Real life needs active management

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E.Q Trendwatch™

Recession resumes (and it's <u>not</u> the end of the world)

"The stock market fell sharply today, then bounced back, spiraled upward, jumped forward, leaped to new heights, tumbled rapidly, and took first place in a gymnastics competition."

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> *"…the downturn that began in 2007 was never really resolved, but was instead just pushed off and deferred by massive monetary interventions, accounting changes, and the like…the S&P 500 remains below its 2007 peak. So rather than being a distinct primary bear market, and a distinct economic downturn, what we're likely to observe ahead will be largely a continuation of the original unresolved mess of bad credit and un-restructured debt, now also writ large across Europe. " --John Hussman, May 21, 2012*

Each week we receive a pretty constant stream of electronic mail from blog readers around the world who are not clients of Venable Park. We are grateful for the insight this offers. Many non-client readers express their frustration at on-going financial loss, along with fear and confusion about what to do with their savings.

Most are suffering under the advice of typical and ineffective asset managers who offer no meaningful risk management. Most do not meet VPIC's asset threshold in order to qualify for our service, have already fired previous "advisors" and are now finding themselves unequipped yet forced to fend for themselves. Things are tough out there. An email this week from a man named Chuck in New York is a good example:

> *"Thank you for the work that you are doing. I am at a very confusing point. All I hear from commentators in the gold and silver industry is that one should cash out of our IRA's and bank accounts, pay the 10% penalty and go all in with physical gold and silver because what is coming in the derivative market will destroy the banks and every one's bank accounts. I am having a hard time wrapping my head around this because if that is true it would mean that people like Donald Trump and the like would lose all of the fiat currency that they have. How is business to be done if every one's bank account is wiped out? I am invested heavily in gold and silver and am concerned for my family. For those of us who are not pros like yourself can you give us some clarity on this whole mess? Should we be cashing out of our IRA's and buying physical or just stay in the market and wait it out?"*

Over the past few years to extort bailouts out of taxpayers, bankers and politicians have repeatedly cited the threat of 'bank-failure'. It has also been a key marketing slogan used by those in the business of selling precious metals to herd the terrified into their products. We have always noted a key hole in this argument: if cash is worthless, why do precious metals proponents accept it in exchange for their rocks and metals? If "paper money" is truly worthless as they insist, why are they so keen to get "worthless paper" from their customers?

The truth is that cash is still liquidity and bank failures do not mean depositors get wiped out.

Last week, Martin Gruenberg, the acting Federal Deposit Insurance Corporation (FDIC) Chairman, explained the legal process of resolving a "systemically important" institution:

