Real life needs active management

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E.Q Trendwatch™

The triumph of foresight

In all the sad news coming out of Japan the past month, we were heartened to also learn some remarkable stories of courage and triumph. One of the most inspiring was that of Susumu Sugawara.

Sugawara is a 64 year old Japanese owner-operator of a small boat named "Sunflower." After the earthquake hit he heard the tsunami warnings urging people to head for higher ground immediately. Sugawara had a split second thought: should he flee or try to save his boat? He knew that if he left his boat docked it was likely to be crushed at the shore with all the rest and be unavailable to assist in the aftermath.

"I knew if I didn't save my boat," he told a CNN reporter, "my island would be isolated and in trouble." Sugawara decided to quickly launch and head for deep water offshore. He ran his 42-year-old craft that can hold about 20 people full-throttle out to sea. After a few minutes he saw the wall of water coming toward him.

Sugawara was accustomed to waves ten and twelve feet high. This one loomed 50 to 60 feet tall. He understood that the wave could crush his boat like a twig. Sugawara opted to drive straight at it - "climbing the wave like a mountain," as he put it. As it approached, the mountain seemed to grow bigger and bigger. He closed his eyes and prayed. Water came crashing over him. Miraculously when he opened his eyes he saw the horizon. He had punched through the wave and made it safely to the other side.

Sugawara looked back toward land as the wave hit, devastating his village and all the other boats that had been tied at shore.

For the 6 weeks since, Sugawara and his boat have been a lifeline making hourly trips to the mainland with people and supplies. Those who can pay him for gas do so, those who have lost everything ride for free; all are grateful for his foresight, courage and help.

Of course we often relate stories to our own experience. For us at Venable Park the saga of Sugawara serves as an allegory for financial conditions the past 11 years.

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Only those of us who have been able to anticipate market dangers and take defensive actions in advance have been able to move through the past decade, unharmed and with net progress. The vast majority have failed because they are not looking for the dangers and by the time risks are widely evident, it is too late to take protective steps, let alone act in strength while others are floundering.

As we write, the world is moving through the third global asset bubble since the late 90's. This third bubble has been caused by massive government credit injected into global markets following the great recession of 2008. Each successive bubble—stocks in 2000, real estate to 2006, credit and then stocks and commodities to 2007, and now pretty much everything in 2011—has been larger and more threatening than the bubble before it. We don't get to dictate or control when bubbles finally burst, but we do know that it is critical to take protective steps before they do in order to remain liquid and ready to seize lasting opportunities in the aftermath.

The insidious part of this present cycle is that governments have intentionally forced down the reward from safe deposits, lowering interest rates to rescue reckless banks and borrowers at the expense of savers. This was acknowledged by Dallas Federal Reserve President, Richard Fisher this month:

> ***"[Those] who have done everything right, have worked hard, saved their money and stayed out of debt are the ones being punished by low interest rates. That state of affairs is not sustainable for a long period of time."***

