Real life needs active management

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E.Q Trendwatch™

Two worlds converge

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"Misers aren't fun to live with, but they make wonderful ancestors".

—David Brenner (b. 1936), comedian and filmmaker

Over the past 3 years the world's financial sector has received incredible monetary support and preferred treatment at the expense of global taxpayers. Government-backed big banks have been able to resume levered trading for their own profits while taxpayers continued to underwrite the enormous risk of loss. This has enabled "too big to fail" banks to extract hundreds of millions in additional compensation for their executives from companies that were, by conventional metrics, bankrupt.

Resumption in bank profits gave many commentators and politicians an unrealistic assessment of the health of the global economy. Rejoicing in their fresh liquidity, and congratulating themselves on a crisis averted, financial elites forgot a key fact: they had saved themselves at the expense of the world's customers.

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Despite help from lower gasoline prices and record-low borrowing rates, consumer sentiment has remained mired in depths traditional of recession. A moribund job market, spreading insolvency in Europe, aging boomers, miniscule household savings and growing distrust for financial markets have all served to justifiably undermine optimism and further restrain spending and hiring plans. US retail sales contracted for the third consecutive month in June, marking a trend that has only ever occurred historically within the midst of an ongoing or imminent recession.

In poll after poll, small business owners express concern about falling sales. While many of the largest corporations are flush with cash, money velocity (the movement of money through the real economy) has continued to plummet. Some multi-nationals have managed to "beat" reduced earnings estimates for Q2, but most are reporting sales and forecasts well below prior expectations. Notoriously late to the business cycle, equity analysts are just now beginning to lower their earnings estimates at the fastest rate since 2009.

This month the next wave of scandal broke with confirmation that major investment banks have been acting in collusion for years now to fix interest spreads (LIBOR and others) for their own advantage and to the detriment of consumers. This is the largest fraud uncovered to date and just the next installment in a never-ending series of revelations of illegal and predatory practices at financial institutions.

Each wave of this news intensifies the pressure on prosecutors and regulators to rout out criminal and abusive behavior in finance. Each wave intensifies the push for claw backs of their executive pay and powers. Each wave increases the pressure on politicians to sign on to new reforms and regulation such as the modern day Glass Steagall Act now tabled as "The Prudent Banking Act" of 2011.

History tells us this process is not finished and that there will be large ongoing cuts to the size and income of the financial sector before the necessary weeding out process completes and it is scaled back to its rightful place in support of the real economy rather than dominating it. Goldman Sachs and Morgan Stanley continued the downsizing trend this month by announcing more bank layoffs in 2012. New York's high-end home prices are falling in sympathy with less income and more job loss in the finance sector. New York City already has 10% unemployment again—the peak it hit in the 2008 financial crisis. **These are all healthy developments and necessary progress toward a more rational global demand cycle fuelled by income, savings and investment rather than speculation and reckless leverage**.

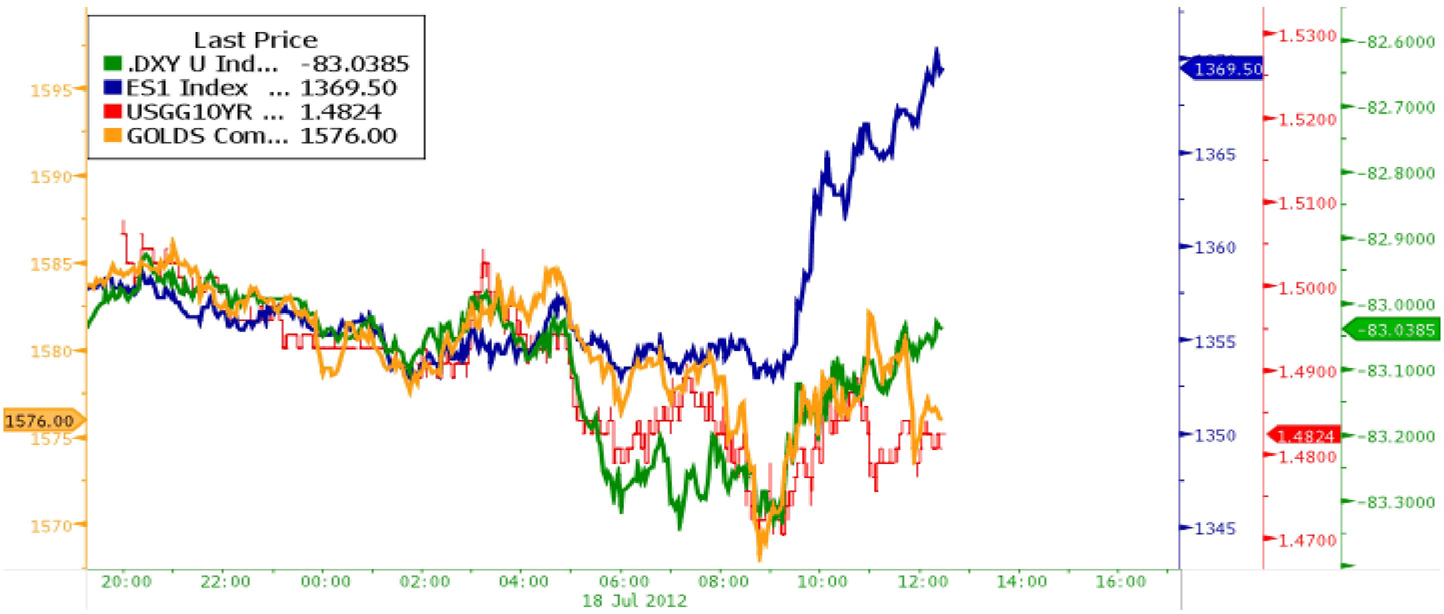
Austerity and default are necessary treatments for insolvency. Withdrawal pains from over-spending can be unpleasant. But the fiscal discipline that we restore going forward will be the foundation of future prosperity. Misers, it has been wisely said, make excellent ancestors.

