Real life needs active management

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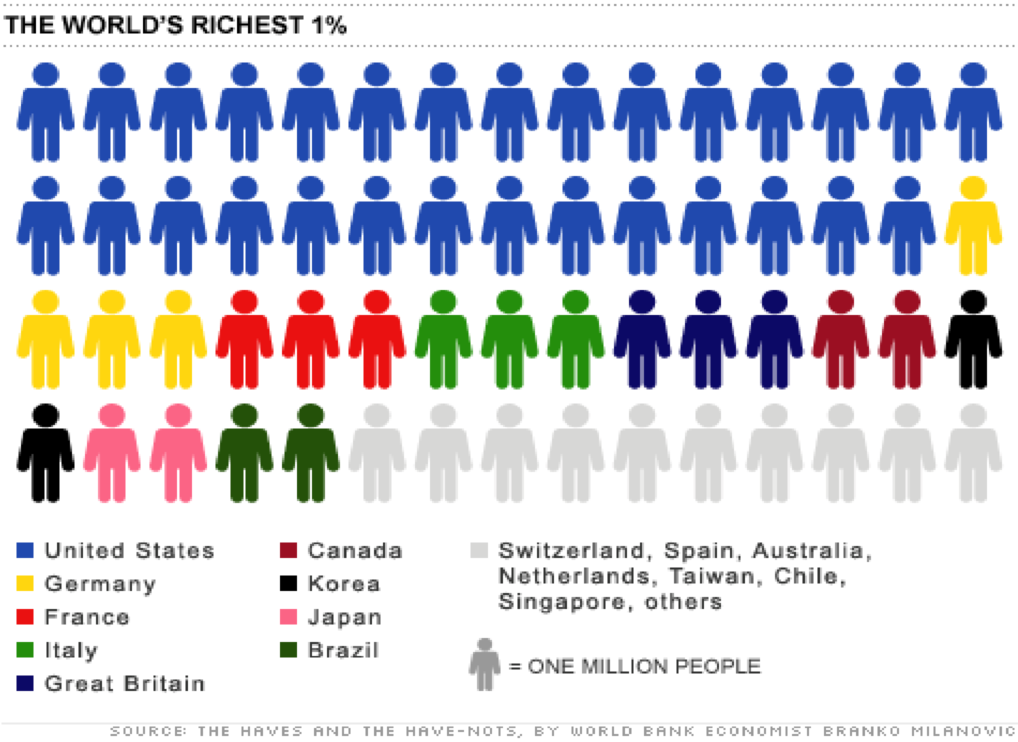
E.Q Trendwatch™

Ode for the 1%

"Learn from the past, live for today, hope for tomorrow."

---Albert Einstein, Physicist (1879-1955)



Source: CNN Money

The above pictogram shows the population of the worlds wealthiest 1%. To be counted in the top 1% of income earners, an individual need only earn income of $34,000 a year, after tax—$68,000 net a year for a couple, or $136,000 a year for a family of four. Overall there are 50 million people (out of 7 billion) worldwide that fall into this group of the "richest" 1%.

29 million or 58% of them live in America (blue). Germany is a distant second with 4 million (yellow); Canada comes in sixth with 2 million (crimson). The rest are scattered through Europe, Latin America and Asia.

