

E.Q Trendwatch™

Slowly making progress



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July has been big. This month BP finally capped the leaking well and the US government finally passed a financial reform bill aimed at curbing some of the crazy behaviour that spawned our financial crisis. Together the oil industry and the financial sector represent the two largest segments of status quo in the world economy. Over the past decade (and more) both have played a large role in helping to drive the world economy into a debt-encumbered ditch. It is fitting that the world is now focused on trying to reform both at the same time. Together these two sectors boast the largest population of billionaires (and mega-millionaires) in the world and both have unfortunately had a disproportionate influence in shaping global policy decisions.

In both cases, the clean up and rebuilding work now underway are essential components of the real change needed for a wiser future. Realistically though, it will take patience and diligent work for the next several years in order to reformulate, retrain and rebuild people and systems.

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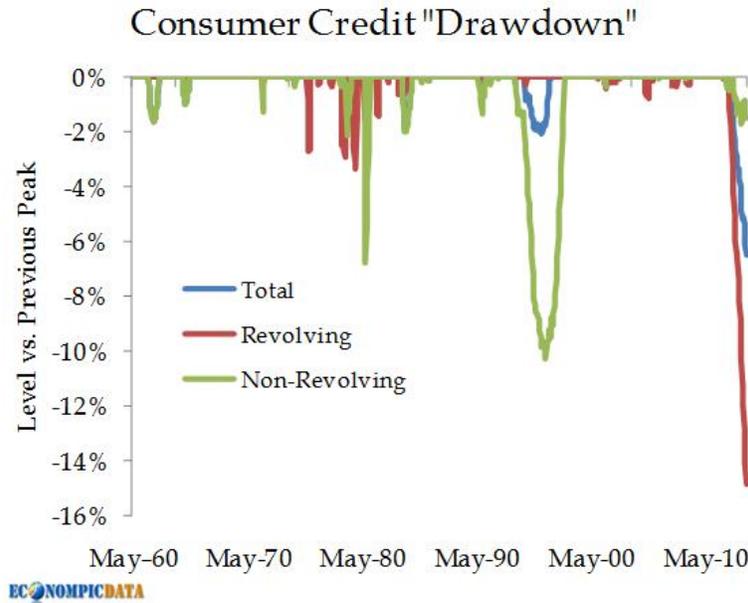
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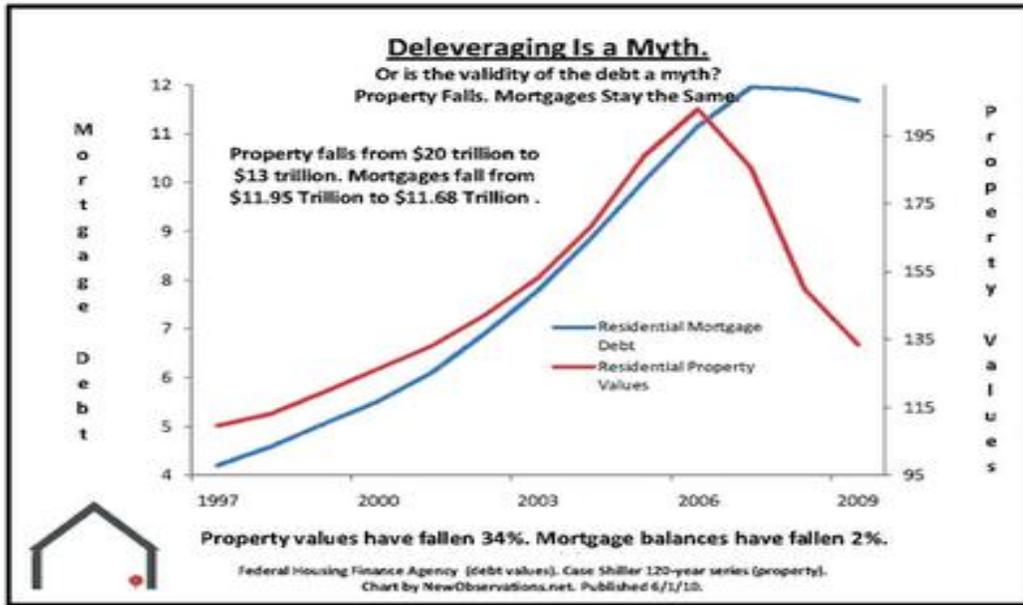
The shocks to the American economy (and the world) over the past few years have been extreme. Bursting bubbles across global asset classes (real estate, stocks, commodities, and debt) led to a synchronous global recession unprecedented in our lifetime. Today most consumers, businesses and governments are feeling the on-going after-shocks. After seeing their financial health flash before their eyes the past three years, the masses today are now focused on getting the credit devil stuffed back into the bottle. This is the logical response to what has gone before.

