Real life needs active management

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E.Q Trendwatch™

Fed up

Cory Venable CIM, FCSI, CMT
Technical Market Analyst

Danielle Park LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.

"Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed."
—Benjamin Graham

The world is full of upheaval and frustration today: angry unions and striking workers in Canada and the US, protests through Asia to outright revolts and civil war across the Middle East and Africa. Nature herself seems to be in an agitated mood. Earthquakes, tsunamis, floods and storms are making weekly news. This month's monster quake in Japan is said to have increased the frequency of future quakes across the globe. It's not as if we didn't have enough challenges.

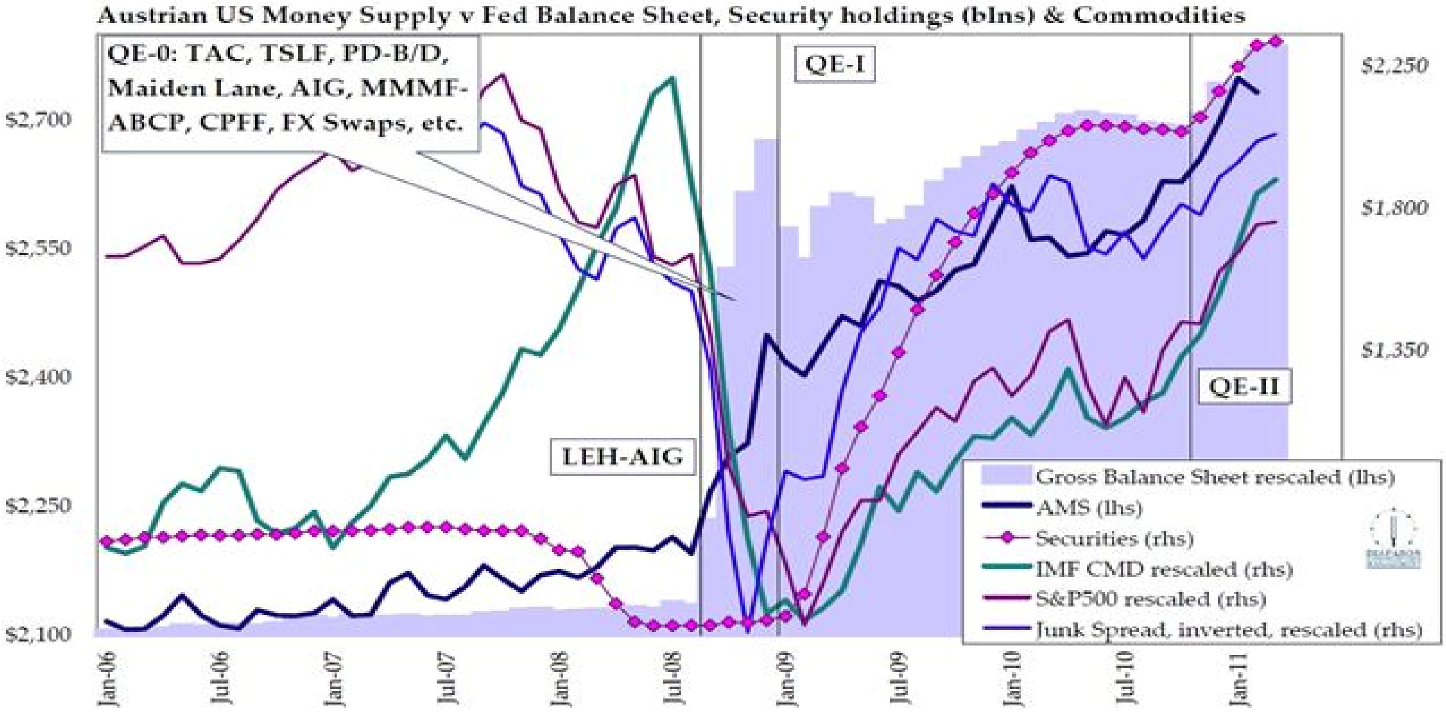
The fact is that Planet Earth is like a closely knit sweater. Every country, continent, people and eco-system is interwoven. As much as we may wish for independence at times, an unravelling or pull in one area naturally impacts the rest. The analogy applies especially to today's financial markets.