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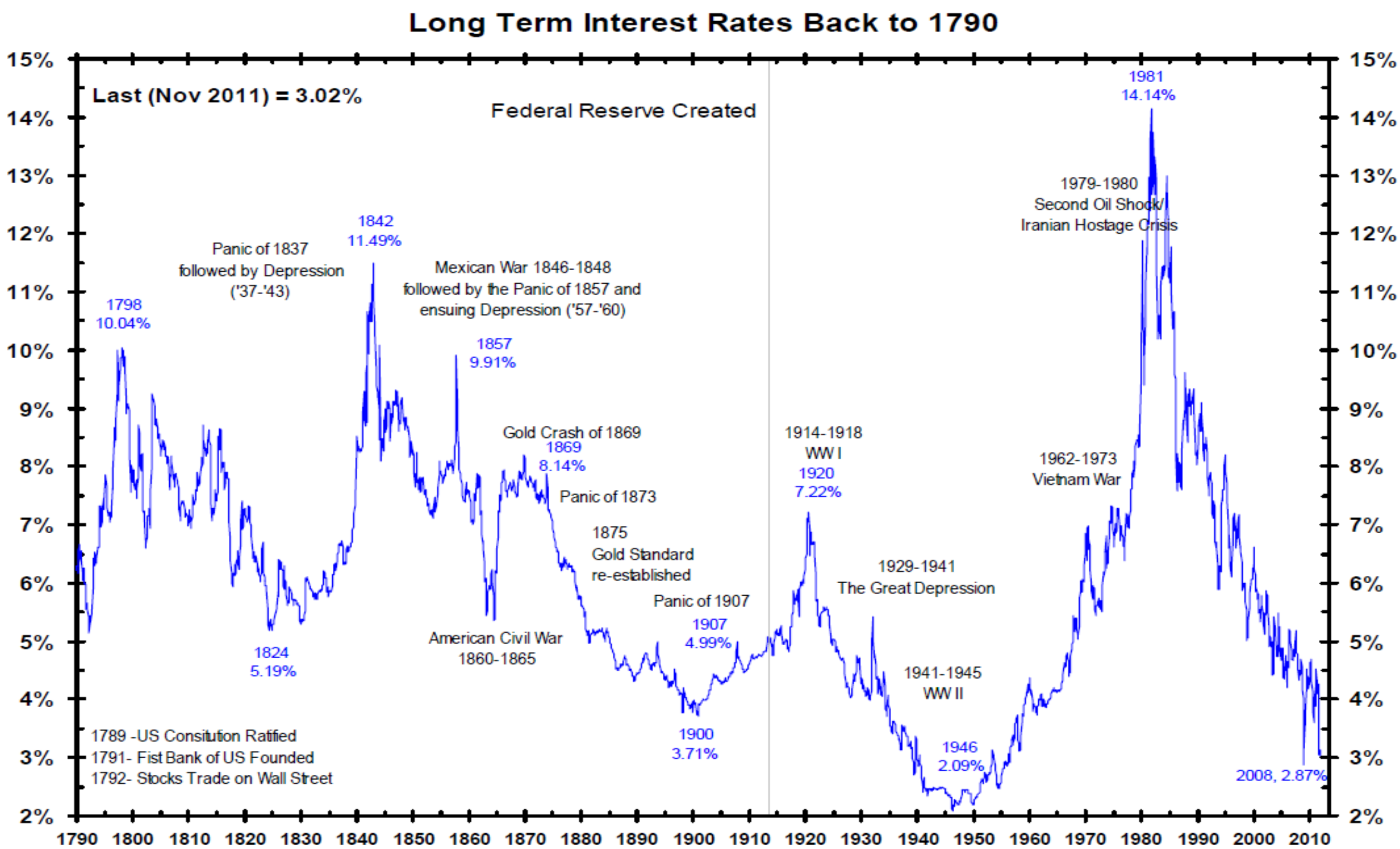
Most of the people that fall into the 'highest income earners' are still working. For those that are already retired however, the current generational lows in interest rates and dividend yields are no small challenge. This next chart puts current long-term interest rates in 222 years of perspective. Our rates today are the second lowest they have been since 1790!

