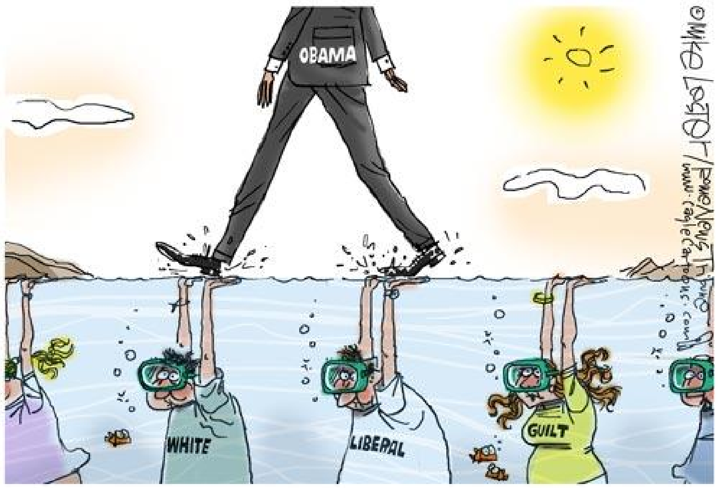
Real life needs active management JANUARY 31 , 2009. ISSUE 1

E.Q Trendwatch™

2009: The audacity of hope



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Watching Americans usher in their new president was pretty incredible. One could not help but feel the weight of expectation for miraculous solutions now on Obama. And while the world will no doubt be frustrated with the work and time required to repair the damage of the past decade, still there is an undeniable nod toward hope now afoot.

It has become widely uncommon to be optimistic about the economy. The press and commentators are almost universally dour. Many have good reason to be cynical. Since the credit crisis began in March 2007, the sky has fallen on risk-takers for 22 months, and many feel certain that the ground is now cracking too. Perhaps they are right. But at VPIC, we are increasingly finding more objective signs for hope than we have found in several years.

As we have discussed many times, secular bear markets for stocks have historically been long, range-bound cycles, arching over a series of successive business cycles and lasting 17 to 20 years. Having started in 2000, this secular bear is now about 9 years in. It occurs to us in looking at the chart below, we may now be seeing the outline of the trading range investors will contend with for the next 8-10 years.

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S&P 500: is the trading range now defined?

If this is correct, the S&P 500 may well hold a re-test at 800 and lead the next business cycle recovery in the not too distant future. If this is correct, once the next up cycle begins in earnest, we could see markets recover over the next 3-5 years before topping out again around the prior cycle peak. For the S&P this would mark a potential gain of 88% from here. We would be quite content to capture the bulk of this gain before moving out of the markets again to miss the bulk of the next cyclical bear (maybe starting by 2012?).

Canada's TSX: Is time and price enough yet?

The TSX also touched its 10-year price support intra-month during November falling briefly to 7724. But as shown in the chart below, so far, unlike the S&P the TSX has not yet had a monthly close “on the line”. This may suggest that the TSX will get off a little easier this cycle than the S&P. It may also suggest that the TSX is lagging the S&P and may have further downside work and time to go before its bottom can be in. In either of these scenarios, we may presently be close to the turn for the TSX as well.

The late-cycle performers of commodities and energy did push the TSX to re-test its final peak in May 2008, some 6 months after the S&P. Perhaps then it makes sense that the Canadian market would now also bottom later than the S&P and be slower to start the recovery.

We know that our much-praised Canadian banks are recently back at prices not seen since their 2001 -cycle trough, pushing their dividend yields now to more than 6%.

Canadian banks: will this half off sale mark their cycle’s lows?

Arguments for further price declines in Canadian banks can still be made. We know that generally over the past year some of the most established companies in the world have been cutting their dividends payouts at the fastest rate since 1958. Canadian banks have not cut dividends since the Depression of the 30’s. Nonetheless, doubts about the banks’ dividends have surfaced as their earnings continue under pressure.

