

E.Q Trendwatch™

Seatbelts fastened



We have a friend named Bob who is a commercial pilot (Hi Bob). He was explaining to us some time ago that our work as money managers is very similar to his work as a pilot. When things are smooth and going up, basically a chimp could do the job; autopilot seems enough. Dangers are always there, but few people see them when all seems well. When danger strikes however, the pilot is hoped to have the skill, training and experience to guide us through safely. If the plane crashes pilot error is often cited. If the pilot averts disaster s/he is considered a hero—at least for a little while, until memories of dangers fade.

This month Danielle was speaking at a Pension manager's conference and she used Bob's pilot analogy to remind the attendees that risk management and a focus on loss avoidance are a pension manager's primary duty of care. (You may think this would be an obvious statement. In fact, it was considered quite counter-culture and shocking!)

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A huge problem is that a sales-driven investment world perpetuates the prosperous idea that ‘investing’ requires one to be constantly buying and constantly holding risky assets. The perverse but well entrenched practice of “benchmarking” actually demands this. A manager who is supposedly hired for their skill and training, is most commonly instructed by benchmarking or mandate to stay fully invested—ignore one’s experience, measurements and technical gauges— just stay on auto-pilot through all conditions: “Fly, damn you, fly.”

Famed investor and market historian, [George Soros](#) gave a speech on these issues at the Institute of International Finance in Vienna this month and summarized the problems with modern investment theories thus:

“It is important to realize that the crisis in which we find ourselves is not just a markets failure but also a regulatory failure, and even more importantly, a failure of the prevailing dogma about financial markets, I have in mind the Efficient Market Hypothesis and Rational Expectations Theory. These economic theories guided, or more exactly misguided, both the regulators and the financial engineers who designed the derivatives and other synthetic financial instruments and quantitative risk management systems which have played such an important part in the collapse.”

Frequently the right answer, against all impatience and external expectations, is to stand down. During a secular bear market (like the one we are flying through today) opting more for caution over risk is the right choice most of the time. A secular bear market is like a 17-20 year hurricane season. The clouds have breaks and periods of apparent calm but those who lose sight of the overall climate do so at grave peril. Figuring out when to time our exposure to risk is an imprecise art for sure. It demands constant measuring, diligence and educated guessing. This leads most so called “financial advisors” today to insist that timing is difficult to do so should not be attempted. We find this idea to be an embarrassment. What other profession in the world could get away with saying, “Risk management is hard to do, so we have decided not to bother?” Surely, just because it is difficult to predict exactly when a storm, recession or bear market will hit does not mean one should proceed as if they won’t.

What the gauges are telling us

This month world stock and commodity markets have continued to break down. The Shanghai Composite Index (a leading barometer of world risk appetite) is now down 27% from its last high in August 2009. Importantly, the next time you hear someone making a bullish argument for economic growth in China today, remember this: the same argument could have been made (and was) every year for the last 4 years and yet at 2535 today the Chinese stock market is down 57% from its cyclical peak of 6000 in 2007. Apparently successful investing takes a little more than reciting a country’s population statistics.

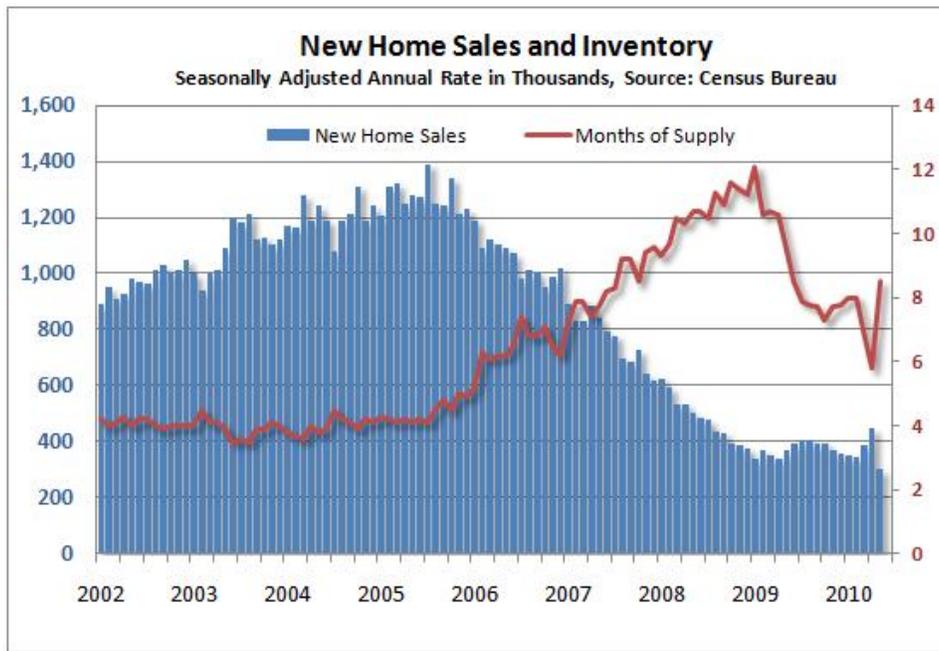
Getting household consumption to be the main driver of the Chinese economy will be tricky too. Domestic

consumer demand in China has fallen over the past couple of years to around 35% of GDP from mid-40% levels a decade ago. A study from Peking University suggests that for domestic demand to rise even back to 40% in the next five years, household consumption growth will have to outpace overall GDP growth by a very unlikely 2.3% each year. Achieving this means making a full commitment to pro-consumption policies, but vested interests that have profited from China's current export-driven growth model will be hard to change.

