Real life needs active management

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E.Q Trendwatch™

Sentiment soars

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This month stock market bullishness reached a new high. The weekly II survey of newsletter writers saw Bulls rise to 51.6 from 48.3 - the highest since Dec 2007 while Bears fell to 19.8 from 23.1, the lowest since Oct 2007. This contrarian indicator does not dictate an imminent change in market direction; but given how misplaced bullish sentiment was back in the fall of 2007, we can't help but feel just a little queasy on their confidence now.

When US Fed Chairman Bernanke was sworn in for a second term this month, he too offered some optimistic assurances of an economic recovery going into 2010. We would like to believe him and we hate to be skeptical but the Fed's economic forecast this month was almost identical to the forecast they gave in November 2007 just as the worst recession in 70 years was getting underway:

"Our forecast is for moderate but positive growth going into next year. We think that by the spring, early next year, that as these credit problems resolve and, as we hope, the housing market begins to find a bottom that the broader resiliency of the economy, which we are seeing in other areas outside of housing, will take control and will help the economy recover to a more reasonable growth pace."

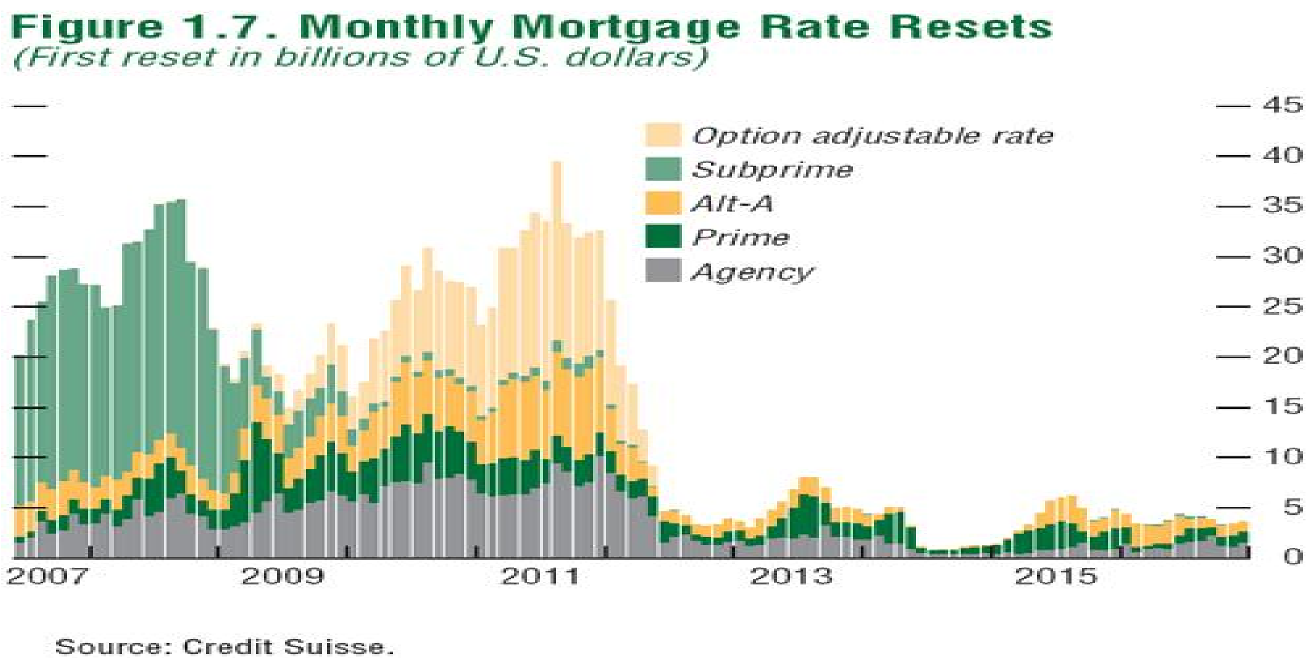
Ben Bernanke, Federal Reserve Chairman, ***November 8, 2007***

High hopes on housing

This month the Case-Shiller housing price index for June recorded an annual decline of 15.1% in the second quarter showing an improvement over the record decline of 19.1% reported in Q1.

