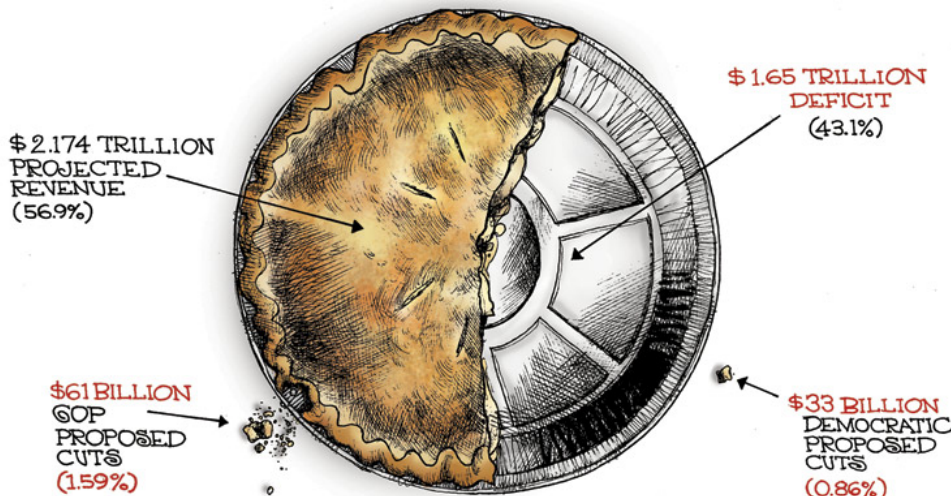


E.Q Trendwatch™

Ready or not—the next recession

FINANCIAL INVESTORS BUSINESS DAILY
2011

2011 SPENDING \$3.82 TRILLION



THE BUDGET PIE ILLUSTRATED.

“Economists who adhere to rational-expectations models of the world will never admit it, but a lot of what happens in markets is driven by pure stupidity – or, rather, inattention, misinformation about fundamentals, and an exaggerated focus on currently circulating stories.”

–Robert Shiller, July 21, 2011

To see where we are going, we must understand where we have been.

The world watched in angst this month as politicians on both sides of the Atlantic scrambled to pull more magical solutions out of hats. While the publicly reported debate focused on credit extensions and the legislative permission to borrow more, realists were pointing to the true elephant in the room, largely over-looked in the fury of the scrum—the global economy has turned down once more. No matter how much the politicians bicker and blame, stimulate and intervene, the economy



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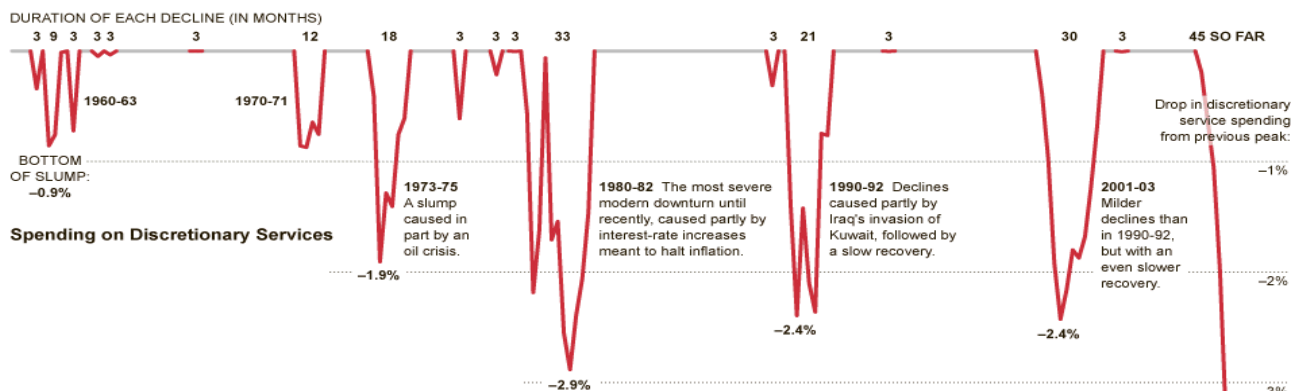
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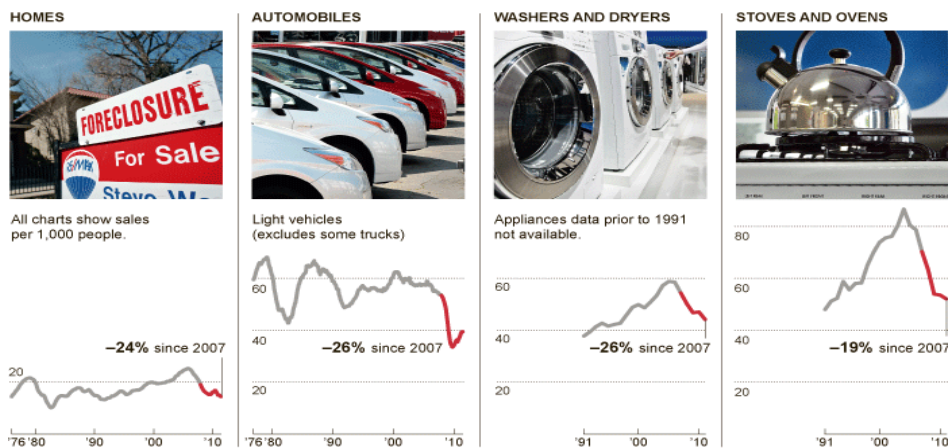
is weakening again and there will be less and less tax revenue coming in for a while. For our part, we welcome this next phase as a healthy part of the needed recovery process.

