Real life needs active management

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E.Q Trendwatch™

Time reveals truth

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Things are tough all over

Harvard University's endowment fund was thought to be run by some of the smartest managers money can buy. At just under $37 billion Harvard boasted the largest endowment fund of any American university. Their board and managers were coveted on the speaking tour. Then came the bear market of 2008 and Harvard lost $11 billion.

Among many mistakes, Harvard placed a huge derivative bet on higher interest rates. They were wrong and now the fund now has to pay half a billion dollars to get out of its bad bets. They also have to pay another $425 million over the next 30 years to offset an additional $764 million in swaps. Throwing good money after bad, Harvard had to sell $2.5 billion of bonds in the current fiscal year just to pay

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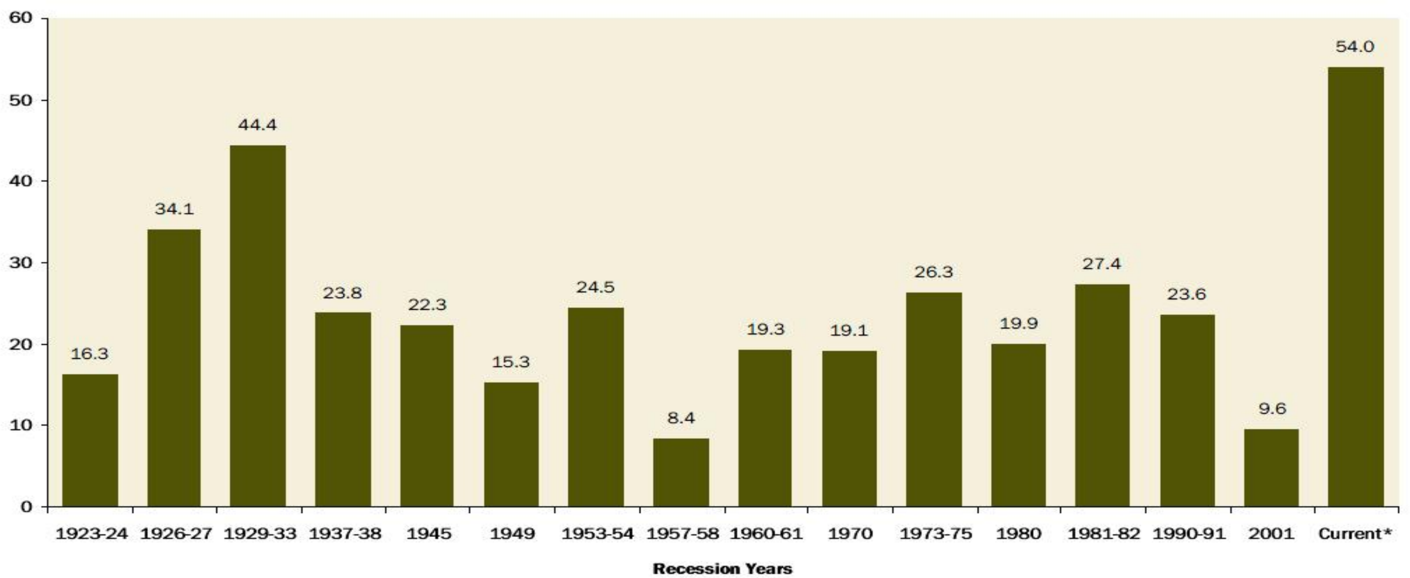
for the swap exit and now they are struggling to pay their bills. The school's General Operating Account from which it pays its expenses has fallen by 45%. They have frozen employee salaries, slowed hiring, cut staff and offered other workers early retirement. See Harvard's Annual Financial Report 2009.

Unfortunately Harvard's losses in 2008 were less the exception than the rule. Now pensions, endowments, foundations and baby boomers all around the world are scampering to cope with deficits and capital shortfalls for years into the future. Most will have no choice but to cut spending and increase contributions. Many boomers will now have to work years longer than "Freedom 55" had promised.