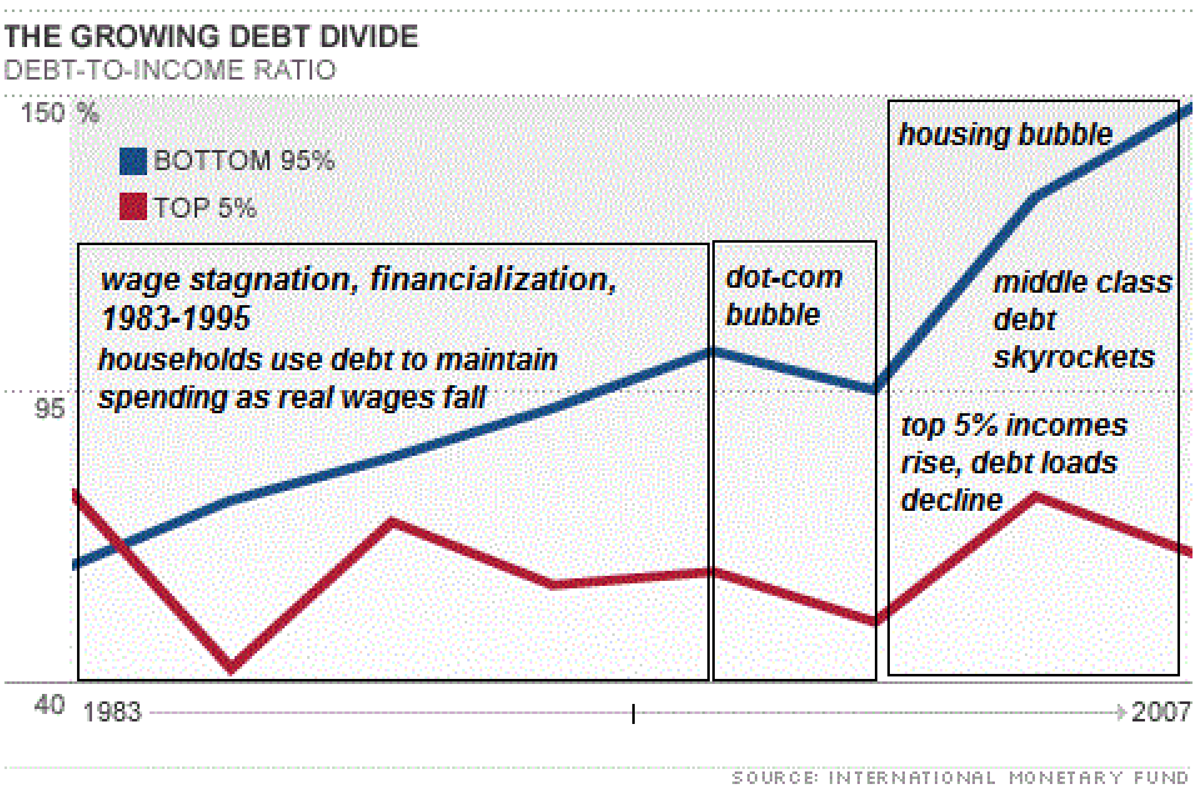
> "The most promising resolution strategy from our point of view will be to place the parent company into receivership and to pass its assets, principally investments in its subsidiaries, to a newly created bridge-holding company."

In resolution process, equity investors—those who bought bank shares—appropriately lose their investment. Such is the risk of equity investment after all. Subordinated creditors don't get paid. Senior unsecured debt holders may get back pennies on the dollar and senior bondholders receive equity and convertible debt in the new restructured institution. **<u>Most importantly, depositors and bank customers are held harmless because their funds are held 'in trust'- not invested in the banks.</u>** Depositor funds do not form part of the bank's assets, so they are not available to be claimed by creditors or investors on its break up.

Bankruptcy laws provide a well-established orderly process that is invoked routinely in capitalism to resolve failed institutions. This is a crucial re-setting process that exacts the cost of failure from the managers and investors who agreed to take that risk. This is fair since these are the same parties who also benefit from gains when the institution prospers. It is this make-or-break discipline that keeps the participants focused and accountable. If failed institutions are not permitted to fail and restructure, then capitalism and stabilizing free market forces are thwarted. The failure to admit and accept this key process is a major reason that the global economy has not been able to heal and recover from the great recession of 2008. It is a major reason why the world is already finding itself in the next period of negative growth, just 3 years after the last.

So to answer Chuck and others who may be worried about a "collapse" of the banking system, short of illegal actions or outright anarchy, there is no reason to believe that depositors are at risk. The legal resolution of some deservingly bankrupt banks will not end the free world. We would also suggest that it is verging on madness to adhere to fear mongering that would have us move all of our savings and retirement accounts into physical rocks and metals. How could these highly illiquid items possibly provide safe haven in a world that is desperate for cash liquidity?

Durable economic recovery requires customers



Over the past 30 years, as globalization exported more jobs to developing economies, wages stagnated for 95% of western workers. At the same time, tax and interest rates were falling along with regulation of the financial services sector. These three elements enabled western consumers to keep buying on credit in order to offset lost wages. The leveraging up also pushed asset prices like stocks and real estate to unsustainable levels. While they were going up, appreciating asset values were able to mask increasing debt with the appearance of net gains on the balance sheet of the masses. When the asset bubbles burst, however, the hangover of living beyond one's income endures as record debt levels shown in the chart above (top line).