The world of finance is finally now joining the rest of the world in the "pain" of our post-credit bubble deleveraging process. The world of the rescued is now reconnecting with the world of the rescuers. Two worlds are converging at last.

Hopes for more central bank stimuli have been heavily priced into stocks once more

As Fed Chair Bernanke finished his testimony to the US Congress on July 18, algorithm machines and other high-frequency traders (80% of the extremely light equity volume today) continued to lay bets on another round of stimulus from central banks as the global economy contracts. The below chart captured the now typical pattern: stocks moving up (the S&P shown in blue) on trader bets for more stimulus, while the US dollar (up in green), bond yields (down in red) and gold bullion (down in gold) all voted against the idea—or at least voted against the likelihood that further stimulus would offset the deflationary force of incoming recession.

Stocks (blue) bet on more QE hopes, while bonds (red), gold and the US dollar (green) disagree



Bond and currency markets are infamously more measured and focused on economic reality than the frequently flighty stock markets. Perhaps the more sober markets have noted that the impacts of central bank stimulus have been increasingly less and quicker to dissipate with each fresh round over the past 3 years.

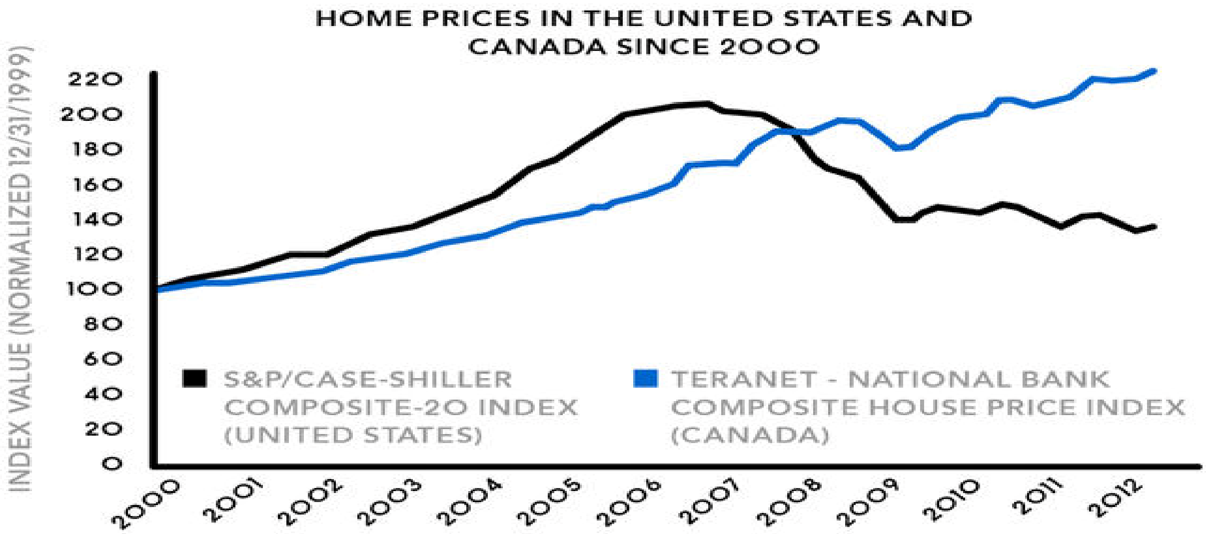
Canadian home prices flash warning for all who wish to see