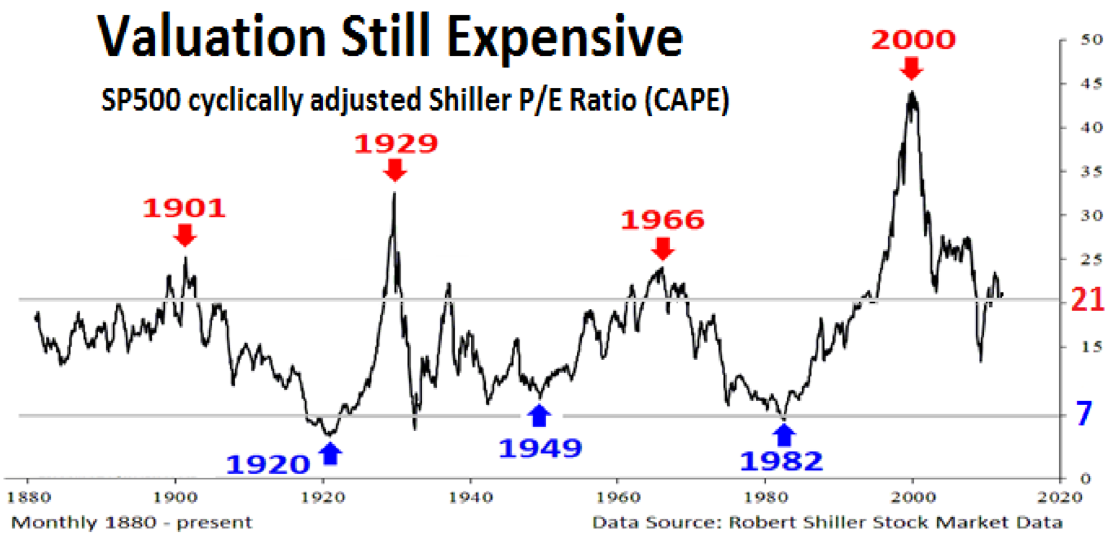
Secular trends: 30 year US Treasury yields since 1790 (at 2.94 in January 2012)



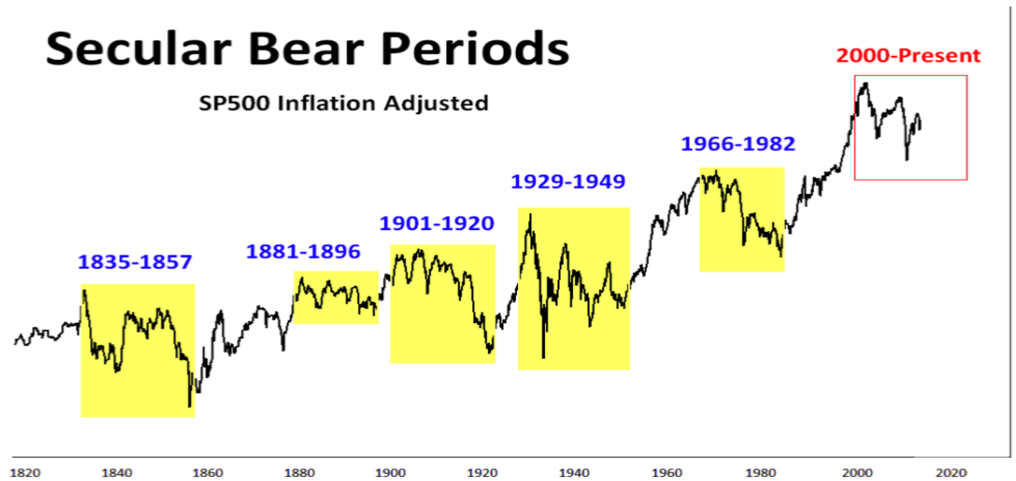
Source: Bianco Research

For the developed world's aging population, who are increasingly moving into retirement, paper thin yields couldn't come at a worse time. Low rates are causing billowing funding gaps for individual retirees and most of the world's pension funds. This month Canadian Prime Minister Harper surprised many at the World Economic Forum in Davos by announcing that like many European countries, the Canadian government was also planning to increase the age of entitlement to old age security past the current start at age 65. Apparently Mr. Harper thought it better to announce this change while abroad rather than at home surrounded by his aging electorate.

