

E.Q Trendwatch™

Ludicrously under-priced risk and other shades of 1999

"Current risks are ludicrously under-priced, at some point, someone is going to get an extremely nasty surprise."

Willem Buiter, former member Bank of England's Monetary Policy Committee.- DAVOS, Jan 2007

We thought we should start off the New Year by bringing you an update of where we are with some of the key market risks we were talking and writing about throughout 2006. First of all on the downside, some significant drops have been underway, (not that our clients have suffered these losses), we include them here in order to offer a sense of the storms that have been swirling around markets over the past few months.

Firstly, housing is still trending lower as confirmed by yesterday's update to the US home price index. S&P Index committee chairman David Blitzer said that prices in the 20- City composite Index *grew at the slowest rate ever for the data*: "The weakness continues to spread, I don't see any signs of a bottom. Unfortunately it's still looking pretty nasty from a housing point of view." *New home sales fell by the largest amount in 16 years in 2006*. Recall last month's Ritholtz piece showing that since rates hit their lows in 2003, Mortgage Equity Withdrawal has been responsible for more than 75% of GDP growth. Fully mortgaged people cannot continue to withdraw equity from homes that do not increase in value.



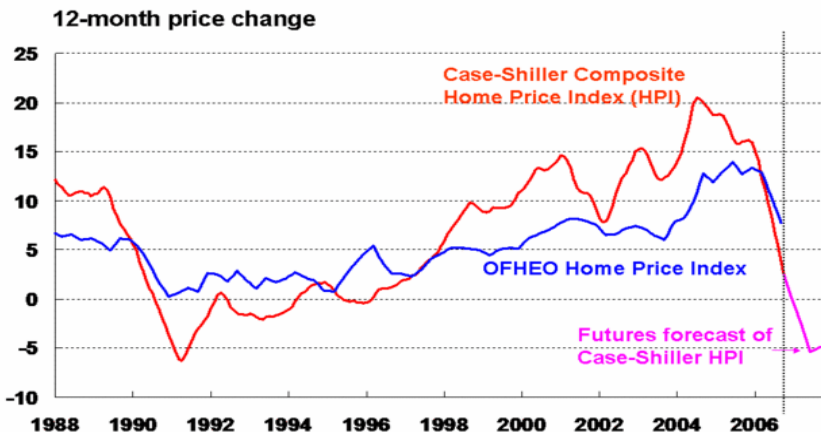
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CASE-SHILLER HOME PRICE INDEXES



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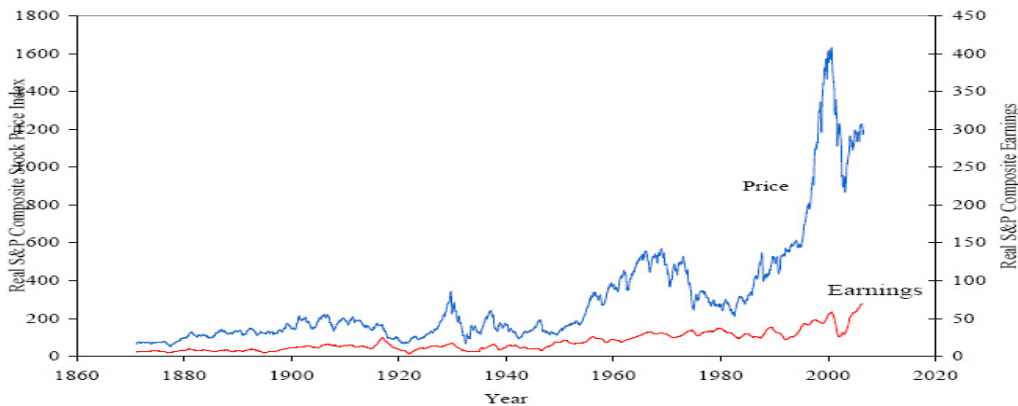
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Price action in other key sectors over the past 6 months:

Copper:	-34%	Copper is known as the metal that leads economic downturns.
Oil:	-31%	
Income trust index:	-18%	

So far the broad stock market indices in North America have not followed these major commodities and sectors lower. So far stock market investors have turned a blind eye to the key themes of slowing world demand, and contracting corporate earnings. They will adjust for this reality sooner or later it is not a matter of if, but simply how much longer must we wait for “ludicrous” valuations to correct.