What we find most instructive about the “China” story today is the way in which its stock market acts as a leading indicator by 3-4 months in advance of more developed markets in the world. The fact that the Shanghai composite is still deeply in contraction mode today, bodes ill for other risk markets over the next few months, and especially those levered to commodity exports like Canada and Australia.

US housing: second dip now playing

Housing data released this month on the US market, all came in much weaker than the consensus had expected. As shown in this next chart New Home Sales in May plunged 33% to an all-time low following the expiration of the government’s homebuyer tax credit in April. If not for the massive downward revision to the April sales total, from an annual rate of 504,000 to 446,000, the monthly decline would have been more than 40 percent!



At a sales rate of 300,000 May came in well below the previous record low from January of 2009 – during the depths of the Great Recession – at 339,000 units. As a point of reference, before the housing boom went bust, homebuilders were selling more than a million new homes a year.

When looking at the back up in the supply of new homes over the past few months, it is important to realize that

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the inventory counted here does not include the several million existing homes that are listed for sale nor those soon to be listed for sale through the roughly 5 million foreclosures coming soon to neighbourhoods across America. Unfortunately, renewed weakness in housing signals renewed weakness for the economy in the months ahead.

Other leading indicators for the real economy are also firmly in retreat mode again

As shown in the chart below, the ECRI (Economic Cycle Research Institute) Weekly Leading Index (WLI- US) has been falling again for the past 7 weeks. To the week ended June 18 it contracted 6.9%.

Each time this size of decline has happened in the past 40 years it has signalled an economic recession in every case except 1988. In 1987 the stock market suffered a large (very sudden) decline, but the Feds were able to dramatically slash interest rates and help avert a recession in the over all economy. Today government rates have already been slashed to virtually zero. In order for this WLI to give a formal “recession” signal, it will need to continue to fall over the next few weeks. So this indicator is not yet indicating recession. But it certainly gives another reason for pause.

When has the ECRI Weekly Leading Index declined this sharply in the past?		
ECRI WLI: 13-Week Annualized Rate		
Date first crossed	13-wk annual rate of WLI	Stage in Economic Cycle
Feb-70	-31.45	in recession
Oct-74	-24.95	in recession
Apr-80	-24.78	in recession
Dec-00	-24.53	2 months prior to recession
Sep-08	-25.07	in recession
Jun-10	-23.46	in recovery?

Source: Rather & Kittrell, NBER, ECRI.

We know that historically declines of 5 to 10% in this index have resulted in GDP growth over the following 2 quarters of less than 1%. Growth of less than 1%, even though slightly positive, would be an unwelcome surprise for the analyst consensus (and stock prices) presently predicting 3% growth in the 2nd half of 2010.

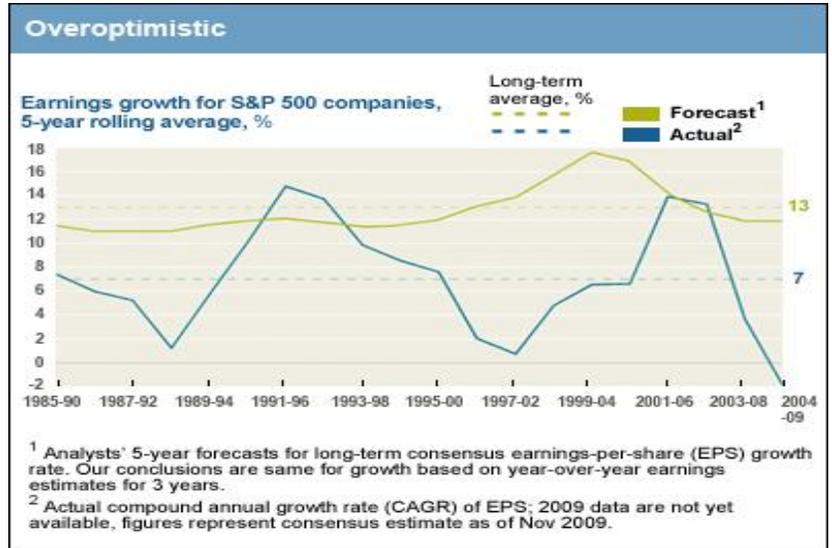
Stock analysts consistently miss the downturns

Bearish economic data has been mounting for the past several months and yet stock analysts en masse continue

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to wax bullish about earnings growth looking forward. However, as shown in the chart on the right below, this is actually the norm. Analysts consistently overshoot earnings forecasts (yellow line) and have missed all of the earnings cycle contractions (blue line) over the past 15 years. It is important to keep this record in mind the next time we are listening to analysts making glowing growth predictions in the business media.

