Real life needs active management

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E.Q Trendwatch™

Deflating into 2009

"Few will have the greatness to bend history itself, but each of us can work to change a small portion of events, and in the total of all those acts will be written the history of this generation."

John F. Kennedy, 1917-1963

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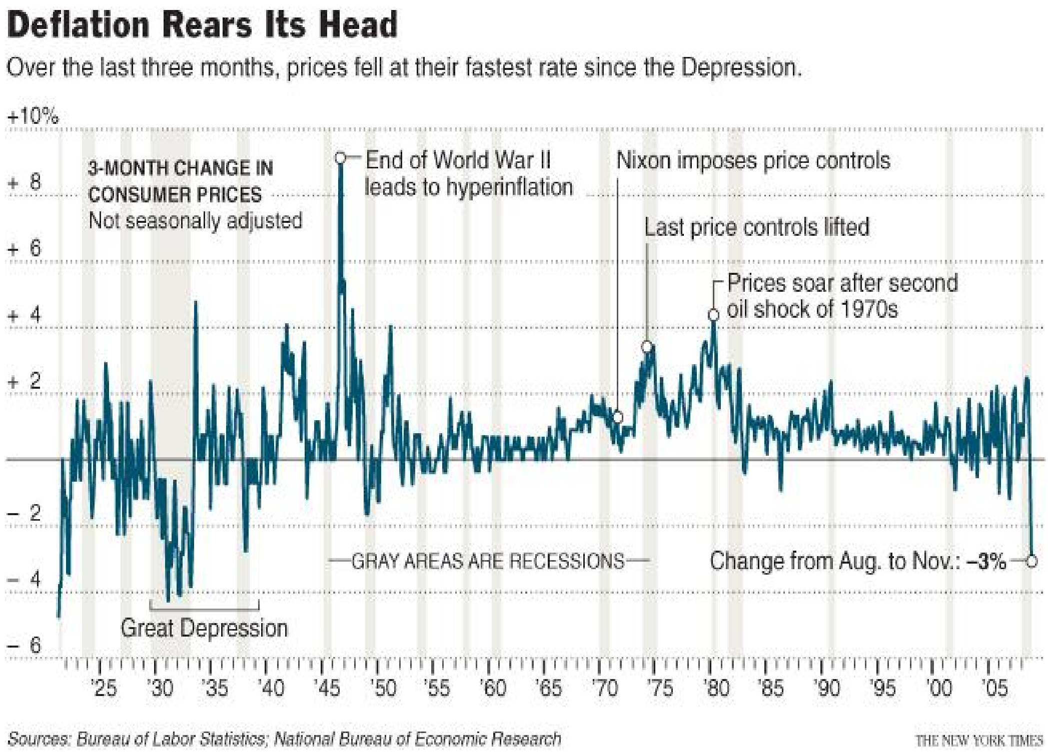
Few people alive today can recall a time when prices were systemically falling across pretty much all assets and goods at once. Consumer prices today are falling at a rate not seen since the Depression.



Deflation causes people to hold off buying things today since they expect prices to be lower next month. As they wait and prices continue to fall, people are encouraged to wait longer still, and so deflation spawns a spiral forcing down consumption and economic growth over time. For this reason, once started, deflation becomes a self-fulfilling prophecy that is hard to reverse. For cash buyers, deflation brings great opportunity. For sellers deflation can be a nightmare.

The long journey to today: an epic human tale revisited

For more than 27 years, falling inflation and falling interest rates encouraged western and particularly North American consumers to become “shopaholics”. Besieged by marketing the average person began to buy more and save less, little and then none at all. The spending disease infected Canada, Australia, the UK and many parts of Europe as well.

As westerners bought more, the developing world ramped up production and became dependent on our over-consumption to sell their low-cost goods. As we bought more and more goods, we had more capital to save. This was plowed it back into US dollar deposits of the world benchmark currency. This influx of growing deposits to US dollars provided great liquidity to our banking system and put further downward pressure on North American interest rates. This allowed us to borrow and buy still more. Financial firms joined into the party by re-packaging credit into new “derivative” investments that quickly spread like a virus around the globe. Finally, too much credit ended up being, well-- just too much. Toxic credit was an international influenza by the end of 2006.

Early in 2007, capital markets began to buckle and blow gaskets. Years of abuse teetered the world banking system on the verge of collapse. The big bubble-making-machine ground to a screeching halt. Oceans of credit turned to a desert seemingly overnight. Governments of the world tried to reverse it. No one had enough good money to throw after the bad that had been spent and lent on over-valued assets around the world. People that owed money were forced to sell assets to come up with liquidity. Too many sellers overwhelmed potential buyers and prices began to fall, and fall, and fall some more. People who had believed that prices only went up had their illusions smashed. Most significantly the experience prompted a seismic shift in consumer behaviour that is likely to last for at least a decade, maybe two.

