Real life needs active management

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E.Q Trendwatch™

Leaping lizards

"…our lizard brains are pattern-seeking, backward-looking systems that allowed us to forage for food, and repeat successful behaviours. This system helped our ancestors survive and reproduce, but financial markets punish backward looking decisions. Consequently, our lizard brains tend to make us buy at market tops and sell at market bottoms."

—Terry Burnham, *Mean Markets and Lizard Brains* (Wiley) p 6.

We start this month's letter with a true story. Fifteen years ago we were waiting for a late night flight out of the Grand Bahamas' Airport. Departure had been repeatedly delayed due to bad weather and with each hour the mood of passengers dimmed. It was annoying; we wanted to get home. But as every seasoned traveller knows— best to stay in low gear—no good can come of stamping one's feet and demanding that planes perform to our time lines.

Hours past, finally a boarding call was made. Jumping to the head of the line, a heavy-set woman in her 40's thrust the crumpled remnants of a boarding pass at gate security. "Where is the rest of your boarding pass, ma'am?" they asked. "I don't have it— lost it somewhere," she retorted with a dismissive, "what's it to

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you?" air. "Well you will have to go back to check in and request a new one," one of the armed guard's replied. "You must be joking," the woman sneered "you're boarding now, I don't have time to go all the way back to the check in desk." "Sorry, ma'am you will have to get a proper boarding pass."

The woman froze stunned. Gate attendants moved on to process the next hopefuls in line. A few moments later, we noticed the woman approach the gate again. This time much to our surprise, she dove for the entrance tossing a fragmented boarding pass over her shoulder like confetti at a wedding. What happened next was simply slapstick. Two female guards lunged for the runaway, wrestling her to the ground in a flurry of flailing limbs. Suffice to say, the outlaw missed her flight. We last saw her face down on the floor, guards sitting on her back in the scrum of arrest. The rest of us starred gob-smacked as we cued past to our seats on the plane.

Many times over the years, we have recalled this scene and mused: what in the world could that woman been thinking? There was simply no chance she could have achieved her goal of boarding the plane that way. A negative outcome was entirely predictable. Nevertheless, emotions ruled and her 'lizard brain' leapt. She opted to make a run for it against all odds.

Fed up and then what?

We are reminded of this scene whenever we have moments of impatience and frustration about the present investment climate (yes we have those moments too). Over-valuations persist. For the first half of 2012, risk markets around the world fell and those who were in them lost money. Then for 9 weeks stocks bounced in yet another low-volume rally on yet another round of Central Bank easing hopes for September. The back and forth of these swings can feel like water torture if we let it, and most investors and savers are feeling frustrated with low returns. But the question that we must each answer here is what are our options?

We can give up on publicly traded markets altogether and park only in guaranteed bank deposits. We can, but that means locking in interest rates at 100-year lows of less than 2% with no liquidity or rule set for responding when more attractive opportunities present. And we know they will. Another approach would be to stop worrying, stop taking risk measurements, stop trying to protect capital from losses and buy into over-valued markets with blind hope. Most investors and money managers do exactly this; we could too. We could, but we know that the hope-plan does not serve real-life needs and repeatedly ends in tears and losses.

