Real life needs active management

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E.Q Trendwatch™

Market déjà vu

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Much as it may upset the individualists among us, human behaviour has been remarkably consistent through time. At VPIC we are but humble students of history and so we are open to its lessons. As we often tell our kids, we don't get to dictate the world; it is just our job to study and manage along.

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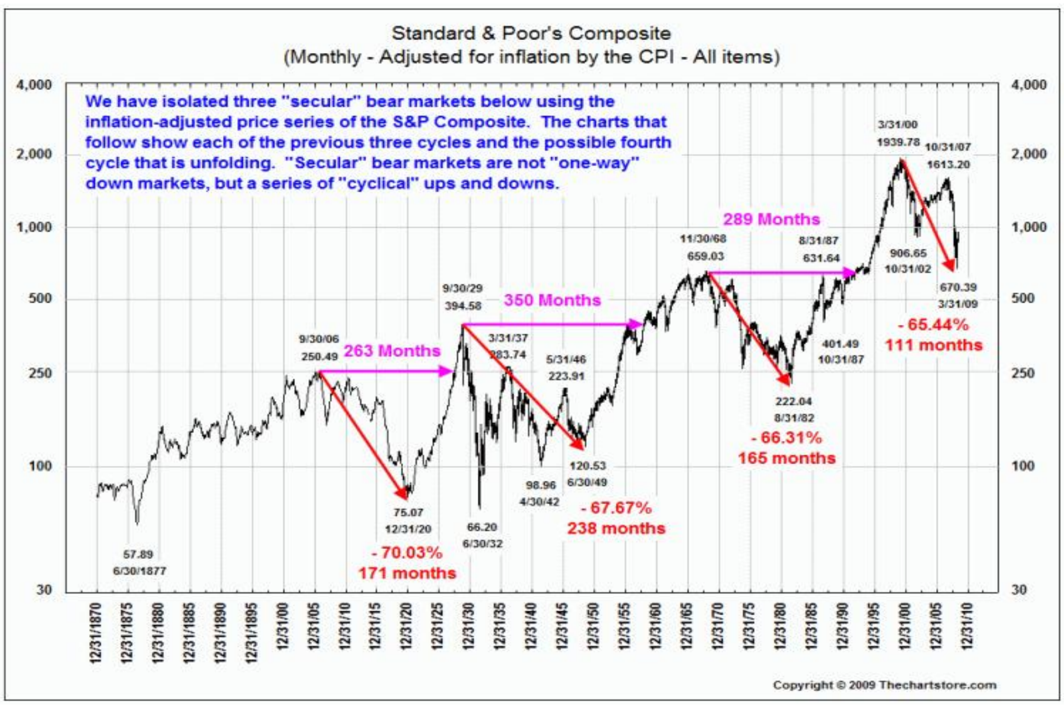
What we find interesting is how similar market behaviour can appear over seemingly unique and unrelated events in time. The following historical chart of the S&P 500 since 1870 makes the point. It shows a series of 4 secular bear periods this century where stocks have dropped 65-70% over extended 14-20 year periods. We can see that so far in *our* secular bear which began in 2000, markets have dropped for a relatively short 9 years to date, although the extent of the decline from the 2000 peak has already been within the historic "norm".



Source: Thechartstore.com via The Big Picture blog

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***Our* secular bear**

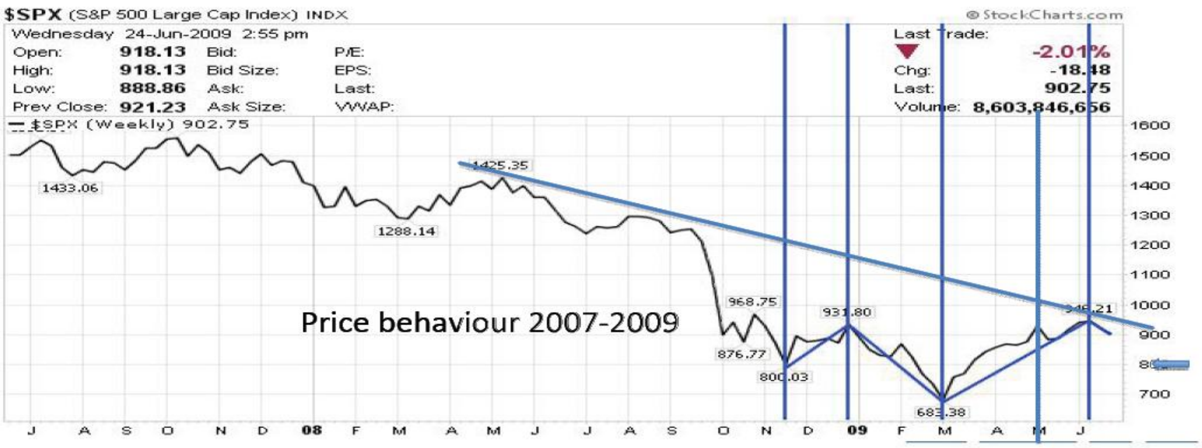
We accept that we are likely to be within a secular bear period for several more years to come. Although the magnitude of market declines has been significant since 2000--starting from the highest-ever levels in history--we can see that the market cap of US stocks is still not quite back to the long-term mean. To revert to the long-term mean, prices would have to move below the mean (red dotted line) over time.

