

# E.Q Trendwatch™

## First quarter ends badly for most

**“No. No. No. Bear Stearns is fine...Bear Stearns is not in trouble...Don't move your money from there. That's just being silly. Don't be silly.”**

--Jim Cramer, on CNBC Mad Money, March 11, 2008



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So far 2008 is fulfilling the promise of its first days and weeks with steep losses in stocks and corporate bonds pretty much around the globe. Those professing “buying opportunities” on each fresh low of the past 18 months have thus far been soundly thrashed. Financial companies in particular, have been hardest hit. In wondering where the next shoe will drop, one analyst aptly pointed out this week, that we are presently standing in a veritable shoe store.

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Year to date in 2008, the Canadian Financial Index has lost 12%. From their peaks in 2007, individual bank stocks have fared horribly, with Bank of Montreal shares -40%, CIBC shares -38%, National Bank -29%, TD -21%, Royal Bank -26%, and BNS -18%—so much for Canadian banks offering investors some safe haven.

At least now we can show readers that we were not crazy when we turned our backs on financial shares a couple of years back in the midst of their “record” earnings.

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**World stock markets performance year to date 2008 (to March 28)**

TSX Comp	-4.3%
TSX Venture Comp	-11%
S&P 500	-10.4%
NADAQ	-14.7
EAFE Index	-9.2%
Europe	-9.2%
Japan	-5.2%
Shanghai Composite	-40%

Meanwhile Gold and other commodities have run higher with the violent price swings of speculators and the inflationary fever of the falling US dollar. Of interest here will be how much longer commodities will run in this cyclical bull market within their secular bull market which started in 2000. We should expect their prices to correct, and perhaps significantly so, with the ongoing demand contraction of world economies over the coming months. This is not likely to be an end to the ongoing secular bull in commodities. We do anticipate that global forces are likely to drive demand for hard assets over the next 8-9 years of this secular bull cycle. However long secular themes are not good enough reason for a passive exposure to this historically volatile sector. Corrections in base metals and other commodity prices could easily fall within the -20-50% range at the end of this business cycle, and still not violate the longer term secular bull story. So as with all risk assets our price entry and exit points must be closely controlled for capital preservation over each business cycle.



A poignant example of this issue can be found in the Chinese stock market over recent months. China is undoubtedly in a super-growth cycle with economic growth and inflation registering double digit for the past several years. And yet this phenomenal growth story has not prevented the Shanghai Composite (left) from suffering enormous price corrections within each business cycle over the past many years. With a 40% price drop year to date in 2008, the present trend is still fully down with no turn around yet in sight.

Interestingly, despite the rising commodities and falling US\$ as against other major currencies, the Canadian dollar has weakened versus the US \$. (see chart next page) The C\$ is presently trading below par, some 4% lower than our November buy of the US dollar. As this trend plays out over coming weeks we will be looking for another good opportunity to increase our US dollar allocation.

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The fact is that while the Canadian economy exhibited its typical lag behind the US over the past year, recent months have shown a marked slowing in many of our national and regional economic indicators.

**With the important US housing and US manufacturing sectors now firmly in contraction, it is important to realize that every time the US has experienced a housing and manufacturing contraction at the same time, Canada has experienced a recession.**

### Cyclical bear markets within secular bears have historically been longer than those within secular bulls

While the recent US recessions of 2001 and 1991 were a relatively short 8 month average duration, it is possible that this time the US recession will be longer and more akin to the 16 month variety experienced during 1973.

As Ned Davis Research points out, since 1900 cyclical bear markets within secular bear cycles have had a median length of 525 days or 17 months. This period is more than twice the median 8 month duration of cyclical bears that have occurred within secular bull cycles. Stocks have been in a secular bear cycle now since 2000 which again suggests we should expect a potentially longer price correction period this time.

As far as how much the on-going slowdown will impact equity prices from here, only time will tell. In retrospect we know that while market downturns are a natural part of each economic cycle, they have historically been most severe when the economy sputters through a period of outright recession. The stock market downturn of 1973-74 saw losses similar to the losses suffered in the most recent bear market of 2000-2002, dropping nearly half its value from the peak to trough.

It seems likely that the present economic contraction began in December 2007. We will not have data to confirm this for a few more months due to the lag in calculating GDP. However, if this contraction is to last in the 16 month area, we may expect it to continue through to the spring of 2009. **In this scenario we would also be looking for the stock market to bottom some 4-5 months before the overall economy.** It is conceivable then that this could present us with an attractive buying opportunity later in 2008. A surge of fear and panic could well accelerate the capitulation selling in the weeks ahead bringing opportunities quicker than may thus far seem obvious. Some assets are already within our buy range at this point, however prices need to firm and stop dropping before action can be justified.

