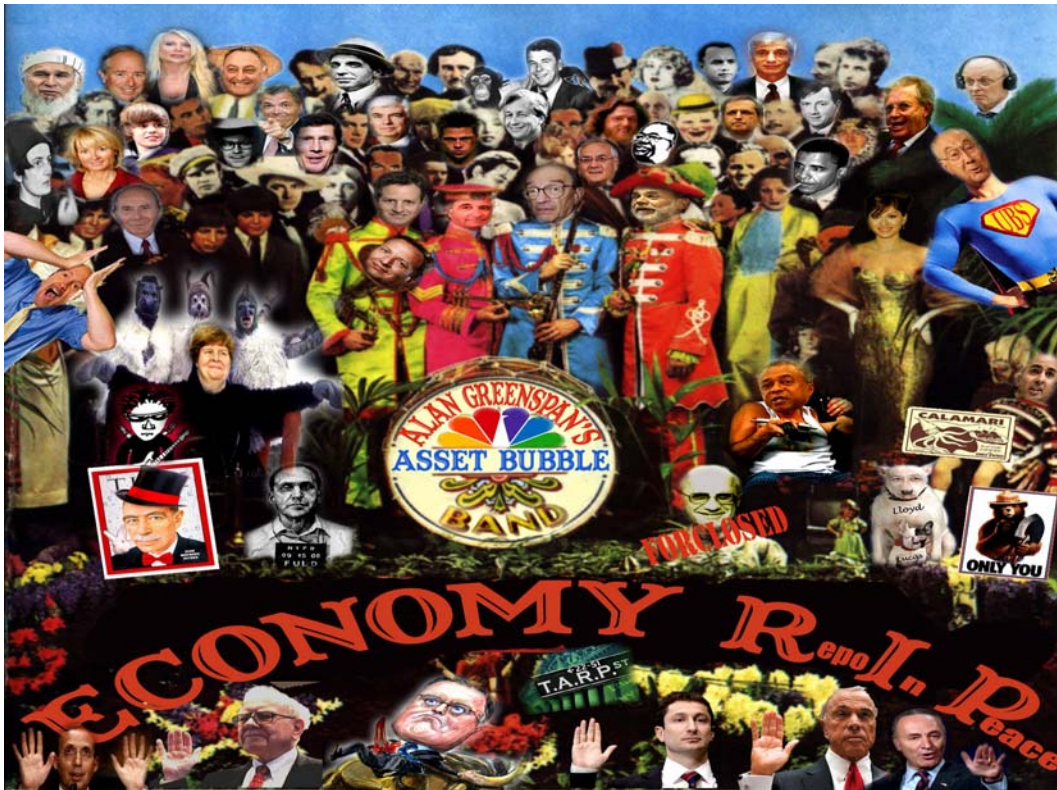


# E.Q Trendwatch™

## Bubble maestros suggest an encore



Source: [The WillianBanza17 Blog](#)

*“The saddest truth about the Fed’s system is that there can be, almost by definition, no long-term advantage from hiking the stock market, for as we have always known and were so brutally reminded recently, bubbles break and the market snaps back to true value or replacement cost. Given the mysteries of momentum and professional investing, when coming down from a great height, markets are likely to develop such force that they overcorrect. Thus, all the beneficial effects to the real economy caused by rising stock or house prices will be repaid with interest.”*

-Jeremy Grantham, [GMO Q3 market letter, October 26, 2010](#)



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Bubble making is in high demand. Over the first 8 months of 2010, the weak economic recovery of 2009 began to falter; equity markets lost value and stock investors saw negative returns. Coming to the end of August, risk markets began sagging toward the historically weak September-October period.

With unemployment still suffocating the economy and not wishing to appear impotent heading into the important November midterms, the US Federal Reserve came under intense pressure for prestidigitation. Team Bernanke began talking about the need for a second round of Fed intervention to prop up asset prices: “QE2”. Stock and commodity markets cheered with a miraculous about face. For the past 7 weeks risk markets rallied as day after day commentators postulated on the quantity of taxpayer funded QE: would it be 500 billion, a trillion, 4 trillion? Since the money proposed is to be printed out of the air, there is really no knowing where the madness might end; literally anything seems possible in the very short run.