Their combined net income dropped by 37 per cent to the end of October 31, 2008. They paid out 76 per cent of their earnings in dividends last year compared with an average of 42 per cent over the previous decade. Their earnings are expected to fall further in 2009. Extraordinary times may call for extraordinary measures to conserve cash and rebuild bank balance sheets. The possibility of dividend cuts may be low, but it is not nil. If dividends were to be cut, bank share prices would likely fall somewhat further from here, it is true. Still all of this considered, the Canadian banking system is still the relative envy of the western world and it has not been this cheaply priced for nearly a decade. At the very least, its price risk is surely lower now than over the past few years when conventional Bay Street babblers regularly gushed: "We love the banks".

Canadian corporate bonds and preferred Shares

Similar logic applies when we now look at the highest quality Canadian corporate bonds and preferred shares. Many that were trading at apparently "risk-free" rates just 12 months ago have since lost half of their market value. This means that yields of more than 7% here are at long last enticing. We know that these asset prices are not likely to recover significantly until the stock market recovers, and some risk of pay-out cuts and defaults remain. But these instruments surely pose less risk now than over the past few years when over-optimism had priced all for perfection.

We are carefully tracking the ETF's that hold baskets of these instruments for our entry point. The good thing about bear markets is the bargain basement prices that they ultimately bring. We are seeing better value now than in a long, long time. Well priced, higher yielding income securities will undoubtedly be a key part of our investment strategy while we wait for asset prices to recover in a potentially slow economic expansion over the next few years.

Gold: is it a buy or a sell?

Over the years we have bought gold and we have sold gold. We have made some money on gold a couple of times, but we have no particular attraction or affinity for it. It pays no income to hold it; it serves little practical purpose for humans or the planet. We see no reason to love it.

Our last trade in gold was a sell last May. As gold broke down from its $1000 peak, and gold shares began to tumble with everything else, our sell rules triggered and we sold our positions.

In recent months, as the global recession spread and risk markets imploded, we continued to chart gold faithfully. As Richard Russell pleads passionately for gold as world currency, we have read with interest and continued to chart gold carefully. As commentators have increasingly proclaimed the end of the US dollar and the irrelevance of fiat currencies, we have listened and continued to chart gold carefully. As GATA members proclaim government conspiracies to manipulate and control it, we have continued to watch gold carefully. As increasing throngs forecast the collapse of the world banking system we have continued to watch gold carefully.

When asked about gold by the media, we have repeatedly said that we would buy gold again if we got a buy on our rules. Until then, we wouldn't. Evidently such impartial commentary enrages some. Time and again, we have tried to assure that it is nothing personal we just need a break out on our metrics before we can see a buy on gold. But as time goes on and gold prices fail to break through last spring's peak, one can't help but ponder this: is gold more likely to be a buy or a sell here? Let's look at the chart:

Since 2001and for 7 long years as the US dollar fell, the price of gold had an exceptionally good run of more than 300%. But as the US dollar broke out last January gold broke down. Since then as the great reckoning broke loose in the global economy, we have seen gold make lower highs, and lower lows.

We don't profess to know the future. But with all the carnage that has hit the world this past year, shouldn't gold have made a fresh high by now? If the economic world does come to an end any time soon, then gold may well break higher still. But the alternate scenario should also be considered. Maybe-- just maybe the worst of this market crisis is now passing by.

Yes the US has a lot of problems. But the rest of the world is in tatters too, and relatively speaking most are worse off. Incredible to suggest we know, but what if the US stock market manages the now largely unexpected and begins to buck up?

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Let’s look again at this chart of the S&P 500 and compare it to the chart above of gold:

Fourteen months into this bear market, the S&P has lost more than 40% and is now at monthly price support last touched in 2003. In relative strength, the US market is now more oversold than it has been at any time in over 20 years. Meanwhile, gold has so far lingered within 10% of its all time high.

Investing is about weighing probable outcomes. This is really all we have. When we look at the two charts above, we must focus on practical questions. With gold at an 8-year high, and the S&P at a 6-year low, which asset has the greater probability of outperforming now?