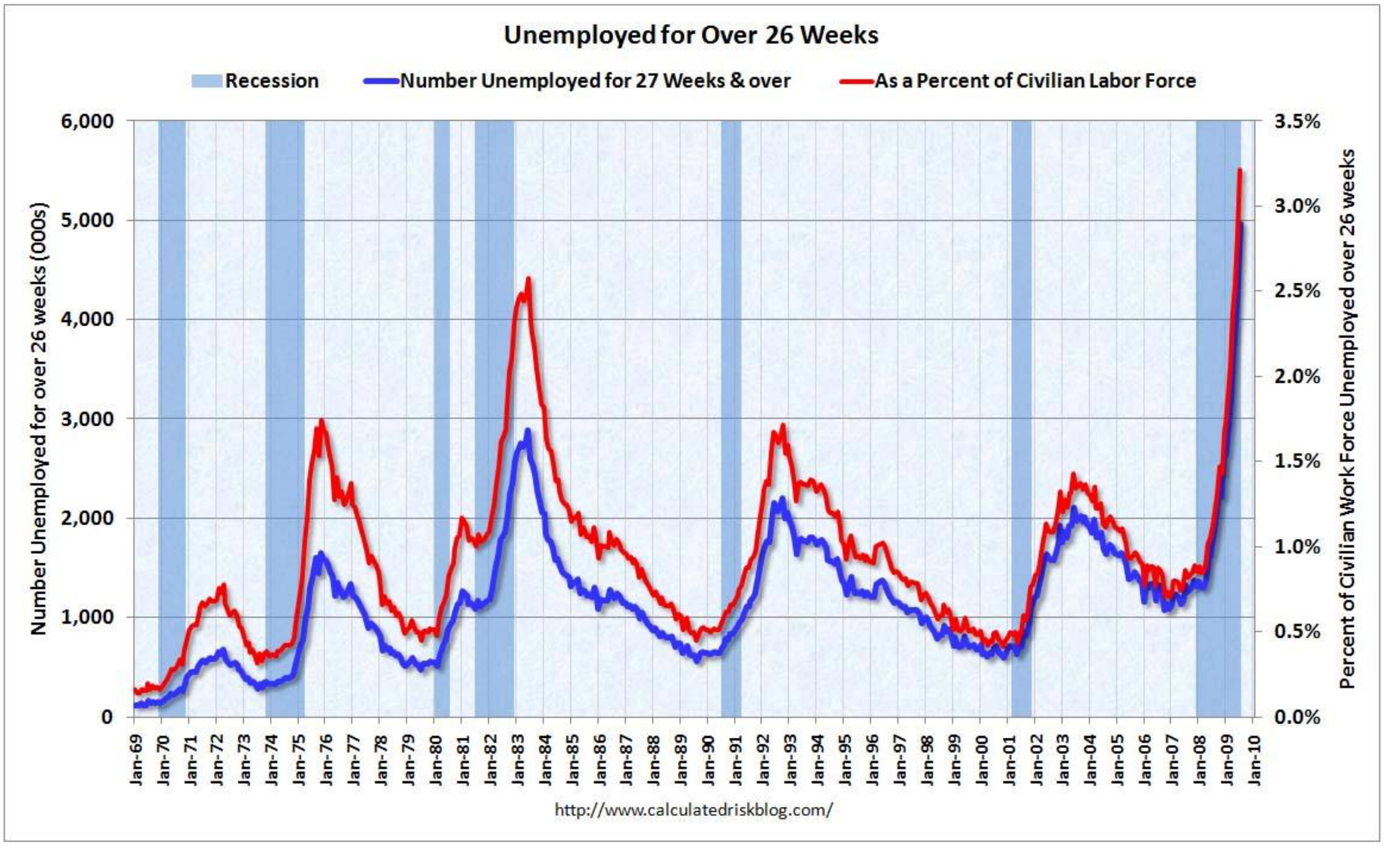
This "less bad" decline spurred some hope that the US housing market may be finding a bottom at last. As we and others have noted for the past couple of years, a halt in falling home prices is doubtless a key part of what is needed to re-stabilize the consumer-led American economy and its demand in the rest of world. But we are not likely to be out of the "housing woods" for a while yet. Two large headwinds remain: rising rates and rising unemployment. As shown in the chart below mortgage resets are likely to dump another swell of housing inventory onto already excessive supply during 2010.