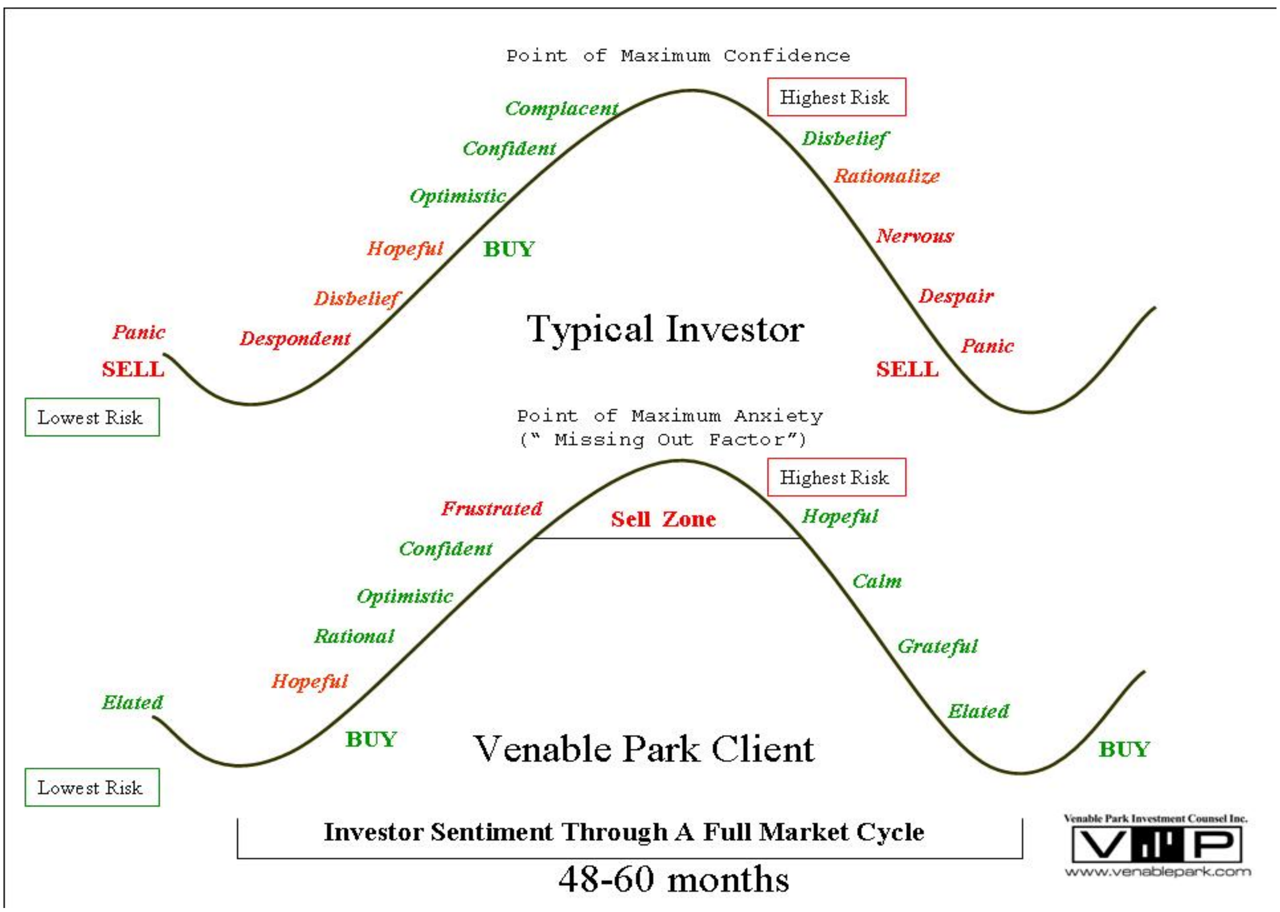
Which brings us to the third option—continue to control our allocation decisions based on disciplined probability assessments, objective rules and on-going analysis.

As money managers, we must accept that this approach brings us career risk at different points in every market cycle. Some clients will decide we are too slow to deploy their capital from time to time and leave us, attracted by hope to other approaches. We do like to please. But since we have to choose—we decided years ago that we would rather lose impatient clients than lose their capital. This is one of VPIC's founding principles and one that has enabled us to garner positive annual and cumulative returns with little volatility through the past 9 years of one of the most dangerous and volatile investment climates in history. It is also the reason that quarter after quarter, shell-shocked clients from other investment firms all over North America, continue to seek us out and move their savings under our management. Apparently, modest returns with less risk are more attractive than negative returns with huge risk. We have to agree.

So we are resolved to keep working to protect the capital and clients under our watch from a world of bad investment advice and self-serving risk-sellers. Given the choices, we see no other rational alternative.

The fact is that none of us can dictate the timing or terms of market cycles. We can only navigate the facts we are given and choose our own risk exposure at each juncture. We cannot force bonds at 100-year lows to pay us more on our fixed income holdings. We cannot order stocks to pay us higher dividend income for the risk of holding them. We cannot demand that central bankers stop meddling in free markets or guarantee the safety of our capital. **All any of us can do is to control our own financial behavior and emotions.**