As shown in the chart below of the last 50 years, consumer credit today is plunging at a record rate.



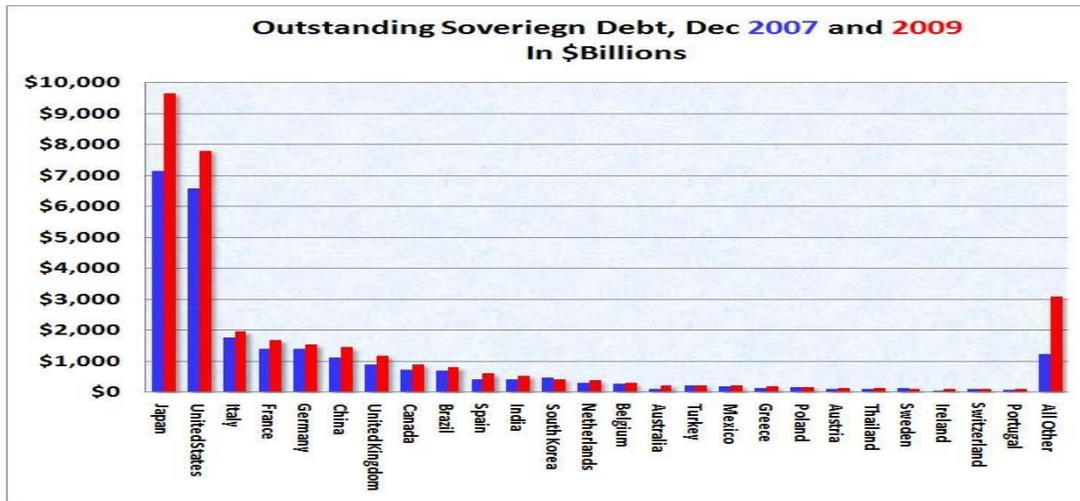
At the same time, with a tourniquet now on the credit derivative machine, banks have dialled down lending and are hoarding cash to buoy up their own solvency.

Protectionism and the paradox of thrift are in full bloom. Every man, woman, company and country is now focused on self-preservation above all else. Three years after the credit bubble burst, most asset values have deflated (in many countries realty prices are down 25-50%, stock markets down 25-50%) but debt levels are much slower to contract. After hitting a record \$1.39 trillion in the second quarter of 2008, today US household debt has fallen just over 2.8% to \$1.35 trillion in the first quarter of 2010 according to the US Fed. Large debts are stubborn and hard to erode. As shown in the next chart, consumer efforts to de-lever themselves to date have actually made little net progress. While the average US property value has declined 34% (from a bubble peak of 20 trillion to 13 trillion) the related mortgages balances have reduced just 2% (from 11.95 trillion to 11.68 trillion). The de-leveraging process in the consumer sector will be slow slogging, but it is underway.



While consumers are making some progress in debt reduction, governments around the world have been exploding their deficits in the opposite direction as they try to “save” stop the global economy from contracting.

As captured in the next chart below, the Bank for International Settlements reports that worldwide sovereign debt exceeded \$34 trillion at the end of 2009. Japan and the United States together have about half of all sovereign debt worldwide, which helps to make their markets the most liquid. 23 other countries have over \$100 billion of sovereign debt outstanding, with the other 100+ countries worldwide having a total debt of about \$1.4 trillion. It is noteworthy that between 2007 and 2009, several countries doubled the amount of their outstanding sovereign debt.



Source: www.calculatedriskblog.com

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There is no doubt that policy stimulus and inventory rebuilding prodded major economies out of negative growth with a 5% annualized growth jolt in the first quarter of 2010. The question now is with the real economy fixed on de-levering rather than spending, how will the prodding continue from here? Leading up to the bust in 2008, the global economy had enjoyed 5 years of credit-juiced-above-trend growth of nearly 5% a year. Today realistic assumptions suggest that the global growth rate over the next 5 years may average between 3 and 3.5%, or about 1/3 less than world output had been geared to assume. This is why the world is likely to remain awash in over-capacity and price deflation for the next few years.