The "income squeeze" caused by epic low rates and dividend yields, has caused most financial advisors to recommend that retirees shift more of their savings into dividend paying stocks in search of more income. The danger in this 'magical' solution is large. Although stock valuations have declined significantly since their treacherous peak in 2000, in 2012 they are still about as over-valued today as they were near the beginning of each secular bear market in history since 1880. When prices are historically high it means that the dividend yields they offer are historically low. It also means that income investors buying dividend-paying stocks today are taking on downside risk potentially greater than -25% in order to collect an anaemic income stream of 2-4%.



History assures us that this period of over-valuation too shall pass, and another secular bull climate will follow. This next chart of US stock performance offers us a useful big picture of the 6 secular bear periods since 1880 (yellow) including our own still in process (red).



Source: Nautilus Capital Research

More row to hoe

Starting from the most crazy and unrewarding stock valuations in human history in 2000, we have undoubtedly made some progress correcting to the downside over the past 12 years. But we are not likely through this process yet.

As analysts who have been measuring and monitoring our journey through this secular bear for more than a decade now, we thought this next chart offers our clients a useful summary of where stock values, dividend yields and unemployment are today (pink) relative to the end of the 5 other secular bear cycles since 1835. Every category suggests that market prices have further downside ahead.

Secular Bear Market Stats	1835-1857	1881-1896	1901-1920	1929-1949	1966-1982	Median	2000-Present
Peak-Trough Decline	-75%	-36%	-73%	-83%	-66%	-73%	-65%
Peak-Trough Duration (yrs)	22	15	19	20	17	19	11
Duration to New High (yrs)	45	18	27	29	26	27	12
Cyclical stock declines (#)	3	5	6	7	5	5	2
NBER Economic Recessions (#)	n/a	5	6	4	4	5	2
Lowest P/E Ratio	n/a	14.3	5.2	5.8	6.7	6.2	10.1
Lowest Shiller P/E (CAPE)	n/a	12.9	4.8	5.6	6.6	6.1	13.3
Highest Dividend Yield	n/a	7.3%	9.1%	9.6%	6.4%	8.2%	4.1%
Max Unemployment Rate	n/a	18.4%	11.7%	25.6%	10.8%	15.1%	10.1%

Source: Nautilus Capital Research

Average dividend yields of 2-4% today are more likely to move up to 6 to 8% in the future. To accomplish this, stock prices will need to work lower than most imagine possible.