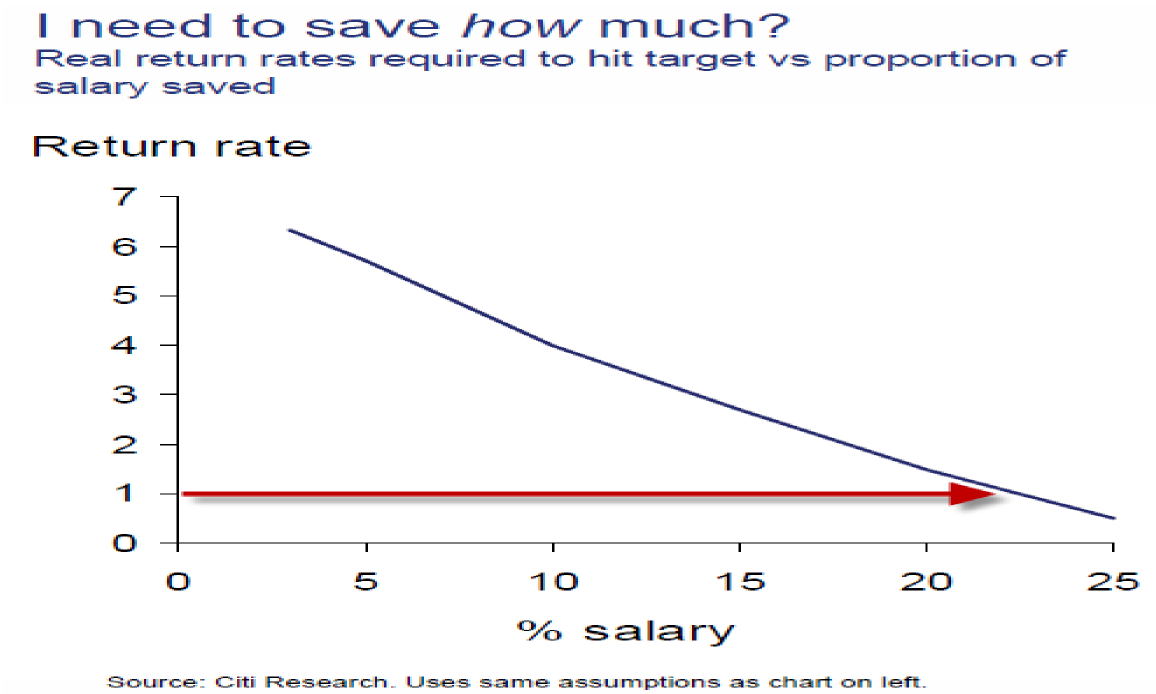
As shown in one of our favorite charts below, **turning the emotional cycle of investing on its head is crucial for lasting success.** The typical investor feels most confident and happy when prices and capital risk are the highest. Those of us who wish to avoid the typical cycle of loss, must continue to do the opposite of this "conventional wisdom". Difficult or not, leaping lizard brains must be tamed.



Present low return conditions are not permanent. But in the meantime, since we cannot predict exactly when this era will end, for now realists must plan to work longer and save more of their income.

Retirees must devise to withdraw less from their savings and, where needed, figure out ways to lower expenses and supplement investment income with other cash flow generating actions.

As shown in the graph below, at 1% interest rates, workers today must save 20%+ of income in order to amass the same nest egg one would have from saving just 5% of income were rates in the more historical 5 to 6% range. This is why savings rates will be quadrupling over the next few years.



It is for this reason that far from stimulating consumption, low rates today are one of the most significant impediments to strong consumer spending. Whether it is workers needing to save multiples more to build nest eggs or retirees receiving less investment income to spend, people the world over are shifting to a more frugal mentality. In the longer run, this will rebuild coffers and be a very healthy trend for future financial stability. In the shorter run the global economy is struggling to recalibrate.

September returns to all things Europe

As European leaders rotated through summer holidays in August, a lack of news from the Eurozone was traded by a few as “good news” for risk markets: the volatility index plunged to 2007 complacency levels, while stocks rallied and bonds sold off for a couple of weeks. September, however, is promising a return to high drama. The following is a list of some of the key dates and decisions coming due over the next month:

- The troika (ECB, IMF and EC) return to Greece to consider whether to release the next rescue tranche. The Greek gov't has said they need to loosen bail out terms. Germany has said no.
- Portugal is set to negotiate for its own second bailout package.
- Auditors are to present a full report on how much money Spain needs to borrow to bail out its banks.
- Depression and civil unrest are building in Italy as a general election campaign gets underway amid the most volatile political climate in 20 years there.
- The new French Gov't is set to reveal its 2013 budget which is likely to disappoint its bond markets with insufficient spending cuts. More credit downgrades will compound already unsustainable borrowing costs.
- Holland (one of the 4 remaining AAA credits in Europe) is seeing dramatically softer economic activity and on Sept 12 is holding a general election that threatens to diminish support for further EU bailouts.
- Germany's constitutional court is to vote on Sept 12 on the legality of the EFSF (European Financial Stability Fund) and the EU fiscal compact. If they declare both entities legal they may do so with constraints and conditions on the funding offered by German politicians for EU "rescues".