Demographic trends are working against old growth assumptions

“The danger today, as opposed to prior de-leveraging cycles, is that the de-leveraging is being attempted into the headwinds of a structural demographic down wave as opposed to a decade of substantial population growth.” -- Bond manager Bill Gross this month:

Over the past several centuries the world has never seen a period of time in which population grew less than 1% a year. As bond manager Bill Gross points out this month, capitalism and its assumptions about incremental demand growth have depended on the assumption of more and more consumers each year. So far the world is adding about 77 million new people a year for an annual growth of 1.15%. But as shown in the chart below global population growth rates have been declining since 1970.

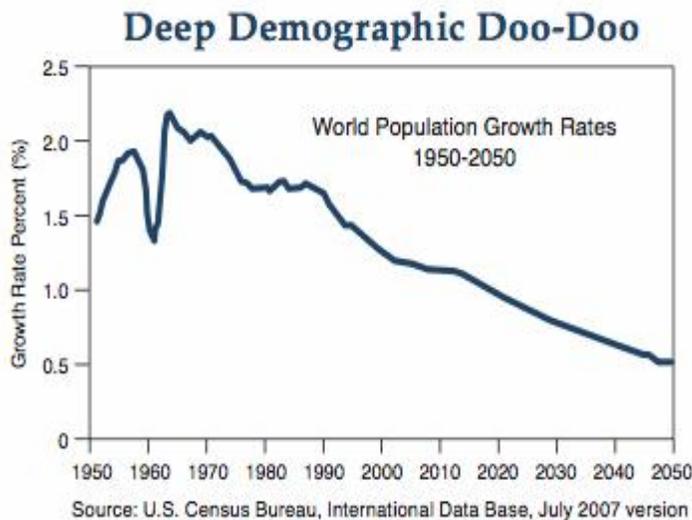


Chart 1

Coincidentally since the 1970s, the private economy has been increasingly dependent on artificial asset price stimulation (governments forcing down interest rates and deficit spending) to fuel the appearance of increasing demand. Reduced population growth was a significant factor in the leveraging of the developed world’s financial systems and the ballooning of total government and private debt as a percentage of GDP:

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“Lacking an accelerating population base, *all* developed countries promoted the financing of more and more consumption per capita in order to maintain existing GDP growth rates. Finally, in the U.S., with consumption at 70% of GDP and a household sector deeply in debt, there was nowhere to go but down. Similar conditions exist in most developed economies.

*...the New Normal of deleveraging, reregulation and deglobalization produces structural headwinds that lead to lower economic growth as well as half-sized asset returns when compared to historical averages. The New Normal will not be [improved] by a slower-growing population nor by cyclical policy errors that thrust Keynesian consumption remedies on a declining consumer base. Current deficit spending that seeks to maintain an artificially high percentage of consumer spending can be compared to flushing money down an economic toilet. **Far better to create and mimic other government industrial policies aimed at infrastructure, clean energy, more relevant education and less costly healthcare services.**”*

The trouble with the main of government rescue efforts to date is that they have been trying to resuscitate a defunct and antiquated model of mindless consumer consumption: cash-for-clunkers (enticing people to buy more cars), home-buyers-tax credits (to buy more houses) are just two glaring examples. Times have changed and consumer behaviour is changing with them.

The good news is that now that ‘old school’ efforts have been tried and shown to be of no lasting economic benefit, we may now find our way to a next phase of creative and thoughtful solutions aimed at infrastructure improvements in health, education and clean, domestic energy. Lasting productivity and sustainable wealth will come from innovations and inventions that work for the good of the many rather than the myopic interests of the few. Free enterprise can provide the solutions and jobs we need. Government policies can support this through tax credits and funding in strategic areas and by withdrawing support from those that try to maintain a destructive status quo.

We now interrupt a year of government spending to resume this secular economic downturn...