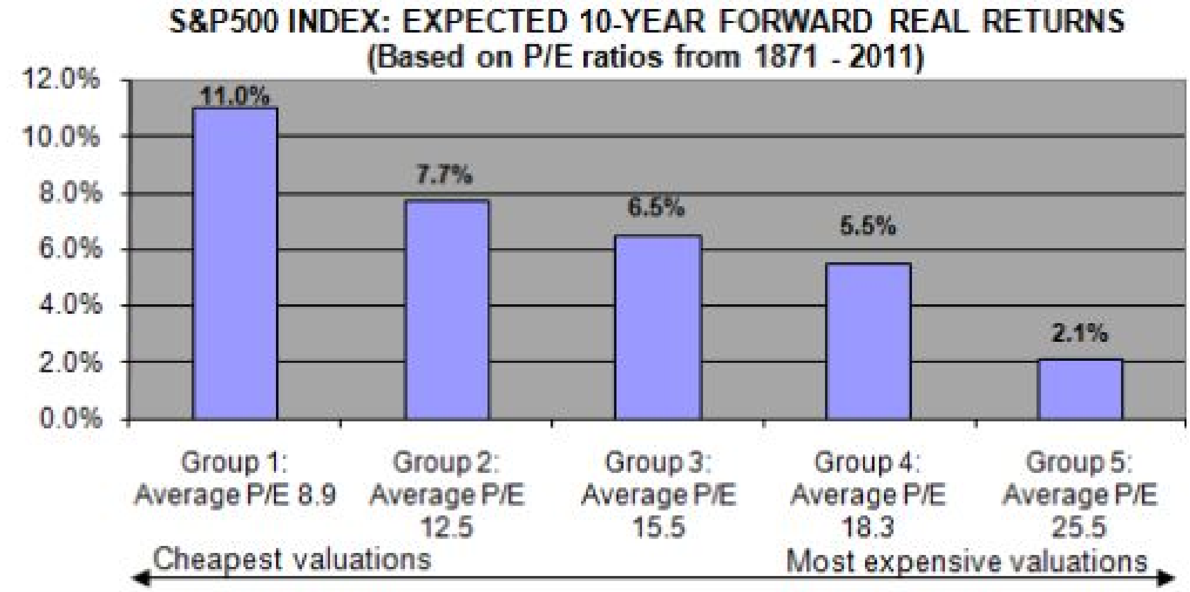
In doing this, governments and central banks have become the enemy of prudent, careful managers and investors—like you, like us! In a time of soaring global risk, the things that are safest have fallen in price, while the things that are most over-priced have continued to rise higher.

Big reward is coming- just not from these levels

Most investment advisors argue that the right time to invest in equities is whenever you happen to have some money. In practice however this argument has not stood the test of time. Repeatedly independent studies confirm that the entry level into the market, i.e. the valuation of the market at the time of investing, is the most significant indicator for subsequent investment returns thereafter.

Plexus Asset Management out of South Africa recently updated a previous multi-year comparison of the price-earnings (PE) ratios of the S&P 500 Index (as a measure of stock valuations) and the forward real returns, as done by Jeremy Grantham's GMO. The study covered the period from 1871 to April 2011 and used the S&P 500 (and its predecessors prior to 1957). In essence, PEs based on rolling average ten-year earnings were calculated and used together with ten-year forward real returns.

In the first analysis the PEs and the corresponding ten-year forward real returns were grouped in five quintiles (i.e. 20% intervals) (next diagram below).



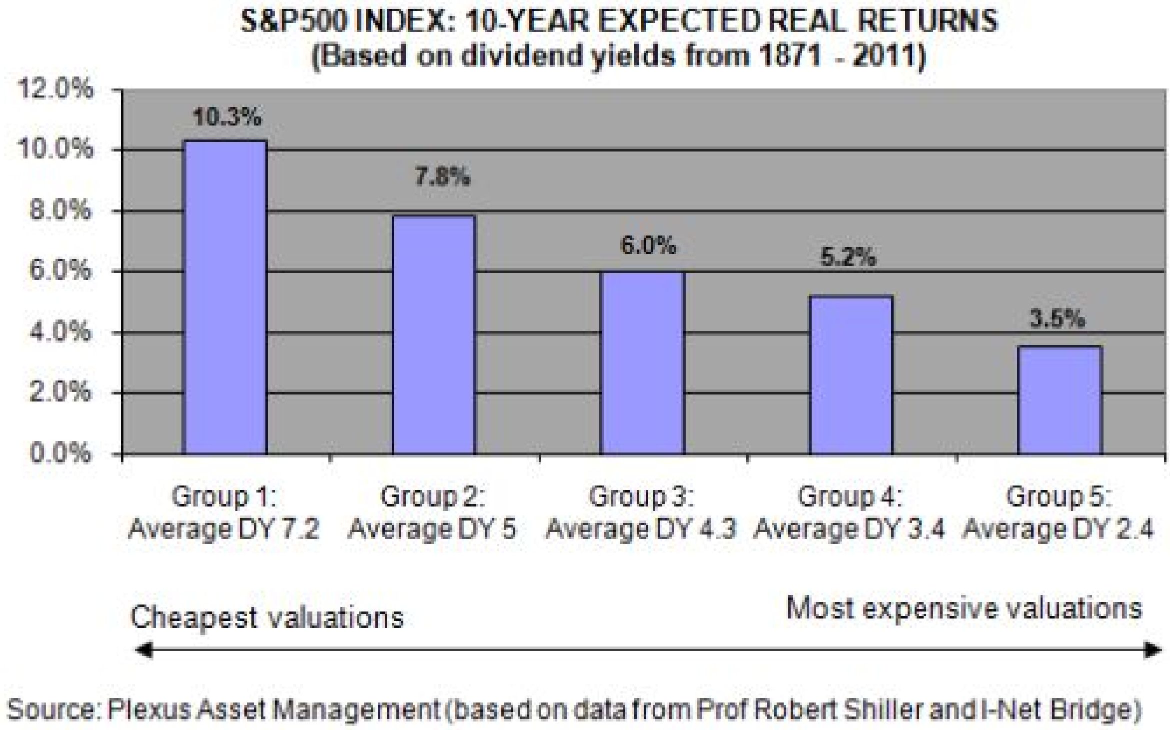
Source: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge)

