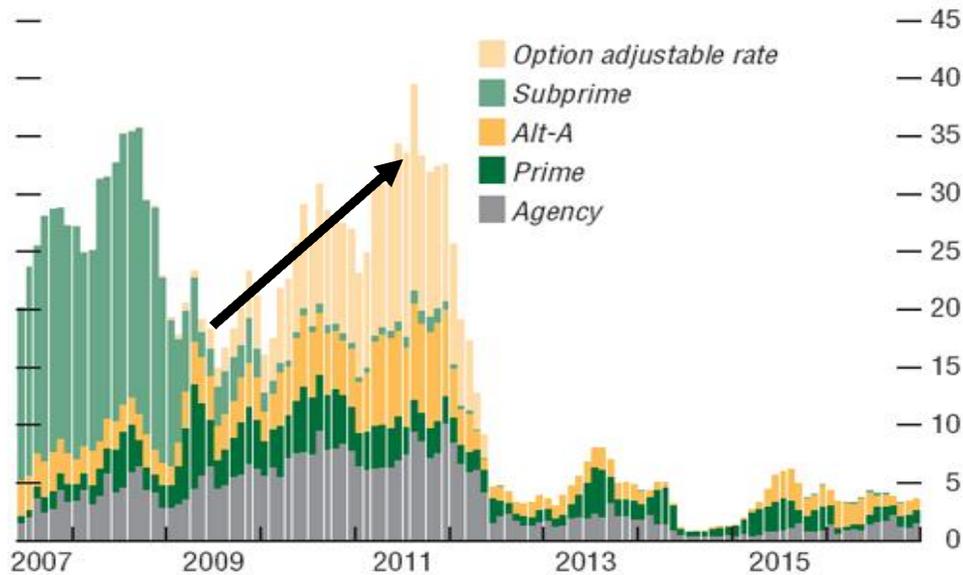


The next major wave of mortgage defaults is now underway

This month, Realty Trac released their December 2009 report showing a 14% jump in mortgage delinquencies over the preceding month. Although there continued to be a massive back-log of foreclosure proceedings in December, the number of filings still managed to hit a fresh record high causing VP Rick Sharga to point out that the default data is "setting new records almost every day...the problem is getting worse...we are in the second wave of a three wave foreclosure cycle."

The below chart (which we have referred to in previous newsletters) reminds us of the next big wave of mortgage resets destined to hit the US property market from now through 2011.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)

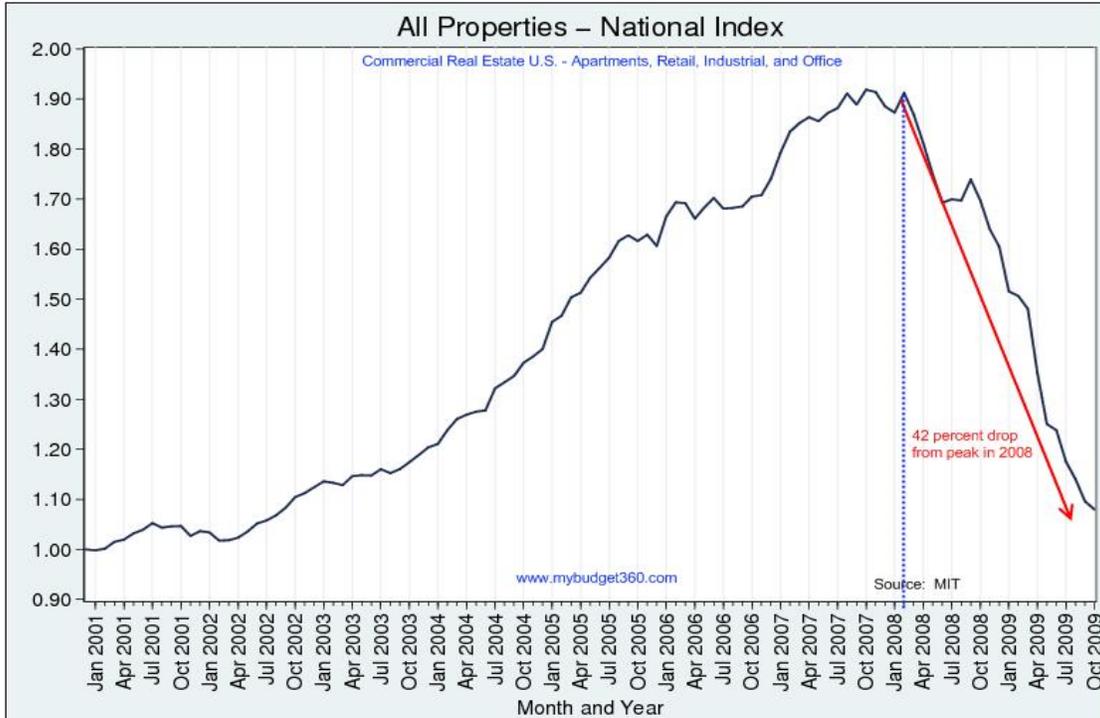


Source: Credit Suisse.