This month the advanced estimate of 2nd quarter US GDP came in lower than expected at an annualized rate of 2.4%. The first quarter was also revised lower. We are now into the second half of 2010, and we expect that economic growth will be weaker over the next 6 months, than over the last six months. If we are able to avoid outright negative growth, that would be a bonus. At this point it appears the likelihood of another negative growth phase is greater than 60%. But even just modest economic growth of less than 3%, presents serious downside risk for stock and commodity markets that until this April were pricing in the expectation of robust “V” shaped recovery and record earnings in 2011.

While stock markets rebounded somewhat this month from their steep sell off in June, year to date levels are still negative to flat. Historically negative stock returns over the first half of a calendar year have proved an 80% correlation with negative returns over the year as a whole. We enter the second half with great attention.

Canada's TSX: July bounce doesn't change the downtrend year to date



S&P 500: lots of corporate hype and noise in July, but market still in contraction mode

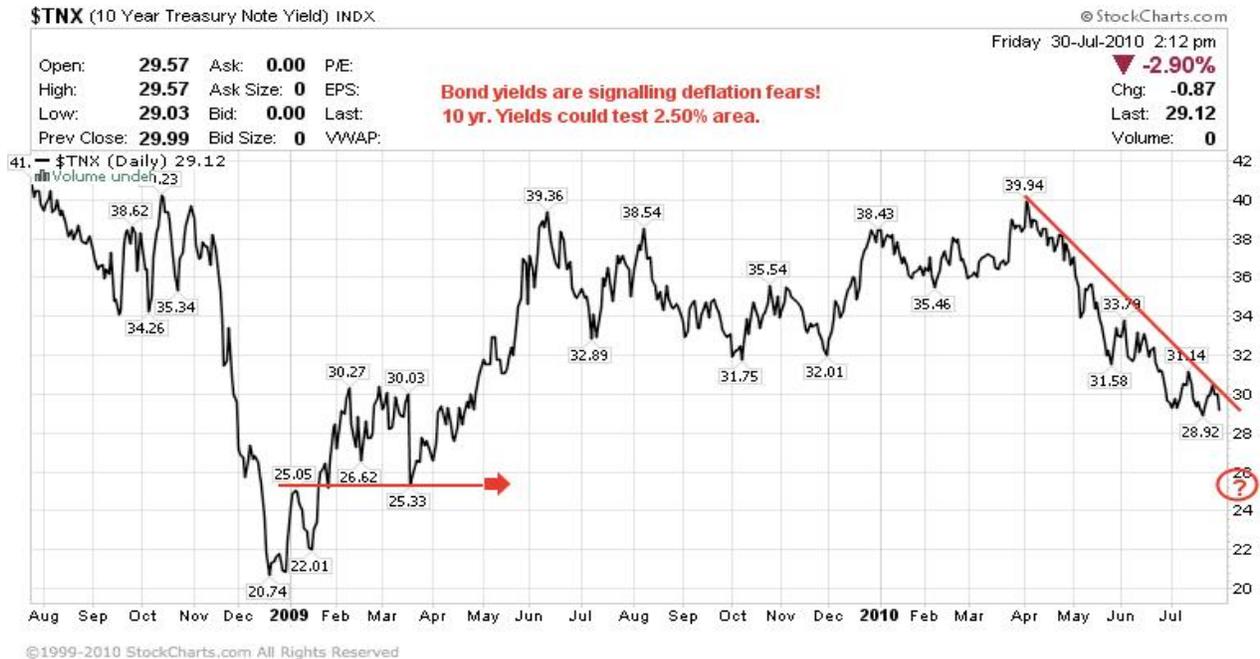


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China still leading lower: a break through 3000 is needed to signal a trend change



Despite some weakness this month, bullish trends in the US dollar, bonds and Natural Gas continue to be in tact, with the 10-year Treasury note yield (chart below) still falling (ie., capital is flowing out of stocks and into bonds, so prices are rising and yields are falling).



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These trends suggest continued momentum strength in bonds and weakness in risk assets like stocks and commodities over the coming weeks.

Best wishes for some fun and sun in August! Where is our summer going!!

Quotes of the Month:

“I am ashamed to be known as a banker, I am much happier being known as ‘Pete the Pirate.’ The bankers of old were very decent people, very cautious people. We looked after other people’s money, we didn’t speculate with it.”

--Pete the Pirate, aka Gordon Dickson, former risk officer for Bank of Scotland Plc

“The salary of the chief executive of a large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself.” —John Kenneth Galbraith

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