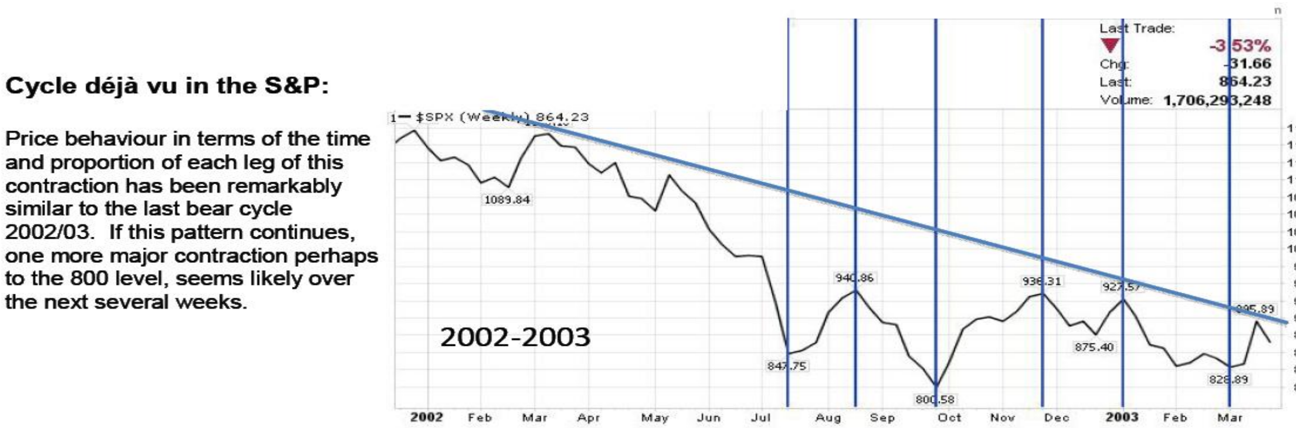
Source: Thechartstore.com

Relative valuations of equities at this point are still on the high end when compared to the finale of other secular bears. To date we are far from the single digit PE's and 9% dividend yields that have marked prior secular bottoms. And it has always taken historically oversold conditions in equity markets to jumpstart the secular bull periods throughout market (human) history. Things could be "different this time" we know, but at this point we are happy enough to just watch for the next cyclical bull within a probable on-going secular bear period. And on that front, *we suspect it is likely that we are getting close.*

Since the March 9 market lows, we have seen broad-based pessimism give way to a synchronous relief rally in risk assets around the world. We would like to believe that March 9 was "the" low of this bear market, but having studied more than 100 years of market cycles, we must acknowledge first, that there is no way to know a bottom in advance, and second, that bottoms have always been a process not a day. *Lasting* bottoms each cycle are typically tested more than twice.

A most recent study can be made in comparing the below chart of the S&P 500 price action during this bear market 2007- to date and the preceding cyclical bear of 2000-2002.





Source: Venable Park Investment Counsel Inc.

We note that the price behaviour to the November 2008 low and the March 2009 lows line up with the July and October 2002 lows in the chart above. It will be interesting to see how much of recent gains this market may now need to retrace in the weeks ahead in order to confirm this cycle's final low. If the correlation to the 2002-03 contraction were to continue, the S&P may need to retest the 800 level by August to October this fall. We are aware of the narrative fallacy of trying to forecast the future. Ignorance tends to breed confidence; and we are not ignorant of the complexity in this area. We do not manage money based on our expectations or hopes.

However, postulating scenarios for what may happen next is a requirement of this fascinating work.