As shown in the pie cartoon above, to date the American Congress has been arguing over spending cuts that amount to crumbs on the table. In truth more than 43% of the spending pie promised has no funding. Large cuts must be made. This forced fiscal austerity will re-accelerate economic weakness as projects are cancelled, jobs cut and consumer sentiment slumps further. As Bruce Hornsby sings, "that's just the way it is." All of this is par for the deleveraging course that has followed all other credit bubbles in history. The ongoing efforts of consumers and governments to pay down debt will be years in action. Like it or not, the process takes its own sweet time. The most misguided comments these days are those who point to a lack of government spending, uncertainty or regulation as the cause of our current challenges. In truth it is precisely the opposite—abuse of government spending, intervention, bailouts, reckless leverage in housing and the financial sector and a repealing of sensible regulation over the past 15 years have orchestrated our present pickle. For the first time in years, consumers have come to their senses and pulled in profligate spending to start building up their own savings and safety net. This trend has not yet run its course.

Consumer spending after credit binges since 1960: today is no run of the mill downturn



Also Not Selling Like They Used To



Source: Slumps in Consumer Spending, [NYT](#)

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Government debt burden for each taxpayer at all time highs all over the world

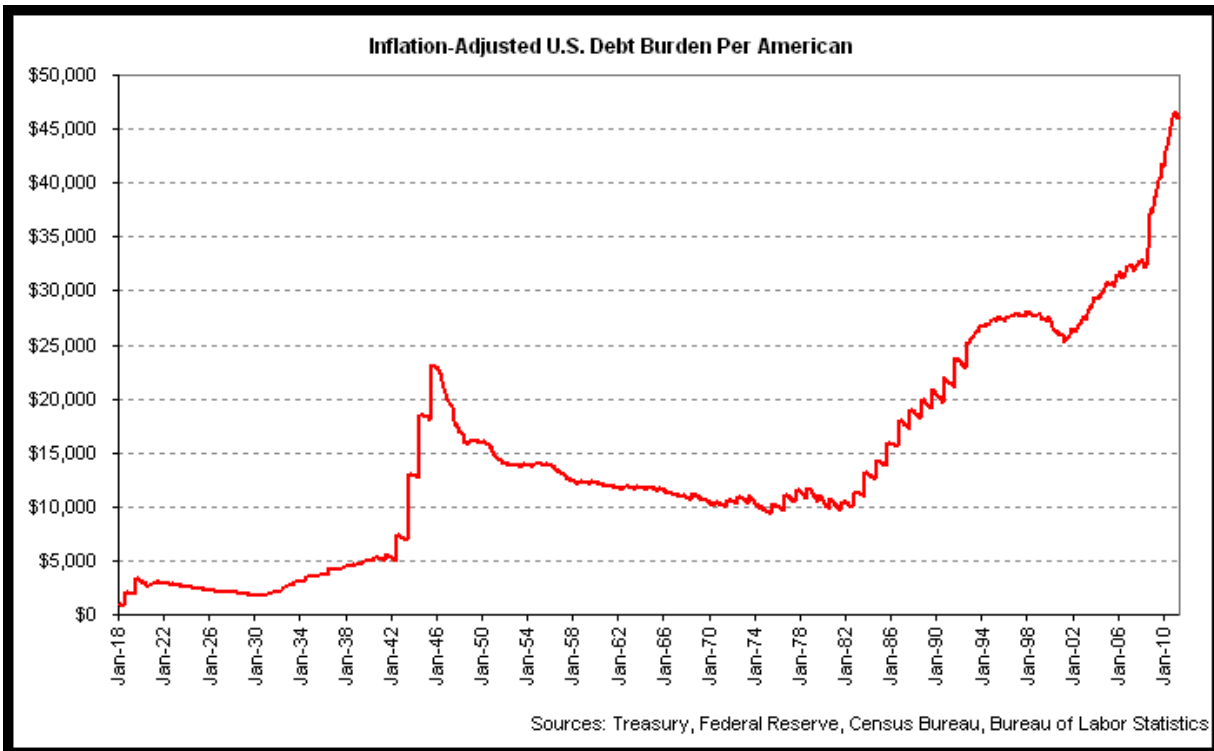


Chart sourced from The Atlantic

The chart above shows US government debt per capita adjusted for inflation since 1918. This does not include consumer credit owed by individuals. Government debt per person was just \$894 in January 1918, adjusted for inflation. The U.S. government had more than \$14.3 trillion in public debt outstanding as of May 31, 2011 and a population of approximately 312.25 million—so each American owes about \$45,940. For a family of four, the household burden is \$183,760 – more than the median US home price in May of \$166,500. The amount of government debt each American owes today is more than 51 times what it was in 1918. This amount is per citizen, but the math is considerably worse when we consider that 50% of American citizens today actually pay no income tax at all. This effectively doubles up the above debt burden on the half of the population that does.