This analysis clearly shows the strong long-term relationship between real returns and the level of valuation at which the investment was made.

The cheapest quintile (Group 1 above) had an average PE of 8.9 with an average ten-year forward real return of 11.0% per annum, whereas the most expensive quintile (Group 5 above) had an average PE of 25.5 with an average ten-year forward real return of just 2.1% per annum. **Today after two years of record government "liquidity", the S&P 500 Index's current ten-year normalised PE is 27.1. This puts stock values today at the most expensive in history except for the higher bubble peak in 2000**. It also suggests real returns over the coming decade of less than 2% if buying or holding from present levels. To achieve the possibility of this meager reward, investors also risk the probability of negative 10 year returns (similar to those achieved by buy and hold investors over the past 10 years).

Another common argument is that investors should not concern themselves with the price level of shares so long as they are collecting dividend income. For this reason it was also considered appropriate to replicate the study using dividend yields rather than PEs as a valuation yardstick. The results (shown in the next diagram below) are very similar to those based on PEs.

Because stock prices today are so high, average dividend yields are a historically low 1.8% for the S&P 500 (less than the lowest 2.4% of Group 5 below). Again this suggests the probability of high volatility and sub 3%--even negative returns—over the next 10 years for those buying or holding stocks today.



The researchers offer the following conclusion from their study (our emphasis bolded):

> *"Based on the above research findings, with the S&P 500 Index's current ten-year normalised PE of 27.1 and dividend yield of 1.8%,* ***investors should be aware of the fact that the market is by historical standards in "extreme overvaluation" territory.*** *As far as the market in general is concerned, this argues for unexciting long-term returns, and possibly a "muddle-through" trading range for quite a number of years to come.*
>
> ***Although the research results offer no guidance as to calling market tops and bottoms, they do indicate that it would <u>not</u> be consistent with the findings to bank on above-average returns based on the current valuation levels. As a matter of fact, there is a distinct possibility of below-average returns."***

Doubt, in the face of uncertainty, is human.

Everyone has moments of doubt. There is no doubt that we have been out of favour in this market since QE2 (quantitative easing) re-inflated risk assets last fall (now 8 months). But we remain content that our method and approach are sound. We have been at this work a long time now. We have had other periods out of favour in the past (the longest was almost 2 years 2006-2007 as the credit bubble peaked) and in each one of these it was eventually revealed that it was not us or our approach that was crazy but market prices. In Juggling Dynamite, Danielle likened these periods to living sober amongst a group of drug addicts where you see the problem clearly but the users keep insisting it is all in your imagination.

We know from experience that when our approach appears out of favour it can feel like forever. But once price adjustments finally hit, the relief and opportunity are priceless.

