Real life needs active management

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E.Q Trendwatch™

Postcards from the edge in 2009

Investor sentiment hit a fresh low this month. Global fear is palpable. So many have been decimated in this ongoing downturn, few highlight hope for recovery. Warren Buffett's Berkshire Hathaway shares have lost 50% of their market value! Delirious euphoria of 2007 has transformed into unanimous despair in 2009. Those that called market bottoms week after week as the market fell are now declaring this contraction bottomless. Billionaires are jumping in front of trains. Previously celebrated money managers are being handcuffed and indicted. Dow theorist E. George Schaefer's 50% Principle theory warns of potential doomsday. The Dow's February 20 close of 7466 now risks a retrace of the entire gains made by this index since 1982. The Dow could be back at 776 some time ahead?

We have noted recently that it feels just as contrarian and uncomfortable to mention bullish thoughts now as it did to mention bearish thoughts when we did near the market peak 2006-2007. This weekend we attended an investment conference where speakers (who had been bullish on equities 2 years earlier) were now recommending that the audience buy gold coins, store emergency food and water, and if possible, buy themselves a "safe house" in the country in case they need to evacuate their city home. Conventional wisdom now suggests that this horror show will never end; the black appears ubiquitous.

The last time we remember such tangible global anxiety was in late 2002. The tech bubble had burst. The twin towers had fallen. Anthrax was in the mail. SAARS was traversing the globe. World markets had imploded by half. The SEC was investigating: CEO's, investment bankers, brokers and insiders. Lawsuits were flying. CNN broadcast terrorist alerts night and day. People were too afraid to fly on planes. Wars in Afghanistan and Iraq had just begun. We recall staying in a hotel in downtown Toronto about this time, staring at the CN Tower looming out the hotel window one night and thinking that if terrorists were to blow the Tower, it would very likely

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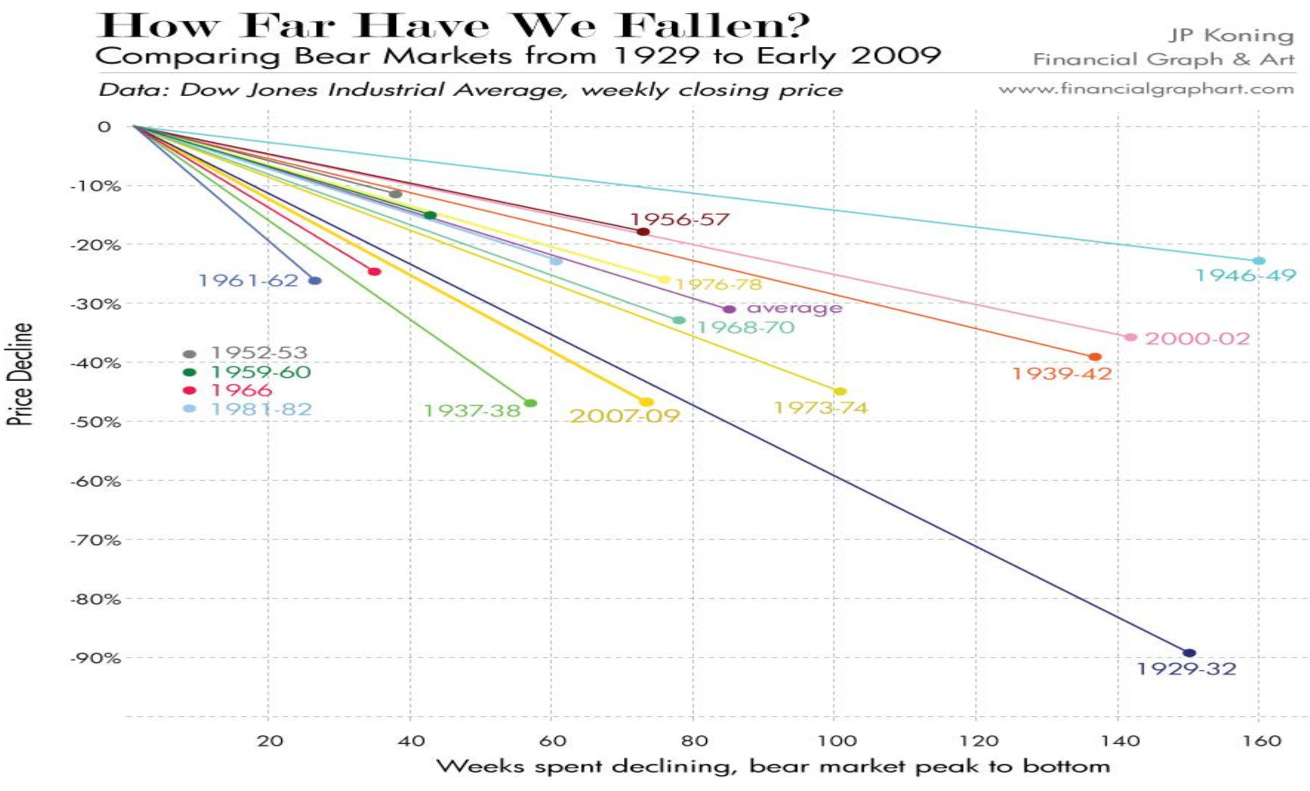
crash through our hotel and vaporise us in our beds. We briefly thought of changing rooms. We then deemed it point-less as the entire hotel would undoubtedly implode. We drifted off to sleep anyway. In the weeks ahead, the news grew bleaker. The jobless recovery began all the same; just when it was least predicted.

