Real life needs active management

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E.Q Trendwatch™

Up, down, round and round

Behemoth roller coaster, Canada's Wonderland

This summer we took the kids on our annual trek to Canada's Wonderland, north of Toronto. Crowd volumes were down, but enthusiasm was high. For those that like to ride, it was easy to get on roller coasters.

As we watched cars of people literally scream up and down the track, we could not help but note an analogy between their experience and those trying to ride world investment markets the past 10 years. Indeed passively riding risk markets during every secular bear period in history has rendered the same result: a series of steep climbs and heart-stopping drops for a wild ride with no lasting benefit.

A study of market history and the present macro-economic hang-over, reminds us that this wild ride of the present secular bear cycle is likely to continue a few more years: perhaps 5 to 10--as individuals, governments and companies restore their wealth the old fashioned way, by building up savings and paying down debt.

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As capital-careful investors, if we keep the above image of the roller coaster in mind, we will never be able to kick back and relax on an uptrend no matter how amazing, no matter how steep. And although we will want to ride on parts of the climb, we will always be looking for the best possible safety gear and least risky spots to get on and get off the ride.

This month there was an almost deafening chorus of commentators cheering on the end of recession and an imminent return to economic growth. The trouble with confident projections and theories is that they can serve to set the mind at ease. When dealing with risk markets and especially during secular bear times, we do not want to put ourselves at ease—we want to be wide awake.

The last 6 months have seen a dramatic rebound in market sentiment. Unfortunately the gains off the March lows have not been fuelled by organic revenue and earnings expansion but rather by an expansion of the P/E multiple buyers willing to pay for anticipated future earnings. Experience tells us that eventually the present valuation imbalance that we are seeing today will be corrected either by an actual and dramatic increase in corporate revenue and earnings, or by a decrease in stock prices.

Longer term we see a pick up in revenue, albeit at a modest pace, as a reasonable probability but in the more immediate term we measure that stocks today are over-bought and over-priced. Sentiment has gone from depressed to manic euphoria in a matter of 6 months. This is not typically the way lasting bull cycles begin. Real economic recoveries begin gradually and build over time with the stock market climbing a wall of worry as it goes.

To give the recent rally some relevant context, historically stock market recoveries of 60% have taken place over the first 2 to 3 years of a cyclical economic expansion. The fact that this run has taken place in 6 months, and before any meaningful turn up in job creation smacks more suspect than constructive and durable. As economist David Rosenberg pointed out this month, usually at this point in a market recovery,*" the economy has already created over one million new jobs — during this extremely flashy move, the U.S. has shed 2.5 million jobs (as many as were lost in the entire 2001 recession)."* So far, the math is just not adding up.

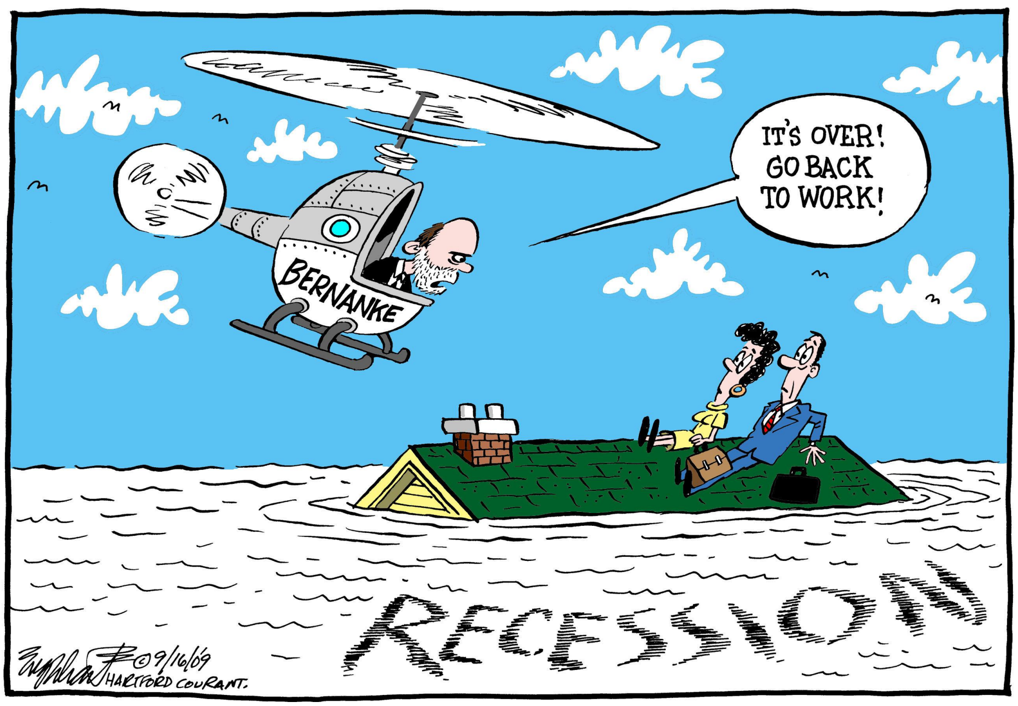
Much of the recent rally has come from a sense of relief that the demise of the world financial system has now been averted. Banks are hungrily scooping up money at emergency windows of government treasuries and using the "free" money to trade and speculate in their own investment portfolios. Markets have gobbled up the liquidity.