Mortgage rate resets are to revisit their 2009 peak in 2010. (note the light pink bars at the top for option adjustable rate)



Even though interest rates are historically low, as teaser rates and artificial-rate loans reset higher in 2010 the carrying costs of already strapped homeowners is going up. In many cases the increased mortgage costs will virtually double. For those that are already facing negative equity in their homes, the most likely response of increased payments will be to default. This will bring a new round of forced sales and debt write-downs for lenders; as well as for the many investors who are holding packaged debt.

Record unemployment continues to rise

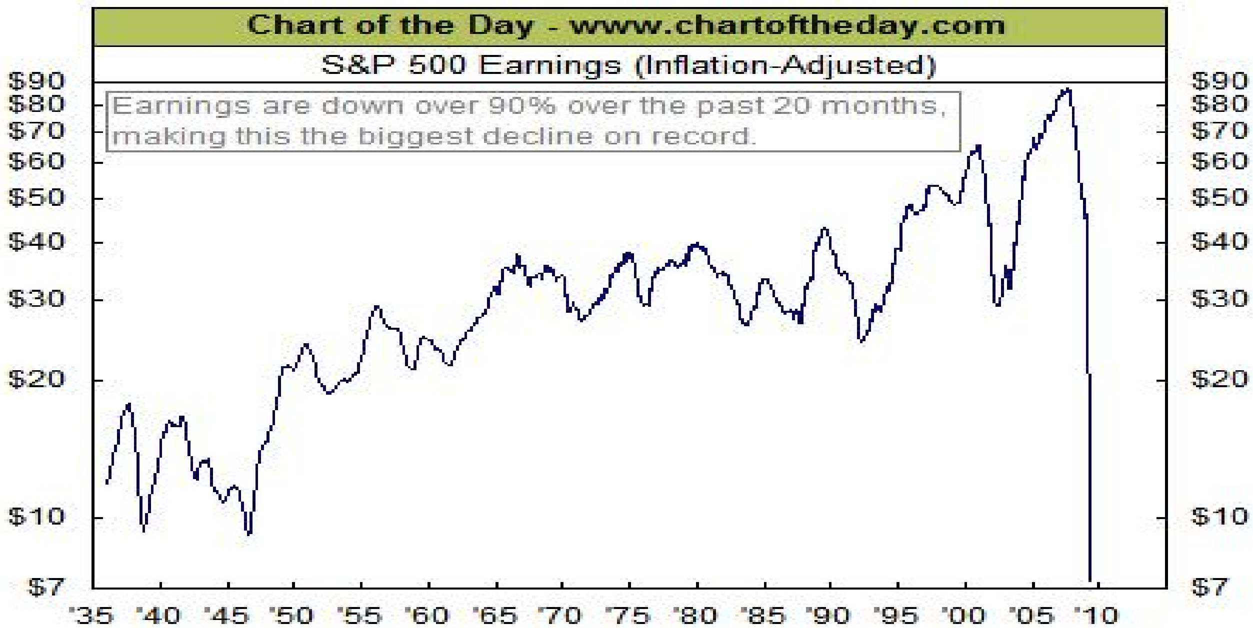


Source: www.calculatedriskblog.com

Official American unemployment is expected to breach 10% by year end. When we look at the chart of unemployment over 26 weeks above, it is worth noting that this high pole is still moving up. Although a little abated in recent months, the US economy is currently still losing jobs at a rate of more than 500K a month; and the unemployed are staying unemployed and under-employed beyond the duration of government benefits. As they drop off the benefit rolls, these people are still without work and without economic prospects.

So long as real estate remains weak, and unemployment remains high, economic growth and corporate earnings will be slow to recover. As shown in the below chart of S&P 500 earnings, the profit declines in the past couple of years have been so extreme, that one can hardly imagine that they will not bounce soon.

This amazing earnings contraction: worst since the Depression



Real earnings dropped to a record low in the first half of 2009 (the largest decline ever on record with data that goes back to 1936). In Q3 earnings are likely to record their first ever 12 month period of negative profit.