Analysts walking off the cliff again?



So much for rosy forecasts: equities are losing again in 2010:



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The S&P 500 is down 12% from its April peak and more than 6% year to date in 2010. Significantly this month, the Index broke down through critical support circled in red above. This suggests that 925-950 is the next key area to watch for support on the S&P. This would be a further -14% from where it is today and a full 26% below its recent peak in April 2010. Hopefully this market decline would stop there, but no one can be confident of the outcome at this point. As a point of reference, 925 would be a full 41% below the cycle peak in 2007. No wonder buy and hold investors are frustrated! We watch with great interest.

Another key economic indicator: bond yields have turned sharply lower (as prices rise)

This month bond prices soared, forcing yields on those instruments to ominously low levels. Simply put, in an improving economy bond yields are supposed to be gradually rising not plunging. Today the US 10-year note yield has fallen back to a remarkable 2.958%.

To put this low yield into historical perspective, taking out the sharp drop in interest rates in late '08 amid the financial collapse--flight to safety trade, the last time the 10-year bond yield closed below 3% was in June 2003, two weeks before Greenspan cut rates to 1% due to the Fed's deflation fears. The closing low at that time matched a record low dating back to at least 1962. Suffice it to say that the bond market—renowned for being much bigger and wiser than the stock market—is signaling serious worry today. The good news is that our bond holdings have appreciated in value as a result.

Long-term bond prices have broken out



The above chart of the 20 year bond ETF (TLT) shows the price breakout since our buy in April.

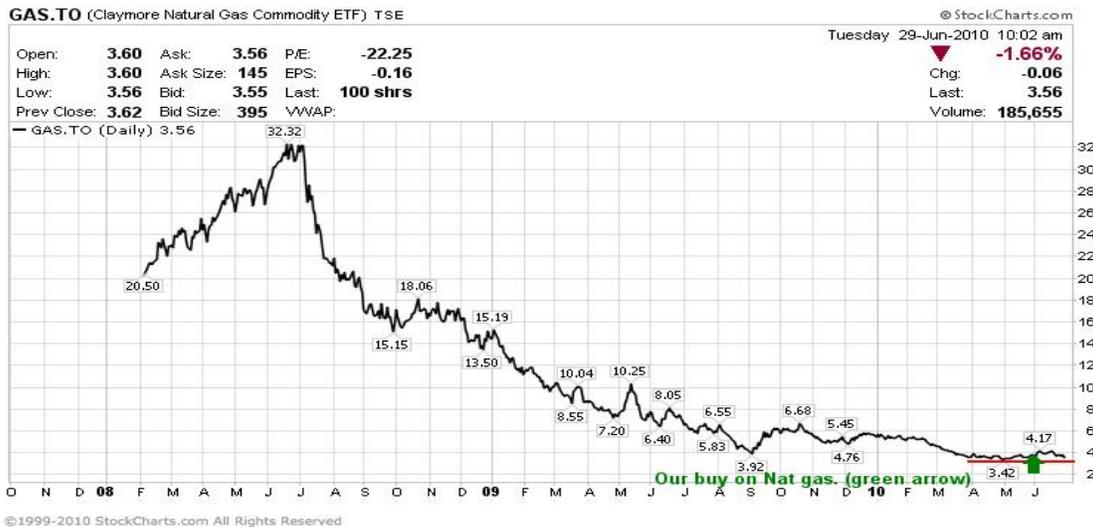
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In keeping with the up trend in bonds, the US dollar is prevailing again as a safe haven



The US dollar index shown above marks the greenback as against a basket of global currencies. As we have been mentioning since December 2009, the US dollar continues to receive large inflows of capital from other asset markets in the world. Until the world sees more grounds for economic optimism, this risk aversion trend is likely to continue.

Natural Gas: bumping along a base?



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This month our indicators suggested a buy on Natural Gas. Since September of 2009, we have been tracking the Gas ETF (shown above) as it traded above the \$3.40 range some 89% below the \$32 peak reached in the commodities bubble of June 2008. There are fundamental and technical reasons to believe that Natural Gas may have bottomed in this area. If it has, then a recovery even just to the \$10-\$12 level could mark a triple or quadruple from present prices. Even with a small 5% portfolio weight, this type of upside could add handsomely to overall returns (i.e., a 300% gain x 5% weight= possible +15% to a portfolio overall). This is the reason we venture this type of strategic risk. That said, as a commodity asset, we should expect the sector to be extremely volatile, with daily price swings of 3-5%. And of course, we do have a sell rule should the trend break down completely.

Overall the month of June and the last 6 months (actually the last 10 years) have been negative for stock investors. That said, our accounts have made net gains throughout. We consider this a success for which we are grateful. But we are never complacent. Given the tumultuous state of the economic environment we continue to watch carefully for the highest probability risks and opportunities.

Best wishes for some fun and sun in July!

Quotes of the Month:

“Nobody ever lost money taking a profit.” —Bernard Baruch

“Blessed are those who can give without remembering and take without forgetting.” -- Elizabeth Bibesco.

Don't forget to visit our market blog www.jugglingdynamite.com for weekly commentary, articles and media clips.