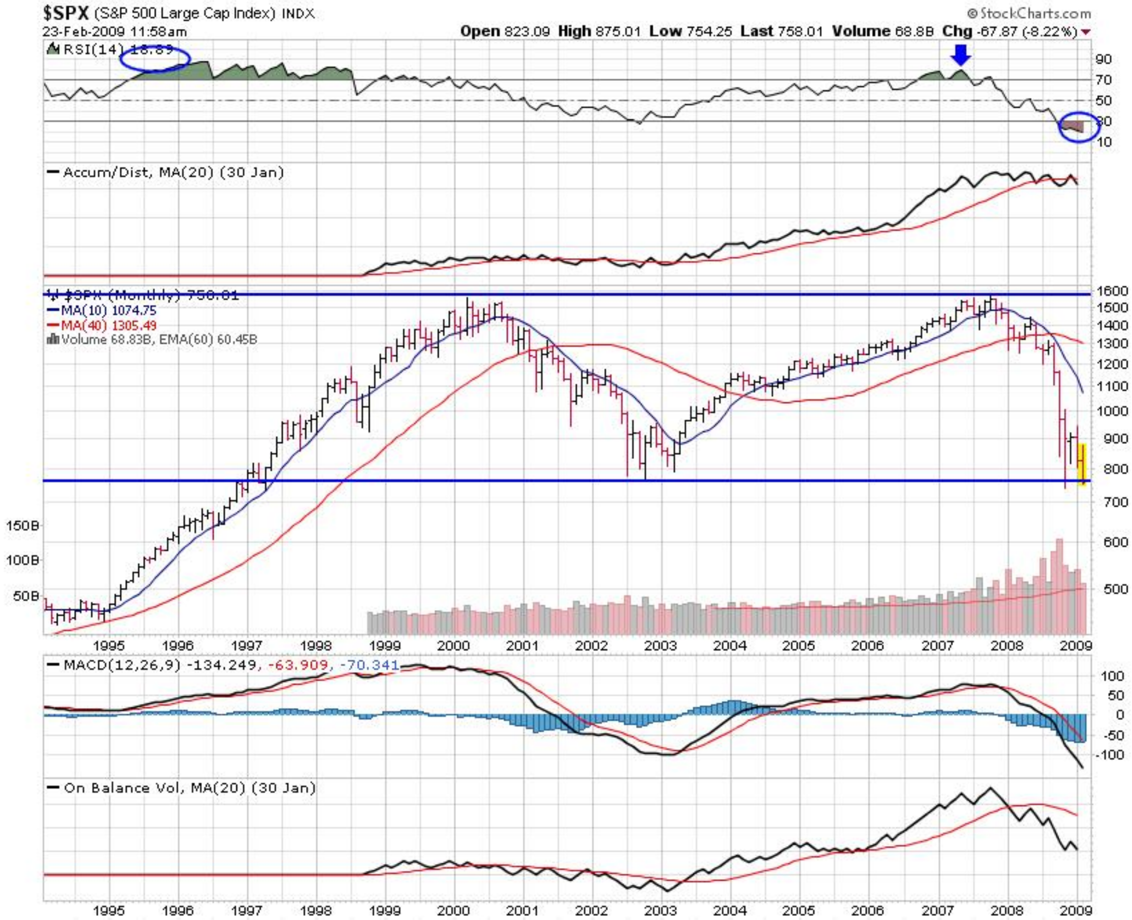
As the expansion ran on, our clients will recall that we became increasingly concerned about reckless credit expansion creating unsustainable demand. By late 2005 objective risk metrics were headed off our charts. By early 2007, to our amazement our technical measurements recommended virtually complete risk aversion. From 2006 to late 2007, it was hard to find anyone as worried as us about the high probability of an imminent bear market. As it turned out, our fears were a little early. But sticking to our rules by early 2008 we were completely out of equities and high yield bonds.

