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E.Q Trendwatch™

Hopes for a better half

Harsh as this global downturn has been, some have held great hope for an economic rebound in the second half of 2009. As we now enter the second half it has become increasingly clear that while the rate of decline in some areas appears to be slowing, the evidence of a rebound in consumption and spending are so far, not apparent.

This week the consumer confidence survey indicated that recently Americans were feeling more hopeful about their future prospects. But, so far at least, hope for the future has not translated into increased spending.

We have pointed out many times that technology is one of the key sectors to receive orders early in a recovery and as a result technology companies tend to be early cycle performers leading out of a market bottom. One of the bell weather tech companies is Hewlett Packard. This month HP announced that its Q2 earnings in the second quarter had fallen by 17%. More significantly however HP also announced that it was postponing its previously scheduled June shareholder meeting until September. Apparently they do not have enough visibility of the second half just yet. This is just one of the companies that have been hesitating of late to forecast the rest of 2009.

The fact that commodities and energy have been the leading sectors (again) in the market rally since March is not a good sign in terms of the likelihood of this being a sustainable bull market and economic rebound. World consumption continues to be weak; to have spiking commodity prices this early in the nascent recovery is a headwind not a support to economic growth.

Whatever the eventual outcome of this rally, the usual suspects have helped to bring the Canadian market back to its long-term resistance this month end.

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Canadian TSX

If this is a true bull market rally, we will need to see the TSX make a decisive move up through this overhead test. The Tech laden NASDAQ Index and eventually the S&P 500 should also do the same and on increasing volume. It is rudimentary, but a bull market should see increasing volume. So far volume has declined steadily through the past several weeks of this advance. This makes the magnitude of gains somewhat suspect.

NASDAQ 100 Index

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S&P 500

The significance of the second half (2H) rebound thesis to a host of government and corporate forecasts and assumptions cannot be overlooked. Indeed the stock market rally from the March 9 low has been partly fuelled by the 2H-rebound thesis (and also by governments pumping unprecedented capital into the financial system causing increased speculation against the US dollar). Our volume studies of this rally also indicate that short-covering (traders/speculators) has also been a large factor contributing to the upside.

In February clients will recall that we expressed some optimism about the potential for a snap-back rally from near 12-year lows. As it turns out, we were a month early. But we have now seen a dramatic rally from early March. The trouble is that animal spirits driving this rally seem likely to have gone too far too fast. If second half data is soon to disappoint, today's still fragile investor sentiment may well be in for yet another anxiety spell. And although we remain longer-term optimistic, in the near term---over the next few months—we are finding our indicators once again cautiously neutral to short-term bearish.

Thanks to herculean government intervention, interest rates are pushing <u>up not down</u>

Another trend that seems mounting against nearer term economic recovery is the growing 10-year Treasury yield shown below. This recovery needs interest rates to stay down. But as governments issue debt to fund staggering deficits, their fiscal policy is undermining their efforts at directing monetary policy. The 10-year Treasury yield has now jumped 80% since December 2008.

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US 10 year Treasury note

The falling US dollar produces exasperating consequences for the economic recovery. One of the more significant impacts of the falling dollar is spiking oil prices. This seems counter-intuitive, but while demand has vaporized, the price of crude has jumped 80% in less than 6 months. Meanwhile the supply of oil and U$ dollars continues to gush.

Rising interest rates and rising oil prices are large headwinds to the renewed demand the world so desperately seeks to have.

On the upside, as US yields rise, the benchmark currency will eventually become more attractive to foreigners. This is likely to be true if and when another batch of risk aversion breaks out in world markets.

But doesn't the market always rebound before the economy?

Market participants tend to talk about the stock market as "always" bottoming before the economy. These bullish arguments presently forecast the economic bottom to trough this fall and therefore argue that March 2009 was "the" stock market bottom this cycle, neatly 6 months in advance of the economy. This theory may prove correct in the end. Only the clarity of retrospect will tell us for sure.

But a risk now is that the "rule of thumb" about markets bottoming before the economy may not hold true this time. The most recent exception was the last downturn where the "economic trough" was November 2001 (now

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clearly defined in retrospect) and yet the stock market did not make a lasting bottom until February 2003 (15 months later). Part of the reason for this lag of the market bottom after the economy last time, was that the jobless, anaemic economic recovery disappointed those conditioned to expect a vigorous "V" bottom recovery. Far from a robust bounce, in 2001-2004 we saw a timid, tepid start. It took a few years before over-juiced credit finally ignited mass speculation and the appearance of stronger growth.