US $ could also be coming round again

One of the great gifts of 2008 was that as stock markets imploded Canadians were able to make low-risk returns strategically parked in US T-Bills. When the US dollar broke down again in the fall of 2008 we were forced to exit and wait as the dollar index fell through its long term support of $80 all the way to $70.70.

US Dollar Index- support is at $80

Source: Venable Park Investment Counsel Inc.

When the world is afraid it buys US dollars, and when the world recovers confidence it sells the dollar. After peaking at $89.62 in early March, the dollar index corrected to the $80 level over the past 3 months as hopes for economic green shoots took hold. It has succeeded in holding at $80 four times in the past 20 years. The question is will it hold here again? If the third quarter ushers in another wave of concern and disappointment about the global economy, the US dollar may well hold here and we may well get another opportunity to make equity-like gains in US T-Bills.

Gold mirrors last May and breaks down (again)?

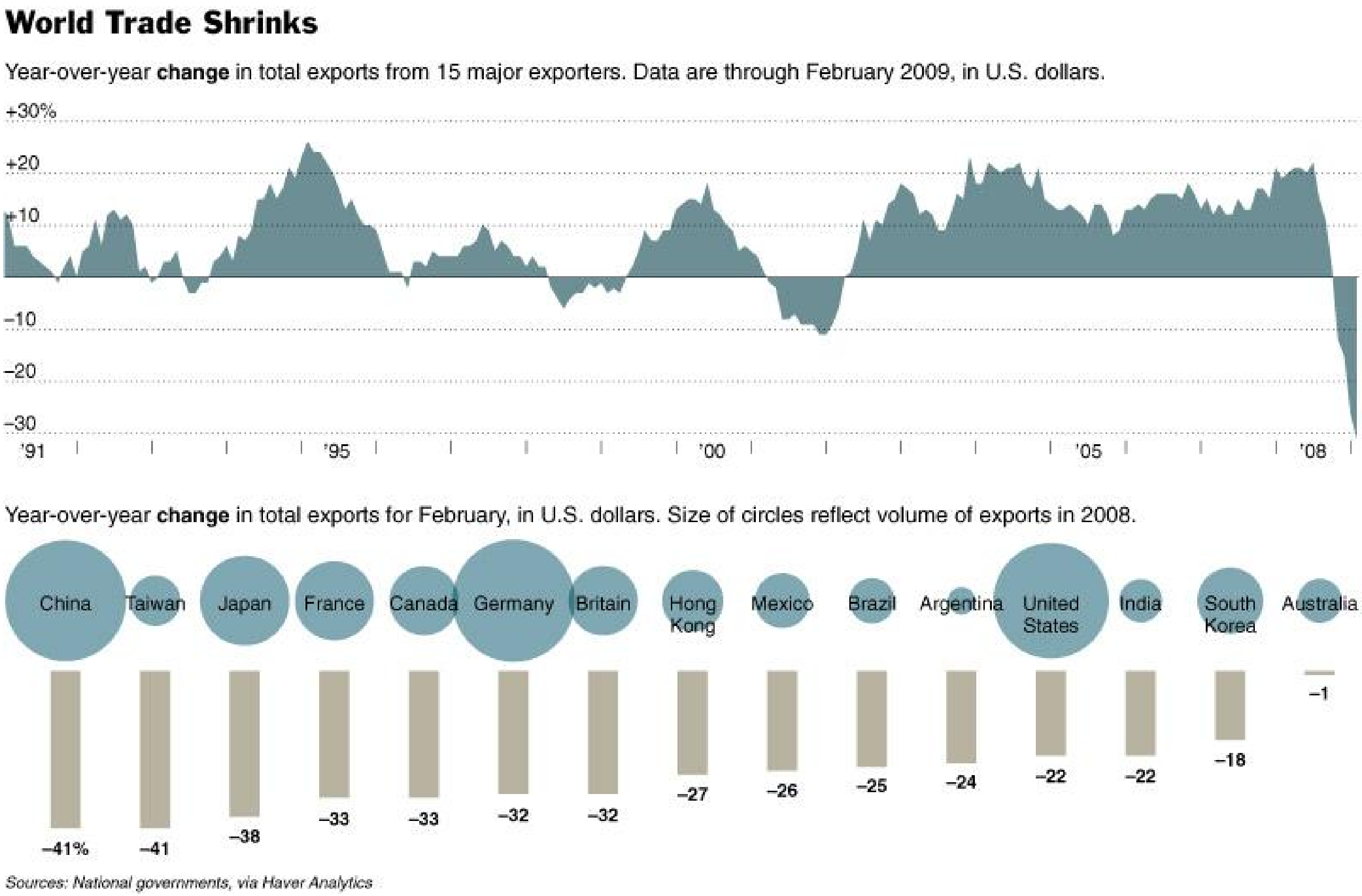
Meanwhile gold too is giving us a sense of déjà vu as shown in the chart below. The run at $1000 has now failed twice and with remarkable symmetry since last year.