The harder question is this: what are reasonable investors to do with our life savings when confronted with such remarkably contrived conditions? There are doubtless moments when it seems easiest (in the short run at least) to pile in and surf the wave with the Red Bull-juiced high-frequency trading crowd. Brokers are calling to us all, “come on in, the water is lovely... problems have been fixed, all is forgiven...” *If only this were true!*

Government depressed interest rates are designed to smoke people back into risky assets. Careless leaders are starting to look alluring again. The careful crowd are worrywarts once more—party-poopers missing out on fun and gains. Less patient clients are growing restless (particularly those who lost heavily before joining us). For us the present ‘feel’ is familiar of previous periods when danger to capital was extremely high. Those who lack self-control and understanding are increasingly at risk of succumbing to the bullish mantra. What to do? There are no easy outs.

Octogenarian market analyst Richard Russell has been following his own defined rules since 1956. He has been skeptical of stock values for over a year and this week he acknowledged the conundrum of the QE2 rally like this:

*“[It]...doesn't mean that I have to join it. I still abide by the Dow Theory thesis of "values first," and I'm not going to play games with this overvalued market. The risk of buying here is too high, and my final thought is that it's just not worth the risk.*

*So what do we have? We have a mystery, and no amount of BS can unravel the mystery at this juncture. The truth is that we must wait and see what develops. By any historical standards, stocks are over-priced, so our task is to avoid doing something stupid. I don't mind taking chances when stocks are historically cheap, but I don't like rolling the dice when stocks are overvalued. The consequences are too costly if I am wrong.”*

—Richard Russell, Dow Theory Letters, October 25, 2010

Centuries of historical precedents speak for themselves: the Feds can print money, they can expand the money supply; they can aid and abet massive bubbles in financial markets, but they cannot force savers to spend, or businesses to invest. And they can't force vibrant growth out of a slack economy.

Governments can buy bonds and push down interest rates (a fraction of a percent further perhaps?), but the weak consumption and massive over-capacity in the world economy today are not looking for lower interest rates to revive them. Rates have already been virtually zero since 2003. The sub-prime, credit securitization madness of 2004-2007 created an interim bubble in consumer spending that never was sustainable. That artificial demand is gone now and it is not coming back— at least not for a decade or more. Once markets are allowed to re-price assets (housing, stocks, commodities, bonds, currencies) and revenue expectations, to the reality of our future, we will finally get back to a favourable climate for investing (and savers) rather than speculating and hoarding.

We hope that this re-pricing phase will happen sooner than later. (Yes we are tired of waiting!!) But thoughtful people have few good options today. We may well feel like under-achievers but such is the lot of meaningful risk management. At VPIC our rule set has been devised based on years of real-time experience and success in navigating capital safely through very challenging markets. We aren't about to start throwing caution and capital to the wind now.

**This chart of the US\$ says it all: US\$ down in October, risk assets up... rinse and repeat**



As shown in our favourite chart of the US dollar Index above, January to August 2010, the US dollar

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strengthened and risk markets sold off. Then the realization that the economy was stagnating again brought QE2 speculation. The US\$ weakened under the prospects of more government spending and risk assets (stocks and commodities) jumped up. In the last week of October, the party paused when rumours swirled that the Fed may not be pumping stimulus with the scale and speed that the market had priced in. Stocks rolled over again. Such is the Ponzi scheme known as today's capital markets. Its nuts, but here we are.

### No recession in 2011?

This month the Economic Cycle Research Institute reported that their leading indicator index is showing definitive evidence of a slow recovery but "no double dip recession any time soon." Hopefully they are right. They note that the leading indicator index followed a similar formation in 2003 when the economy weakened but did not go back into recession. It is noteworthy, however, that while the 2001 recession officially ended in 2001 according to NBER, the stock market went on to make a series of lower lows thereafter falling a further 36% before finding a final bottom in October 2002 followed by a nasty retest in March 2003 (see chart below).