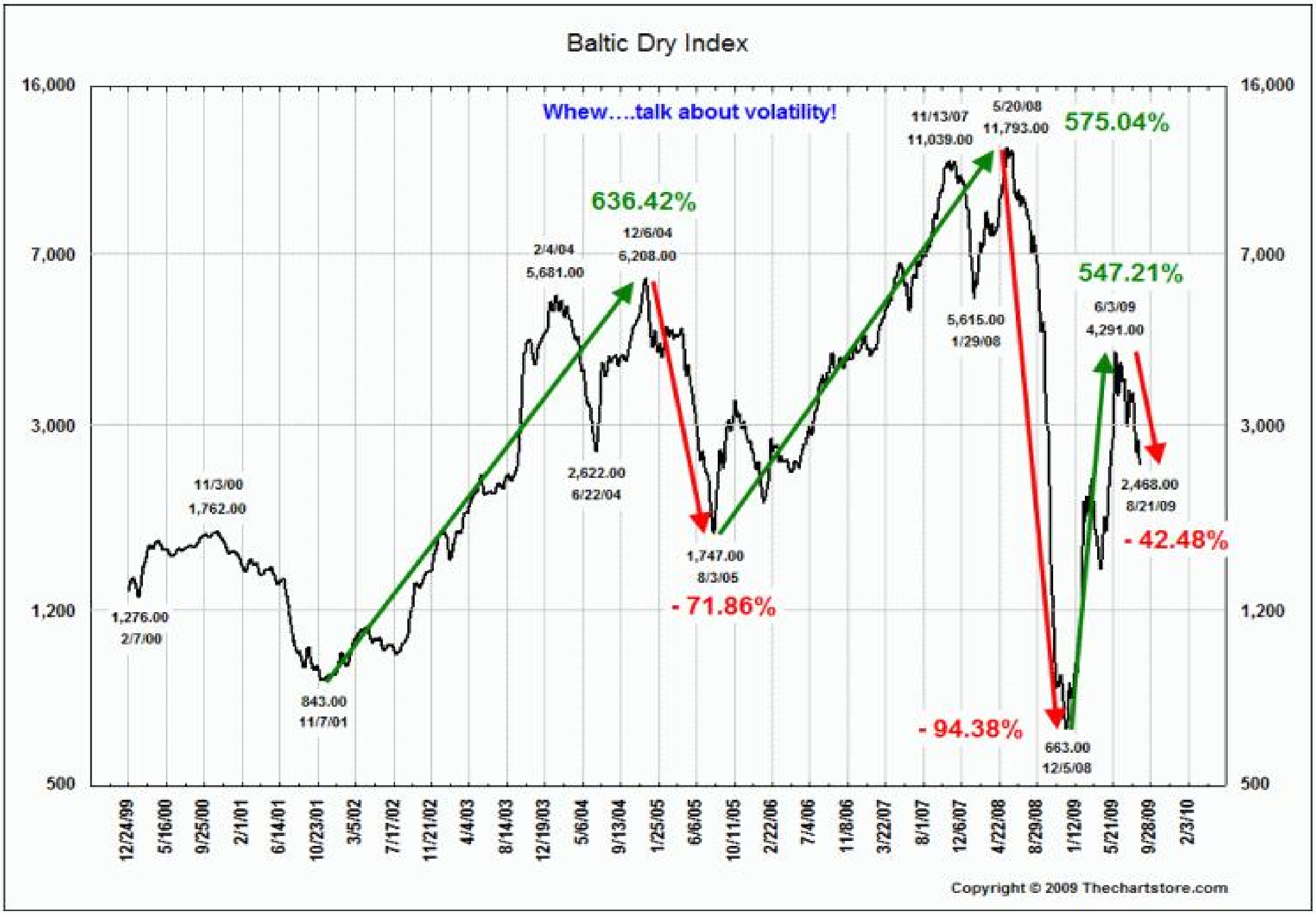
Having declined more than 90% over the past couple of years, we feel increasingly encouraged that some improvement in net profits should soon be in the works. Our concern in the short term is that after the run up in prices since March, the stock market is now pricing expected earnings growth for the S&P 500 of 50% in 2010. Without any significant increase in near term sales, we don't yet see evidence that this degree of earnings recovery is likely to materialize. Current stock prices seem therefore over-stretched.

What about Chinese demand saving the day?

In the second quarter of 2009, the Chinese government ramped up record bank lending and liquidity in an effort to stimulate consumption at home. There was some effect evident in increased domestic sales of cars and appliances in the first half of the year, but lately this demand has fallen off again.

The below chart of the Baltic Dry Index shows the remarkable tale of world shipping volumes falling more than 90% through 2009, rebounding with Chinese demand for commodities in the first half of 2009 and then plummeting again over the past 2 months.