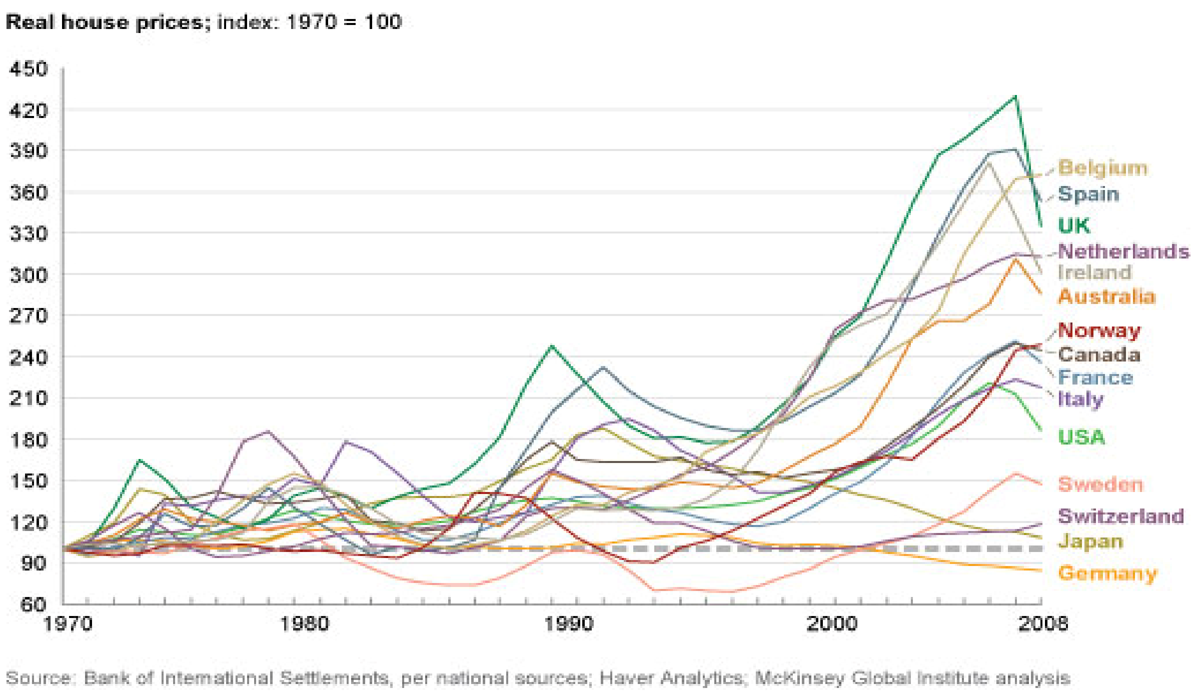
To earn the $34,000 (net of tax) per person that puts one in the top 1% of the wealthiest income earners today—assuming the most preferential average tax rate of just 15%--a retired individual would need to have some 1.3 million in retirement savings, or 2.6 million per couple. Less than 9 million people in the entire world have that much savings outside of their primary residence. Doubtless, very few people in the western world living on $34,000 a year consider themselves to be “wealthy”.

Housing prices are more likely to hurt than help net worth in the near term

It is also important to understand that in the post-credit bubble world, realistic math is different than it may have seemed just a few short years ago when a ferocious real estate bubble obscured historical trends and planning for many. Starting from about 1998 (shown in the graph below) we see that western housing entered into a massive uptrend fuelled by irresponsibly low policy rates set by central bankers, and aided and abetted by speculation in the financial sector.

The fact that these forces drove real estate into frenzy is old news. Less understood it seems, is just how much further downside work many countries need to accomplish before prices finally correct for the mania of the past decade. This next chart reminds us that although US housing may not have bottomed yet, the US in general is actually further along this mean reverting process than many countries. While places like the UK, Spain, Ireland, Canada and Australia are likely just getting started. Many people remember the housing downturns that followed previous peaks in 1980 and 1990. Compare those previous spikes to the run up from 2000 (below), and we get a sense of the magnitude of decline that would be proportional to mean-correct housing prices this time. Wow.

Relative houses prices: one chart where you don't want to your country near the top



We believe that all of this perspective is important in informing our financial expectations, planning and investment allocations today. As the quote from Einstein at the start of our letter advises, we must learn from past history in order to manage our capital carefully for today while retaining longer term optimism that investment opportunities will improve again in the future.