The trouble is the vast majority of consumers in the world have not been helped. Credit has continued to contract: consumers are borrowing less; lenders are lending less. Jobs have continued to vanish as companies continue to cut costs in the ‘new normal’ world of much lower sales. Home prices continue to fall; foreclosures continue to flood the market.

Recovering to where, is still unclear

As politicians assure us that a recovery is underway, we are reminded of a Monty Python scene from “The Meaning of Life” where a British soldier is missing a leg, freshly chomped off by a tiger. The Doctor arrives to examine the bloody stump. Poking it with his pipe, he mutters assurances to the patient that he should recover and be “all right.” “Oh good”, says the relieved patient, “so you think the leg’ll just grow back then?” In an instant we see two vividly different ideas of what “recovery” means for each man.

For the millions of people who are now unemployed and under-employed as a result of this recession, the expectation of economic recovery no doubt includes a return to full time employment at a decent wage. Unfortunately this goal is unlikely to be achieved for several years. The unemployment rate now just under 10% in the US, and 9% in Canada, is likely to climb for at least another year rivalling the previous post-WW2 peak of 10.8% recorded in the double dip recession of 1980 through 1982.



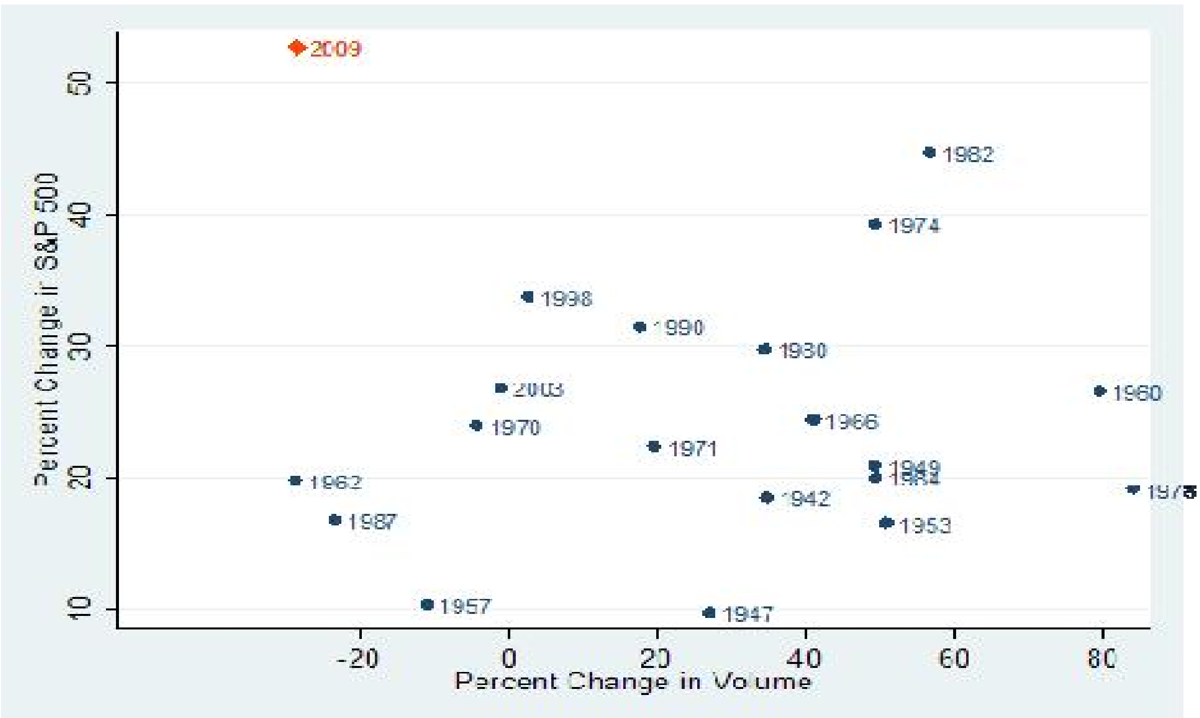
But earnings are bound to start trending up again--one of these days

As we noted last month, corporate earnings fell 90% over the past 2 years. *90%!* Managing in response to this catastrophic decline, companies have cut costs relentlessly. The good news is that after such a large downsizing, company overhead is now the leanest it has been in a couple of decades. Lean operating costs should bode well for corporate earnings once we see some demand pick up. Stormy seas build the best sailors and those that survive this will be stronger in the end.