Meanwhile, those in the top 5% of income earners (lower red line in graph) saw a much more modest increase in debt levels since they were able to earn more, invest more in appreciating assets and keep more after tax.

At the same time, an extractive culture developed in the minds of business executives who were increasingly running publically funded, publically traded corporations. CEO's became judged more on what they could extract out of companies—in terms of income for executives and shareholders—rather than on the sustainability and long-term health of the companies they were hired to manage.

Although asset bubbles and extreme extractive policies ultimately blew up the economy leading into 2008, the vast majority of people at the top remain rather oblivious to what this means for workers and the global economy. Perhaps this is because those 'at the top' so to speak, live far removed from the reality of the "Everyman". In 2011, the head of a typical public company in the US made an average of just under 10 million a year, 6% higher than 2010, and the highest executive pay ever recorded. At the same time, the average US worker earned just over $39,000. Put another way, the average worker now needs to toil 244 years in order to earn the same pay that the average C- Suite earns in just one year. And the working people are the fortunate ones— there are millions of other workers who have no jobs at all and have been dependent on government handouts. Amazingly, 1/5 of total US household income today comes from government transfers.

Three years after the last recession, hundreds of thousands of people are coming to the end of extended government benefits every month. Leading into the next global downturn in 2012, job growth is already slowing. All of this suggests that real disposable income is about to get weaker still.

The net result is that the masses today have less income to service more debt and thus less money to fuel demand and growth in the economy. Now that the debt securitization machine has imploded, there is no quick fix available to jump-start demand. Slower, more organic growth is the new, old norm once more. At the same time, most of the developed world is in the midst of significant political upheaval with a litany of leadership changes this year all over Europe, the UK, China, Japan and, of course, the US. Consensus on the fiscal policy side will be difficult to harness in the coming months just as globally, central bank stimulus programs are coming to a near synchronous end.

There is every reason to believe that central banks will try to think up more exotic forms of easing as the downturn and political paralysis continue. The reality however is that the biggest guns—interest rate cuts—have already been deployed in this battle. Real interest rates are already zero or negative in all of the largest economies. Resource constraints dictate that on going efforts will necessarily be smaller and even less effective than those already implemented. The die for this downturn has long been cast in previous policies and behaviours.