Venable Park Investment Counsel Inc.
VIP
www.venablepark.com

33 Clapperton St.
Barrie ON L4M 3E6
Tel: (705) 792-3991
Toll Free: 866-792-3991
Fax: (705) 792-3992

The chart below shows the near-perfect correlation between the US Federal Reserve's two emergency "quantitative easing" programs over the past two years (with total liquidity added in purple-shading) and plotted against the price performance of stocks (S&P 500), high yield debt and commodities.

Central banks have pumped asset markets with waves of liquidity for over 2 years



Source: Bloomberg Finance L.P.

The above offers graphic evidence of what an extraordinary impact US Federal Reserve intervention (actually global Central banks) has had on asset prices the past couple of years. As Quantitative Easing "QE-0" (TAC, TSLF, ABCP etc) ended, QE1 threw fresh billions at the rescue. Flirting with a double dip last fall, the Fed announced its second phase of QE. QE2 is now to expire this June and at this time Fed members have said there are no plans to continue their unprecedented liquidity support to capital markets.

Ben Bernanke insists that the global economy is now entrenched in recovery mode. If he is right, there can be no argument for further degrading Fed assets and the US dollar with more QE. **The economy is supposed to be able to grow organically from here.** There is even some discussion that the Federal Reserve should ease out of QE2 before June. Federal Reserve Bank of St. Louis President James Bullard, when speaking to reporters in France on March 26, summarized the thinking this way:

> *"If the economy is as strong as I think it is, then I think it may be reasonable to send a signal to markets that we're going to start withdrawing our stimulus, and I'd start by pulling up a little bit short on the*

> *QE2 program… We can't be as accommodative as we are today for too long, we'll create a lot of inflation if we do that."*

The facts are that QE has already created a lot of inflation for still struggling consumers and business in the sensitive areas of energy, food and other commodities. It has been particularly harsh for the poorest people and countries. No matter how much Bernanke denies it (hey, he said there was no housing bubble either), QE-sparked inflation has undoubtedly been a final straw igniting the civil upheaval we are seeing in many parts of the developing world. Poor people in many countries (that were already disenfranchised by oppressive and corrupt rulers) can no longer afford to eat. As the history of revolutions has shown, without food, people rise up. They literally have nothing left to lose. The toppling of these regimes may be better in the end, but there are a lot of risks around how this proceeds and who now comes to power.

Ongoing price pressure in commodities, a tripling of oil prices, a double dip in housing, new wars in the Middle East and Africa, unresolved crisis in the Euro zone, and Japanese devastation, nuclear contamination and resulting supply shocks to the global economy have all increased the probability that the global economy and corporate profits may weaken significantly over the coming months. Examples of the impact from Japan's export disruption are everywhere today. Our local Honda plant just announced they would be cutting over half of their production due to recent supply constraints on Japanese parts.

This realization has led some to bank on the belief that further rounds of QE are inevitable. If economic news turns negative again, governments may well offer another round of juice. But as with all things, QE will inevitably meet the law of diminishing returns. Even Federal Reserves have limited tools and finite amounts of influence.

Despite recent confidence in the powers of Central banks, remember this: if they were able to permanently control capital markets, history would not be filled with recurring bear markets and economic contractions every 3 to 5 years over the past couple of centuries - and it is. Buy and hold investors would not be suffering through year eleven of negative compound returns since the start of this century - but they are. And Japan would not have struggled with ongoing asset deflation for the past 30 years even as her government doubled its debt levels in round after round of QE and other stimulus.

The end of QE this June, whether permanent or interim, is a major near-term risk to lofty asset prices. We believe this is particularly so with respect to commodities, equities and petro-based currencies. We admit that we were expecting this correction to continue last summer before QE2 stepped in. QE2 managed to interrupt the downward trend in markets but sadly, it did not solve any problems. To the contrary, QE commodity-inflation has now added drag to the global economy. More QE would be an even greater inflationary nightmare. Trying to withdraw what they have already added will be difficult enough. The "V" rebound in prices over the past 7 months have made the downside risk from here that much greater.

On the price of oil

Lately bullish commentators have been assuring that the price of oil isn't a problem at current levels and shouldn't pose a threat to economic growth unless it breaks above $120 - $125 a barrel.

The fact is that any significant rise in the price of oil directly impacts consumer spending— full stop. Gas is spending power literally burned out our tailpipes. To suggest that a consumer-driven economy isn't hurt by consumers having fewer dollars to spend is intellectually dishonest.