The only fly in this ointment is that thanks to the previous cycle of over-investment, and over-building, the world economy is now lugging around large over-capacity—about 30% more than we are using. Some of this will need to be further downsized in order to restore pricing power for the next economic expansion. This will take some time. Business owners we have spoken to are so far not yet sounding cheery. Most are still focused on surviving this recession, still looking to reduce their costs, still hoping for a pick up in sales.

While stock prices continued their death-defying rally in September global shipping volumes have not followed suit, falling 45% since June and leaving a now ominous gap between tangible evidence of world demand (goods shipped), and the price of the S&P 500 as shown in the chart below. History tells us that the diversion between these two lines must close: either by a significant pick up in shipping (orders) or by a significant pull-back in equities. We would be delighted to see the former; we are concerned that the latter may be more likely.

We admit that the ferocity of the recent snap-back in markets has been almost unprecedented. We have made some remarkable gains on the limited equity positions we have held since our buy in February, and we very much look forward to more buying opportunities ahead. Piling more capital into the party over the past few months would have been so much easier if we didn't worry, but the following chart presents yet another disturbing perspective on the stock rally since March. Of all the market recoveries since the second-world war, 2009 is the unparalleled leader for the sharpest rally on the lowest volume *ever.*



Source: www.hussmanfunds.com

In a spooky worst case scenario, we must also note that the only other time when the stock market did rally so far and fast was an almost identical percentage gain over 6 months following the October 1929 crash when the market peaked in April 1930, before suffering a subsequent decline to fresh cycle lows. This is not our forecast, but we aren't making this stuff up - the comparison is there.

As we have mentioned frequently the past few months, if this rally is to last we will have to see greater participation by many more buyers. We are watching patiently for it.

Perhaps institutional investors have been too spooked by last year's losses to heavily buy in, perhaps they are just not seeing attractive enough valuations. The S&P is now trading around 180 times reported earnings for 2009, and just under 18 times the consensus of expected operating earnings for 2010. Meanwhile S&P dividend yields are not too attractive at just over 3%. Those advocating stocks at these levels are confidently bidding for a strong recovery. Those of us expecting a slower, lower demand expansion from here are finding over-priced assets less appealing.

As the WSJ reported this week: Fallen Fund Stars Find Few Takers, many of the fund managers that stayed fully invested year to date, racking up large gains the past 6 months, are still seeing large client redemptions. After heavy losses last year, shell-shocked clients are looking to take back what's left of their money and run. Maybe some have figured out that they are riding the Behemoth!

Corporate insiders are selling like there's no tomorrow

One group who apparently have deemed recent prices very attractive are corporate officers and directors who this month *were selling* their publicly traded shares at a ratio of 30:1 This is a intensity of selling not seen since just before the credit crisis hit two years ago.

Maybe the speculators buying now will be right. If so, we will see a significant bounce back in growth over the next couple of quarters. If that happens we should see a sustained market rally for a period of many months supported by a conviction in volume. Having to manage our risk in real time rather than retrospect--as always-- we will deal with the evidence as it comes.

Bond prices have gained throughout this equities run

Another factor that throws some doubt on the veracity of the recent global stock rally is the fact that bond prices have steadily increased right along side equities throughout. Generally speaking both markets cannot be right in their forecast. The stock market is predicting that the economy is snapping back to growth. If that is true then interest rates will be heading up sooner than many think and bonds should have sold off over the past few months. In fact though, bonds have been steadily gaining in price. This suggests that the bond market does not yet see stronger growth and higher rates on the horizon. There is a standard joke that the bond market is run by mathematicians while the stock market is run by sales people and so the bond market is generally thought to make more sober assessments. We shall see over the next few months, which group is going to be right this time.

As we noted in our March 2009 client letter, corporate bonds came up as a buy on our metrics in the spring of this year. Since that time, Canadian high yield bond prices have gained about 30% on top of the attractive income they have paid.

Before the start of the credit crisis in early 2007, corporate bonds had become so richly priced that their high-yield spreads narrowed to a tiny +241 bps over government bonds. The historical norm for high-yield spreads prior to the credit crisis was about 600 bps. This suggested they were over-priced.

When panic set in during 2008, corporate bond prices fell more than 28% to year end so that their yield spreads widened to a record 2,182 bps. This was a buying opportunity we had not seen in several years.

The present +800 bps spread appears to be fair value at this point. High yield bonds are not yet a sell in our work (and hopefully won't be for some time), but in the near term we are finding better value in the higher quality corporate credits, and so we will focus more on higher grade corporate bonds going forward.

We also know that governments will not want to keep their interest policy near zero forever. Once rates begin to rise, probably in 2010, long duration fixed income holdings are likely to lose some ground and so a more active laddering at the short end is likely to be more rewarding over the next couple of years.

Quote of the Month:

"Fish see the bait, but not the hook; people see the profit, but not the peril." - Chinese Proverb.

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