This month Bloomberg ran with the story "Congratulations Canada on your ongoing housing bubble" and made the following observation:

> "American home prices more than doubled from 2000 through 2006, and then cratered. Canadian home prices rose a bit more slowly, but unlike in the U.S., they have kept going up, up, up. Prices in America's 20 largest housing markets are 36 percent higher than they were twelve years ago; in

Canada's 11 largest, they are up 125 percent.

The most valuable asset that the typical household owns is its home. Since Canada isn't done with its housing bubble, it's no surprise that households up north are now wealthier than those down here. Until the bubble bursts, that is."



Source: Bloomberg

Overall house prices in Canada have doubled over the past decade- averaging gains of 7% a year and nearly 3% annually above the long-term average. Over 10 years, this has accumulated to some 30% over-valuation in Canadian realty prices. The likelihood of Canada giving back a significant chunk of that above normal gain is large. Those hoping the Great White North can escape the downside of the credit bubble to which the rest of the world has already succumbed, are rolling the die in the face of very poor odds. Actually, there has never been a bubble in history which has not gone on to give back all of its above trend gains. Not one.

For those who are not heavily mortgaged and are happy and able to hold their current real estate for the next 10 years, this is not a big issue. Balance sheets may well see a 20%+ drop in the value of properties, but longer term— a good house is still a home. For those who are thinking they will need to downsize or change their holdings over the next few years however, Canadian realty trends urge sellers to action sooner than later.

Over-valued realty markets and over-indebted consumers have been a toxic mix for banks and economies in other countries. This month rating agency Standard & Poor's cut its outlook to negative on 7 Canadian financial institutions citing "a prolonged run up in housing prices, consumer indebtedness and dimming prospects for the global economy tending to rising unemployment in Canada" and pointed out that all factors will amplify Canada's vulnerability to a downturn in the months ahead.

<u>IN THE CHARTS:</u> "Safe havens" saw massive inflows this month

Growing investor appetite for safer and more-liquid assets continued to push government bond yields in several advanced economies to record lows. In a testament to how abnormal conditions have become, in a handful of countries (Germany, Finland, Holland, Denmark Austria, Switzerland and US 2 year) bond yields have actually gone negative, meaning bond investors are willing to pay these countries for the privilege of lending them money. Believe it or not!

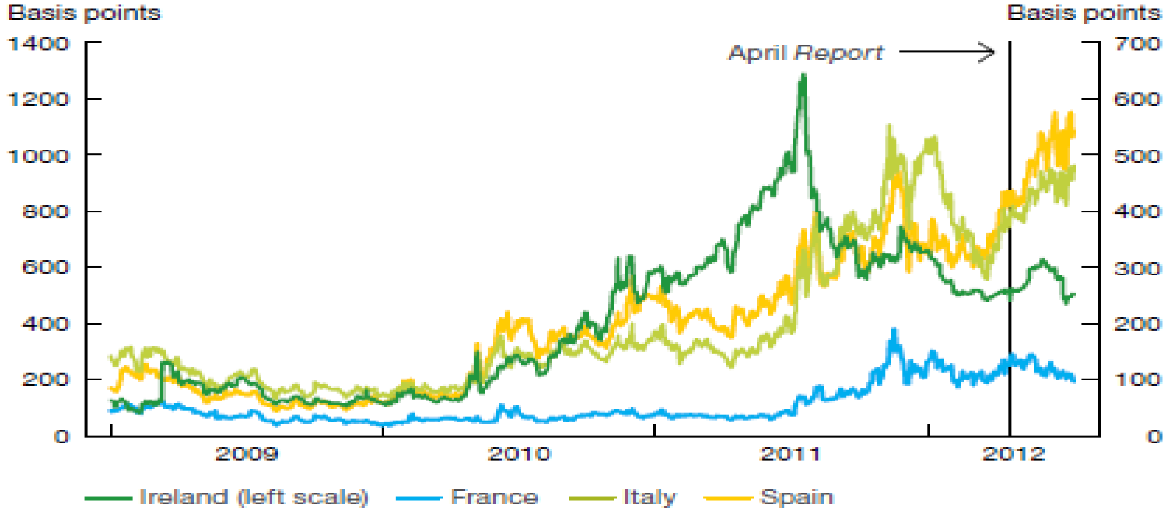
To the surprise of many, China and Japan continued to add substantially to their holdings of US treasuries despite anaemic yields and fiscal problems. The latest Treasury International Capital (TIC) data for May showed a fifth consecutive month of strong foreign buying of US securities as capital continued to judge the US attractive in a sea of global risk. In the spirit of risk aversion, **97% of the $55 billion net foreign inflows into the US dollar made their way into US government bonds, while just $1.4 billion moved into US equities.**