All of this happened because most fund managers and investors fail to plan for the reality of recurring bear cycles. What's worse, this secular bear cycle is in all likelihood with us for a few years yet. Sadly, most investors still don't understand the error of their ways.

Death defying rally

Over the past 7 months, the stock market has defied weak economic fundamentals with the fastest, sharpest rally in 100 years. As shown in the chart below, the rally since March has been steeper than all other rebounds; even surpassing the incredible bear rally that followed the crash of 1929.



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As an interesting aside, even with the biggest 7 month rally this century, this decade will be the worst decade in stock market history. The decade from Jan. 1930 to Dec. 1939 showed a net loss of -1.7%. From Jan. 2000 to the present the S&P 500 has lost 13.8%. It would take a blockbuster November and December to take the current decade out of the "worst in history" class (InvestTech Research).

While risk assets have been shooting the lights out the past 7 months, the economic data this recovery has so far been remarkably weaker than average. The chart below shows 10 of the most significant economic indicators and how they have scored during previous recoveries while the S&P 500 was rallying 60%.

Period of 60% Rally	Yr/Yr Retail Sales	Consumer Confidence	Capacity Utilization	Yr/Yr Industrial Production	ISM	Payroll Employment Gains Over Period	Decline in Cont'd Unemployment Claims from Cycle Peak	Yr/Yr Growth in Total Credit Market Debt	Yr/Yr Growth in Household Debt	P/E Multiple
5/70-8/72	10.8%	104.1	84.7%	11.1%	61.7	4.3%	-23.1%	8.7%	11%	17.9x
10/74-1/76	13.7%	101	78.4%	3.8%	58.8	-0.2%	-32.6%	9.7%	9.3%	8.7x
8/82-4/83	7.6%	83.1	73%	-1.3%	38.3	0%	-21.3%	10.3%	5.1%	9.5x
1/90-1/94	5.8%	82.6	82.5%	3.7%	56	2.9%	-22.3%	7.8%	6.8%	21.4x
3/03-1/06	8.5%	106.8	80.9%	3.3%	54.8	4%	-32.5%	9.4%	11.7%	26.5x
Average	**9.3%**	**95.5**	**79.9%**	**4.1%**	**53.9**	**2.2%**	**-26.3%**	**9.2%**	**8.8%**	**16.8x**
3/09- %	**-5.3%**	**53.1**	**66.9%**	**10.7%**	**52.6**	**-2%**	**-11.6%**	**3%**	**-0.1%**	**20.0x**

Data Source: www.zerohedge.com

As highlighted in the table above, the economic progress during this rally has scored below, and in most cases far below, the historical average in every category. If the stock market is correct in its optimism about a

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rebounding economy in 2010 there seems to be pity little evidence of it anywhere in the real world.

It is also note worthy from the dates in the far left column of the table above that it typically takes the stock market 2-3 years during a true economic recovery to rally 60% from the prior cycle bottom. This time it has achieved these gains in 7 miraculous months!

The consumer has exchanged blind faith for buckets of doubt

We believe that the biggest hurdle to a strong economic rebound in the near term is that while many banks and bankers have been rescued by government intervention in the past year, regular people continue to suffer from a million cuts. Consumer sentiment is presently floundering at a generational low. US sentiment numbers in October came in at a depressed 47.7. As a point of reference, we note that the average low for consumer confidence during recession is 72 and the lowest this sentiment reading ever reached in the last recession of 2001--even after the tech wreck, 9/11 attacks and SARS,--was 84.9. Now it is 47.7!

Lack of economic confidence is not just a US phenomenon but rather has spread faster than H1N1 throughout large parts of the world. UK and European confidence surveys are plumbing similar depths. Several recent surveys have found that an increasing majority of people on Main Street believe that this recession has still further to run. Most are reporting plans to retrench, live on less and pay down debt where ever possible.

At the same time, polls show that Americans are rapidly becoming disenchanted with the Obama government. The massive tax spending to date has so far stimulated risk-taking and paper transactions rather than the real economy. Obama has thus far insisted on retaining Wall Street henchmen in his inner counsel. To date, his promised “change” has been an empty cup.