Oil has traded above the $120-125 level for just 10 weeks in all of recorded history (in 2008). But spikes in the price of oil have been one of the most reliable precursors to economic recession over the years, even at much lower prices. It is the relative change in price and the length of time that price stays elevated that causes the shock, not a particular price target.

As the chart below shows, since 1970 whatever the starting price, each time the price of oil doubled from its previous low a recession (grey bars) began. The only exception was the last cycle when in 2005 unprecedented credit expansion during the credit bubble allowed the economy and the price of oil to expand for two more years to 2007.

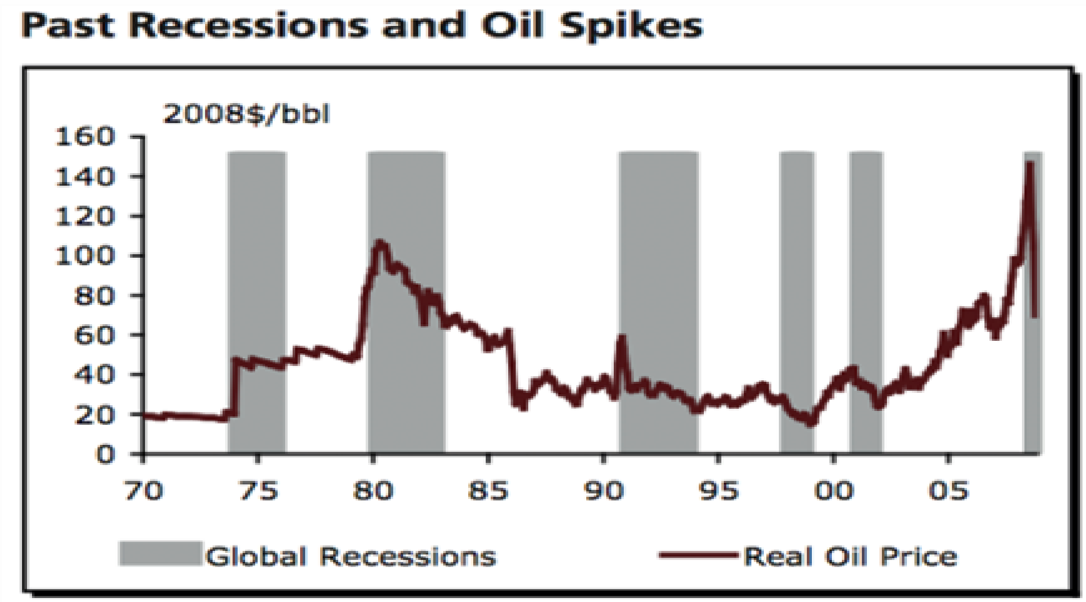
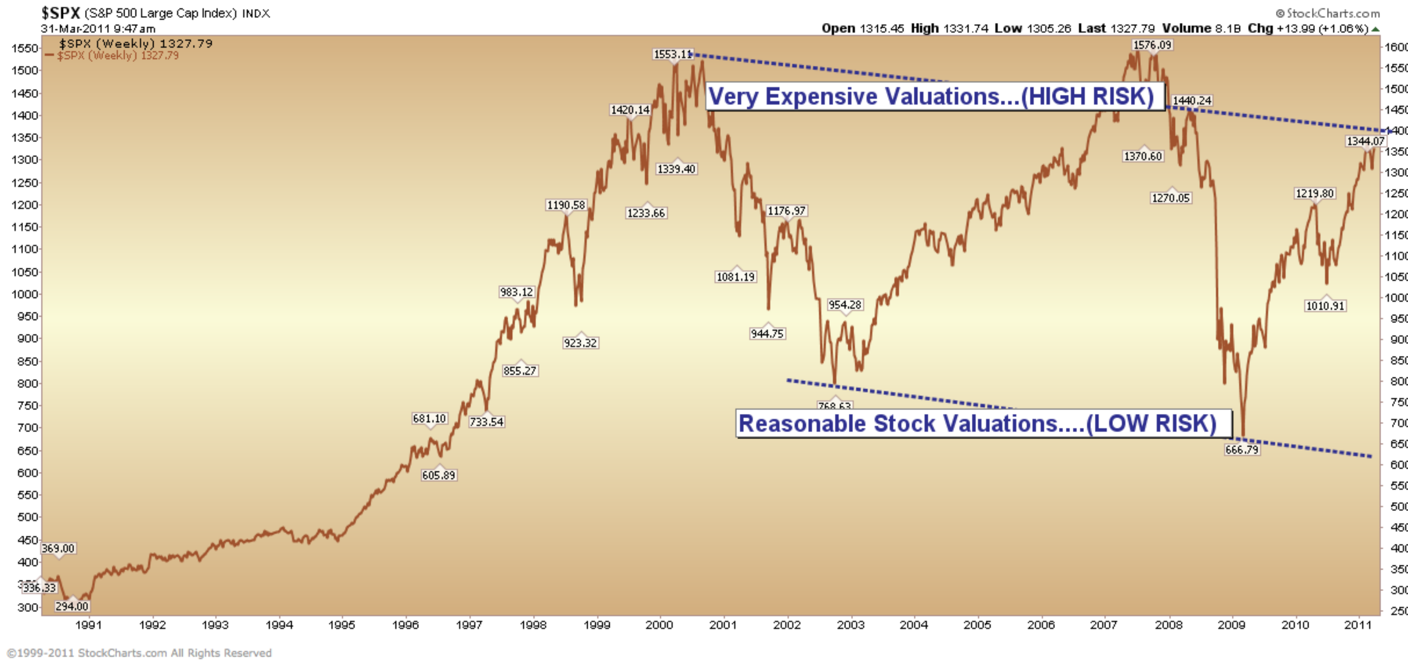