10-year US Treasury bond yields scream 'deflation' for the foreseeable future

In other major economies like Italy and Spain, bond yields soared (shown in below chart) as their saturated bond markets struggled to find enough buyers to finance presently insatiable spending needs.

Chart 2: Yield spreads on Italian and Spanish sovereign bonds are at or near all-time highs

10-year sovereign yield spreads over German bonds, daily data



Note: Owing to data limitations, yields on 9-year sovereign bonds are used for Ireland.
Source: Bloomberg
Last observation: 13 July 2012

US dollar index achieves 84, 88 target remains in tact

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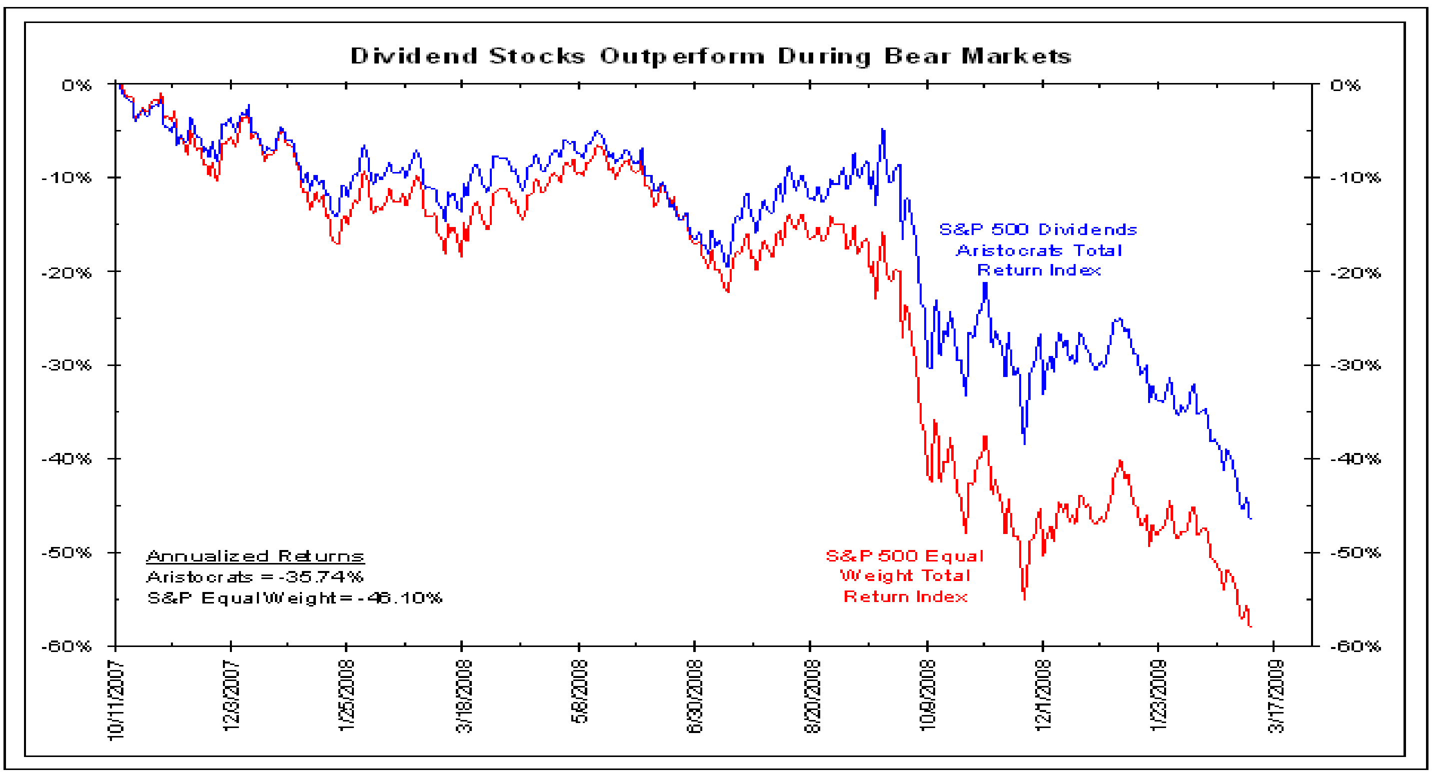
Equities not cheap yet—a little historical perspective