Something has to give. At current spending levels the US government is running an annual deficit of 1.5 trillion dollars and shortfalls add directly to the national debt each year. Even the 4 trillion in cuts that the parties are this month fighting to find is a drop in the bucket of what is needed. \$10-12 trillion in cuts will be needed over the next decade to bring the country back to fiscal stability.

The US is not unique in this predicament. Most developed countries from the UK to Europe to Japan to Australia and Canada face daunting deficits, mounting debt, an aging population and a shrinking tax base. Math demands that those who are working will pay more while governments will have to shrink and promise less. Individuals who have increasingly become dependant on their state for entitlements the past few decades must

become more self-reliant—it's time to sink or swim. Some will sink; most will become better swimmers.

Financials and semi-conductors: canaries in the market coal mine

As architects of the credit bubble, financial companies are widely followed as a leading sector for the stock market and overall economy. It is worthy to note then that this month the S&P Financials hit a new low for 2011 and are now at their lowest level since last November when QE2 became liquid courage for risk takers. Overall the financial index is down about 11.6 % in 2011, with many prominent names down by a lot more:

Financials This Year

Bank of America	-27.15%
Morgan Stanley	-25.17%
Comerica	-24.10%
Goldman Sachs	-23.62%
Citigroup	-21.44%
Fifth Third Bank	-19.48%
Bank of New York Mellon	-18.37%
SunTrust Banks	-18.53%
Regions Financial	-17.28%
Barclays	-16.65%
Wells Fargo	-14.31%
Royal Bank of Scotland	-13.80%
Credit Suisse	-12.72%
KeyCorp	-12.03%

This weakness in financials comes notwithstanding Citigroup and JPMorgan's better-than-expected earning reports this month. In reality these banks only beat estimates by moving down their loan loss reserves, an expense set aside as an allowance for bad loans. This creative accounting decision is likely to prove short-lived as a fresh wave of losses on all sorts of mortgage and loan portfolios in North America and Europe are starting into the next crescendo. At the same time, a move back to regulation will lower the death-taunting leverage and prop trading that has been the life-blood of banks who were 'running the table' with government injected liquidity the past couple of years.

Semiconductor companies (green line below) are another key leading barometer for the overall economy and the broader stock market (S&P 500 black line). The Semiconductor index also broke down this month as shown below with the financial sector index (in blue). These sectors led to the downside by several months in past major declines including in 2000 and 2007. We have learned to respect their signal.