Recent focus on Wall Street greed (again) has cast a broader public scrutiny onto executive pay in general. Just 45 years ago, in 1964, the average CEO made 20-40 times that of the average American worker. This had been a consistent ratio for the preceding 30 years. By 2006, this ratio had expanded so much that the average CEO now made 400-600 times the pay of the average worker. Arguments that obscene income levels are needed to attract the best business talent are simply not supported by results. The 100-year trend growth of US GDP has been 3.5% but growth since 1982 has been steadily falling; now below 3% a year since 2000. Meanwhile, stock market returns for the past decade have been less than zero.

Given the entrenchment of nepotism between government and big business, and the apparent lack of political will to change, it is difficult to see how this negative trend will eventually be reversed. However, history will

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tell us that unjust enrichment and economic imbalance have been the driving force behind every civil war and societal uprising since humans began. Serfs eventually rebel.

Consumer credit still contracting at record pace in the US

Source: Haver Analytics, Gluskin Sheff via Big Picture Blog

It's not just that banks have been cutting back on their lending appetite over the past couple of years. US Consumers have developed a growing revulsion to credit. Like a food that once made them ill, many are now sickened at the thought of acquiring more debt. The above chart of US consumer credit levels outstanding since 1943 really says it all.

Unfortunately Canada seems to be lagging in this revelation. Low rates have served to renew a mortgage binge in Canada year to date. Our household debt did not fall but rose 3.4% in 1H 2009! Government intervention to lower rates have spurred many Canadians to buy houses they will struggle to afford once interest and unemployment rates move even modestly higher. Canadians continue to owe too much and save too little. This presents a significant downside risk to the Canadian housing market and economy going forward. Hopes that we can somehow be "different" and avoid our debt reckoning are simply without precedent. See Globe: Raising the Roof.

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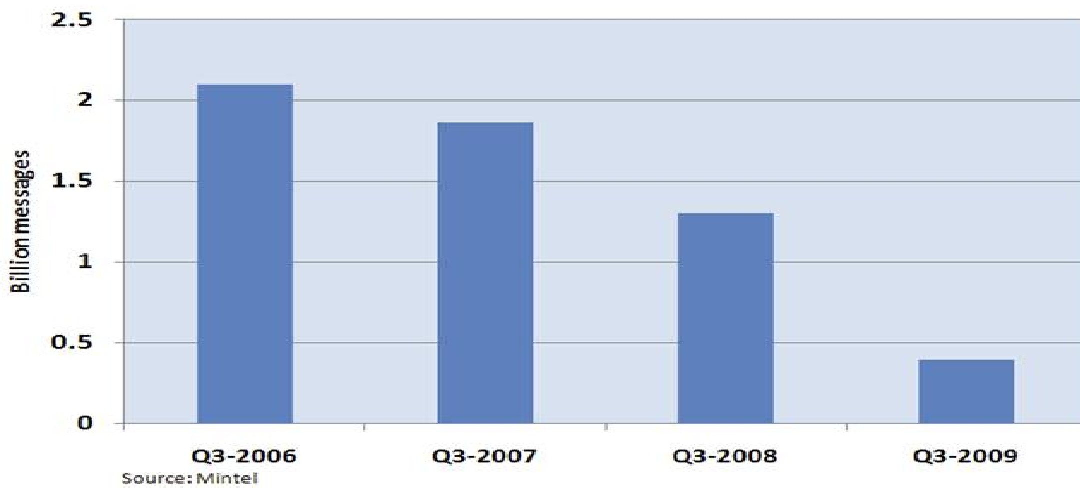
One of the triggers to the credit virus that swept the world the past few years was virtually unrestrained marketing of "free" credit to anyone who would have it. At the credit bubble peak in 2006 unsolicited direct mail offerings from credit card companies (in the US alone) were hitting consumers at a rate of 2.1-billion offers a quarter. As shown in the chart below, the latest Mintel data on credit card direct mail offers shows a massive drop to 391-million offers in the recent quarter.