One way or another, we all must pay for the investment approach we chose: either we pay by moving contra to the pack and feeling left out of the fun for a while, or we will pay by staying with the pack and ultimately suffering the toll— emotional, psychological, and financial— along with them.

Whenever we feel frustrated with how long it can take for reality to re-price assets, we find it encouraging to review timeless words of wisdom and experience like these from 1920's trader Fred Schewd Jr.:

> ***"When there is a stock-market boom, and everyone is scrambling for common stocks, take all your common stocks and sell them. Take the proceeds and buy conservative bonds.***
>
> ***No doubt the stocks you sold will go higher. Pay no attention to this—just wait for the depression which will come sooner or later. When this depression—or panic—becomes a national catastrophe, sell the bonds (perhaps at a loss) and buy back the stocks.***
>
> ***No doubt the stocks will go lower. Again pay no attention.***
> ***Wait for the next boom.***
>
> ***Continue to repeat this operation as long as you live, and you'll have the pleasure of dying rich."***

The opportunities coming are so great… we literally struggle to contain our excitement at times

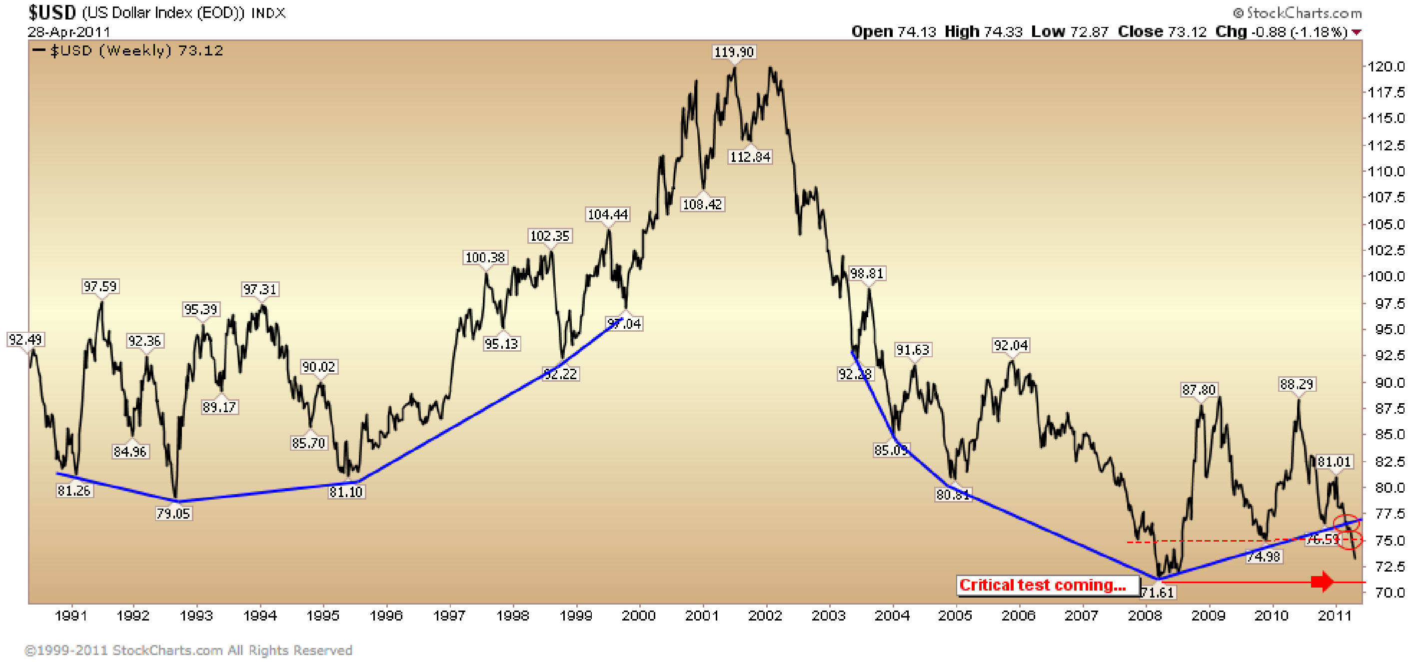
Having already blown their budgets on rounds of 'rescue' the last two years, in the next decline, governments and central banks will have less power and money to inflate prices quickly. The next cycle of recovery is therefore likely to be much slower and organic over time. This will no doubt be excruciating for those trying to rebuild their savings from a third big decline. But it promises to be very rewarding for those who are able to bypass the drawdown, maintain liquidity and buy good assets at cheap prices to collect fat dividends as the world slowly recovers.