By all accounts, German taxpayers are becoming increasingly resistant to perpetual funding of EU member bailouts. This is especially true since slowing Club Med economies (Greece, Italy, Spain and Portugal) are continuing to disappoint with widening budget shortfalls. On August 18, German Finance Minister Wolfgang Schaueble noted, "it is not responsible to throw money into a bottomless pit." Thinking people would have to agree.

Global recession evidence continued to mount in August

Our global economy is closely coupled—there should be no mistake about it. Here are a few key updates.

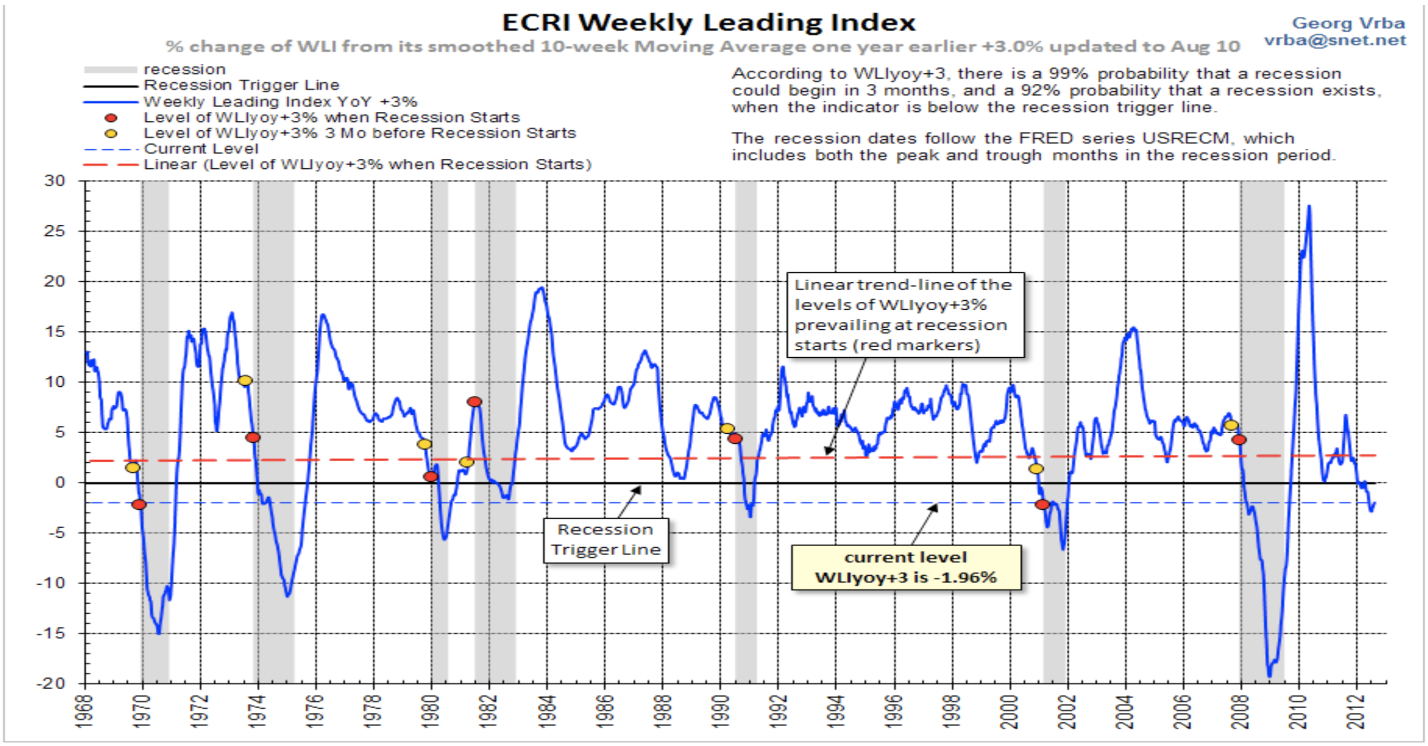
There was only one developed market, Ireland, with a PMI (purchasing managers' index) above the crucial 50 mark, signalling expansion, and rising in July. PMIs were below 50 in 23 countries and still falling in 14 of them including China.

Even the German economy, the jewel of strength in the Eurozone has now registered a year over year decline in industrial production with GDP data likely to confirm a fresh recession over the next 2 months.