Figure 2. Jeff Rubin's graphic showing connection of oil prices and recessions.

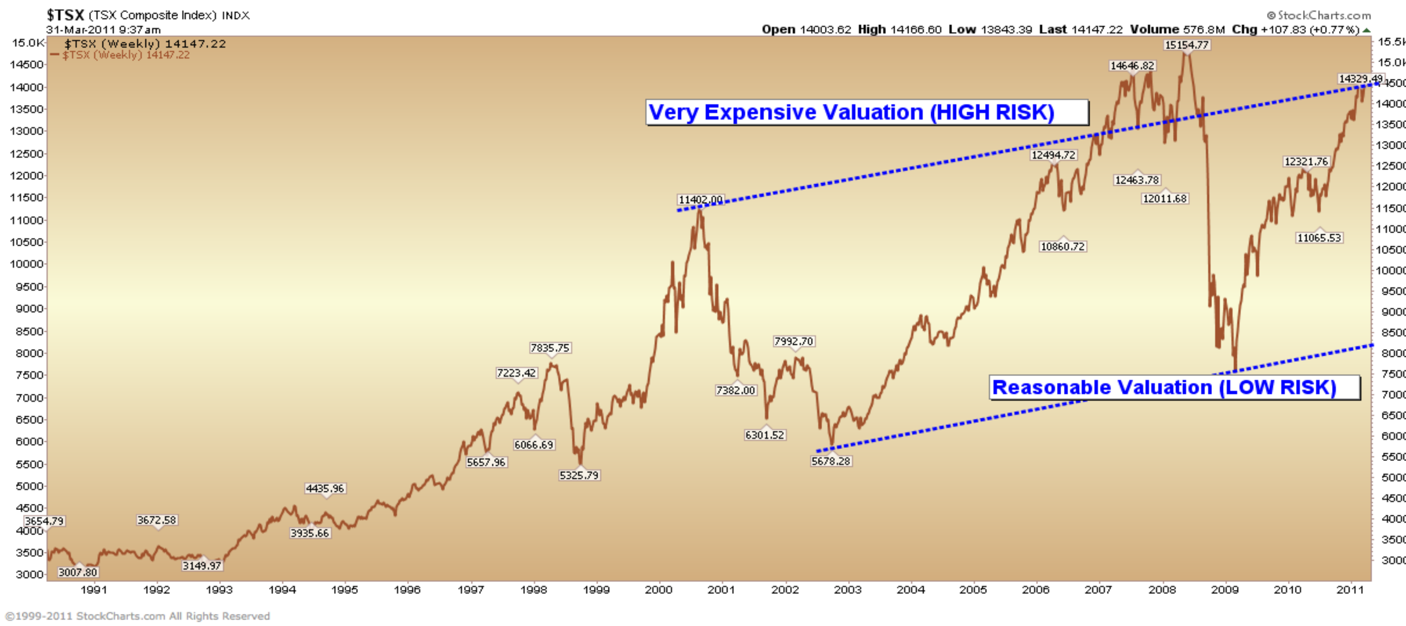
In the last cycle oil went from $17.20 in 2002 to $147.90 in 2008 and was above $75 for 51 weeks when the bust finally hit. Since the correction low in 2009, **oil has tripled** from $35 to $105 and sustained above $75 for 61 weeks as of this week. This suggests that the "oil shock" factor has already been of sufficient quantity and duration to deliver its usual body blow to global growth. And that is without all of the other headwinds working against growth today. This time we cannot count on credit bubbles to sustain us; consumer credit is contracting today not expanding. (And that is truly great news for the longer term health of families)

