Real life needs active management

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E.Q Trendwatch™

IT TURNS OUT IT IS STILL ABOUT THE ECONOMY…

"US GDP growth swooned by more than expected in the second quarter of 2006, growing by just 2.5% annualized—considerably less than the 5.6% growth recorded in the previous quarter and the consensus expectation for a 3% gain."

"The US economy is starting to slip, and we suspect a further weakening will be in store over the second half of 2006 and into 2007. An elevated level of inventory accumulation in the latest quarter suggests that output growth was artificially elevated relative to demand, raising risks for the future. Although spending on equipment and software is likely to rebound in coming quarters, further downward pressure should be exerted by consumer spending and residential construction."

TD Fixed Income Senior Research Analyst Eric Lascelles—July 28, 2006

Whether we like it or not, in Canada we are but a feeder fish on the whale of the US economy. While US demand grows during an economic expansion we, in Canada, directly benefit. But nothing lasts indefinitely. Three years of expansion is about the norm, this cycle had been extended beyond the average with creative financing. The inevitable economic slowdown we should expect and embrace as a natural part of the economic order is upon us.

We knew that 17 consecutive US interest rate hikes since 2004 would achieve their target of economic slowing. <u>But since there is a lag of about 12 months before hikes impact the economic data, only about half of the hikes are so far apparent</u>. Further slowing will continue to appear over the coming months. Recall that consumer spending drives about 70% of GDP in the US. Stagnating home values make consumers less optimistic and they traditionally pull in spending. Spending habits have been extra stubborn this time around, and have been slower to respond, but are now easing off.

The following chart shows the remarkable correlation between the Housing Market Index (prices) and real consumer spending. As we can see there has been an unusually long disconnect this time around in that the housing index has fallen so far much more than spending since the end of 2005. The spending line has some more slowing down to do.

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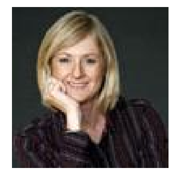

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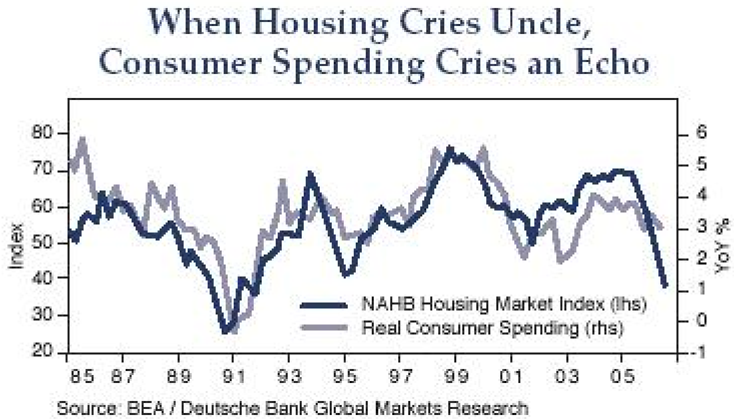

Exhibit 1

The greatest economic damage is done when rate of economic growth begin to slow.

Frequently on business channels we hear pundits saying that notwithstanding the obvious slowdown underway, they do not expect the economy to recess (ie record 2 consecutive quarters of negative growth) and so some will say they remain bullish on the stock market over the near term. There is a fundamental flaw in this logic. It does not take a "recession" to wreck havoc in the stock market. History has shown repeatedly that the largest part of the damage to stock market values is done well before any actual recession makes an appearance.

Joseph Ellis has written an excellent book on this topic, entitled **Ahead of the Curve: A Commonsense Guide to Forecasting Business and Market Cycles. Ellis** was a partner at Goldman Sachs and was ranked #1 retail analyst for eighteen consecutive years by *Institutional Investor* magazine.

His comments on the economic cycle and stocks are so poignant re our present time, we thought it was worthwhile to include the following exerpt from the book:

> *Early in my career as an investment analyst on Wall Street, I discovered an important truth in providing sound advice to my clients: ….Without question, there were long periods during which retail stocks and stocks in general were unrewarding. During such times, a buy-and-hold posture would prove to be destructive. These periods usually coincided with slowdowns in the economy lasting for two or more years. Economic cycles—periods of advancing and then slowing economic growth—were the rule and not the exception. These cycles appeared to occur every three to six years and carried with them corresponding bull and bear markets.*

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Furthermore, on the downside, there seemed to be a repeating pattern in which businesses and investors were invariably caught, without warning, in economic downturns and the accompanying bear markets. In cycle after cycle, the abilities of the business and investment communities to perceive the downturn as it occurred were typically so belated that there was little capacity for avoiding its damaging effects.

Much of the problem seemed to revolve around businesses' and investors' focus on recession—typically defined as two successive quarters of absolute decline in total economic output (real GDP) on a quarter-versus-prior-quarter basis—as the key economic event to be feared, the big bad wolf of the economy, so to speak. Businesses and investors seemed to feel that, if there were no recession, then everything was basically OK. But, repeatedly, business conditions, corporate profits, and the stock market appeared to suffer badly before recessions ever came into view.

