

E.Q Trendwatch™

Why we don't (won't) gloat

Over the past couple of months, several people have been congratulating us for seeing the current market problems coming. "You must feel vindicated," they kindly offer. While it is comforting to see that the rules of gravity have not really been repealed and a crazy time is finally coming into the light of day, this is truly no time to gloat. It is hard to watch millions of people being taken by surprise--again. It is hard to watch investment bank wizards cashing out their options and bonuses while millions of regular people lose their homes, jobs and happiness--again. And unfortunately we (and many others) believe there is still significantly more pain to come before this all plays out. A Sept 3 MarketWatch headline "Wall Street hiring machine goes idle" warns that after years of build-up, employment levels have flattened and job cuts across many sectors now loom.

As our readers know, we have been talking about looming debt and excessive leverage and unsustainable profit margins for many months. If you feel a bit weary of these themes by now, admittedly so are we. That is one of the necessary things about being ahead of the curve, by the time issues become the pre-occupation of the masses, we are already looking past them to the opportunities that will present.

While we cannot forecast market direction over the short term, we can state that based on all rational metrics and measurements, current market prices are over-bullish and over-priced. And that following similar periods in the past, investment returns have been characterized by significant volatility while earning less than T-bill rates for those who remain fully invested.

Since we have not been fully invested in the broad equity markets or long bonds we offer the following summary chart as a point of reference for our clients. This shows the returns that other Canadian investors have experienced being fully invested, enduring great volatility, through the first 8 months of 2007 to the end of August.



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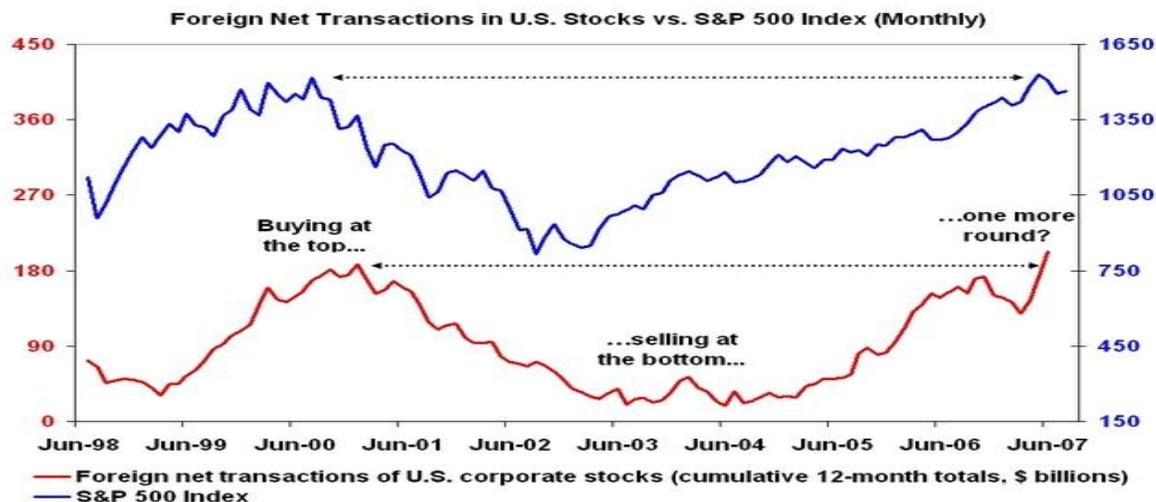
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World Market returns year to date (ending August 31, 2007): source API Asset Performance Inc.
Yr. to date in \$Cdn

TSX 60	5.8%
TSX Venture Comp	-11.4%
S&P 500	-5.8%
NASDAQ	-2.5%
MSCI EAFE index	-4.4%
Europe	-0.3%
Japan	-10.1%
Asia Pacific	-4.4%
Broad Bond Index	0.3%
All government bonds	0.5%
All corporate bonds	-0.1%

So having the bulk of our equity weight in safe government of Canada T-bills and money market earning about 4% has been more rewarding to our clients over the past 8 months than had we been fully invested in world equity markets and long or corporate bonds. We show the above numbers because it is often hard to appreciate losses going on around us when we are not suffering through them first hand.

The next chart is also illuminating (we thought) since it shows how the net inflows to the US stock market from foreigners (including Canadian investors) has picked up as the S&P 500 has risen back to present lofty heights. It demonstrates just how perfectly investors have sold at the bottom and bought at the top of this market cycle over the past 9 years. As you know, we at VP seek to do the opposite of the masses (red line below) in this regard.



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It is also important to explain that the top line in the above chart shows the S&P 500 value in US dollars, which is why it shows the market has rallied significantly from its 2002 lows. In fact, of course, the US dollar has depreciated dramatically against most other currencies during this same time frame, and so the net returns to foreign investors that held during this period have actually been much worse than the chart depicts. As pointed out by author and analyst Micheal J. Panzner, July marked a record for foreign investor inflows into the S&P 500:

"When was the last record set? In January 2001, just as the dot-com bubble was bursting and the bottom was falling out of the U.S. stock market. Indeed, over the past decade, foreigner investor behavior has proved to be a reasonably good long-term timing signal -- in contrarian terms, that is.