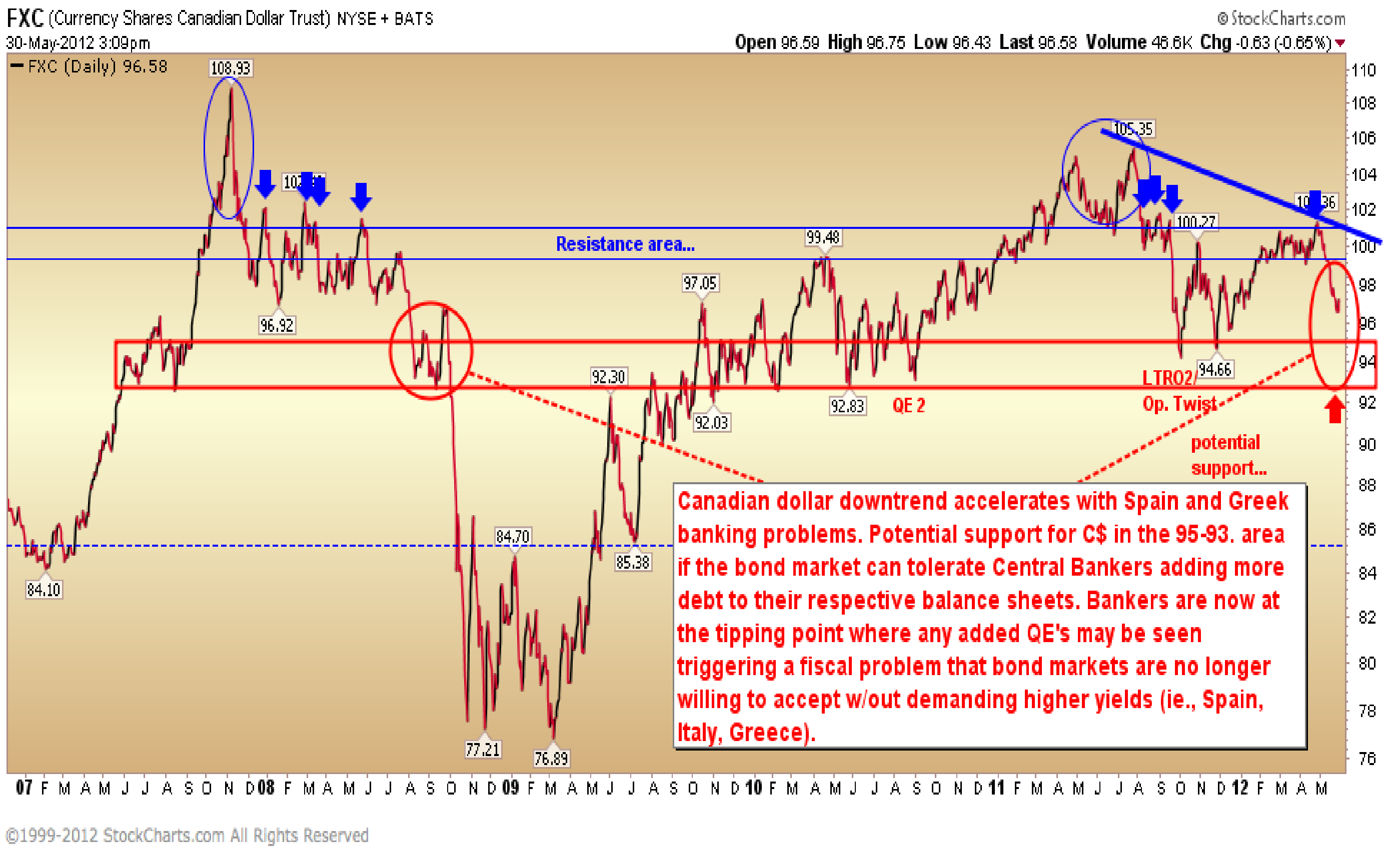
For all of these reasons, the next cyclical recession—the third since this secular bear began in 2000—appears well underway. This means there will be more job losses and less customers for many products over the next several months. History tells us that this is just par for the mean reversion course. Rather than lament or deny these conditions, individuals and businesses that can see, understand and adapt expectations and timing can still prosper. For our part, we plan to do precisely that.

In the charts: US dollar Index 1990 to May 2012: 82 now support, 88 still upside target

We have remained steadfast on the greenback simply because the market is telling us we are correct in our thesis—capital is leaving higher beta periphery countries to the safe-haven status of the U.S dollar. We will adjust this position when the market flows tells us otherwise. Having broken through $82 this month, $88 remains our upside target on the US dollar index. This uptrend suggests further significant price risk to commodities and global equities on the other side of the global teeter-totter.

Canadian dollar 2007-2012: Lift leaves the Loonie

At the same time, the Canadian dollar (below) faltered with the risk trade once more as anticipated.



International equity markets doing some good downside work

Some international equity markets are beginning to look enticing. The Italian index ETF for example has fallen to levels first attained in 1997. Spanish stocks are back to 2004 levels. That said prices have yet to stabilize and show meaningful inflows beyond mere private speculation. This suggests we have further to go in the re-pricing journey. **We are grateful we have not had exposure to such a violent, capital-eroding landscape.** We continue to monitor the contagion of this crisis in bond yields, bond spreads, Credit Default Swaps and equity values with a view to finding an attractive re-entry point once selling exhaustion occurs.