As we compare the fears today with those in 2002, we think some are worse, some are not. Certainly the world has more debt today than it did 7 years ago. More people have negative equity in their homes today than they did in '02. This recession has been in motion for 15 months, already a year longer than the then 3-month contraction in 2001. This economic downturn is already deeper and longer, and it is not finished yet. The following chart shows the price decline percentage and duration in weeks for each bear market in stocks (Dow 30) since 1929.



From the above chart we see that in terms of losses the bear of 2007-2009 at over -50% has already wrought the second worst ever losses in history; far surpassing the last Bear of 2000-2002 and marginally surpassing the legendary great bears of 1937-1938 and 1973-1974. Only the -89% of 1929-1932 has beat this decline in terms of depth and time. In terms of time alone we see that at 75 weeks this decline is so far still relatively short of the historical average of 85 weeks. None of this can tell us how much longer, or deeper this downturn will go. For prudent risk management we always have a strategy that recognizes worst case scenarios. But to be practical we must also acknowledge the probability that there may be less price risk in equity markets today than at any time in at least 15 years.

Let's look closely at this monthly chart of the S&P 500 price action since 1994.



Note that the Relative Strength (RSI) readings at the top of this chart were incredibly overbought--well over 70 on a monthly basis around the market peaks in both the late '90's and 2006-2007. (This was one of the indicators which had us feeling bearish back then.) Now let's note that this same indicator is presently the most oversold ever in the past 15 years, with a reading of less than 20!(see the circled area at the top far right) Even in the depths of the 2002 Bear, the oversold RSI bottomed out around 30.

A lay person can think of it this way. The probability of further market gains when the RSI is at 80 are about 20%, with the inverse 80% probability of market declines. With the RSI at 18.8, there is an 18% remaining probability of further declines and 82% probability of a price rally. This is not how technicians might explain this indicator, but the analogy is still useful.

Before rabid bears tear at our flesh, we are compelled to highlight some bullish thoughts that seem presently overlooked:

- Commodity prices have literally imploded more than halving input costs over the past 12 months.
- Interest rates have been slashed to a fresh record low. A 1% Fed rate started a reluctant spending spree in 2003. Recent .5% rates are bound to have some tangible stimulus. Anyone remember the saying: "Don't fight the Fed"?
- There are more governments and people working to jump-start the global economy with more dollars now, than ever before in history.
- The Obama administration is focusing formidable political will and stimulus dollars at green energy and energy independence precisely at the time when there is a dire need for sustainable domestic industry and jobs.
- Living people still consume. Even though we are no doubt spending more responsibly today, to exist is to necessarily spend and consume.
- Corporate earnings expectations have fallen from a ridiculously high $94 a share for the S&P 500 at the start of 2008 to an expected $32 a share in 2009. Even if earnings fall further still the inevitable upside surprise will one day rear its head again. Earnings won't be nothing; at least not forever.
- Capital is starting to tiptoe back into corporate bonds. 2008 was one of the worst years ever on record for corporate bond prices. Risk aversion and de-leveraging drove high yield bond indices in North America down by more than 26% in 2008. The worst loss before this had been –9.6% in the last bad recession of 1990. Recent in-flows to corporate bonds are the necessary leading edge of investor return to risk appetite.

The sky is still very dark, but will it fall? Opportunities are doubtless emerging all around for those not too shell-shocked to come out of the bunkers and rummage around. We have started some careful buying of high yielding equities and corporate bonds. Yes we are holding a lot of cash. And yes we have pre-defined our sell rules. We would never advocate wild abandon. We will continue to monitor and measure carefully and we will not hesitate to sell if major markets break our rule set below the

November lows. That said, market bottoms are a process. They are notoriously bumpy and must be given some latitude to form.