What can we say? S&P 500, 1990 to March 2011: Expensive today = high price risk



Source: Venable Park Investment Counsel Inc.

TSX 300: 1990 to March 2011: Expensive alert!



Source: Venable Park Investment Counsel Inc.

None of us get to pick our cycles or dictate world prices. All we get to do is decide when to participate. Let us assure you that we are not waiting for the world to become 'risk free' or perfect. But thanks to QE, as captured in the last two charts of the S&P 500 and the Canadian TSX, prices are just plain dumb. We can't knowingly do dumb; no matter how fed up we may feel.

<u>The Bond market is not buying the lasting inflation story</u>

US 10-year Treasury Yield October 2007 to March 2011

From October to December yields spiked as bond prices dropped (red arrow on the far right of above chart). This looked like concern from the bond market that QE was sparking higher inflation and would necessitate higher interest rates ahead. But an interesting thing has happened over the last three months: bond prices firmed and their yields moved lower again. As the above chart shows, each time this has happened over the past three years, it has signaled the start of a fresh wave of risk aversion where stocks and commodities falter and bond prices rise.

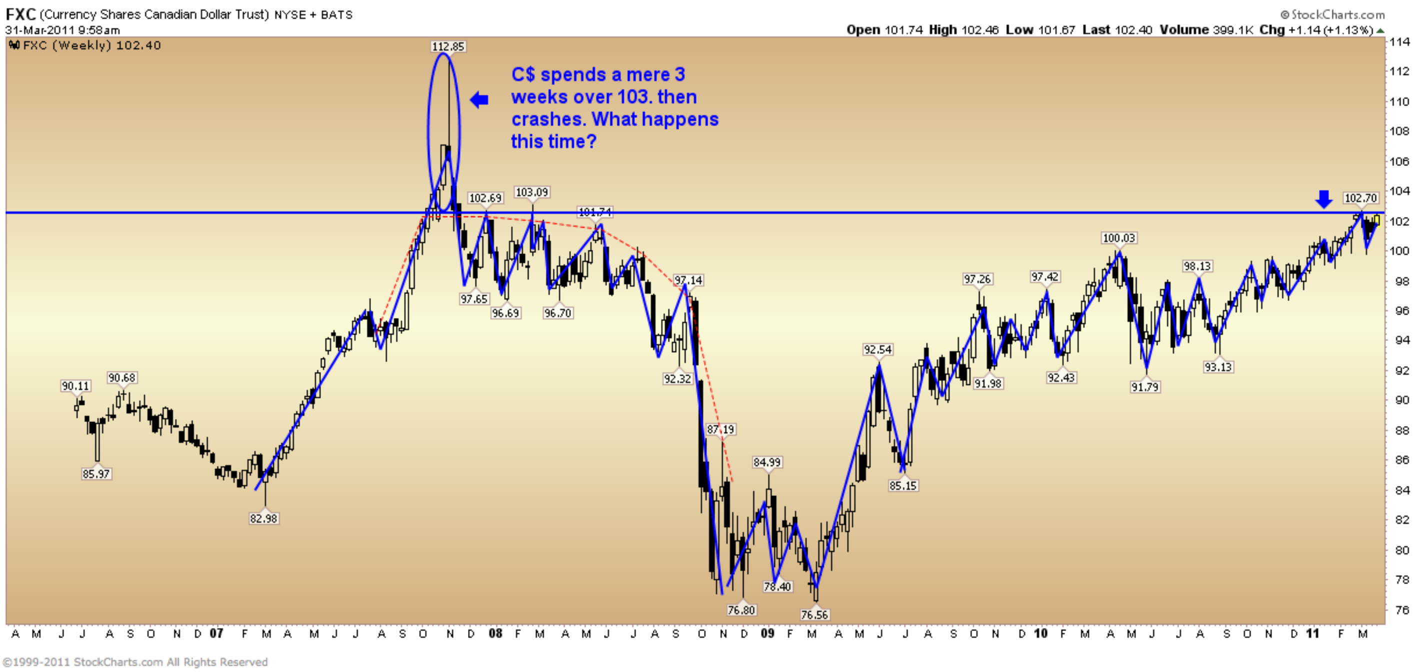
The quick sell-off in bonds and the U$ over the final three months of 2010 hurt our account performance at VPIC in the final inning of the calendar year. If bond prices continue to firm here that would be positive.