World Shipping has been falling again since June

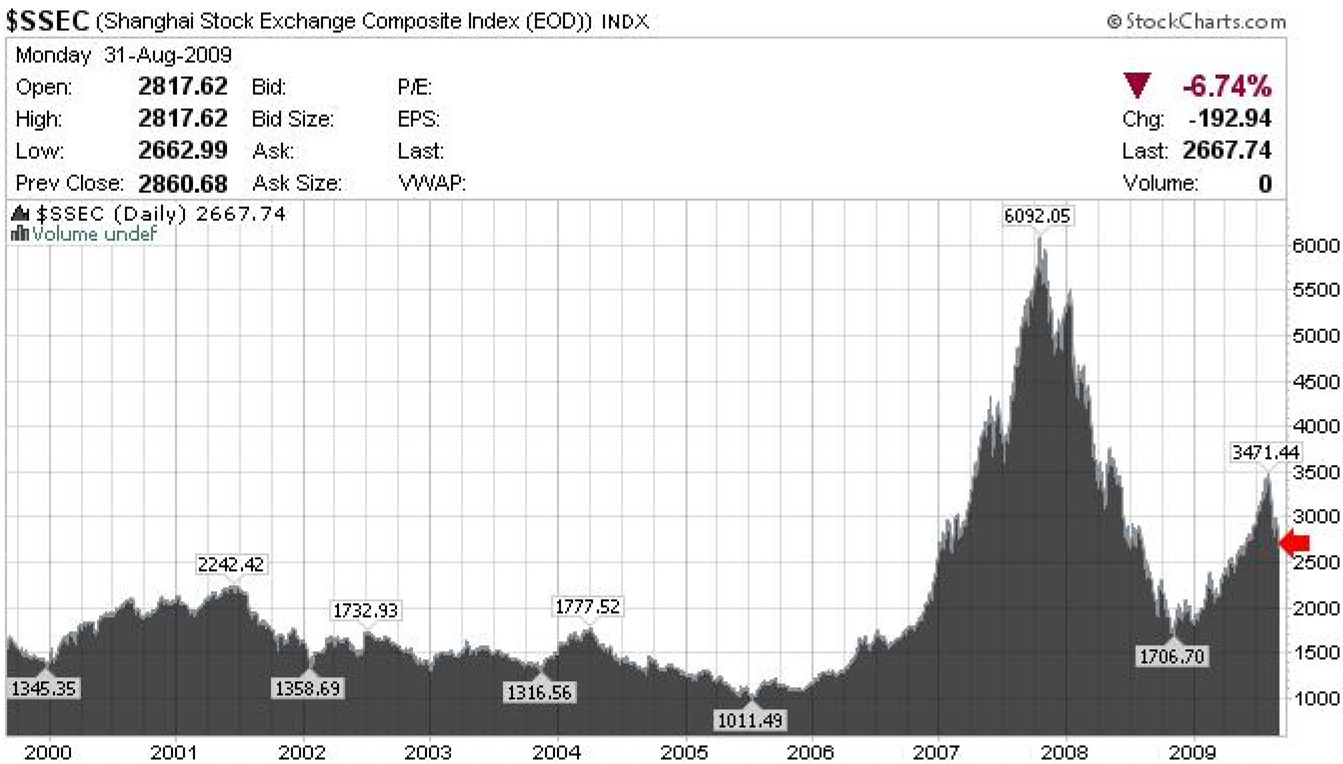


Source: thechartstore.com via The Big Picture blog

Historically, Chinese people have not been big discretionary spenders. It is likely to take many years for them to develop anything close to western-style habits. Rather than stimulating domestic consumption and infrastructure investment, a lot of the Chinese stimulus money has found its way into the unproductive ends of stock-piling and reckless speculation in commodities, real estate and the stock market.

China and the rest of Asia are still far too dependent on exports for "self-sustained" economic growth. Chinese exports fell 23% in July; weak exports will continue to mark a slow global recovery.

The Chinese stock market offers another lesson in investment math



In an investment world that seems to perpetually gloss over the numbers, we would like to point out that the Shanghai Index (shown above) gives us yet another opportunity to revisit some basic math.

From 2000 to 2005 the Chinese stock market traded in a range from 1300 to 2242 with a series of several dramatic +60% to -40% price swings in between. A buy and hold approach from 2000 to the low in 2005 would have resulted in a -25% return for 5 years of holding. Then from the 1011 level in 2005 to a bubble peak in 0ct 2007 the Chinese market increased an incredible 500% in just 2 years. For those of us that were aware of how dangerous and unsustainable such parabolic price spikes traditionally have been, calls to 'get out' were not hard to make. The Shanghai eventually fulfilled its overbought promise, falling more than 72% to 1706 in less than a year.