### 2002-2003: NBER said the recession ended in 2001; someone forgot to tell the stock market



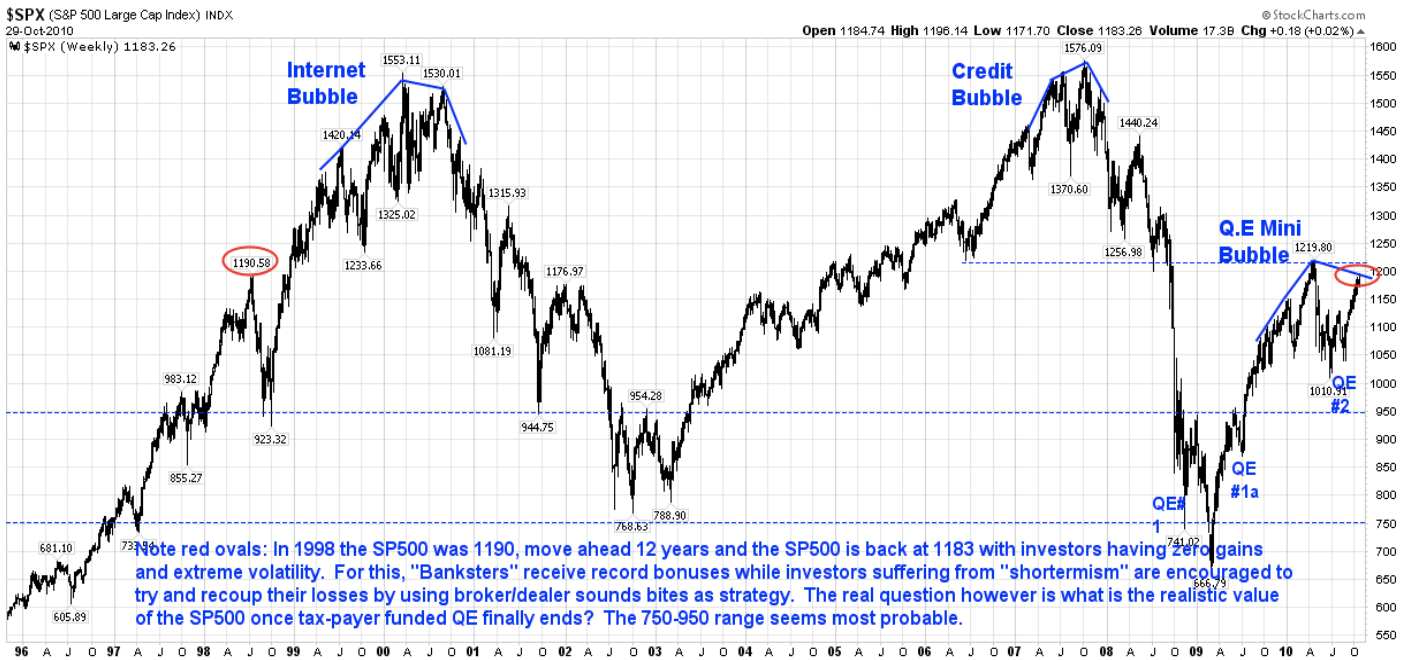
When we compare the above price behaviour of the S&P 500 to the most recent cycle 2009-2010 (next chart), we have reason for concern about the v shaped rebound in stocks and their elevated values at this point in our government funded "recovery".

## S&P 500 recovery March 2009 to October 2010: price tests thwarted so far



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## In the end bubbles always burst: S&P 500 1996-2010, 3 bubbles and counting...