For instance, while U.S. share prices were bottoming in 2002, foreigners continued to reduce their exposure, until they eventually rejoined the bullish party in late 2005. A cynic might wonder: now that they are all in, can much lower prices be far behind?"

The trouble with Financials

One of the major headwinds, for both US and Canadian markets at this point in the on-going liquidity crisis, are that financial services companies are a large weight in the broad markets and are in the midst of a cyclical contraction. Year to date the US broker-dealer index has lost more than -16% in Canadian dollar terms, even our own Big 5 Canadian banks have been taking on water, with the largest Royal Bank now off more than 9% from its peak of a few months ago.

Over the past few days, markets rallied on promises from Bush and Bernake that the government was watching and may step in to cut rates should the credit crisis spread throughout the economy. Bond markets have now fully priced in an expectation for a 50 basis point cut to the Federal funds rate in the US by September 18. And the markets may very well rally if this hoped for intervention arrives. The trouble, however, is this: the present credit crisis in world markets was not created by too-tight conditions. Our troubles were actually created by too lax for too long interest rates, when the US Fed reserve cut the overnight rate to 1% and left it there for a full year 2003-2004. The present resulting crisis is one of liquidity, as lenders tighten standards, loan less and at higher rates. People who are maxed out on their credit and teetering on insolvency are not going to be rescued by a half point cut in short term lending rates. They bought homes and goods which they could not afford and now they cannot make their monthly payments.

Not only did the Feds leave the floodgates wide open--*they left their post completely*. The should-be-guards failed to man the gate at all. They turned their back on the party that got underway and failed to step in to curtail the irresponsible lending and consuming that followed. This lengthy lapse of reason is the root of the evils we are now confronting.

These patients cannot be rehabilitated by handing out more opium (other people's money through credit). These patients (consumers and risk-junkie investors) will need to spend some time in rehab to clear this debt hangover and find their way back to healthful habits. People need to reign in their spending--yes it will slow the economy,--but that is the inevitable outcome of spending our brains out on credit over the past few years. The markets may rally initially on coming rate cuts, but the fact is that profits will decline, growth will slow, and risk assets will continue to be re-priced. This will all be normal, healthy stuff for those that have been clear-headed enough to see it coming.

Meanwhile lay-offs have likely only just started as outlined in a recent forecast change from Merrill Lynch today:

Merrill slashes banks' profit forecasts **Analysts see Fed-driven stock rally followed by pullback as credit woes linger**

BOSTON (MarketWatch) Sept 4, 2007-- Analysts at Merrill Lynch on Tuesday lowered their 2008 earnings estimates and target prices for some of the nation's largest regional banks as they expect a short-term rally inspired by Federal Reserve rate cuts to fizzle out with credit fears stretching into next year.

Economists are now predicting a 65% chance that an economic recession materializes in the next year. The forecast is based partly on rising unemployment, a slowing housing market and declining consumer confidence.

Still, Merrill expects the Fed to cut the federal funds rate by 0.5% at its meeting later this month, which it says would fuel a short-term rally in banking stocks. The analysts are predicting the key interest rate will be a full 1% lower by the end of 2007, to 4.25%. Yet despite the rate cuts, the analysts expect employment figures to worsen as economic growth slows in early 2008 driven by weak consumer spending.

During the two most recent credit-quality deterioration cycles in the early 1990s and 2000s, banking stocks enjoyed an upswing for a couple months after the Fed began cutting rates, Merrill pointed out.

"However, the benefits of the Fed easing cycle were quickly overwhelmed by the market's realization that a profound credit cycle would not be avoided, which caused bank stocks to decline" despite additional Fed rate cuts, the analysts wrote in a research note Tuesday. "This time around, we expect a similar pattern."

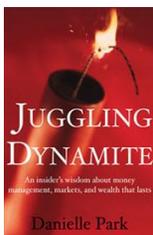
If a 50-basis-point Fed rate cut does spark a rally, "we would expect to become even more cautious on the group as we would still expect a meaningful credit cycle to materialize."

We note that even three months ago, bank analysts were almost unanimously predicting that consumer credit problems would be contained and not affect the broader economy. Revisions like this mark a significant shift in recent sentiment as more participants enter "the belief" phase about this economic contraction.

UPCOMING TELEVISION APPEARANCES

For those that are interested, **Danielle will be the guest Portfolio Manager on *CBC NewsWorld*, (Channel 23 on cable) at 9am on Wed Sept 5, and on *The Street* at 9:20am on Mon Sept 24 (Channel 49 on cable).** Unfortunately the clips can no longer be viewed for the week following the appearances on the BNN website so we will not be able to email them out to clients after the fact.

Remember to visit our Blog at www.jugglingdynamite.com for interactive daily commentary.



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