<u>Will the Loonie defy gravity for much longer?</u>

Not surprisingly as oil has spiked again, the Canadian dollar has rallied along with it. This month, as it did in

October 2007, the net speculative long positions in the C$ on the CME more than doubled compared with the same month one year before. This means speculators are once again betting on a continuation of recent strength in the CAD (FXC chart below) just as they did in late 2007. Of course, that was just before the C$ plunged with the world's stock and commodity markets. We are watching the below chart with great interest: will this time be different?

Canadian dollar ETF in U$ ("FXC")



Source: Venable Park Investment Counsel Inc.

Investment markets today: the opposite of 'Buy and Hold'

Even as conventional planners and money management services still counsel their investors to "stay the course" and passively allocate large percentages of their savings to equity markets regardless of price levels or risks, the NYSE Fact book reports that **the average holding period for stocks is now only three or four months.** **'Investors' may be holding equities 'for the long run', but apparently they are flipping in and out of individual stocks within the group at a dizzying rate.**

The average holding period in 1960 was 100 months (eight years). By 1970 it had dropped to 63 months (five years). By 1980 it had dropped to 33 months, by 1990 to 26 months, by 2000 to just 14 months, and in 2010 just six months (see: Why Investors are Abandoning Buying and Holding by Sy Harding).

At the same time, recent studies cited in the CFA Magazine this month underline increased risks to passive investors from market participants known as High Frequency Traders ("HFT'). In close physical proximity to major stock exchanges and using high-powered equipment, HFT operators (many working for the trading accounts of financial firms) are able to enter and modify trades in less than 10 microseconds ('µs' - one microsecond is equal to one millionth of a second). Given that the blink of an eye is a "slow" 300 milliseconds, an HFT application operating at 10 μs can make multiple alterations to quotes or orders with information and signals that it views well ahead of most other participants. (Yes folks, this is actually happening.)

Up to 96.5% of the HFT orders are cancelled almost instantly. The tactic of order cancellation has played a key role in the recent phenomenon of "disappearing liquidity" where buyers literally evaporate when regular market participants wish to sell in mass.

Incredibly HFT is today a legal activity because law-makers have let them away with it, and because regulators have an understandably difficult time tracking and unravelling the paper trail HFT creates. Virtually unchecked, this rapid skimming is a multi-billion dollar business in fractional cents per trade and accounts for some 70% of volumes on North American and 40% on European stock exchanges.

Increasingly buy-side firms such as ourselves have been voicing alarm over the consequences of HFT for market trust, confidence, efficiency and safety. **The practice should be prohibited as it serves no bona fide public service or purpose**. It skims profits and provides an unfair advantage for a few at the expense of legitimate investors who face increased risk of excessive price movement and rapid losses like those witnessed in last May's flash crash.

Over-valuation, excessive government liquidity, weak buying volume and still poor financial regulation are all making the job of diligent risk management more challenging today than ever. **Stringent portfolio risk controls are critical.** Unfortunately, most conventional advisors and commentators are still serving up the same old toxic soup of "don't worry; buy and hope".

We have to wonder, how many life-altering market drops need to happen before the financial world, its clients and regulators learn???