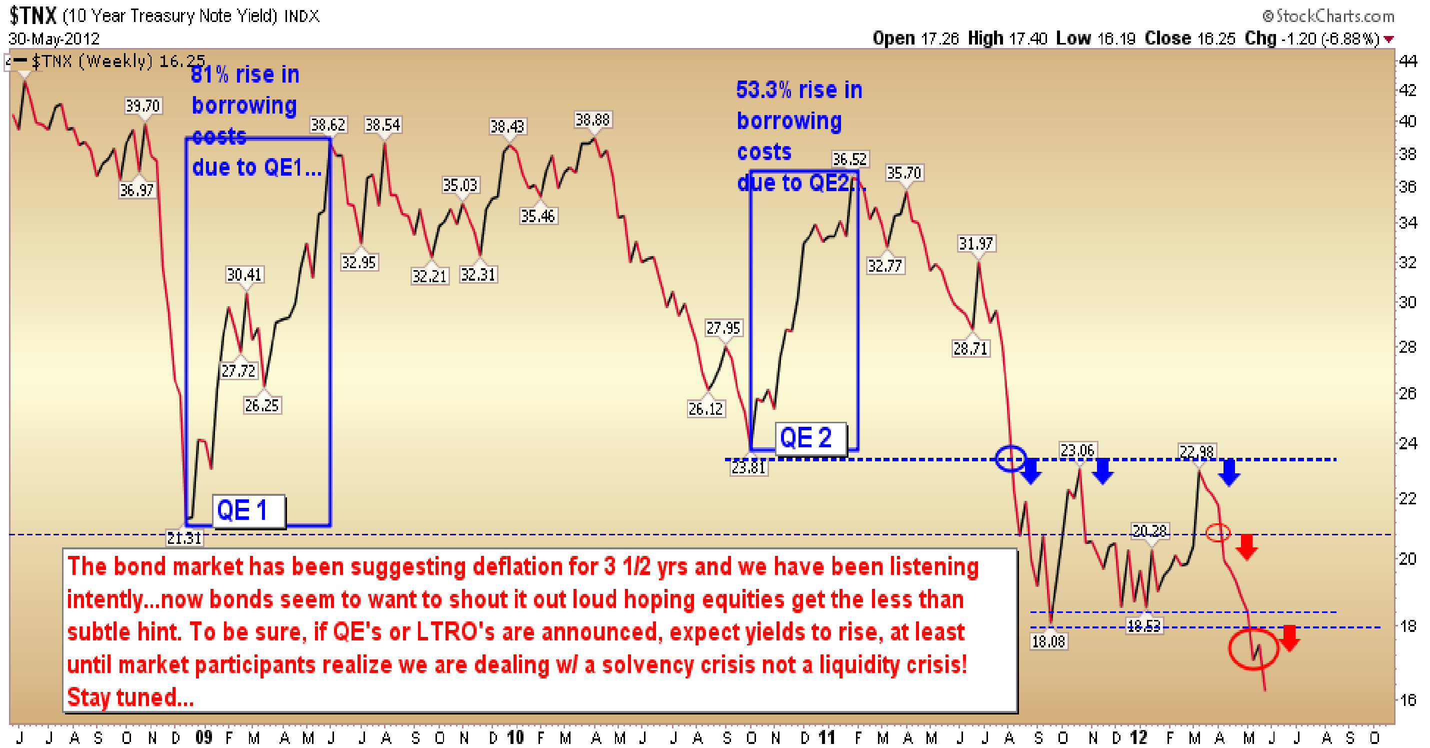
Buying at the ultimate price bottom is not likely even with skill. But if we can enter on our rule set, somewhere close to the bottom we will be content. As yet, we do not see sufficient evidence of bullish capitulation. We are watching carefully as always.

Canadian stocks since 2003: post credit bubble, working their way back down toward value in 2012

S&P 500: Three bubbles and counting. First downside test from here at 1250

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 in tact. 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 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 continuing lack of wage pressure, weakness in housing, contracting GDP expectations and historic slack in economic capacity as countries now follow each other into growth contraction.