Make no mistake, yes we are defensive today, but we are very excited about the opportunities we see coming. Our concern today is not that they won't present, our near term concern is in keeping our clients out of harm's way until they do.

Strategy update: for clients who like detailed strategy we offer the following month end summary

Our current investment stance continues to be defensive. Risk measurements are at extremes matching if not exceeding levels measured before the crash in 2008. Some of the speculative measures we watch such as margin use are now at the highest levels ever seen.

US dollar Index 1990 to 2011: the benchmark currency still calls the shots



As shown in the above chart, the US dollar index is once more testing long term support between .71 and .73 against the basket of world currencies. Approaching this key tipping point, we should not have to wait too much longer to learn the next chapter in this story.

Asset markets and other currencies have been pushed on to a dangerous teeter totter. As the world's benchmark currency has been forced down on the one side by US policies: QE and fiscal abandon, other assets like equities, commodities and other currencies have been forced up in price and now dangle precariously far above fundamental or demand-based value.

It is important to make a distinction between the multiple waves of QE undertaken by the Japanese government over the past 30 years since its property bubble burst, and the QE path the US Fed has experimented with over the past 2 years: the Yen is not the world's benchmark currency.

QE in Japan has not reinvigorated the Japanese economy or the Japanese stock market into a new secular expansion. At best they have bought a few short cyclical bursts that ultimately flame out and fail anew. Nevertheless, because it does not hold the global benchmark status, Japan has been able to perform these experiments, debase its currency and drive up its national debt without directly causing price dislocation in global asset prices.

In a world where goods and commodities are all priced in the US dollar, the US Fed does not have Japan's luxury. The Fed's efforts at QE have already caused global mayhem and unrest by helping to rapidly escalate food and energy inflation. In his press conference this month, Fed Chairman Bernanke acknowledged that there is a limit to liquidity assistance from the Fed as the knock-off inflation this causes naturally undermines the economic recovery they are trying to ignite.