The four stages of economic downturns.

I observed four stages of perception associated with these downturns:

- ***Stage 1: The peak.*** *The economic environment would be uniformly favorable. Real GDP and its key component, consumer spending, were increasing at a strong pace, corporate profits were showing superb gains, and the employment picture was clearly favorable. The stock market would be reaching new peaks, with investors enthusiastically embracing a bright business outlook.*

- ***Stage 2: A modest slowing.*** *The uniformly bright outlook of stage 1 would give way to a period of moderate slowdown in the rate of growth of the economy, particularly in consumer spending at the front end of the cycle. Retail sales growth would slow a bit. Interest rates would be rising gradually in response to the strong economy, and some vague concerns about interest rate and inflation would be raised, but not sufficiently to quell business and investor optimism. Capital spending and employment would still be growing at a strong pace (accompanied by much happy talk about a "full-employment economy"). And corporate profits would still be on the rise, but with percentage increases at a somewhat slower pace than the robust pace of the prior period. Few forecasters would yet fear that a recession—an actual decline in total economic output—was in the cards. And the stock market might well be sideways or, more likely, even down 5 to 10 percent, but believed to be only taking a "breather" after the strong market gains of the prior period.*

- ***Stage 3: Intensifying worrying.*** *The economy would now enter a period of more intense worry, in which interest rates and inflation were higher, the rate of growth in real consumer spending and real GDP had slowed from a peak of 5 to 6 percent to "moderate growth" of perhaps 2 to 3 percent, and economists and others would begin to contemplate the possibility that the economy could enter a recession. Conjecture would now begin to center on how long and deep such a recession (if it occurred) might be. The stock market by now might have declined an additional 10 percent or more from stage 2; a bear market was now under way. However, some comfort would still be taken from the fact that capital spending was still relatively strong and the unemployment rate remained low.*

- ***Stage 4: The advent of recession.*** *Now the economy would actually enter the recession, a period of absolute decline in real GDP, with corporate profits falling significantly, capital spending beginning to weaken, and—perhaps most alarmingly—the first major increases in the unemployment rate. And if an accelerating number of workers were losing their jobs, where would the impetus for an upturn come from? Fears of a protracted decline would now become more widespread, with a great deal of economic discourse devoted to determining when the*

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recession began: when quarter-to-quarter real GDP comparisons fell below zero—that is, began to decline (as if the zero demarcation level were any more important than any other number). During the early phases of stage 4, stocks would continue to decline as investors confronted these fears. As a period of unusually wide-spread pessimism, stage 4 appeared very much like a mirror image of the unquestioned optimism of stage 1. And, most perplexingly, at some point during the recession, when economic conditions were at their worst, stock prices would stop declining and—mysteriously—would begin to advance.

As an analyst responsible to my clients for providing guidance on the performance of my (retail-industry) stocks, I began to recognize patterns of economic and investment damage. Not only my retail stocks, but also the stock market as a whole, had peaked during stage 1 when economic growth was still at its best and optimism was rampant. Stock prices were already in decline as sales-growth rates for business throughout the economy began to slow in stage 2, and this decline intensified in stage 3 as sales increases slowed even further, but before an actual recession was even considered likely. By stage 3, it was already too late for most companies to react to slowing business conditions. Investors, too, were faced with a dilemma by the time stage 3 ran its course: the difficult choice of either waiting things out in the hopes that a recession could be avoided, or selling—to avoid further losses—at what could be the bottom.

"The greatest economic damage was done when rates of economic growth began to slow."

I now began to understand that the central role given to recession—the advent of stage 4—as the accepted definition of economic harm was itself most damaging to businesses and investors. The emphasis that economists, businesspeople, and investors placed on recession as the key negative economic event actually led them to miss the fundamental fact that the greatest economic damage was done when rates of economic growth began to slow, and this period began at the end of stage 1 and continued through the beginning of stage 4, long before stage 4's absolute decline in economic activity. It was in stages 2 and 3 that an unexpected slowdown in sales growth would begin to cause rising inventories, pricing weakness for businesses, falling profits, and declining stock prices. In fact, in a number of downturns (for example, 1966-1967 and 1984–1985) the economy never even reached stage 4; that is, a recession, or actual decline in economic activity, never even occurred. Yet there was clear damage to corporate profits and the stock market.

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This book is well worth reading in its entirety for anyone that would like to learn more about anticipating business cycles.

We believe that January to March 2006 will be shown to be what Ellis refers to as Stage 1. The confidence before the storm. From March to the end of July has been Stage 2 and in August 2006 we are now entering Stage 3, with higher rates of interest, and slowing consumer spending and real GDP slowing from 5% to "moderate growth" of perhaps 2 to 3%. At this point the bear market in stocks is now under way.

REPORT ON BUSINESS TELEVISION UPCOMING APPEARANCES (ROBTV- Channel 64 on Cable)
Danielle will be the guest Portfolio Manager on AM Business at 9:20am on Aug 25, and September 20. 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.

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