The probability of a sluggish recovery this time is likely higher than after the tech wreck in 2000. This time we have a multi-asset, multi-country, financial crisis. This time the savings rate is coming back in earnest, as a shell-shocked consumer comprehends the importance of a saving buffer rather than just access to a line of credit.

This time people already have too much credit; few want more. This time the masses already own multiple-real estate or too much house, they wish to downsize not lever up. This time the economic recovery is more likely to be slow and plodding, blurred by rising unemployment and more modest (perhaps wiser) consumers.

We suspect this is a marathon, not a sprint. Reducing over-capacity, building up savings and equity are the foundations of our future sustainable growth, but none of this is as easy as throwing more credit around.

These will be healthy developments in the longer term—they make us longer-term more optimistic--, but in the next year or so, masses weaned on quick growth and easy money may not be mentally prepared for a slower and plodding course.

The trouble with “no brainers” and “gut” in a secular bear

Recently we have heard a couple of investors comment that they committed all of their remaining cash in March as they felt that a market low there was “a no brainer.” The trouble is using “no-brainer” allocations to equities also meant that most suffered horrendous declines over the past couple of years.

A little understood fact is that *volatility of returns actually erodes wealth* over time. Of course, there is little wonder that this fact is misunderstood when traditional investment dealers tell everyone the opposite. Naively or not, equity sellers erroneously tell us that the source of out-sized investment returns over time is the extent to which we are able to endure and tolerate volatility in equity markets.

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We were delighted to see this myth disabused in an article in the CFA Institute Magazine this month:

> "Volatility actually erodes returns and wealth accumulation, a fact not commonly understood. Thus, the path that returns take over time has important effects on the long-term total return achieved. We all know that over a multiyear investment horizon, return (and thus wealth) accumulates by compounding discrete return periods. ***Less known is the fact that as the variability of returns increase, compound return decreases.*** So, the higher the volatility over time, the lower the wealth accumulation to the investor. In this way, return volatility can actually punish investors over the long run."
>
> *CFA Magazine, May-June 2009, Rodney Sullivan, p.12.*

What a relief to see this truth acknowledged in writing! The reasons for this truth can be found in the math of loss. If investors lost 50% of their capital in the market downturn (2007- to March 9) then a recent rally of 30% still results an overall loss of 35% as shown below.

The math of loss works like this:	**$100K portfolio to start – 50% (decline) = $50K**
	$ 50K + 30% (rally) = $65K portfolio
	$100K start- 65K end = -35K or a 35% loss from the outset.

So, even with the big rally since March, passive equity investors are still down –35% and need further gains of +53% just to get capital back to where it started 2 years ago. As capital spends months and years trying to grow back to whole, the hope of compound growth over time is utterly incapacitated. It is for this simple reason, that it is not chasing gains, but protecting against capital losses which is the source of capital growth and preservation over time.

The problem with "no brainers" or going on "gut" when dealing with risk assets is that it really amounts to random bets dependent on luck. And historically this type of random approach to investing has proven devastating, particularly in a secular bear climate.

This S&P 500 chart since October 2007 gives some important perspective about the way a bear market moves and also about the duration and magnitude of the latest rally.