From November 2008 to August 4 this month, the Shanghai Index doubled to 3471. Those that had been China bulls at the 6000 peak have been shouting from the rooftops about the recent 100% rebound taunting those that had steered clear about "missing out". Since Aug 4 the Shanghai has once again declined 23% (so far).

To evaluate the actual progress of Chinese perma-bulls over the past couple of years, it is important for thinking people to do some simple math in net dollar terms. This can be done easily by reading index levels as if they were dollar amounts all the way through:

Dollar results of Chinese stock market investment over the past 2 years

$6092 became $1706
$1706 became $3471
$3471 became $2667
$2667 became $?
Net result after 2 years: $6092 became $2667 for a -56% return

From the above we can see the net dollar results after all the ups and downs of the past 2 years: $6092 has become $2637, for a net loss of more than 56%. Those that missed out should be jumping for joy!

At the end of the day, asset bubbles --whether in technology stocks, real estate, commodities, or emerging markets—are incredibly irrational, wild, dangerous places to expose one's savings. Keeping our eye fixed on net dollar results rather than 'market returns' is the most reliably rewarding course for real life investors.

Stock market trends looking near-term weak

With the Shanghai market officially re-entering a bear market (-23%) this month end, near term we at VPIC continue to be concerned about downside risks for the other inter-connected markets around the world.

As we pointed out over the past couple of months, the low volume feature of the global stock rally continued through August. We will continue to be skeptical of sustainable upside gains until low volume is remedied with greater inflows from more investors.

Interestingly the Volatility Index (VIX) that peaked over 80 in late 2008 and rebounded off downside support early this month seems to be now breaking out again to the upside. As we have said for the past few months, one more downside test for stock markets would seem reasonable and “healthy” in the long-awaited conclusion to this cyclical bear market.

If markets do fall into another period of price weakness over the next couple of months increased volatility may well afford us another reasonable price point to add further equity targets to the growth side of our portfolios.

At the end of the day, realists know that even a slow growth recovery can be rewarding for investors **so long as we do not overpay for the assets**.

And now we have September… grab those last days of summer sun wherever you can.

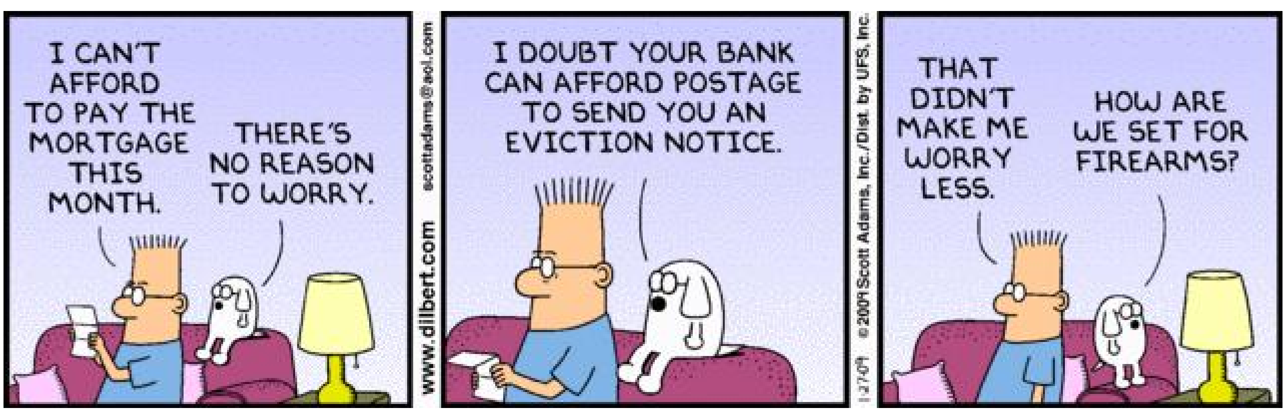
Quotes of the Month:

“Money goes where it is wanted and stays where it is well-treated."

-Walter Wriston, commercial banker (1919-2005)

“The trick for the future is to hang on to what you've got rather than trying to make the big bucks.”

-Richard Russell, Dow Theory letters, Aug 21, 2009



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