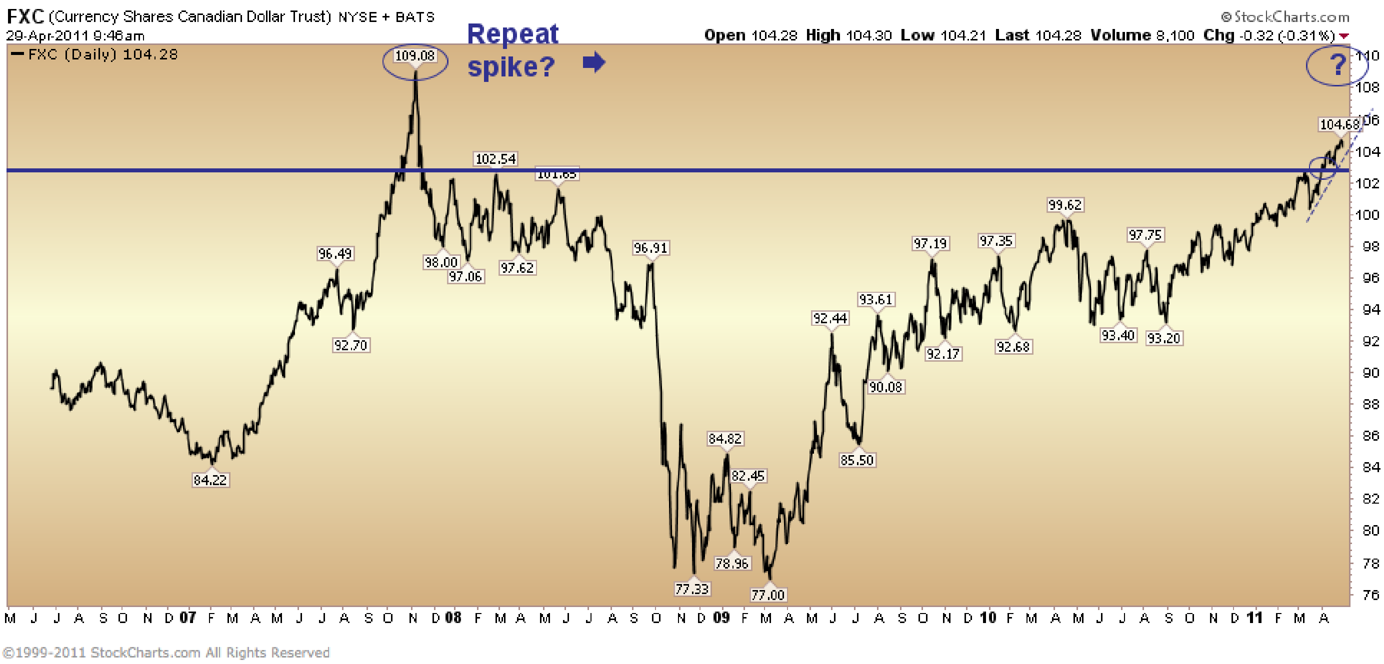
Fed liquidity experiments have already run to the end of reason. The government may well extend its debt ceiling a little further. **But as reflected in this month's downgrade of the US outlook by the S&P credit rating agency, the time for further credit extension is about done**.

We are reminded of Winston Churchill's famous quip that the US eventually does the right thing, after it has exhausted all other options. The time for serious budget reform and spending cuts have arrived. The US has an overspending problem. This can be fixed by reducing spending. They do not have the ineffective tax collection systems of Greece, or the paltry average income of most of the developing world, or the negative immigration and low birth rates of China, Japan or even Brazil. They also do not have the dictator regimes, civil wars, systemic inequality and broad scale corruption of many other countries. The US has great potential to turn its ship around. It just needs to get serious about going on a fiscal diet. Reducing its incredibly inflated military budget is one of the easy and most effective places to start.

Wherever the US dollar finds its next leg of support we are virtually certain to see a sell off in the rest of the markets that have spiked on the other side of U$ decline since last fall.

A few weeks ago in our Canadian accounts, we hedged our US dollar exposure (as we said we would in our last newsletter) by buying the FXC (Cdn dollar ETF) with our US cash when the C$ broke through 102.50.

The Canadian dollar 2007 to 2011: a perfect reflection of the risk trade everywhere



In this way we will not lose holding US cash if the C$ happens to spike higher for a bit. Maybe 1.10 is back in the cards for the loonie ahead? We suspect that this phase of over-valuation is likely to prove just as fleeting in

2011 as it was in 2008. The C$ is at levels that have historically been the catalyst for quick and severe adjustments as higher commodity prices prompt global demand destruction.

We are watching this trade extremely closely as a leading indicator for the risk cycle. If the C$ can get to its weekly closing high around 1.07 with commodity prices rolling over, our thoughts would turn to selling the FXC and reinstating US dollar exposure as a strategic place to gain while other assets fall.

It is interesting to note that the Canadian dollar peaked with the US stock market in October 2007 and bottomed with the world stock markets in March of 2009. The fact that we are back at peak value again in 2 years is a remarkable feat of government stimulus money flooding into financial markets. But it also suggests that the risk trade may now be topping out.

Equities: on ANY reasonable and historically reliable valuation model, equities are overvalued. The Fed's efforts to re-flate risk assets have come at a large price. Valuations across the board have become overblown on high margin, low volume trading. This short term side-effect should dissipate as the QE drug wears off and markets are left to find their own equilibrium.