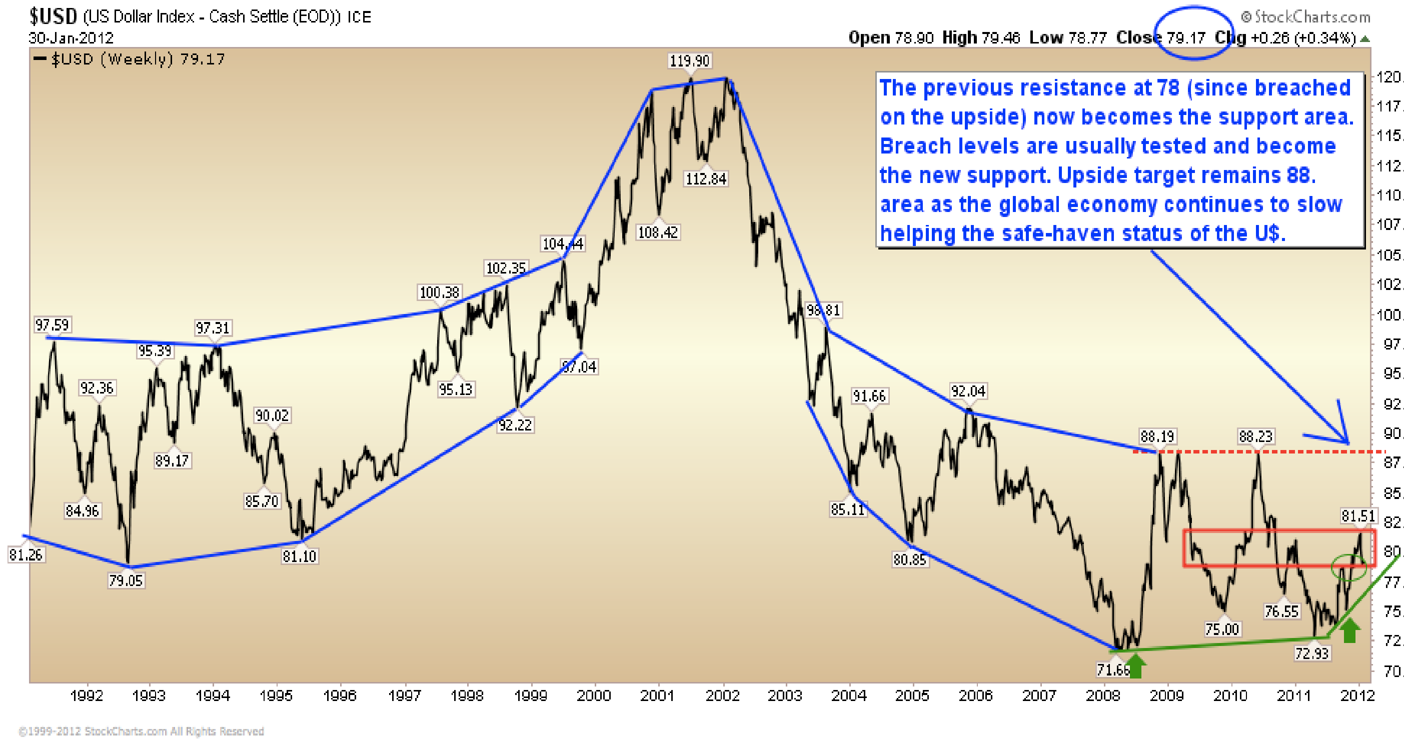
Key investment themes we glean from all of this are as follows:

- Interest rates in North America have been falling for 30 years and history suggests that eventually this long secular down trend will end and rates will begin to rise for a similar period in a long secular up trend of 25+ years. This will be hard on those who are in debt, and who have grown dependent on abnormally low carrying cost over the past decade.
- Higher rates will be better for those who value efficient capital allocation and for those looking to collect interest income in retirement. Higher rates means that current bond prices will eventually move down over time and especially hit investors who bought holdings at market prices above their maturity value. To control capital risk in this process, it is important to eventually shorten the duration of our bond holdings so that money can be rolled back into shorter instruments in a rising rate environment.
- That said, the experience of Japan warns us that after a credit bubble bursts and interest rates flat line, weak demand and growth in the economy, can result in an extended period of flat interest rates beyond what may be historically expected. This may be especially pronounced in present terms because so many countries are dealing with the same deflationary drag all at once.
- Stocks continue to be historically over-valued at present levels, and especially as the world moves into its next global economic slowdown now underway. Consensus earnings growth estimates for 2012 may be wildly optimistic.
- 60% of the world's wealthiest people live in North America and that suggests more domestic demand and growth potential for our economy than many other places. However, to benefit from domestic wealth, we will need to manufacture and supply more products and services in North America for our own consumption and decrease our consumption of imports.
- Few who are in the top 1% of income earners in North America, presently have enough capital saved to live comfortably and entirely off of savings given our elevated cost of living and currently low interest and dividend yields. Most people will need to downsize their living expenses and/or find a way to supplement their income through some form of work well past age 60.
- US housing prices may have a further 10-20% of downside to go, but Canadian home prices are lagging in this trend and therefore face the risk of an even greater price decline going forward. The condo market in some larger Canadian cities, like Toronto and Vancouver, seems particularly overbuilt and vulnerable to softer demand. There are 132 condo buildings under construction in Toronto today versus 17 in Chicago as one point of reference.
- Anyone planning to downsize Canadian housing within the next 5 years should consider doing this sooner than later. Anyone planning to upgrade Canadian housing may well find better prices 2 or 3 years hence.