Recent proposals for more consumer protection in this area are sorely needed. The financial industry is opposing this with their considerable might; they employ 25 government lobbyists for every 1 employed by consumer protection groups. There is some nasty irony in the realization that bailed-out banks are using tax payer infusions to fight the introduction of better consumer protection laws.

Direct mail credit card offers per quarter since 2006



Source: Mintel via paulkedrosky.com

The U$ dollar is looking ripe for a bounce

As risk assets have soared the past several months, the US dollar has fallen in lock step. This week a Cleveland Fed study determined that the US dollar is now about 7% undervalued against other world currencies. Currencies can stay under or over-valued for long periods of time before valuations may correct, but lately our technical work on the U$ is suggesting that it may now be in the midst of an interim bounce.

As we see in the next chart of the US dollar rout from 1991 to 1995, the bottom was a process that took place over 4.5 years with three distinct tests. The symmetry of this period to the present is interesting in terms of price trend and time between down legs. If the U$ can hold and bounce near current levels, this is likely to usher in another phase of risk aversion in the world.

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US dollar Index bottom process 1991 through 1995 compared with today

A rally in the U$ would likely withdraw global capital out of stocks, commodities and other currencies and back to US Treasuries. On Friday, October 30, the US dollar Index closed at 76.36, rebounding off the 75.47 test shown above. A break-out through 77 on this Index would further support the U$ rebound thesis.

At the same time equity, market action over the last two weeks of this month suggests that the overdue equity correction may already be underway, with most world indices closing below key support levels and breaching the up trend that has been in place since March.

As we had warned over the past few months, the problem of declining volume as the market advanced has left prices now particularly vulnerable to a downside test. The past couple of weeks a surge in volume has consistently come on the down days as institutional selling has overwhelmed the smaller pool of those who were buying.

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S&P 500: correcting into the box?

TSX: the higher they rise the harder they fall?

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As we show in the charts of the S&P 500 and TSX above, the rally since March has lacked a meaningful retest to confirm the cycle low. In recent months, many have declared that March 9 was "the" low of this cyclical bear market. If that is to be the case, we will watch for the market to 'test the box" we have drawn above. We can see that the drop in early July bounced off the top side of the box.

The uptrend since March has now been breached to the downside, and because the summer rally was so fast and steep, the first level of support is now a lot further down than it was in July. When the market can bounce and recover on strong volume that will be a positive sign. If it can't hold within 'the box' then it is possible that a lower market low may yet be before us. At this point it is impossible to know which outcome we shall see. As a result, we stand ready to sell our existing positions if our sell rules are met, and will look forward to buying again when our buy rules are met. To say otherwise would be foolish. These are remarkable times, and we stand on high alert.

Are interest rates heading a lot higher?

This month a few countries took first steps toward raising interest rates from emergency lows that were implemented amid the threat of depression in 2008. Once central banks begin to hike, they generally do so in gradual, regular steps until rates are back to a neutral level they deem appropriate for sustaining economic growth and controlling inflation.

Neutral overnight lending rates have typically been about 5% in North America. They are now just above zero. Existing bonds with higher rates have rallied strongly in response. One of the key questions going forward then is when will policymakers start the inevitable hike back to more normal levels? So far American and Canadian central banks have indicated that they would start to move up as soon as the recovery seems to be underway and not likely before next summer. Those who believe we are headed for rapid inflation in the not too distant future predict interest rates will spike up dramatically in the months and years ahead. Those that believe we are in for years of Japan-like deflation say we will not see rates increase much at all.

For our part, we know that money is not really 'free' and so higher rates, perhaps a year from now, would make some sense. That said, with house prices still falling, and commercial real estate and their related bank loans just starting to implode we see a phase of asset deflation for at least another year. Given these competing trends, we have no choice but to monitor the data carefully and adjust our fixed income exposure with a goal of the highest income with the least price risk as events unfold.