Our estimate is that at a minimum, pre-QE2 price levels could easily re-appear (about 1000 on the S&P, 11,000 on the TSX). It is also entirely plausible that most if not all of the speculative gains made since the QE's first began in the spring of 2009 will ultimately be given back (to 666 on the S&P and 7600 on the TSX).

S&P 500 2007 to 2011: Back at resistance in half the normal time

The removal of stimulus is likely to prompt a re-pricing on many of the commodity and interest sensitive stocks that we seek to purchase. As June is the proposed expiry of QEII, markets may well adjust ahead of time, as traders seek to sell into earnings strength. Higher commodity costs are setting up to be a large drag on earnings going into the second quarter of 2011.

Bonds: In bond selection our strategy continues to look through the current fog of uncertainty to focus on our target quality and duration (avg. term to maturity under 5 years). Holding good quality bonds in the short to medium part of the yield curve has meant looking past short term price swings while inflation and deflation forces do battle.

For a good big picture barometer on this battle, we continue to monitor the US 10-year treasury yield.

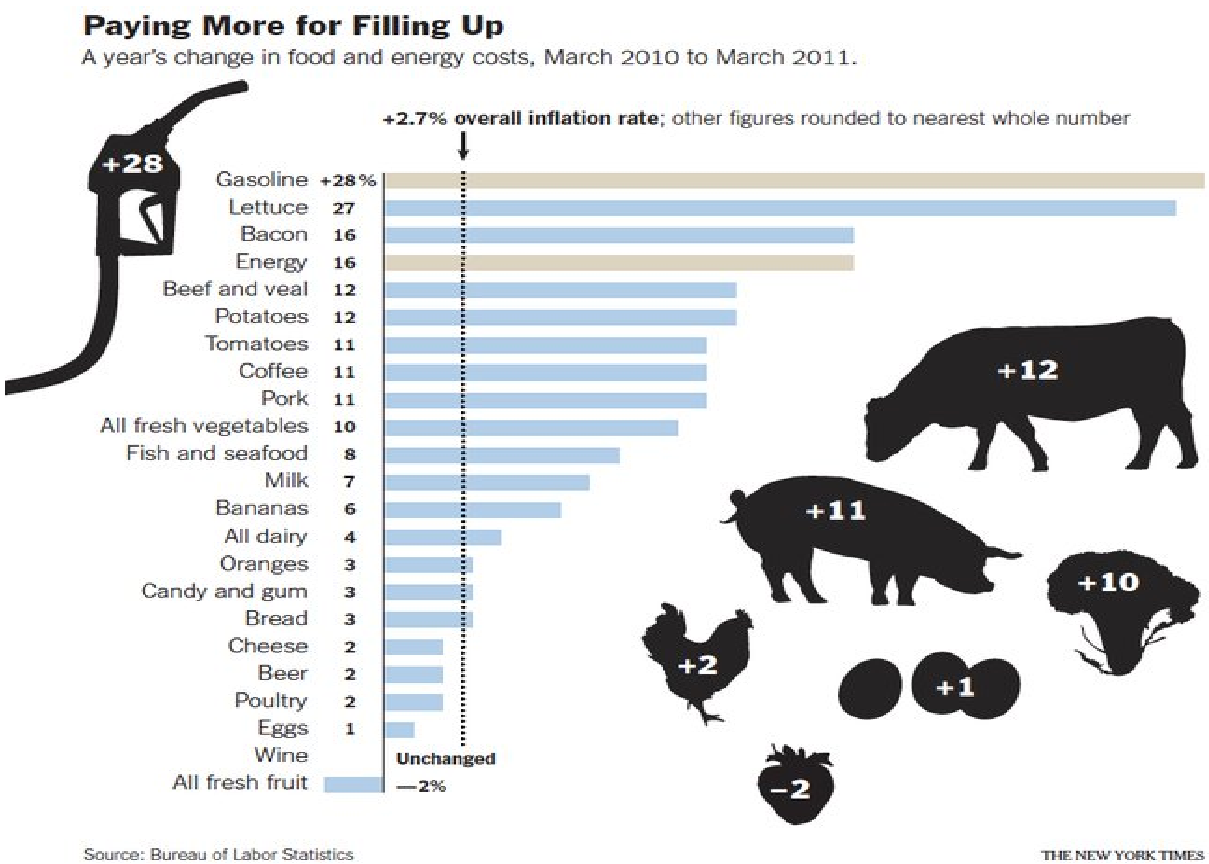
10 year Treasury Yield 2001 to 2011- down trend still in tact- supportive of bond prices