In the charts: strategy update

After breaking out to 81.51 at the middle of this month, in the last 2 weeks the greenback retrenched a couple of cents. The US index is comprised 57% of Euros, so the manic swings of further bailout talks in Europe are naturally causing daily gyrations in this index. Notwithstanding this, the US dollar continues to receive safe haven inflows at this point, and $88 remains our upside target.

US dollar Index 1990 to 2011: 78 now support, 88 still upside target



The Canadian dollar: running on empty?

At the same time, the Canadian dollar continues to move in close correlation with the risk trade. As the US Fed this month vowed to leave US overnight rates at presently anaemic levels through 2014, some speculators funnelled more into the 'inflation trade' buying commodity exposure like gold and oil. This caused some 'risk on' rebound in the Loonie from the past couple of months of weakness.

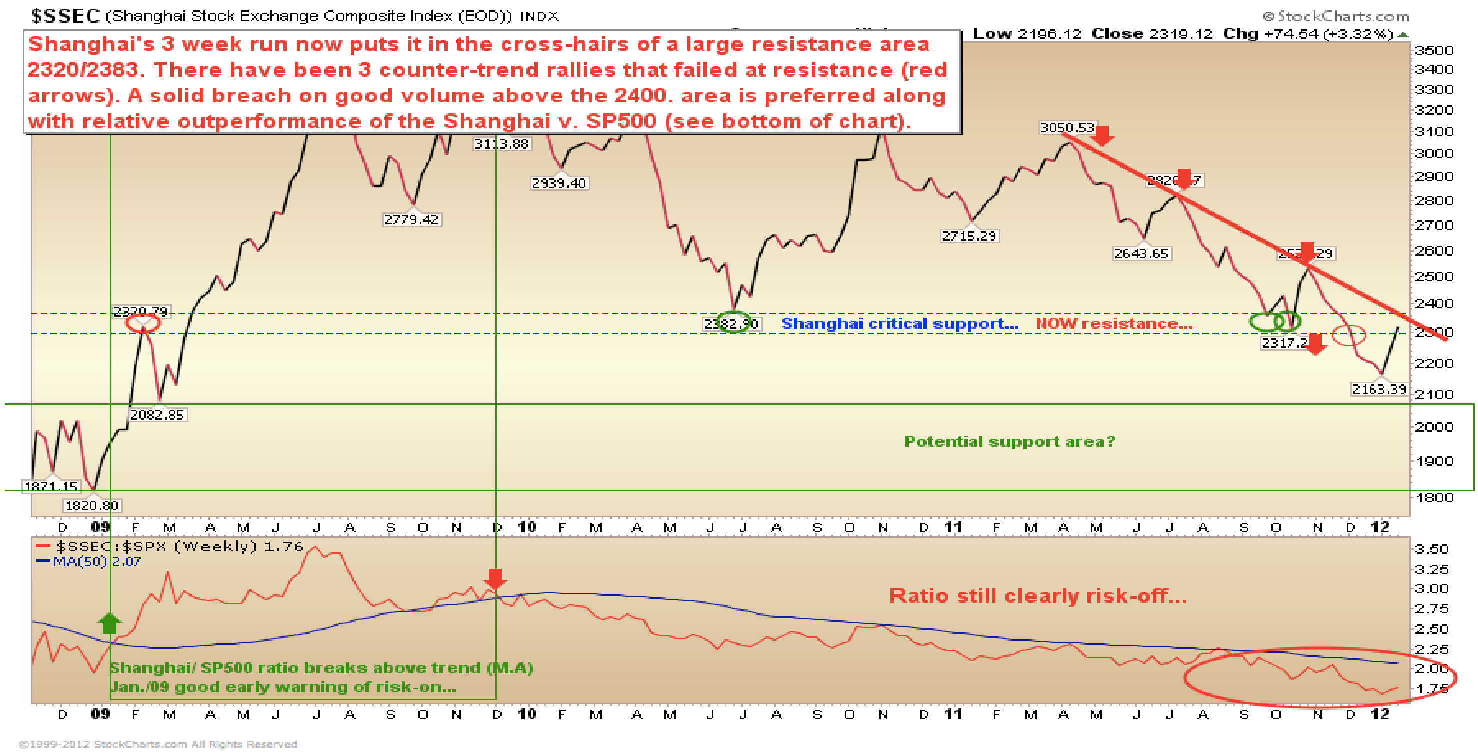
This is the old dance we witnessed in the last cycle just before the 2008 recession. Financial speculation at zero rates leads to higher commodity prices, which leads to less affordability and lower consumption for consumers and manufacturing, which leads to slower growth and eventually lower (usually much lower) prices. This next chart graphs this sequence and its impacts on the value of the Canadian dollar and Canadian stocks (similar for other commodity-centric countries as well).