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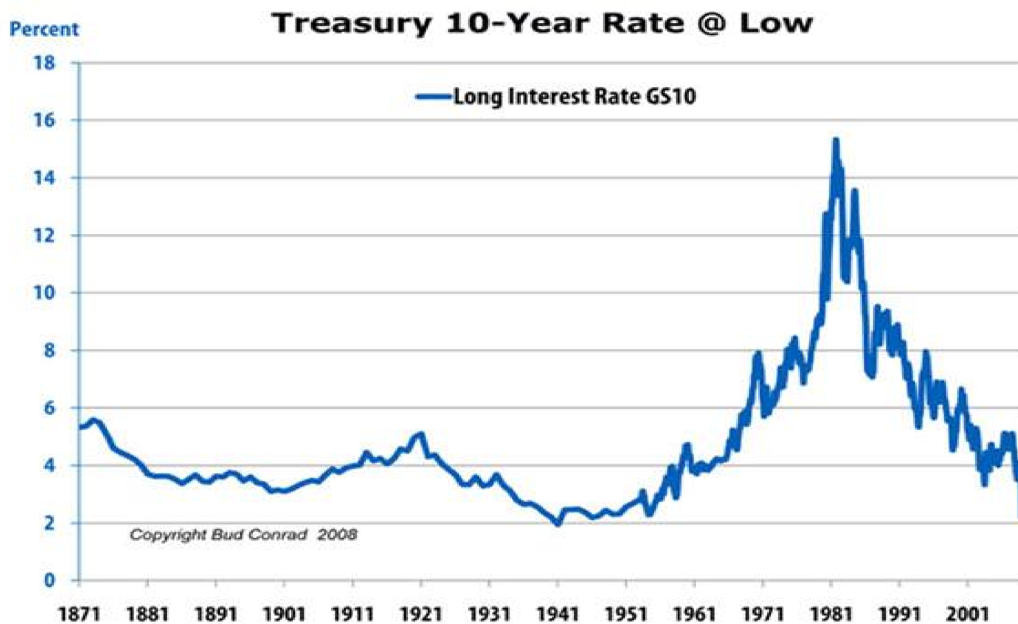
We thought that the following chart of 10-year treasury rates going back to 1871 gives a remarkable perspective of our own recent rate experience relative to where rates have historically been:



Source: TD Securities

As one sees the mountain-peak of rates in the early 80's, we have a sense of just how anomalous that period really was. We can further see that while present 10-year rates of just over 2% are undoubtedly low, they are not outside the range of the mode over the past 140 years. So, while rates will no doubt increase at least a few percentage points over the next couple of years, perhaps they are not so below the norm as one may have recently thought. This is not great news for aging boomers and other savers around the world who are in need of regular and safe fixed income in retirement. But on the other hand, it would also suggest that the cost of living may not face a period of significant inflation.

How will our economic troubles unfold?

We know that we live in unsettling, turbulent times. Many people today are under more financial duress than we have seen in decades. There is plenty of angst and worry to go around, but perspective is very important. As much as things have gone wrong in the past few years, there are also many things that are going better now than ever before. The world is today inventing solutions for disease, suffering and resource

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management which short years ago seemed impossible to imagine. Recall that it was only 5 years ago in 2005 that GM collected and crushed all of its EV1 electric car prototypes to the horror of their adoring owners! Today what's left of the car industry is clamouring over each other to roll out the most fuel efficient vehicles.

We in North America still live in one of the most naturally privileged places on the planet. We have an abundance of environmental wealth and a relative freedom and democracy that inspires many less fortunate parts of the world. We do not always understand each other, but the world today undoubtedly has better communication among more people than at any other time in human history.

Caring for our health, families, our work and our world demands constant effort, but this has always been the case. Yes, we must be careful and diligent to look after what we value, but we will manage our way through these times; just as our parents and grandparents and great-grandparents did before us. Anyone today wish we could go back and live in ancient times? We think not.

Many have placed hope on Asia leading the world in the next economic recovery. We wish Asia well in their journey, but while North America has recently been down, we are far from out. On top of having one of the most free, democratic, and diverse peoples on earth, we also have the remarkable advantage of a society where men and women share power and influence. A wise society embraces all of its diversity as the source of its greatest strength.