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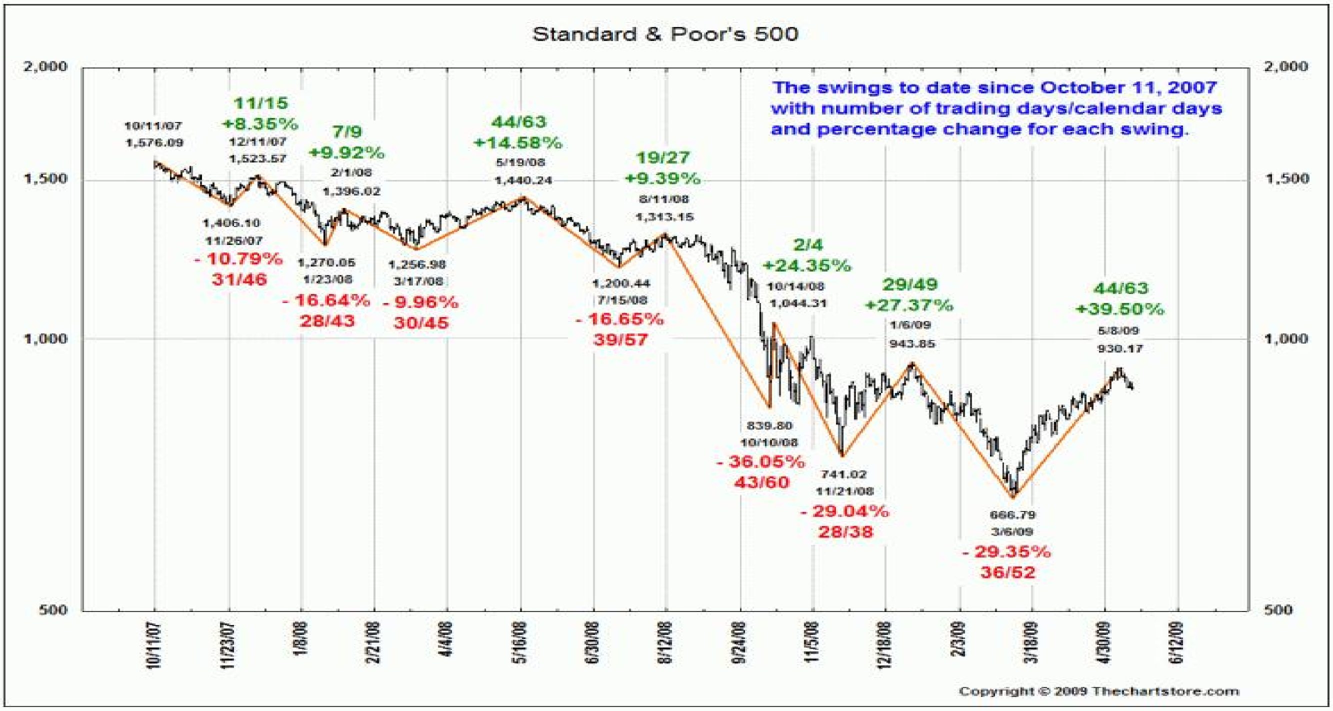
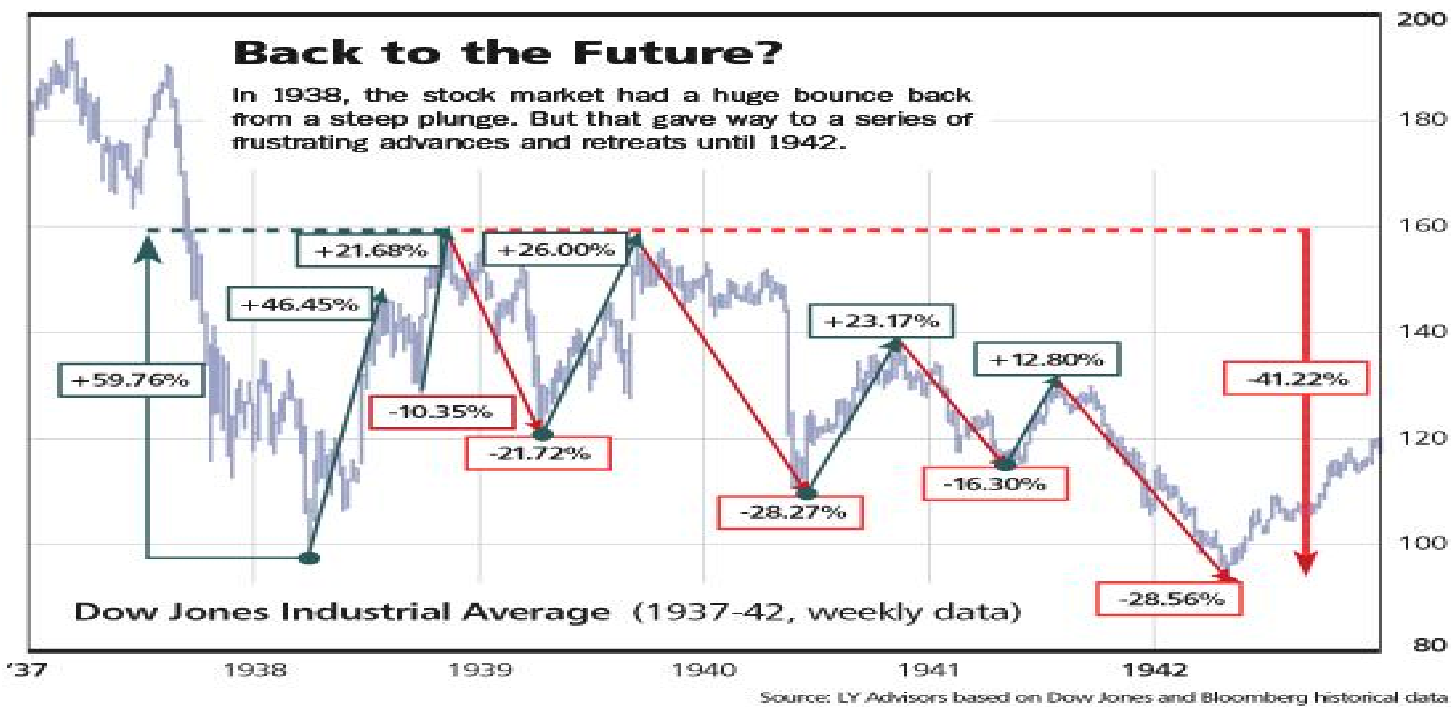