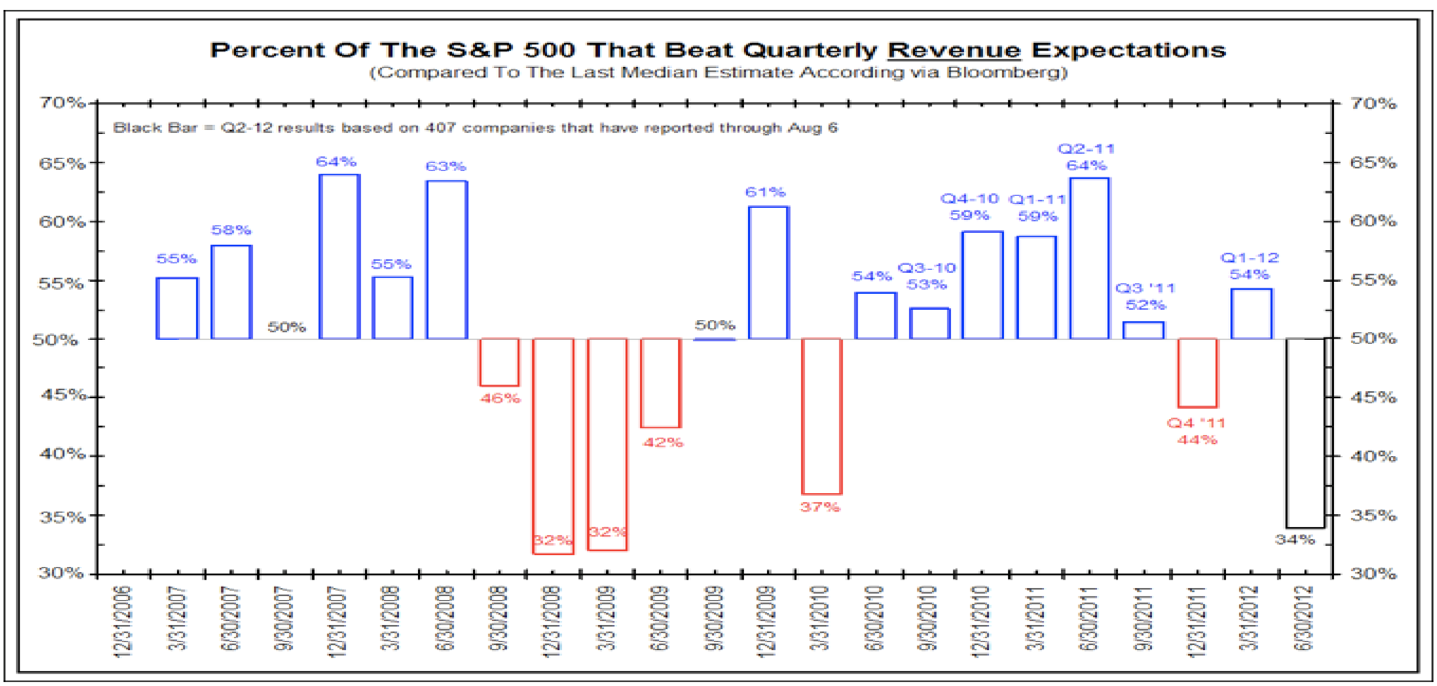
Japan, meanwhile, just reported its largest trade deficit ever (twice as much as the consensus forecast) as Japanese exports to Europe fell 20-30%.

Leading indicators are continuing to signal that America has now entered the 3rd recession since the secular bear began in 2000. One of the main arguments that pundits cite against this call is that US stocks managed a rebound since June. The reality, however, is that monetary liquidity has been so determinant of stock market speculation over the past 2 years that prices have now become more of a coincident indicator to anticipated policy than a leading indicator for the economic cycle. History suggests this too shall end, as monetary policy proves insufficient in itself, to overcome the math of falling corporate revenue along with declining government (tax) revenue and consumer demand.