As U.S. Treasury yields dropped to a historic low this month, **it is revealing to note that bond yields during the Great Depression were higher than they are today**. This says something about the ineffectiveness of central bank easing efforts over the past 5 years to offset the massive retrenchment in consumer demand and the magnitude of deflationary forces now working their way across the globe.

As another historical reference, during the last Depression, the S&P 500 was trading at a bargain basement Shiller P/E of less than 5 (versus 21 today), and was yielding 16% (vs. 2.3% today). **Stop and grasp this for a moment: a portfolio of the largest US companies in the 1930's was yielding 16% a year in dividend income alone.** This is one of the reasons we know it utter nonsense today when equity analysts proclaim "incredible value" in US stocks because the 2.3% yield on the S&P 500 exceeds the intentionally supressed 1.45% yield on 10-year Treasuries. **Stocks have historically yielded many percentages more than treasuries—93% of the time!** In finance theory of old, this extra yield was known as the "risk premium": the extra income that stocks had to pay investors in order to entice their capital away from the principle security of interest bearing bonds.

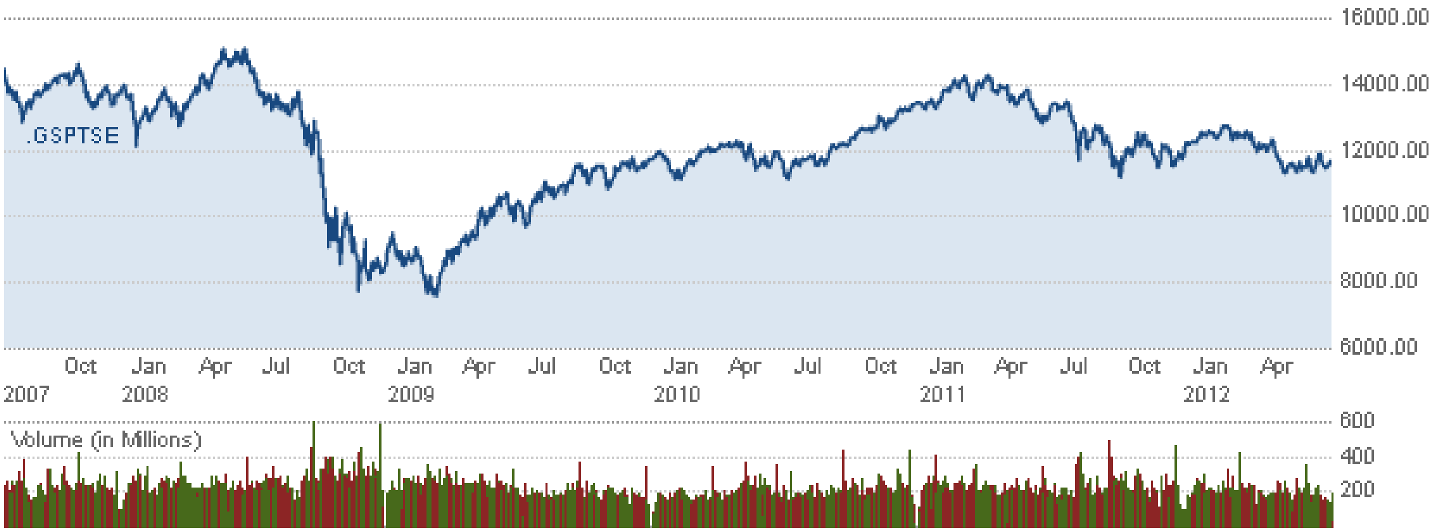
Toppins-like stock yields today reflect an asset class that remains dangerously over-priced. As the chart below of the 2008 bear market reminds us, S&P investors grasping for 2.3% yields are doing so in the face of horrible odds and unreasonable downside risks to their capital.