Eventually, this change will be positive and an era of thrift will help to set the world up for the next secular boom time some years in the future. The crazy times of the past decade had to end. But even as we go forward from here, the world will not stand still. Growing population will necessarily prompt increasing demand and nudge forth the next business cycle expansion just when it is predicted least. That said, growth this expansion is likely to be more subdued and organic than we have experienced in many years.

More than 1 year into the US recession and the global downturn, very few people are now citing reasons for optimism. But we must keep in mind that the majority of the now pessimistic throng were wildly bullish the past couple of years and well into this downturn. In other words, most were unable to see the risks at the peak just as they are now unable to see emerging opportunities through the present gloom. For our part, to be valuable managers, we must fight euphoria and depression at all times. What is needed is an impartial objective view and so we continue to monitor and count our many metrics for evidence of a turn. We know from history that investment markets will turn up for the next bull cycle some 6 to 9 months in advance of the overall economic data. We keep our eyes carefully fixed on the road ahead.

6 key elements to spur the coming recovery

1. Housing and car inventories must work down

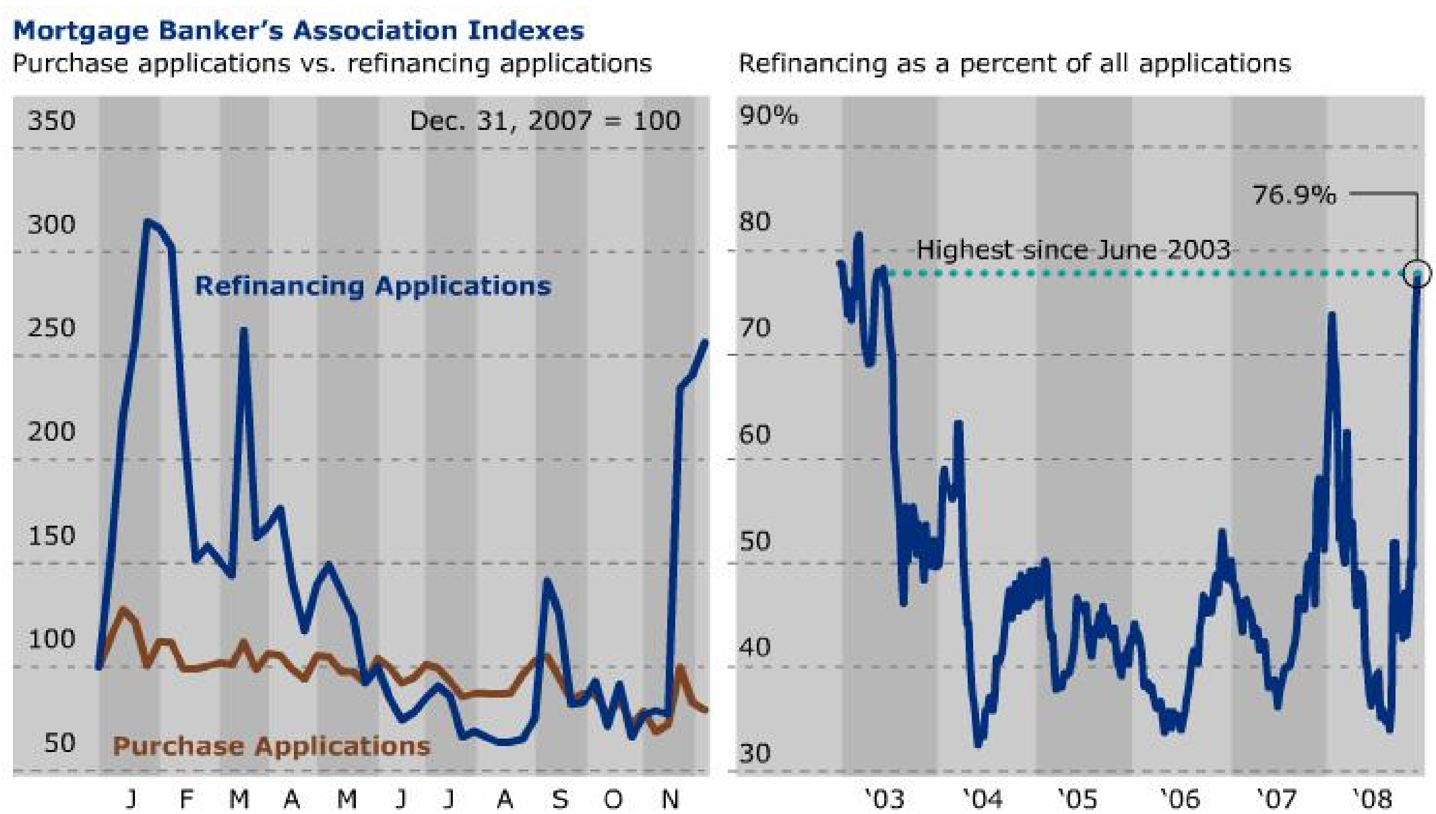
In the late 1990's leading up to the Y2K mania technology companies were pumping out record inventory to meet seemingly insatiable world demand. Technology it was said had abolished the economic business cycle. We all know what happened next. Y2K passed without incident and suddenly everyone realized we were awash in technology companies and products. Demand seemed to literally vanish overnight as the inevitable contraction kicked in.