This is no place for blind optimism. We have never recommended that anyone passively buy and hold risk assets, and yes we are likely to be in a range bound secular Bear market for the next several years. But all of that said, we should be wary of doomsday cults. Just as in every other bear market, the picture is always darkest before the dawn. The beginnings of a new cyclical bull are more likely to be in the offing, than at any time in many years. We must acknowledge the downside risks, devise an escape or hedge plan in case of emergency, but also force ourselves to keep taking the objective measurements and be open to opportunities as they present.

Market action in February

Responding to the buy signals in our work this month, we added an opening 1/3 of target positions in XFN (Cdn financials), XIU (Cdn broad index), XDV (Canadian dividend), XRE (Cdn Reits), XSP (S&P 500, hedged in C$), and QQQQ (Nasdaq 100). At our entry levels, dividend yields on these units range from 3% to 15% a year. This is better income than these units have paid in many years. Being paid to wait, we would be happy enough to hold these units even if markets trade sideways for an extended period. That said we are watching the prices very carefully for any breach of our sell triggers. Price support will need to hold if these trades are to stay in place in our accounts. If prices can rally from here, we will add the next partial tranche of our target positions.

In response to a buy on the Canadian corporate bond sector in February (after 3 years of being out of it altogether), we opted to add f class shares of the Northwest Hi Yield Corporate Bond pool (yielding 10.8%) as part of our fixed income holdings for a diversified and liquid exposure to this sector.

How now gold?

Gold bullion flirted with the illusive $1,000 an ounce level again this month. By month end it had rolled back below $943. Meanwhile gold company shares that were in the midst of a formidable rebound since their November 2008 low, this month hit price resistance and turned back down. The chart below shows the picture of each rally, and then break down since last March.

The story of gold over the past few years has been a story of falling confidence in the US dollar as the benchmark currency. Some continue to forecast gold will be at $3,000 an ounce. Of course, we cannot know what will happen, but we cannot help but think of the children's story about King Midas and his golden touch. King Midas loved gold so that he asked for the magic powers to turn everything that he touched into gold. This seemed to him like a wonderful idea until he helplessly turned his food, water and daughter into lumps of golden rock and realized how utterly useless the substance was.

As this economic crisis matures, we note some interesting data about gold prices and gold ETFs over the past year:

- Gold ETF's are trust units that offer investors a direct bet on bullion prices. The trusts have to buy physical bullion to match investment levels. Responding to investor demand over the past year, Gold trusts have doubled the amount of gold in their vaults
- Gold trusts have added 306 metric tons to their gold vaults in the first 7 weeks of 2009 alone, which is almost as much as the 322 tons of gold they added in the whole of 2008.
- If this rate of accumulation continues, ETF buying will be greater in 2009 than the 2120 tons procured by the whole world for jewellery in 2008. Jewellery has always been the strongest demand segment for gold. If present investment demand continues, by the end of 2009, ETF's would overtake as the largest segment of global gold demand.

  Source of statistics: Wall Street Journal: Investors Decide: In Gold We Trust, http://online.wsj.com/article/SB123534062320443825.html

This story of investor demand seems to us eerily reminiscent of the data we were seeing from energy and commodity ETF's and investment funds a year ago. *Just before materials and energy prices plummeted more than 75%.* The reality is that this type of investor demand in hot sectors is fickle. It is not "real" or physical demand for consumption purposes. It is investor demand or really just hopeful speculation. As investor fervour turns off hot sectors, investment funds have to liquidate the underlying commodities as unit holders sell. World consumption has plunged over the past year to be sure, but the additional pressure of "investment" funds liquidating has been a relentlessly, negative and compounding factor for commodities. We suspect this phenomenon may prove a double-edged sword for gold as well.

Quotes of the month:

"The prizes go to those who meet emergencies successfully. And the way to meet emergencies is to do each daily task the best we can." *--William Feather 1889-1981, Publisher and Author*

"Cherish your visions and your dreams as they are the children of your soul; the blue prints of your ultimate achievements." *-- Napoleon Hill, 1883-1970, Author*

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