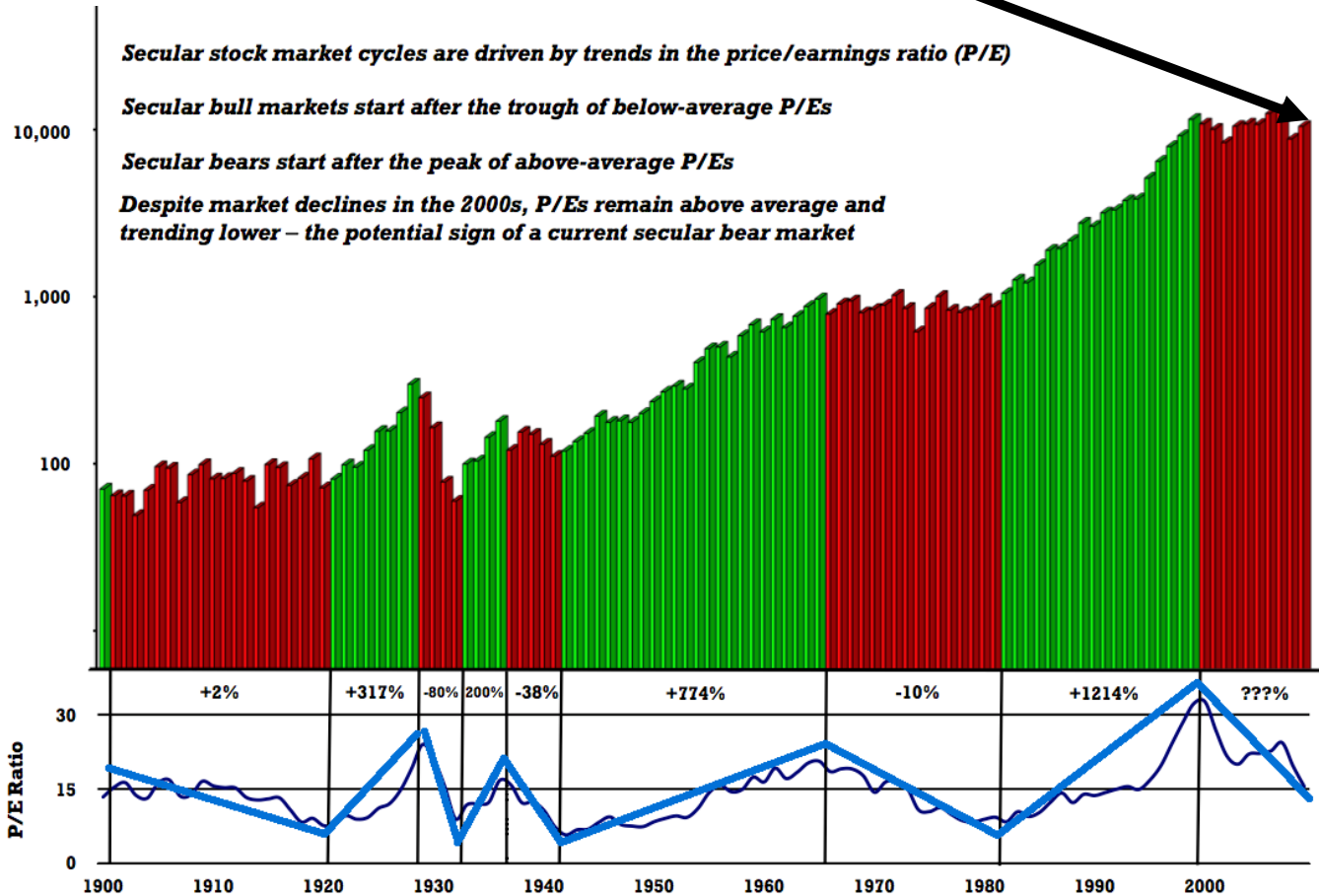


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As shown in the chart above, despite all the government efforts to stop the inevitable correction to rational valuations, this secular bear since 2000 is working stocks lower all the same. We have further to go, but we are making progress. Imagine how exciting it will be to finally find ourselves back at truly compelling valuations offering investment opportunities not seen for 30 years.