This cycle is very similar to what we have seen over the past 5 years in real estate and other consumables like cars, commodities and energy. Riding the wave of compulsive consumer spending (thanks to credit) builders and car manufacturers went full out to produce more products than ever before.

We can recall even in 2005 hearing about the big three car companies leasing acres of vacant land all over

North America in order to park their enormous and growing inventory of vehicles that had been made but not yet sold. Acres and acres of land became parking lots on the assumption that record demand would continue indefinitely. Land developers and builders were optioning land all over the globe. Almost everywhere saw waves of voracious speculation. The world went wild for real estate. Credit derivatives and “Chindia” were said to have abolished the business cycle. We now know what happened next.

Today despite steep discounts and herculean efforts to lubricate mortgage and car loan lending, demand has continued to fall. As shown below, mortgages being written today are almost entirely for refinancing existing mortgages rather than for the purchase of new homes.



US homes for sale remain at record highs of over 10 months supply nationally. This means that if builders could completely stop building today, demand should be able to soak up existing inventory over the next 10 months. In cars, fields of new vehicles are waiting and rusting on their axles. Unfortunately home and car builders have not stopped pumping out their product. Few, if any, companies can afford to shut down completely with a plan to turn back on months down the road. And so cars and homes are continuing to flood already over-saturated markets. This means that it will take longer for the excess supply to finally be absorbed by buyers. In other words it will take considerably more than 10 months. It will take a few years. This will set the stage for the muted economic recovery that we expect to start late in 2009. For this reason, it is likely be a long, slow recovery as debt is paid down and savings are built up. This will hold back consumption levels for some time into the next economic expansion. But supply will eventually work down over time and there will eventually be a "bottom" to prices. The companies that survive will be those that can cut costs to the bone and live on their cash for another year. Those that fail will leave increased market share for those that survive.