A break out above the 4.05 yield would be a signal that inflation is winning and we would look at lowering our average duration further. So far the bond market is signalling that since QE2 brought higher yields (lower bond prices)— the opposite of what the Fed said would happen— the end of QE2 in the next few weeks should correspond to lower yields and higher bond prices. This trend would be supportive of our current bond holdings. The 10 year note closed the month just slightly above the 3.2% yield level (red line above). If it breaks this support level, this could be significant for equity markets as the past breaks below 3.2 % (red circles above) have marked the start of both the 2008 and 2010 stock market sell-offs.

So far the bond market does not seem to be buying the idea that the economy is strong enough to produce inflation. To the contrary, so far it is suggesting a stagflation environment where input costs are raising while economic growth is slowing. The trend of falling inflation is supported by a lack of wage pressure, continued weakness in housing, contracting GDP expectations and continued slack in economic capacity.

Wal Mart warns: "shoppers are running out of money"

The next chart captures the dramatic increase in food and energy prices over the past year now consuming more than 26% of the average North American worker's income. Consumer spending drives 70% of our economic growth. It would take robust employment, wage gains and expanding consumer credit in order for these sharp price gains to be afforded without a cut back in other spending. Presently we have none of these supports to assist consumers. Wal Mart, one of the largest retailers and transport companies in the world today serves 140 million shoppers a week in its US stores alone. This month Wal Mart's CEO warned that consumers are showing increased signs of fatigue and duress. Following 7 straight quarters of sales declines in its stores, Wal Mart says there is no improvement yet in sight: shoppers are running out of money at a faster pace each month.



We know from past economic cycles that when food and energy costs have moved above 24% (now 26.5%) of average income, a recession is in the offing. Perhaps this time will be different. But a new Gallop poll released this week confirms a pessimistic consumer:

> *"More than half of Americans (55%) describe the U.S. economy as being in a recession or depression, even as the Federal Open Market Committee (FOMC) reports that "the economic recovery is proceeding at a moderate pace." Another 16% of Americans say the economy is "slowing down," and 27% believe it is growing."*

Americans' Ratings of Current Direction of Economy

Right now, do you think the U.S. economy is growing, slowing down, in a recession, or in an economic depression?

	Growing	Slowing down	In a recession	In a depression	TOTAL: In a recession or depression
April 2011	27%	16%	26%	29%	55%
September 2008	3%	27%	36%	33%	69%
February 2008	7%	46%	33%	12%	45%

GALLUP'

We look forward to brighter times ahead. In the meantime those of us with savings, homes and income have much to be grateful for. Best wishes for May.

Quotes of the month:

"I Wish You Enough!"

I wish you enough sun to keep your attitude bright.
I wish you enough rain to appreciate the sun more.
I wish you enough happiness to keep your spirit alive.
I wish you enough pain so that the smallest joys in life appear much bigger.
I wish you enough gain to satisfy your wanting.
I wish you enough loss to appreciate all that you possess.

I wish you enough "Hello's" to get you through the final "Goodbye." --Bob Perks

"People often say that this or that person has not yet found himself. But the self is not something one finds, it is something one creates." –Thomas Szasz, Psychiatrist and Author

Don't forget to visit our market blog www.jugglingdynamite.com for weekly commentary, articles and media clips.