Source: Thechartstore.com

We can see similar movements in this chart of the Dow 1937- 1942 (a previous secular bear) and it offers insight as to why blindly riding bear market rallies risks a volatile and unrewarding course.



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Even holding through every dramatic rally throughout this period meant that overall investors lost money in the end. To succeed one had to be content to take a piece of the up legs while staying obsessed with missing the bulk of the down legs. And we are.

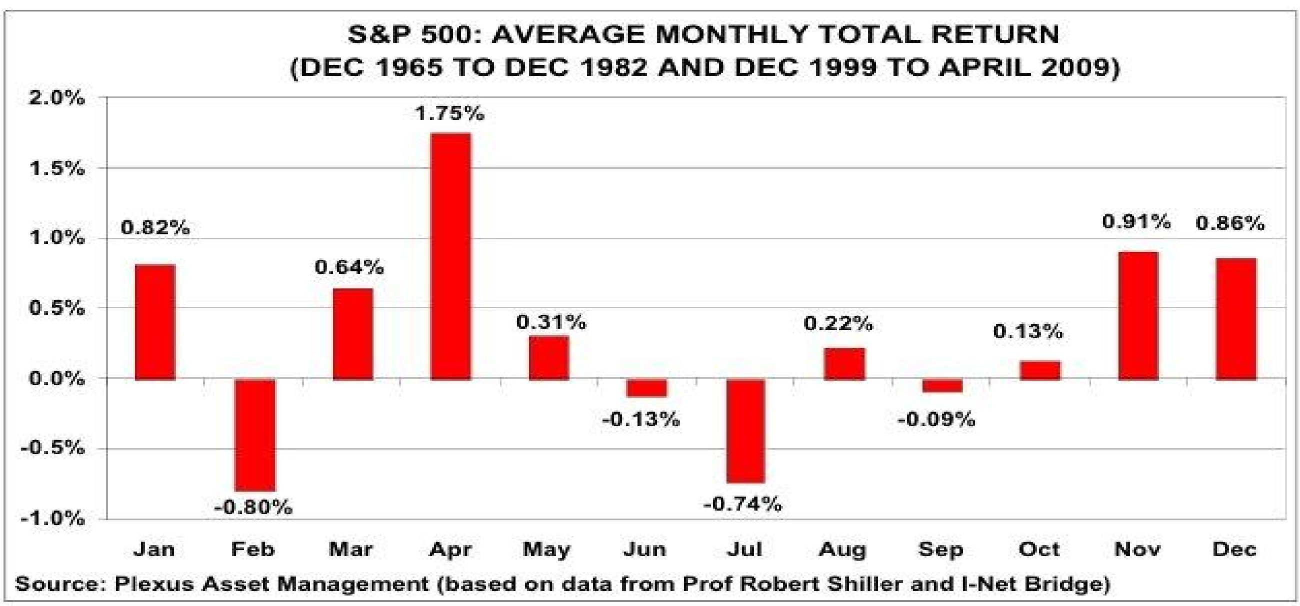
Seasonal headwinds have tended to be strong June to November during secular bears

Most market participants have heard the saying "sell in May and go away". It is a statement that highlights the historical tendency for stock market returns to be lower than average during the June through October period.