Refocusing on key principles in this era of "Fed-Head"

On the blog this month we referenced a must read article for those wishing to keep a focus on intelligent investing rather than Fed-drugged gambling. The article by GMO analyst James Montier is called The Seven Immutable laws of Investing and it is one of those pieces that one should keep as a reference, particularly now. Here are his 7 principles:

1. Always insist on a margin of safety: "this means avoiding over-valued assets. When investors violate this by investing with no margin of safety, they risk the prospect of permanent impairment of capital"

2. This time is never different: over-valued assets and peak earnings always revert back below their long-term average eventually; every single time.

3. Be patient and wait for the fat pitch: "Patience is required when investors are faced with an unappealing opportunity set [like today]. Many investors seem to suffer from an "action bias"—a desire to do something.

However, when there is nothing to do, the best plan is usually to do nothing. Stand at the plate and wait for the fat pitch."

4. Be contrarian: "Currently, there is an overwhelming consensus in favour of equities and against cash [67% of global equity managers are today overweight their target in equities] Perhaps this is just a rational response to Fed policies that actively encourage gross speculation…valuation-indifferent speculation will end in tears and a massive hangover for those who insist on returning again and again to the punch bowl."

5. Risk is the permanent loss of capital, never a number: "regrettably, the obsession with the quantification of risk (beta, standard deviation, VaR) has replaced a more fundamental, intuitive, and important approach to the subject. Risk clearly isn't a number…investors would be considerably better served in avoiding the permanent impairment of their capital."

6. Be leery of leverage: "Leverage is a dangerous beast. It can't ever turn a bad investment good, but it can turn a good investment bad." Recent NYE data confirms that in February investors were the mostly highly levered with the lowest net worth (supporting cash) since 2008. We know what happened then.

7. Never invest in something you don't understand: "If something seems too good to be true, it probably is."

In conclusion Montier offers this:

> ***"I hope these seven immutable laws help you to avoid some of the worst mistakes, which, when made, tend to lead investors down the path of the permanent impairment of capital. Right now, I believe the laws argue for caution: the absence of attractively priced assets with good margins of safety should lead investors to raise cash. However, currently it appears as if investors are following Chuck Prince's game plan that "as long as the music is playing, you've got to get up and dance."***

<u>A word about them fat pitches…</u>

Standing down from the game at high risk times may well be the wise thing to do, but that doesn't mean there aren't days where we all feel taunted by a sense of missing out. For this reason, we thought it helpful to review the following return data for a balanced portfolio of 50% bonds and 25% domestic and 25% international equities held consistently through all the ups and the downs of the past decade. <u>Buy and hold investors</u> have to read 'em and weep. After a nauseating ride they have <u>earned a gross return before any fees of .34% a year</u> and they have had to suffer through massive annual variance. After fees returns have been negative. If one were holding more than 50% stocks, the ride has been even more negative. So much for risk/reward assumptions. For the vast majority of investors and managers, this was a decade of something ventured, nothing gained.

Balanced Portfolio returns: 50% bonds, 50% equities

Benchmark	
Year	**Return %**
2001	-7.27
2002	-13.80
2003	6.95
2004	7.7
2005	5.9
2006	14.0
2007	-4.1
2008	-16.00
2009	9.3
2010	5.7

Compound annual return: .34%
Standard deviation: 9.8%
Sharpe Ratio: .03

Waiting for fat pitches since this secular bear began has been tedious at times for sure. It has forced us at VPIC to stay out of equities about half the time. But it has also allowed us to beat the above benchmark handily, creeping along with positive compound returns year over year and <u>with 1/3 of the volatility of buy and hold</u>. We should feel fortunate…especially since rich valuations today are setting stockholders up once again for the probability of significant declines ahead; just where we plan to step back into the batters box. Carefully controlling our risk exposure, dear clients, is how the tortoise beats the hare and sleeps at night.

Best wishes for spring!!

Quotes of the month:

"Where is the wisdom we have lost in knowledge? Where is the knowledge we have lost in information?"
-T.S. Eliot, (1888-1965)

"All of the great leaders have had one characteristic in common: it was the willingness to confront unequivocally the major anxiety of their people in their time. This, and not much else, is the essence of leadership. -John Kenneth Galbraith, (1908-2006)

"Education is what remains after one has forgotten what one has learned in school." –Albert Einstein, (1879-1955)

"Hanging onto resentment is letting someone you despise live rent-free in your head."

--Esther Lederer, a.k.a. Ann Landers, (1918-2002)

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