Semiconductor index (green) and US Financials (blue) leading the S&P 500(black) down



The global economy appears to be tipping into the next recession

This month we learned that the Canadian economy “unexpectedly” contracted in the month of May. Since most commentators deny that recessions are a regular recurring feature (every 3 years on average during a de-leveraging cycle), contractions are always “unexpected” by the mainstream.

At the same time US GDP revisions took the fourth quarter of 2010 down to 2.35 (from previous estimates of 3.1), Q1 2011 to .36%! (from a previous estimate of 1.9), and Q2 2011 to 1.3% (originally forecast at 3.3%). It is possible that these estimates may be lowered even further down the road as time provides more clarity. **This is what trillions of dollars of government stimulus spending all around the planet bought: a paltry recovery that added much more debt than growth.** And the second half of 2011 is looking weak. It takes 3.3% GDP growth just to keep the US unemployment rate from rising. Over the last three quarters, real GDP has averaged just over 1%, it is no surprise then that the largest economy in the world is struggling. Even the now hoped for 2% annual growth rate, will push the unemployment rate up by a full percent per year from 9.1% now to 12% by 2014.

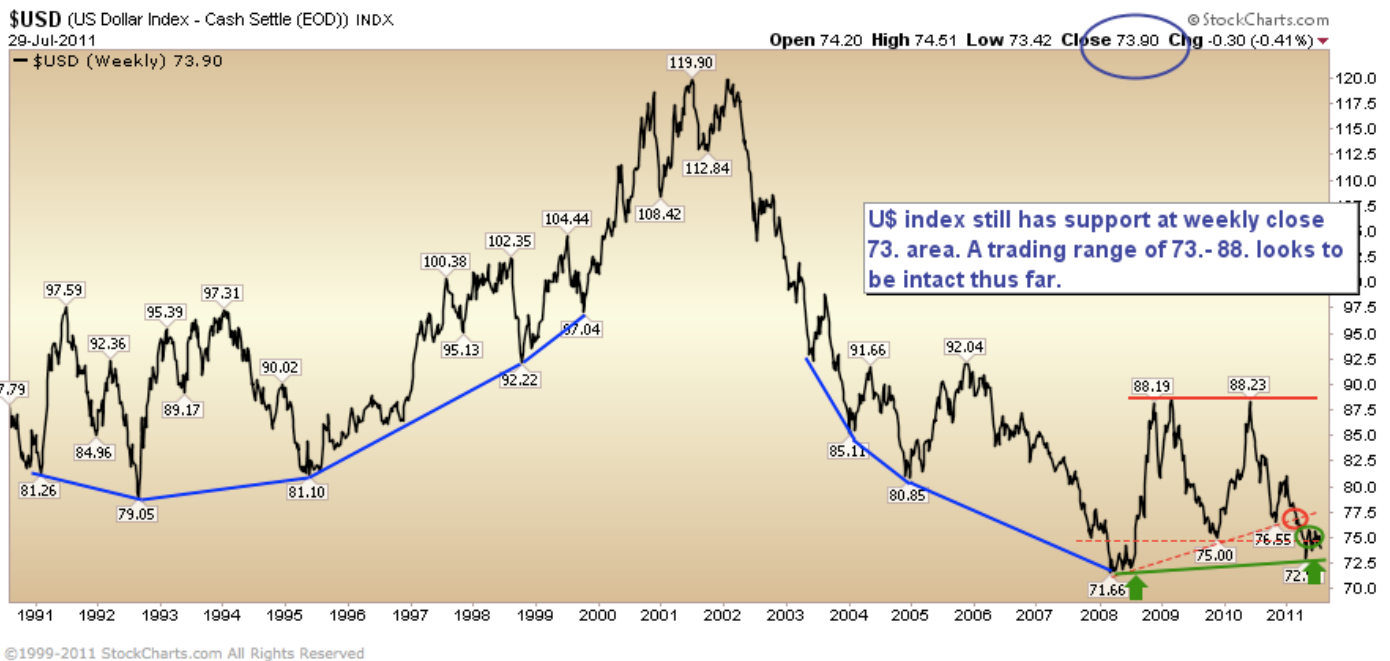
The previous cycle peak in the economy was December 2007. This December that will be four long years ago. Ready or not, facts must be faced - we are due for the next recession in this secular bear run any time now. **Global stocks lose on average 40% of their value during recessions. History urges us to be defensive, liquid and prepared. And we are!**