That said over the past 100 years there have been times when this rule of thumb has not held true and so applying this type of general seasonality is not itself sufficient as a timing tool. One of the reasons for some of the variance in the historical data seems to be that it includes periods of secular bull and secular bear markets.

Recently Plexus Asset Management separated out the historical returns of the S&P 500 for the June to November period during just secular bear periods: 1965 to 1982 and the present secular bear from 1999 to present.

It turns out that the weakness of the June through October period has been particularly poor during secular bears as shown in the following chart. We also note that in keeping with the market performance this spring, February has traditionally been the worst and April has been the strongest month of the year in these past secular bear cycles.



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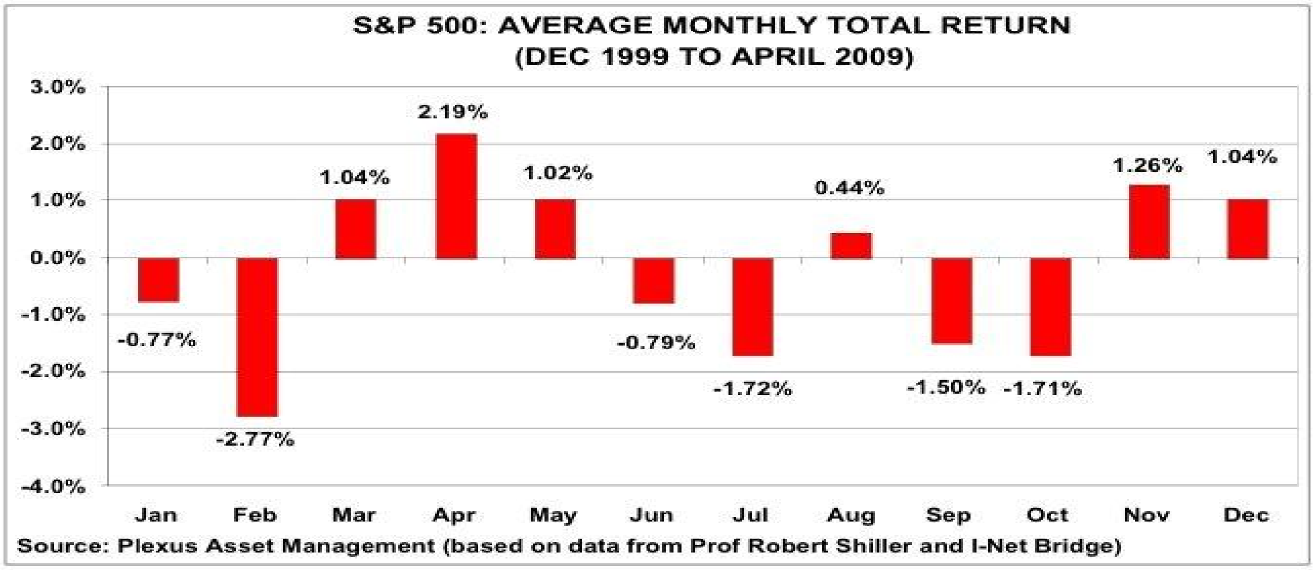
Of closer relevance to recent history, Plexus also summarized the market returns for just the secular bear we are now living in from 1999 to the present. They found that June to October market losses in this secular bear has been considerably worse than even the previous secular bear period as shown in the following chart.



Again February has traditionally been the worst month of the year for losses, with the market rebounding March through May, only to fare badly again for the 5 months June through October.

So what does this tell us about the likely market behaviour this June through October? Nothing one can bank on. But it does add some more weight to the need to remain objectively focused and realistic about the price risk that may now be present in global markets over the next few months.

Housing: the next wave. "Prime" mortgage foreclosures now picking up

One of the key supports needed for the next economic recovery is a *stabilization* in housing prices.

Unfortunately there is so far no evidence that housing prices on average have bottomed. This month the most recent update for the Case-Schiller housing index which showed that nationally house prices in the US have now declined more than 32% from their peak; bringing home prices back to 2002 levels as of March. And they are still falling.