In the meantime, the drum roll of dire economic facts continues to build. We thought we would share with you a summary of some facts that caught our analytical eye this month.

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## **Facts that caught our eye this month, and the silver lining at the end**

2007 Q4 Final US GDP confirmed February's preliminary report of weak .6% growth.

Q1 2008 Preliminary US GDP is expected April 30 and consensus is for a negative reading.

Index of US Leading Economic Indicators (LEI) for February showed a decline of .3% being the 6<sup>th</sup> consecutive monthly decline, and the worst reading since the start of the 2001 recession.

US Consumer spending accounts for 70% of US GDP. 78% of Canadian exports and 29% of Cdn GDP depend upon trade to the US.

U.S. consumer confidence in March fell to 64.5 from 75 in February (and from a high of 110 last summer). This is the lowest reading since the US invaded IRAQ in 2003.

Consumer Confidence is a very lagging indicator, and has historically fallen to a 50-60 range before beginning to recover. Confidence typically does not turn up again until long after a recession has ended.

The expectations index fell to 47.9 from 58 in February and is at the lowest level since the Oil Embargo and Watergate scandal of 1973.

US ISM Services Index has now been below the pivotal 50 reading for January and February.

A report from S&P/Case-Shiller showed US home prices in January fell by the most on record. Dropping 10.7% from January 2007, after a 9% decrease in December. The index has now fallen for 13 consecutive months.

Inventories of US new homes for sale in February stayed at 9.8 months, the highest inventories have been since 1981.

US durable goods orders declined for a second consecutive month in February down 1.7%, following -4.7% month over month drop in January.

Consumer spending may grow at an annual rate of 0.5 percent this quarter, the slowest pace since the 1991 recession, according to the median estimate of economists surveyed this month by Bloomberg News.

The amount of consumers who said jobs are plentiful dropped to 18.8% from 21.5% last month. The percentage of people who said they expect their incomes to rise over the next 6 months fell to 14.9%, the lowest level since 1967.

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In March the US Central Bank carried out its first emergency weekend action in almost three decades and became the lender of last resort to the biggest dealers in government bonds.

The FOMC has slashed its benchmark rate 3% since September, taking it to 2.25% and still investors have refused to increase their purchase of risk assets including corporate bonds. Fed Funds futures are currently pricing in 66% odds for a 25 bps rate cut on April 30 with the remaining 34% odds for a larger 50 bps cut.

Some 51% of US corporate borrowers are presently rated below investment grade up from 28% in 1992. (S&P).

US Housing Market present market value estimated at 20 trillion. US residential mortgages total 12 trillion. US National Debt 9 trillion. Total US unfunded liabilities 53 trillion.

Global credit losses estimated to be 1.2 trillion, with 460 billion or 40% being born by US levered institutions such as banks, broker-dealers, hedge funds and govt sponsored agencies. About 120 billion of the 460 billion in losses have been reported by these institutions since the credit crunch began in the summer of 2007. (Goldman Sacs report Mar 26, 2008)

With a multiplier effect of about 5 to 1, losses of 400 billion imply a contraction of about 2 trillion in the balance sheets of these institutions and would subtract just under a trillion in lending that would otherwise been available to households and business. (Levered Losses: lessons form the mortgage market meltdown, paper Feb 29, 2008)

**The silver lining:** As our readers know, we at Venable Park were worried about precisely these risks unfolding over the past couple of years. But there is a silver lining to all of this. Now that this correcting time is underway there is a sense of relief and building optimism that we have not felt in many months. Prices are still dropping and we are not inclined to catch falling knives, but valuations are now in the process of becoming attractive and reasonable across many different asset classes.

Soon regular people should once again be able to buy nice homes at reasonable prices. Soon income investors should once again be able to buy good income investments at rational and rewarding prices. Soon growth investors should be able to find growth investments at the best valuations in a decade. This will ultimately all be positive in the end for those that are ready for it.

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**Juggling Dynamite: the blog** turns 1 year old this April, and to our surprise its readership is now up to thousands of people per month from all over North American and Europe. Last week Forbes Magazine asked Juggling Dynamite to become a member of its new business and finance blog network Forbes.net. Since its US release 5 months ago, Juggling Dynamite the book has already sold more copies in the US than it has in Canada over the past year.

Blogging is an incredible communication tool. If any of our readers are interested in starting a blog for their own business or message, please feel free to pick our brain on how to get started. We are always happy to help.

Danielle will be speaking in **Calgary April 12 and 13** at the Calgary Resource Conference and in **New York, New York at the Hard Assets conference May 12 and 13.**

**Visit [www.jugglingdynamite.com](http://www.jugglingdynamite.com) for our weekly commentary and media interviews.**

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