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

July continued to maintain support for our bond holdings and saw the US dollar hold support amid weakness in stock and commodity markets. Our current defensive investment stance seems to be gaining support. Although prices did move down this month, risk measurements for stocks and commodities are still signalling extremes last measured before the price declines in 2008. **In fact, we see the near term risk of contagion and shock to the global financial system as broader and potentially more dangerous today than at the start of the sub-prime debt crisis in 2007.**

Remembering our analogy of the global teeter totter with the bench mark currency—the US dollar on one side and the rest of global asset markets (stocks, commodities, some of the other currencies) on the other:

US dollar Index 1990 to 2011: the benchmark currency still holding support



As shown in the above chart, the US dollar index held its long-term support against the basket of world currencies this month. Amid all the fear about the US debt limit impasse, the trend in favour of the US dollar and away from equities continued. At this point there is simply no other viable contender for a safe and liquid currency for global commerce. Currency markets must vote in favour of the relatively least ugly contender today: so far the US dollar still wins this dubious distinction. In addition, there is little doubt that some budget cuts will come out of the present debt-ceiling stand off in the US. Spending cuts will be supportive of the US\$.

The Canadian dollar 2007 to 2011: this month the C\$ re-tested 106 and failed again



As shown in the above chart the C\$ Index took a run at resistance again this month, before failing and breaking down once more. Key catalysts were euphoric hopes that China and Europe's new banking bailouts would stem contagion and re-launch the global economy into a renewed demand cycle for commodities. At this point these hopes are unlikely to prove durable due to a mounting list of headwinds that include a further 10-20% decline in home prices, an oil spike back to recession-prompting levels, the Euro-zone debt crisis and banking contagion, post-earthquake disruptions with renewed fiscal strain in Japan and a hard landing risk in China. Anyone of these issues is likely to prick highly levered speculators in global stock and commodity markets. **As it did in 2008, the C\$ is most likely to fall with these risk markets.**

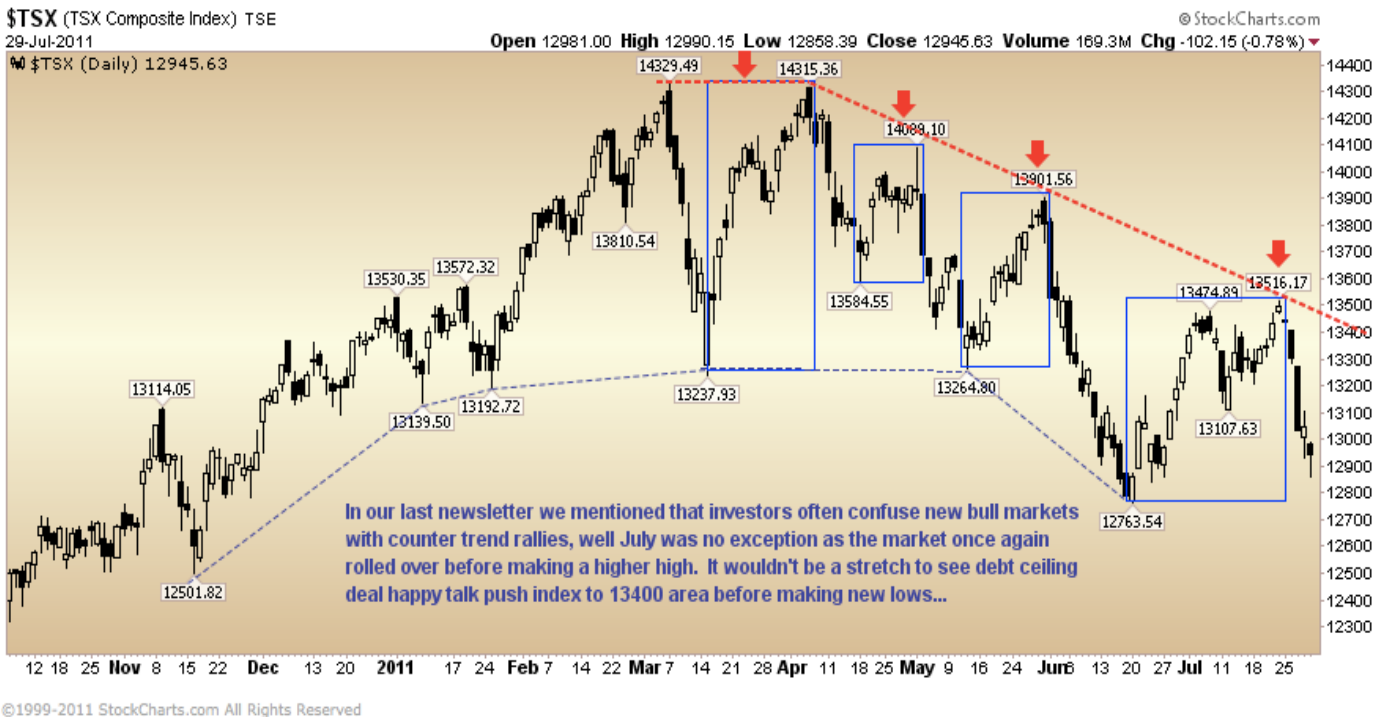
Equities: on ANY reasonable and historically reliable valuation model, equities are overvalued. The Fed's efforts to re-flate risk assets have come at a large price. Valuations across the board are overblown on high margin, low volume trading. This short-term effect should dissipate as earnings decelerate, stimulus abates and markets are left to fend for themselves.