2. North American savings rate will move up to 10%+

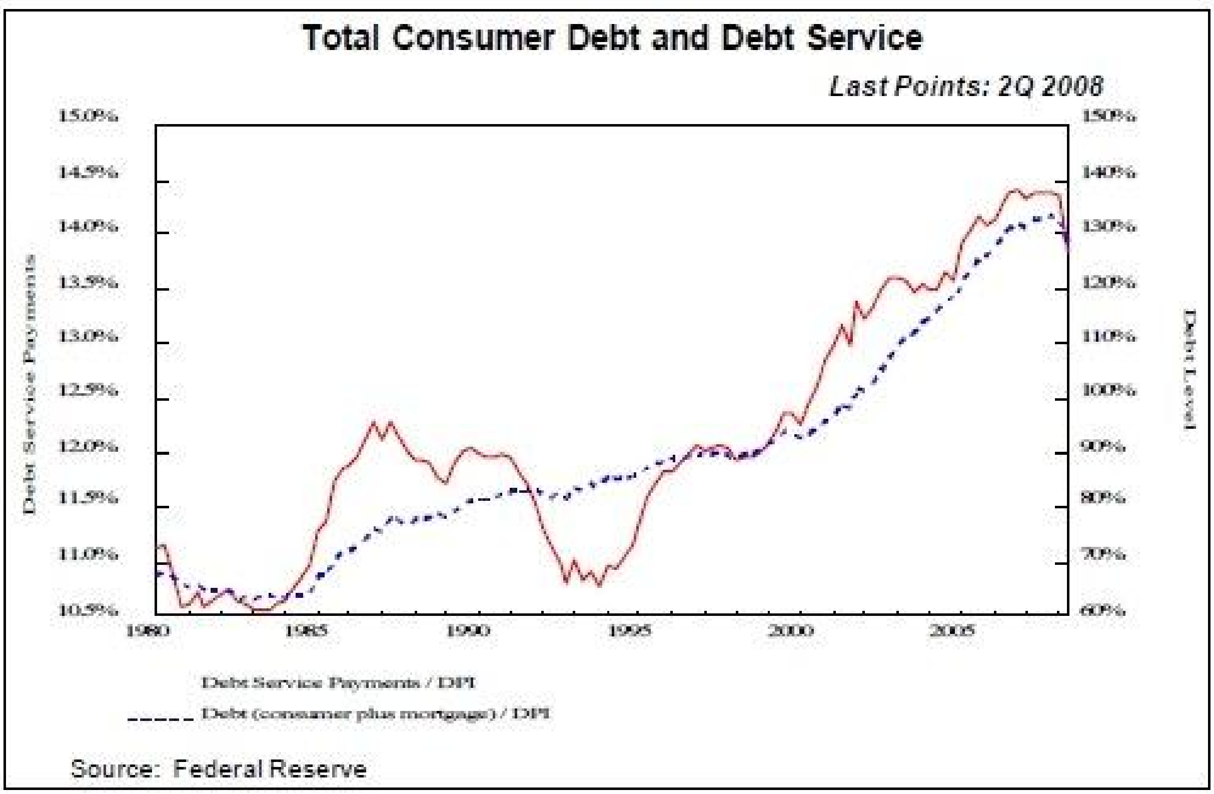
One of the hallmarks of the past few years and the prelude to the present global contraction was the falling and then finally non-existent US (and Canadian) savings rate which dropped from +15% of personal income in 1976 to -2.5% in 2005. Just as it looked like the urge to save was completely dead, this year it began a slow, tepid recovery. As at October 2008, the US savings rate was slowly climbing above 2.4% (see chart).

CHART 5

In the long-run increasing personal savings is a healthy development for families In the short run however, as consumers build up savings it will continue to take away from their spending and the global economic growth which became dependent on it. It is expected that the savings rate will slowly build back about 1% a year over the next decade until it returns to its long term average of 10-12% of disposable income. This is likely to mute economic growth for perhaps the next 7-10 years.

What we find really interesting about this scenario, is how well it matches up with the historical evidence that secular bear markets for stocks have averaged 15-20 years throughout time. From the secular bear that started in 2000, we suspect that we are about half way through this period which is likely to end sometime around 2017. It seems this would roughly line up with the projected time it will take for consumers to re-build a healthy average savings rate. As spending is curtailed and savings are amassed, debt is paid down. As debt is paid down, free cash flow that may be otherwise available for savings and consumption picks up. Presently the all time record debt service born by consumers is an enormous drag on their spending. (See chart below)

CHART 6



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3. Financials and Technology (not commodities and energy) need to lead the next cyclical bull

Financials led the world into our present mess but as the grease that lubricates world commerce, financial institutions will eventually help to enable the world back to economic recovery. Since financials are hit first and hard in the downturn, they typically stabilise and recover earlier than other sectors. *For this reason we are watching their price trend very carefully for signs of a break out.*

Recently we have noticed some signs of strength in the financial sector. We would not be surprised to confirm a buy on financial indices in the not too distant future. An important bonus is that financial shares have fallen so significantly now that their dividend yields are the highest levels we have seen in many years. Dividend yields near 5% will be great comfort during a long, slow economic recovery, where capital gains may be slower to build for some time.

Right now as is typical of the contraction phase, companies are laying workers off at a dramatic pace. Recent data has seen the US economy lose more than a half a million jobs per week. This will continue for some time yet, until the national US unemployment rate climbs from 6.5% now to somewhere between 8 and 10% over the next year or so. Employers as well as employees are traumatised by the experience of mass layoffs. Employers in survival mode cut expenses to stay alive. In order to improve efficiencies with fewer staff, companies look to technological enhancements. It is for this reason that Tech companies tend to benefit first coming out of an economic contraction. It is for this reason that technology shares are considered early cyclicals. They receive capital spending before many other sectors notice any improvement. An additional bonus is that many technology companies today are at compressed prices with little debt and high levels of cash on their balance sheets. This also makes sense, since the tech companies were the poster children for excess at the peak of the 2000 cycle. They have had 8 years now to consolidate and reorganize themselves. The weakest links have now disappeared and the survivors are lean and ready to serve increasing demand. *We would not be surprised to see technology sector shares break out in the not too distant future.* This chart of the Semiconductor Index (tech) as a ratio of the broader S&P 500 is one of the key metrics that will alert us when the technology sector finally breaks out.