The January issue of National Geographic did a front cover feature on *“Gold. The true cost of a global obsession.”* Leaving aside the contrarian sentiment arguments one could see in this mainstream coverage, the article brings up some interesting facts on gold:

- Adjusted for inflation in 2008 dollars, $1,000 has been the high water price for gold since Sir Isaac Newton first standardized it in 1717. (The NG article has a great chart of this.)
- Every time it has spiked through this level in the past three centuries, gold prices have fallen for the next 100 years or so.
- Investors are marginal buyers of gold. Jewellery and trinket demand have accounted for about 75% of global gold demand this decade.

- Worldwide jewellery demand collapsed with other wealth in 2008, and is expected to fall further in 2009.
- In all of history only 161,000 tons of gold have ever been mined, barely enough to fill two Olympic-size swimming pools. More than half of that supply has been extracted from the earth in the past 50 years alone.

The most bullish argument we hear for gold is that retail investors, now scared out-of-their-wits by the global downturn, mistrusting governments and paper money, will continue to feverishly snatch up gold bars, coins, wafers and gold ETF's. Maybe they will; but for how much longer? They can't eat or drink it. They can't use it for shelter; it won't pay them an income. Even gold-obsessed East Indians generally stop buying gold to collect when its price rises past $750 an ounce. East Indian demand collapsed last year, with India's gold imports plunging 81% in December.

Maybe with the on-going implosion of hedge funds that were recklessly speculating in this and other commodities over the past 7 years, dumb money is gone for a while, and gold prices will continue to fall. Maybe the world won't end and the US dollar won't lose its benchmark status- at least just yet. Maybe the beleaguered stock market will start to recover this year and gold will continue to contract from its multi-year high. Based on history at least, it would seem that gold's inevitable reversion to the mean is now overdue.

Lest we sound too bullish

Our regular readers will no doubt notice that in this market letter we are sounding more bullish on risk assets than we have for the past 3 years. Lest you think we have lost sight of present risks in the world, let us assure you that we have not. As prices plunge we are becoming cautiously optimistic, because it is part of our job to see high probability opportunities when they present. We know that the markets will eventually hit bottom and begin their slow climb back into the next expansion. We believe that the next economic expansion will be slow to build this time; more like an "L" than a "V" recovery. Once the stock market does rebound, we are mindful that it is still within an ongoing secular bear, with the next up cycle likely to be shorter in duration and less in magnitude than in some past cyclical bulls.

The "January Effect" is noted

We are also aware of the potential threat of the so called "January effect' which historically suggests that if the S&P 500 falls over the month of January (as it has done this month) then it will fall over the course of the year. Since 1969, this correlation has been confirmed 32 out of a possible 39 times, or about 82% of the time. (Mirabaud Strategic)

But we must also note that in 18% of the years this correlation did not hold. A most recent example in our memory was 2003 when the market, having lost 45% over the previous two years, fell in January only to gain 26% by year end.

In other incidents although the market may have finished lower at the end of the year as compared to the start, it had several months in between of a strong counter-trend rally that could be partially captured to one's benefit. Our method is not calibrated to speculate in day to day gyrations, but more lasting trends can sometimes be captured depending on their duration and strength.

No gut or rules of thumb can be blindly applied here. It is for this reason that we take direction and comfort from our own objective management rules which track what the market is actually doing rather than what we, or others, fear or hope will happen. In addition, it is important to realize that even if we start to get buys on risk assets going forward, we will as always, edge in gradually in segments rather than all at once. And if the primary trend breaks down again we will not argue with it, but rather take that cue to exit back to cash on our sell rules.

And now we enter February. Two more months until spring! *Stay warm.*

Quote of the month:

"The more tranquil a man becomes, the greater is his success, his influence, his power for good. Calmness of mind is one of the beautiful jewels of wisdom."

James Allen 1864-1912, Author of As A Man Thinketh

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