Having been patiently waiting for global markets to digest what was occurring under their feet, we at VPIC look to the next phase of the crisis—the inevitable rate bottoming process, how this may take shape and how we may take advantage of it.

The first order of business will be to shorten our duration exposure (avg. term to maturity) on the bond assets we hold and allow a portion to float upward along with a rising yield curve. We seek to do this for two reasons: the first is to reduce capital risk in holding longer duration bonds in a rising rate environment. The second is to have increasing income flows from the bond portfolio as a falling rate environment finally gives way to a rising one. As long as market flows—the voting majority— continue to seek safe-haven assets, we are reasonably comfortable holding our current bond configuration.

Looking forward to some summer fun. Now for some quotes of the month:

"Critical thinking has to include assessing one's own thinking."

—Daniel Kahneman, psychologist, behavioural scientist and Nobel laureate.

"It is the dull person who is always sure, and the sure person who is always dull."-

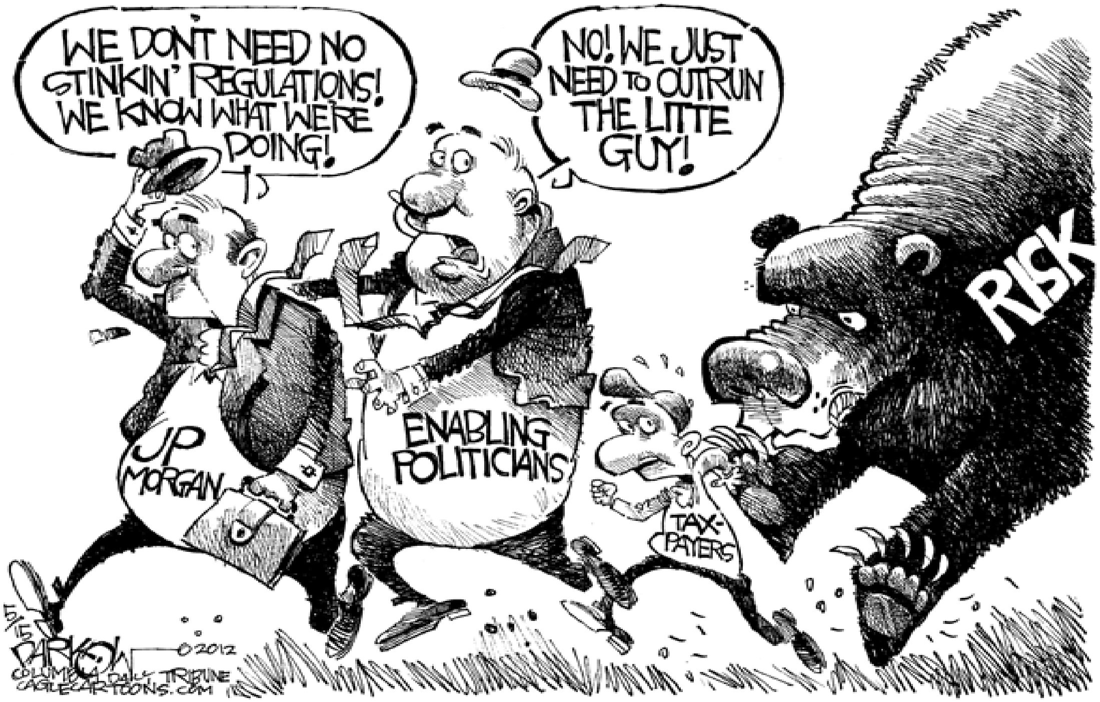
-- Henry Louis "H. L." Mencken (1880-1956), American journalist, essayist

"The purpose of life is not to win. The purpose of life is to grow and to share. When you come to look back on all that you have done in life, you will get more satisfaction from the pleasure you have brought into other people's lives than you will from the time that you outdid and defeated them."

--Harold Kushner, Rabbi and Author

"Everyone for himself," cried the elephant, as he danced among the chickens."

—Robert Bork, American judge and anti-trust scholar, author of "The Antitrust Paradox".



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