Our guesstimate continues to be that pre-QE2 price levels could re-appear (about 1000 on the S&P, 11,000 on the TSX).

S&P 500 2007 to 2011: QE2 uptrend broken



Canadian stock market: lower highs and lower lows still confirming downtrend



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Although many are wagering all on hopes for an imminent next round of stimulus from the Federal Reserve, with a focus on deficit slashing today, political tolerance for adding to national obligations is presently low. Austerity has become the new buzz mantra of those seeking re-election in 2012. It is reported that Congress has already warned the Fed not to repeat the massive liquidity support to Eurozone banks in their present crisis as it did in the 2008 implosion. **We note that in 2008 the Fed was working in the dark corners of private windows and hidden deals.** Since then the Supreme Court has ordered them to disclose to the public—who, what and when of their liquidity support. The Fed will therefore necessarily be more restrained this time in calculating actions that will be politically defensible in the bright light of day.

Less government stimulus and some spending cuts amid a slowing global economy, are likely to encourage a continued re-pricing (lower) on many of the commodity and interest sensitive stocks that we seek to purchase. Still elevated commodity costs in many areas following a period of “peak” earnings continue to be a drag on corporate earnings going into the third quarter of 2011. The many analysts who were characteristically too optimistic on economic growth over the past 6 months are now (too slowly) downgrading estimates for the second half of this year.

Bonds: In bond selection our strategy continues to look through uncertainty to focus on 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 volatility while inflation and deflation continue to battle.

10 year US treasury yield 2001 to present- yield downtrend still supportive of bond prices



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This month the bond market continued to signal that since QE2 brought higher yields (lower bond prices)— the opposite of what the Fed said would happen— the end of QE2 warrants lower yields and higher bond prices. This has been supportive of our bond holdings. Economic data and the fear of sovereign debt contagion saw yields swing wildly in July from the high of the range around 3.2% down to a low of 2.805% as the “risk-off” trade picked up believers.

Once again it is also likely that an inevitable conclusion to the debt ceiling negotiations and some spending cuts will also prove further support for North American bond prices. As shown in the above chart, while volatile, the yield trend is still down and at this point there is no evidence to change our view that yields will continue to drift lower for a while longer still.

We will continue to watch the medium trend carefully. But 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 rising 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. And all of it points to lower asset prices ahead. **This can be an incredible opportunity for those who are prepared for it.**

Speaking of optimistic ideas, we suggest that everyone make a point of seeing **the new documentary [Carbon Nation](#), available for rent this month**. We can all help to jump-start a sustainable, healthy economy. Spread the word— the future is bright indeed!

Best wishes for August, fall is just around the corner again.

Quotes of the month:

"Every dollar you spend is a vote for what you value in life." —Anonymous

"Have the courage to say no. Have the courage to face the truth. Do the right thing because it is right. These are the magic keys to living your life with integrity." —W. Clement Stone 1902-2002, Businessman, Philanthropist and Author

"The real measure of our wealth is how much we'd be worth if we lost all our money."

—Benjamin Jowett, 1817-1893, English Scholar, Classicist

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