4. Signs of life in the battered Chinese stock market

China was the primary benefactor of the most recent US spending bubble. When US spending began to contract heavily in 2007, the Chinese stock market collapsed with it. From a peak of 6000 in late 2007, the Shanghai Index fell a whopping 73% to 1606 in November 2008. Since then, the Chinese market is beginning to show us signs of recovery. Mindful that low cost Chinese goods will continue to be items of preference in the long, slow recovery of western demand, signs of a bottom in the Chinese market (see next chart) offer us a leading indicator that other global markets may not be far behind.

5. The US dollar

Recently the US dollar came under some selling pressure. We are watching this carefully to see whether it is a short or longer term phenomenon. At this point we are watching for any significant break out in the Canadian dollar as against the greenback. This would require a break out through .85 cents. At this point we suspect that the recent greenback weakness is not likely to continue in the medium term. Governments, banks and other firms are still scrambling for dollars to repay their USD-denominated debt while signs of global recession and credit crisis spur on the flight-to-safety. More aggressive monetary easing in the U.S. compared to Europe, are still likely to bring the U.S. out of a recession faster than the Eurozone.

By the same token, a stabilized exchange rate near present levels for the Canadian dollar will also help to fuel US demand for Canadian goods, and this will be a positive for Canada helping us into the recovery, albeit with a lag of several months behind the US recovery.

6. Bond prices will come back down to earth

Flight to safety has been “the” predominant trade in December driving the highest quality bond issues to record prices. This means that bond yields have been compressed to virtually nothing. It also means that the inventory of fixed income that we would consider worthy to purchase has in December been virtually nil. *This has made it practically impossible to reinvest fixed income this month.* We expect that this recent bubble in bond prices will begin correcting itself in the New Year as risk aversion moves down from panic highs to more normalized levels. We have seen some significant decline in panic readings recently in the Volatility Index, after weeks above 80, it is now below 50. Still elevated, but improving none the less.

Meanwhile we are seeing some very attractive yields rising on corporate bonds and preferred shares which have been sold heavily by those running from risk and raising cash. Corporate bonds and preferred shares will be a welcome addition to fixed income yields in our accounts. *We expect to confirm buys on some ETFs in this area shortly once price trends turn positive again.* From being wildly over-priced up to 2007, many are now selling at discounts to their face value of 30 to 50%. This means that yields that were an unattractive 3-4% are now yielding more than 6%. Once the price trends stabilize, this will offer us some great opportunity for steady yields and capital gains as corporate bond and preferred share prices recover over time. This will be part of our “row strategy” to augment portfolio returns while equity markets claw their way back over the early recovery phase.

Conclusion

Sorry this has been an extra long market letter this month. A lot has happened in 2008! But at the close of December we find that cash is still the reigning king of assets, as it has been all year. Thankfully we have plenty of it. We are watching carefully for opportunities to invest well.

At this point we see deflation, not inflation as the dominant force in 2009. Eventually, all of the liquidity being pumped into the world monetary system may well lead to a new era of inflation, but it seems to us that inflation will not filter into the global mix for some significant time to come. Perhaps 2 to 3 years. The excess inventories of homes, vehicles and other hard goods will have to be worked down gradually before pricing pressure can rear its head. Consumers will have to pay down debt and build up some savings before they can buy up goods, even with steep discounts. Presently soaring unemployment will need to stabilize a bit before many are even tempted to buy. And with so many losing their jobs at this point, wage pressure will be decidedly soft for some time.

We continue to watch whether equity markets may move to retest their recent November lows. We are thinking this may be possible again in early February when Q4 ’08 earnings data will no doubt be appalling. *In the meantime though, we are open to the possibility of even a bear market rally of maybe 20% in the New Year. If we get some buys we may have an opportunity to make some gains even if the rally lasts just a few weeks. As always if we do get some buys and then prices begin to break down we will follow our sell rules to the exits again if need be.* We recognize the risk that a future re-test could still break markets to a fresh, lower low for this bear cycle in the weeks or months ahead. We are open to all of these possibilities and do not peg our allocation decisions to any one projection, opinion (guess) or thesis.

In a year of staggering global losses, our balanced composite 50/50 account is up 5.93% net of all fees in 2008. Our rules have served us well, and we are grateful to have them. We will continue to follow them carefully.

We are grateful to be of service to our much deserving clients. We wish you the very best of health and happiness for 2009.

Quote for the month:

“The conventional view serves to protect us from the painful job of thinking.”

John Kenneth Galbraith *US (Canadian-born) administrator & economist (1908 - 2006)*