Canadian dollar 2001-2012: Those banking on above-par strength have lost

Canadian stock market currently range bound, with overall trend bias still down

Canadian banks looking ominous: during the last 2 recessions they lost 45%. Encore?

Chinese stocks: a leading market, leading global stocks lower since April 2011



Bonds: North American bond yields moved lower this month, as investors continue to flee other international markets in favour of US and Canadian bonds. Our thesis of short-term deflation and growth slowed by government debt and austerity remains intact. There is significant upside resistance for higher bond yields noted at the dotted line below shown on a chart of the bellwether US 10 year Treasury yield.

10 year Treasury Yield 2001 to present- yield downtrend still supportive of bond prices

We will continue to watch the medium trend carefully. So far, the bond market is still signalling “risk-off”. The trend of falling inflation is supported by a lack of wage pressure, continued weakness in housing, contracting GDP expectations and slack in economic capacity.

All of these issues are economic headwinds moving into 2012. At the same time, we still think that the stock market may well give us a valuable cyclical bottom some time this year. This may also afford us the catalyst to shorten up our fixed income duration, while adding dividend paying equities to increase portfolio yields as we row our way through the next cyclical recovery phase, whatever length it turns out to be.

Half way through the winter now!!

Quotes of the month:

"The best years of your life are the ones in which you decide your problems are your own. You do not blame them on your mother, the ecology, or the president. You realize that you control your own destiny." -- Albert Ellis (1913-2007) Psychologist

"The doctor of the future will give no medicine but will interest his patients in the care of the human frame, in diet and in the cause and prevention of disease."

-- Thomas Edison (1847-1931) American inventor and businessman

In case you have an interest…here are 5 documentaries we enjoyed this month:

Chasing Madoff (2010): A look at how one investigator spent ten years trying to expose Bernie Madoff's massive Ponzi scheme.

May I be Frank? (2009): A journey to health and personal transformation.

Forks over Knives (2011): Insight on how degenerative diseases can be controlled, or even reversed, by whole food diets that avoid animal-based, processed foods.

The Revenge of the Electric Car (2011): The inspiring sequel on how electric technology and innovation are finally bypassing the combustion engine.

I AM (2011): A look at how individuals, and we as a race, can improve the way we live and walk in the world.

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