**100 years of secular stock cycles: not likely through the red years yet...**



**Trim Tabs report: “investors are so deep in the red, that rallies matter little to them.”**

Here is some food for thought on the importance of loss avoidance. A recent report on investor returns by Trim Tabs Investment Research found that **even after riding the stock market bounce up 2003-2007 and 2009 to now, more than half of U.S. equity investors have still lost 25% over the past decade.** As a result the retail investor continues to sell equities even as the market rallied over the past 18 months. Trim Tabs found that retail investors pulled out \$55.4 billion from U.S. “growth” funds in 2010 even though the average fund was up 36.4% from the beginning of 2009. "The past decade was a lost one for U.S. mutual fund investors," said

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Vincent Deluard, executive vice president at Trim Tabs, in a statement. **"Most investors are so deep in the red that rallies matter little to them, and some might be selling just to harvest tax losses."**

Pension funds are in a similar pickle. After more than a decade of “playing” this secular bear in stocks, the bulk of pension funds have massive deficits. In a move to stop kicking their funding shortfalls down the road, this quarter the 10 largest US private pensions all moved to reduce their traditional allocation in equities to increase cash and fixed income. Soon trustees will also be announcing contribution increases as well as reduced and delayed benefits to beneficiaries. Facts are starting to be faced—healthy developments to be sure.

### **How the financial furies were let out of the box: a short summary of the long demise of Glass-Steagall**

*“There is nothing new in the world except the history you do not know.” - Harry S. Truman*

Few people today know much about the history of our financial markets. At VPIC it is our particular passion. We believe that if the world is to learn from recent mistakes and effect necessary reforms for a better future, it is crucial to revisit how we travelled full circle in just 66 years from the financial crisis of the Great Depression to the financial crisis that is hobbling our economy today.

In the early decades of the 1900’s investors were seriously harmed by banks, whose over-riding interest was in promoting stocks of interest and benefit to the banks, rather than the investors.

In 1933, Senator Carter Glass and Congressman Henry Steagall introduced historic legislation seeking to limit the conflicts of interest created when commercial banks are permitted to underwrite stocks or bonds. The new law banned banks from underwriting securities and forced them to choose between being a simple lender or an underwriter (brokerage). The act also established the Federal Deposit Insurance Corp (FDIC) insuring bank deposits and strengthening the Federal Reserve’s control over credit. In 1956 the Bank Holding Act was passed which extended restrictions on banks. Further rules were implemented heavily restricting the amount that public pension plans could invest in the stock market. Stocks were seen as dangerous investments.

In the early 1960’s banks began to fund lobbyists against Glass-Steagall. Some lobbyists bragged that the bill allowed them enough work to put their kids through college.

In the 1970’s brokerage firms begin encroaching on banking territory by offering money market accounts to their clients that allow personal banking features like cheque writing and credit cards.

The thin edge of the wedge to repeal Glass-Steagall finally got a foot hold in December 1986 when the Federal Reserve Board, which had regulatory jurisdiction over banking, reinterpreted Section 20 of the Glass-Steagall Act, which barred commercial banks from being "engaged principally" in securities business and decided that banks could make *up to 5 percent* of gross revenues from investment banking business. The Fed Board then permitted Bankers Trust, a commercial bank, to engage in certain commercial paper (unsecured, short-term credit) transactions. The Fed Board concluded that the phrase "engaged principally" in Section 20 allowed banks to do a small amount of underwriting, so long as it did not become a large portion of revenue. This was the first time the Fed reinterpreted Section 20 to allow some previously prohibited activities.

In the spring of 1987, the Federal Reserve Board voted 3-2 in favour of easing regulations further (over-riding opposition of then Chairman Paul Volcker) and allowed banks to underwrite commercial paper, municipal bonds, and mortgage back securities. The Fed also reinterpreted Glass-Steagall to say that the original congressional intent was to allow for some securities activities.

In August 1987, Alan Greenspan—formerly a director of JP Morgan became Chairman of the Federal Reserve. Greenspan favoured bank deregulation. (*Surprise, surprise!*)

In January 1989, the Fed Board approved an application by JP Morgan and other banks to expand the Glass-Steagall loophole to include dealing in debt and equity securities in addition to municipal securities and commercial paper. The board then raised the limit of bank revenue that can come from such activities from 5 to 10%.