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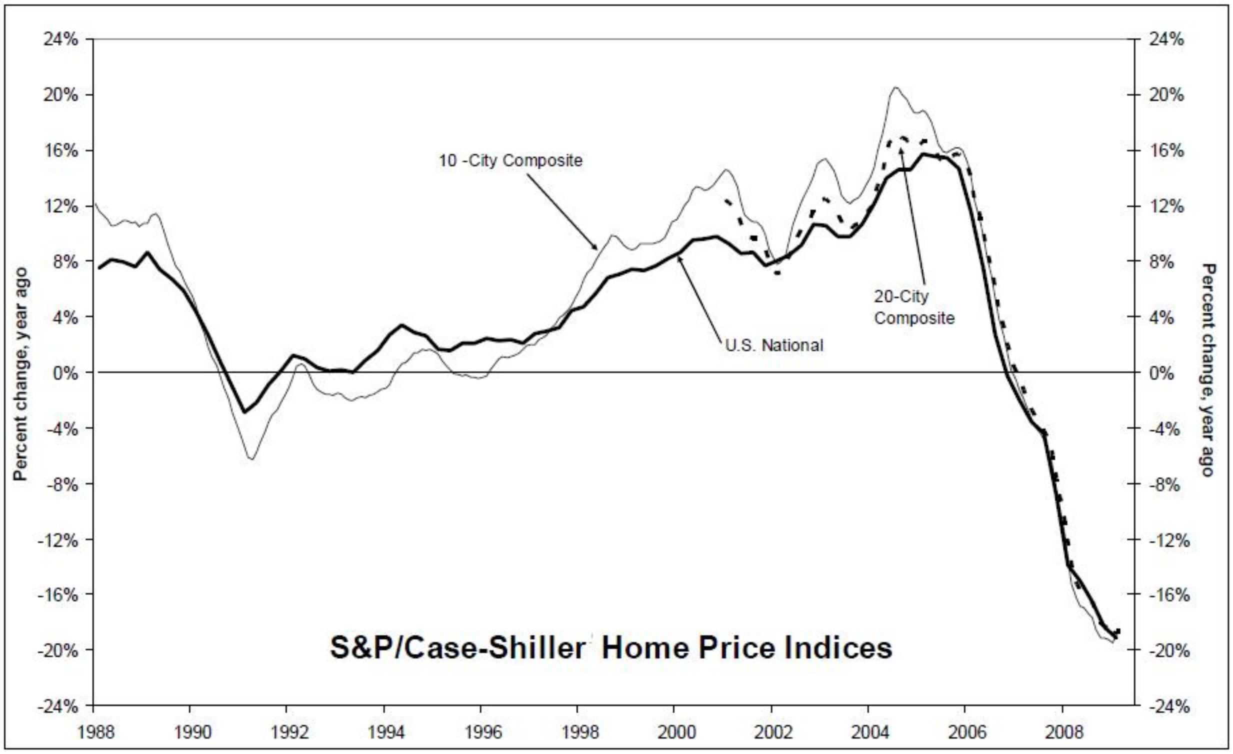
March US housing prices decline 18.7% year over year



With the official US unemployment rate at about 9% presently, destined to be above 10% over the next year (unemployment is a lagging indicator), more job losses will inevitably prompt the next wave of foreclosures even for prime borrowers, pumping more inventory onto markets already swamped in supply. Unemployment is likely to push down on housing prices and demand for some time to come.

In fact, when we consider the existing inventory of housing available (or soon to be available) for sale in the US, it is a very high 12 months supply. But more daunting still, the National Association of Realtors reports that the months' supply of existing homes listed at over $750,000 is now a breathtaking 40 months! We can see that further price declines are likely needed to increase affordability, attract new buyers and soak up this supply over the next few years.

And so we leave May and enter into the third quarter and second half of 2009 with world markets at a cross-road. Will prices retrace or break through their long-term resistance at last? We have said many times that bottoms are a "process" not just a few days. If markets manage to rally with sufficient force *and participation* through our buy targets we will be increasing our equity exposure in stages. If they break down we will be lightening up our equity exposure again.

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If markets do re-test to the downside over the next few months, we would not be surprised to see support near the November 2008 lows. If the November lows fail however, the March 2009 lows could be back on the radar-screen once more.

Our sense, however, remains that over the next few months we are likely to see another downside test (or two). After that, it is probable that markets could see a sustained rally for some time to come. We look forward to the next leg whatever it may be.

Quote of the month:

"Riches do not consist in the possession of treasures but rather in the use made of them."

-Napoleon Bonaparte

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