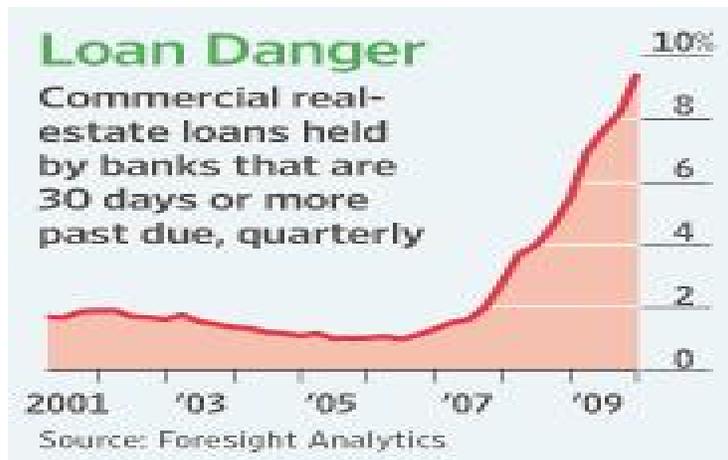
Even with a relative pick up in home buying the past few months spurred by tax credits and historically low interest rates, housing supply at this point is presently above 7 months. The next wave of defaults can't help but exacerbate an already high supply of existing homes for sale. More supply in this market suggests lower prices ahead.

US Commercial real estate prices down 42% and falling

The commercial real estate decline continues to pick up momentum. Commercial properties including apartments, industrial, office, and retail space are now performing worse than residential real estate. Not just by a little. While the commercial bust took about a year longer than the residential housing bust, once defaults started hitting in this market prices have been steadily declining. At the peak, it was estimated that commercial property values hit \$6.5 trillion in the US with \$3.5 trillion in commercial debt outstanding. Before the price declines, this seemed to provide a healthy equity buffer. As shown in the next chart, that buffer is now erased.



Right on cue, commercial loan defaults have been accelerating as shown in this next chart. We know that few of these loan losses have been declared by the banks to date and so we can see that bank earnings that rebounded so sharply the past few months (prompting another big round of banker bonuses), should soon face another round of “surprise” bad news.



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Bright light: the US dollar continues its rebound:

Last month we noted that the US dollar seemed to be mounting a come back amid an overwhelming sea of negative sentiment. This month its resilience against other world currencies has held as over-bought currencies like the Euro and the Canadian dollar have turned down.

US dollar vs. the Loonie (2000-2010)—a new U\$ floor for the next trade?



Source: Venable Park Investment Counsel Inc.

As the US dollar rally defied its critics, equity markets have faltered. A continuation of this trend is a bearish indicator for the remarkable risk asset advance since March 2009.

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S&P 500: rebound rally now below support



Source: Venable Park Investment Counsel Inc.

TSX 60 back below peak from 2000--10 years ago! So much for commodity-rich Canada:



Source: Venable Park Investment Counsel Inc.

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In summary, lest we go on and on...

So much to say, so little time. The world is fascinating at the moment. (Perhaps it always is). To recap, our observations at the end of January 2010:

- Risk assets seem to be into their next correction wave; we have taken profits.
- Oil and gold have also rolled over and have significant downside price risk from here.
- The US dollar seems to be in a rebound leg; we look to add a strategic allocation shortly.
- Long bonds seem to have oversold in expectation of rate increases that are not likely to start soon. We will look to move further out the yield curve until signs of inflation show up. For now asset and wage deflation continue to trump monetary and fiscal stimulus efforts.

Venable Park now serving North America: we at VPIC are pleased to announce that this month we completed registration with the Securities and Exchange Commission (SEC) in the US and are now serving clients across Canada and the United States. We are humbled and happy for the opportunity to be of service to so many wonderful people who inspire us to our work every day. We are grateful. Warm wishes for February...

Quotes of the Month:

"The man who views the world at fifty the same as he did at twenty has wasted thirty years of his life."
--Muhammad Ali

"The tragedy of old age is not that one is old, but that one is young." --Oscar Wilde

"Success means having the courage, the determination, and the will to become the person you believe you were meant to be."
--George Sheehan 1918-1993, Physician, Author

"It's not what you do once in a while; it's what you do day in and day out that makes the difference."
-Jenny Craig, Diet Specialist

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