And further to this point, we close **with some interesting data on fertility rates from our dear friend, the wise and witty Dennis Gartman:**

"Fertility rates… the average number of children that a woman will bear during her lifetime… are important, for it takes on the order of 2.1 births/woman to keep a population rising. Of the industrialised world, only the US and Australia have fertility rates at or above 2.1 with the US spot on that figure while Australia's is a very healthy 2.4 [Ed. Note: We take the US' number as optimistic news, for this figure, along with net-positive in-migration figures allows for the US population to continue to grow, and growth, as they say, is good. The Aussies, with plenty of room to grow their population, are actually paying people to procreate… nice work if you can get it, eh?]. In Europe, the fertility rates are all well below 2.1, with Spain's at 1.6; France and Germany average 1.4; the northern nations of Norway and Sweden are 1.8, and Russia's, like Germany's and France's, is 1.4% and is falling. Apparently, in Russia, too much vodka does not do wonders for the libido; it does damage.

In Asia, save for Japan, fertility rates are higher than in the industrialised world. China's fertility rate is a very meagre 1.6, and we've said many, many times previously, as a result of China's truly idiotic "one baby" policy,

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the population there is soon about to turn downward, will become heavily "male" oriented, and will also become very old, very quickly. China is on a demographic course toward disaster and no one seems to be talking about that fact. Oh, but in India, Pakistan and Afghanistan, Iraq et al, the fertility rate is 3.0, while in the Saudi Peninsula and on into the Middle East it's 3.3. It is in Africa that our thesis that rising fertility is a cause for bullishness, for the Africans have the highest fertility rates of anywhere in the world, with the central portions of the continent having fertility rates averaging 5.7. In the sub-Sahara, its 3.0, and only in S. Africa does it fall below 3.0 to 2.8. In Africa, birth rates have to be inordinately high to offset the high death rates there, and to help with the agrarian societies that exist and where manpower is a necessity as back-breaking labour remains the norm [Ed. Note: For this data we've relied upon The International Herald Tribune; the United Nations Development Program, and the Population Reference Bureau and Newsweek.]"

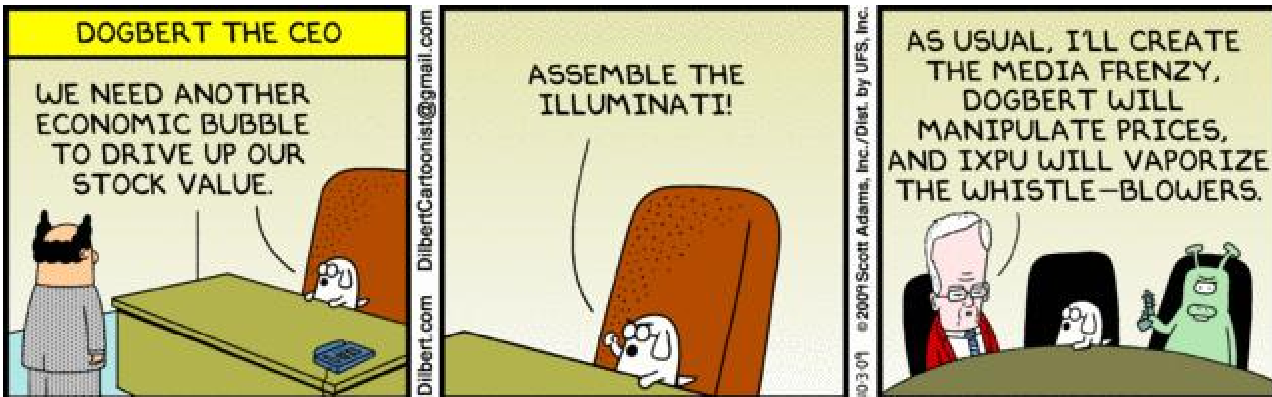
The Gartman Letter, October 20, 2009.

www.thegartmanletter.com

Quote of the Month:

"To be uncertain is uncomfortable, but to be certain is ridiculous." Chinese Proverb

And now we'll have November….



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