The gravity defying wonder of current stock prices



The above 200-year chart of the S&P 500 (US) Index captures the remarkable trend towards high prices over the past 10 years. Notwithstanding the significant 45% correction in prices from the all time high in 2000 to the rebound that started in 2002, stock prices today remain very high by all measurements. In fact from today’s perspective, the stock market bubble of 1929, looks like a minor blip. And yet its painful correction from 1929 to 1933 took 25 years to recover.

Corporate earnings growth has been very robust over the past 4 year economic expansion. But even taking into account the increasing real earnings trend (shown in red at the bottom of the above chart), we must admit that the prices investors have agreed to pay for these earnings in recent years has gone way above trend. Currently prices are about 25 times long-term earning trends. **Throughout the past 200 years, whenever stocks have been trading at 20-25x earnings, the subsequent returns over the next 10-years have been just a touch above zero.** Whenever prices have been less than 10 times earnings, subsequent real returns have averaged more than 15 percent a year. So back to the point--the price you pay for an investment is the greatest determinant of whether its ownership will be rewarding over time. We must be careful to buy once prices correct if we are to stand the best chance of making **and keeping** lasting gains. Markets that moved from expensive to now ridiculous valuations are still not a good deal.

For those of us who have been feeling frustrated that markets are making gains and we are missing out, we must remember 1999. 1999 was the last time that markets were so hot and investor confidence so high. We realize it is very hard to continue to practice faith and discipline at these times. We too live this every day as we are all bombarded by mainstream media and investment hype. And yet we know from years of experience now that the buy and hold at any price method that the vast majority of managers follow does not serve real clients well over the course of their

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investing life. It is human nature to assess performance over short time frames 1, 2, 3, years, and switch course when a style seems out of favour. But the truth is that it takes longer than a couple of years to assess the success of an investment approach.

If a management style does not have a strict valuation method of one kind or another to follow, then they will be perpetually buying and holding investments, or moving about ad hoc chasing one hot sector to another. When bear markets come their clients will suffer painful losses and it will then take those clients the next several years to try and make their way back to whole again. Disciplined investors suffer through our version of a bear market at the last throws of a market peak, when everyone around them seems to be making great paper gains, and we are left collecting modest interest. **But it is the tortoise that wins this race, not the hare. Volatility and speed are not what wins lasting gains for people.** Care, diligence and abhorrence of reckless risks are the only prudent course. When prices drop, investors that have been happily surfing the wave on the way up will also stay with it all the way down. At that point they will realize that they have just been on another merri-go-round that left brokers and underwriters richer, and investors only back where they started.

Without a conscientious manager and a sell and wait discipline before buying, recent equity market gains will end up being nothing more than a painful memory for buy and hold investors.

Wise quotes relevant to present times:

Wall Street [and Bay Street] exist to sell investments. From a business point of view, no one on Wall Street has any earthly reason to ever suggest that the market is overpriced."

Mahar, Maggie(2004). **Bull! A History of the Boom, (1982-1999)**

...we must muster the courage to sell stocks when the year-over-year rate of change in consumer spending, at the front end of the cycle, is at its best, and optimism about the economy (ie. Encouragement to be heavily invested) is ubiquitous –or, conversely to wade into the market and purchase stocks when the world appears to be coming to an end.

Ellis, Joseph, H. (2005). **Ahead of the Curve. A Commonsense Guide to Forecasting Business and Market Cycles.** Boston: Harvard Business School Press.

'[Risk is present] if there is a danger that the price may prove to have been clearly too high by intrinsic standards—even if any subsequent severe market decline may be recouped years later."

Graham, Benjamin. (1973). **The Intelligent Investor.** New York: HarperCollins.

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For those that are interested, **Cory** will be the **guest Technical Analyst on *The Chart Room*, Friday March 2, at 3:40pm**, and **Danielle** will be the **guest Portfolio Manager on *The Street* at 9:20am on Wednesday February 21**. The clips can also be viewed for the week following the appearances on the ROB website at http://www.robtv.com/shows/past_archive under past video archive for the date and time in question as well as through a link on our web home page at www.venablepark.com.