Source: Venable Park Investment Counsel Inc.

There are two key themes governing gold. The first is the prospect for inflation. So far inflation is not in the mix. Given the weakened state of the global economy, inflation is not in the foreseeable future. This is a headwind for gold. The other key theme is the status of the US dollar. Those that predict the dollar's collapse argue gold will break out as an alternate world currency. That may be right. But first, the dollar would have to collapse and so far it has not. Meanwhile after a 7 year bull market, even as gold mania has swept the world, prices have not been able make new highs in over a year.

Many gold bulls point to the fact that the US has a external debt to GDP ratio of 95% presently, predicted to climb over the next several years from deficit spending. Levels of indebtedness are always a concern. But at the same time we must acknowledge that as the world's largest economy the US is not the world's most indebted nation. The top 14 debt-laden nations include Germany at 137% debt to GDP; France at 168%; Switzerland at 264%; Hong Kong at 295%; UK at 336%, and Ireland at 811%!!

The world's indebted nations have all hit the global slowdown with compromised resilience because of their debt. But this is a problem for the lenders as well as the debtors. The world's biggest consumers are on the abstinence wagon. Global trade has shrunk dramatically as a result. The relatively less indebted nations like China, Japan and Canada have all lost the most in terms of exports with volume falling more than 30% over the past year, shown in the following chart.



We have noted from the beginning that this global slowdown started in the US. We still believe that the US will need to stabilize to a new normal level of consumption and growth before the world can do the same. So we will continue to watch for signs of stabilization in the US housing, spending and employment data with great interest.

What about Canada's TSX?

Having hit resistance this month, the TSX has been recently trending down. If equity markets weaken over the next few months, we will be watching key down side tests for the TSX in 9000-8000 range as marked in the red boxes below. Finding support in these areas would be a constructive sign for confirming the start of a cyclical bull in the third quarter.

Source: Venable Park Investment Counsel Inc.

Canadian short and medium term bonds are so far holding their own

With no near-term threat of inflation, Canadian bonds prices have continued to hold up well this quarter. Our corporate bond unit has enjoyed very positive price gains over the past few months with the return of global risk appetite. Capital gains on top of income are good. We should expect that some of the gains may be taken back over the next few months should a fresh wave of equity market angst hit the world. We will watch support levels carefully, but given that corporate bonds were so deeply oversold in 2008, we have reasonable price cushion even with the recent rally. That said, if gold were to make a successful run through $1000 this would be one of the signals that inflation is picking up and that bond markets are at risk of decline. We will continue to watch this relationship carefully. At the same time, with overnight rates at virtually zero, we continue to prefer fixed income holdings with terms to maturity of less than 5 years.

In Closing

These are challenging times for many. We recently posted an ad for a new assistant to join Venable Park and within 4 days we had received more than 300 resumes. The world is in recession and there are lots of people looking for work. Stores everywhere are in liquidation mode. There is a palpable financial strain.

While things here are certainly not the best, we must remember that they are also far from the worst the world has seen. We will get through this. We in North America are still incredibly fortunate in our natural environment, resources and geography. People, companies and governments today are now intensely motivated to reinvent and reorganize. There is nothing like failure and crisis to bring about solutions and we will get them.

Today we are making more advancement in big picture innovation and technology than we have seen in many decades. Today's new wave of frugality, resourcefulness and hard work will bring us eventually to the next wave of prosperity in the future. In the meantime, we should aspire to every bit of care and personal discipline that we can personify. Now is not at time for idle talk; now is a time for doing, inventing and creating. And on that note, we will end with the following quotes from two great thinkers (American) who lived to change the world.

Quotes of the month:

"What you are doing is speaking so loudly that I cannot hear what you are saying"

--Ralph Waldo Emerson (1803-1882)

"Our greatest weakness lies in giving up. The most certain way to succeed is always to try one more time."

--Thomas Edison (1847-1931)

Best wishes for a wonderful summer, as this too shall pass…

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