Lest we forget: dividend paying stocks fell 45% during both the 2001 and 2008 recession and bear markets

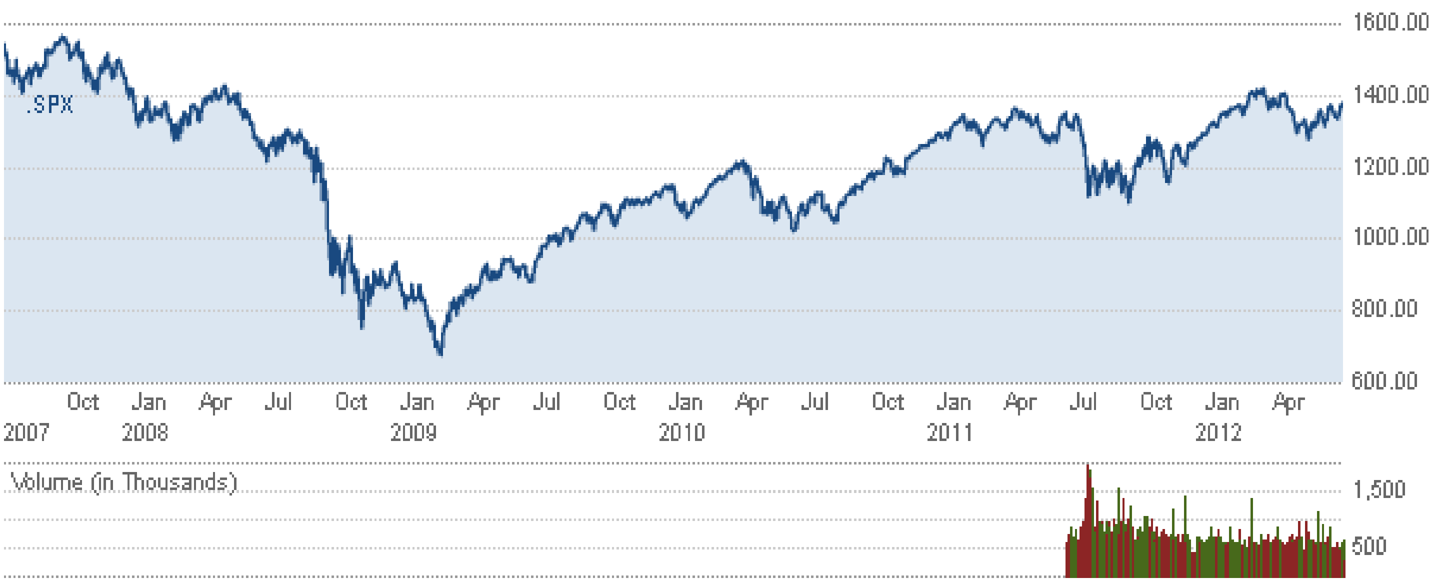


And for those expecting that bear markets stage a slow-moving orderly decline, the below charts of the 2008-09 downturn remind us of the rapidity of stock market declines once denial turns into belief and then panic.

Lest we forget: Canadian stocks (TSX) lost 50% in just 5 months from June 2008 to Nov 2009



Lest we forget: S&P 500 lost 57% in 17 months from October 2007 to Mar 2009



Chinese stocks fell 72% over 12 months Oct 2007 to Oct 2008, peaked July 2009 and fell 38% since

Source: CNBC.com

We continue to watch the slowdown in China with great attention. Chinese manufacturing PMI has contracted every month now since last October. Its stock market continued to fall this month even as other global markets rallied on stimulus hopes. **Importantly, Chinese stocks have led other risk markets like stocks and commodities over the past decade with a lag of 3 to 4 months**.

The fact that the Chinese economy is still weakening and its stock market still searching for a new cyclical bottom warns of further downside risk to global demand, commodities, equities and particularly commodity-centric countries and currencies like Australia, Canada, Russia and Brazil.

Rejoice in August! Summer is on the run.

Quotes of the month:

"If you want to succeed you should strike out on new paths, rather than travel the worn paths of accepted success." --John D. Rockefeller (1839-1937), Industrialist and Philanthropist

"Anyone who keeps the ability to see beauty never grows old." --Franz Kafka (1883-1924), Writer

“There are two times in a man's life when he should not speculate: when he can't afford it, and when he can”.
—Mark Twain (1835 –1910), American author

“Investment bankers believe in what they do. They don’t want to hear that their decisions are no better than chance. The rest of us pay for their delusions.” --Daniel Kahneman (b.1934) psychologist

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