From 1984-1995 the Senate repeatedly passed bills to lift the major restrictions of Glass-Steagall but the House repeatedly block passage.

In December 1996 with the support of Chairman Greenspan the Federal Reserve Board issued a precedent-shattering decision increasing the 10% restriction on under-writing business for banks to 25%.

In August 1997 the Fed further eliminated further restrictions saying that the risks of underwriting by banks have proven "manageable" and banks should have the right to acquire securities firms outright. Right on cue, Bankers Trust (now Deutsche Bank) bought brokerage Alex Brown & Co., becoming the first US bank to acquire a securities firm since the 1920's. This precedent then spawned a surge in mergers and acquisitions to combine various different firms into conglomerates of insurance underwriting, securities underwriting and commercial banking. The new firms received temporary approval from the Federal Reserve and plunged into a relentless lobbying campaign to repeal Glass-Steagall completely and pass new rules known as the "Financial Services Modernization Act". "Modern" indeed.



In the 1997-1998-election cycle the finance, insurance and real estate industries spent more than \$200 million on lobbying the government and made more than \$150 million in political donations targeted at members of the Congressional Banking Committee.

In November of 1999, Congress finally voted to pass the Financial Services Modernization Act of 1999. After 25 years and more than \$300 million in lobbying efforts the repeal of Glass-Steagall was finally complete. Supporters hailed the change as the demise of a Depression-era relic.

Days after the Treasury Department agreed to support the repeal of Glass-Steagall, and then Treasury Secretary Robert Rubin, former chairman at Goldman Sachs, accepted a top job at the newly configured Citigroup.

What followed the repeal of Glass-Steagall was a decade of the most reckless and fraudulent financial products and practices ever sold in the history of humanity. Our historic circle back to the challenges of the 1930's is complete. Re-regulating our financial industry and restoring barriers between our governments and banks is just one of the massive tasks now at hand. It must be amazing for Paul Volcker now 83 to see that his opposition to deregulating the banks was prescient. He was exactly right. Little comfort indeed.

### **Near-term events**

This month we confirmed a sell in our rule set on the 20-year bond and moved the TLT out of our accounts at a profit. The bond market seems to be saying that prospects for further QE are raising inflation risks further out on the yield curve. At the same time we confirmed a buy on the Euro and purchased an ETF of the currency for our accounts. Europe has a lot of fiscal problems, but it also has announced some pretty serious spending cuts of late. So far Europe is walking its talk of "austerity" more than the US and Japan and we suspect this may well be the impetus for recent strength in the European currency, which had been heavily sold from the start of the year.

This week we will learn the results of the Mid-term elections in the US as well as details of the highly anticipated next phase of stimulus by the Federal Reserve. (We should keep in mind that they are suggesting QE2 because the 787 billion Q1 in March 2009 was not successful in reviving the economy into a self-sustaining recovery). But massive further easing from here is no slam-dunk. The word "stimulus" has increasingly become a dirty word on Capitol Hill the past few months. Republicans are poised to take back control of the House and they have vowed to cut spending and rein in exploding deficits (all the while extending the Bush tax cuts). Impossibly antithetical promises it would seem. Either way, more Republican control and/or government gridlock is less likely to result in large stimulus going forward. Given the unusual September-October run-up in markets on wild expectations of just that, it seems quite likely we could see

another wave of disappointment selling ahead as those who bought the rumour now sell the news. It is also likely that the recently oversold US dollar may be primed for its next leg of strength. If this is the case this should also prompt a fresh wave of weakness in stocks and commodities.

### Best wishes for November!

### Quotes of the Month:

“Any intelligent fool can make things bigger, more complex, and more violent. It takes a touch of genius -- and a lot of courage -- to move in the opposite direction.” -Albert Einstein

"I wish there was a knob on the TV to turn up the intelligence. There's a knob called 'brightness,' but it doesn't work." -Gallagher



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