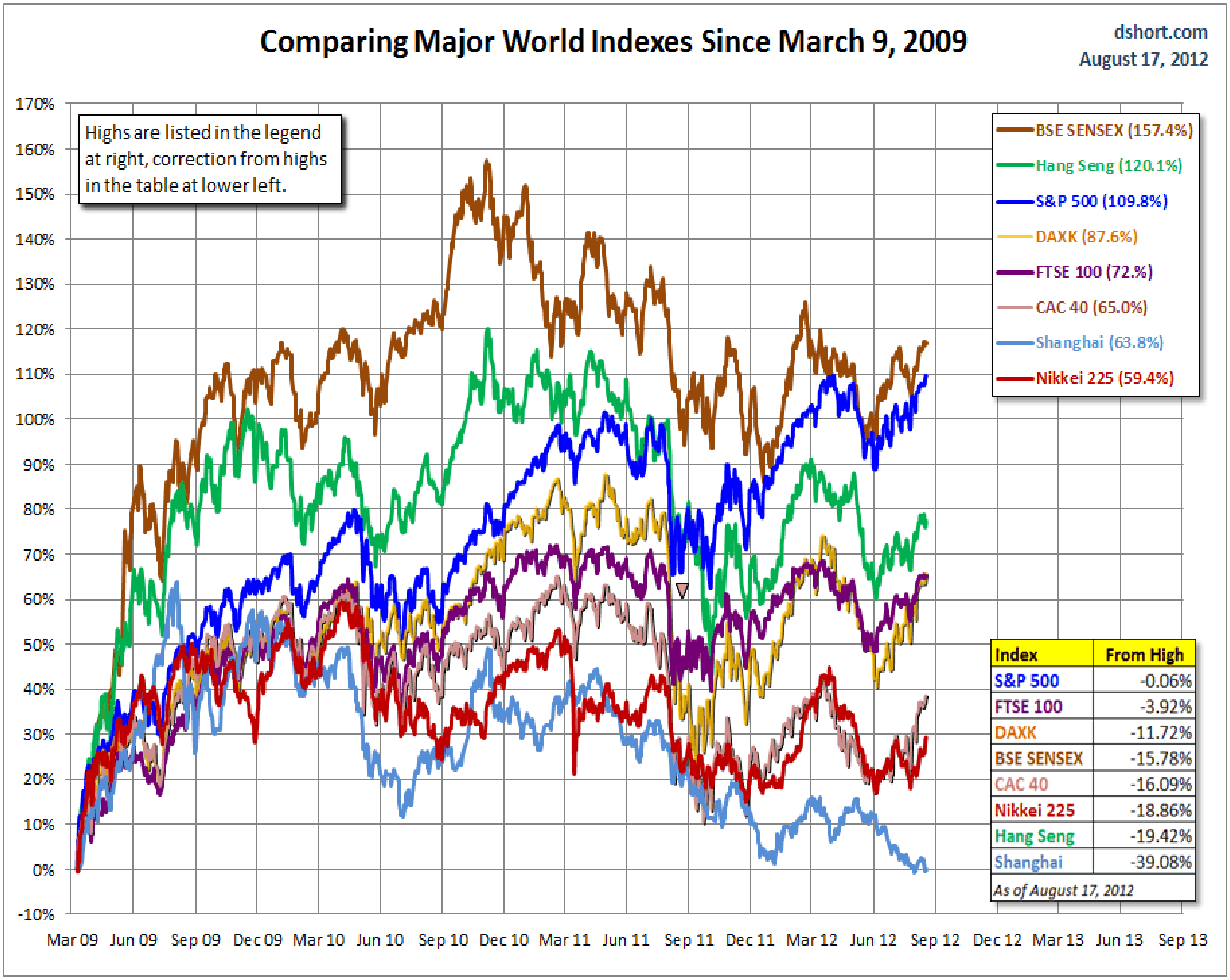
The below chart from the ECRI (Economic Cycle Research Institute) reaffirms a US recession warning based on a basket of key leading indicators to the end of Aug 10.



At the same time, US Corporate revenues declined in Q2 the most since the 2008-09 recession



As shown in the chart below of major global stock indices since March 2009, generally global equity markets have been deflating again since 2010.



Over the past 2 months, US stock indices (S&P in dark blue above) have rebounded on hopes for more Fed stimulus. We believe that 'faith in the Fed' will prove to be even more misplaced this time than it was heading into all the previous recessions and bear markets of the past. For those of us who care about capital risk, it should be noted that **US stocks now boast the highest price to revenue ratio since the tech bubble of the late '90's.**

The end of August is likely to bring the end of low volume and low volatility. Repeated gaming by traders and the coercive influence of Central bankers has always been fleeting. Central bankers and politicians cannot simply print our way to prosperity. At this point, monetary interventions just pass on greater input costs, choking-off the very growth they seek to create. Unfortunately, higher borrowing, food and energy costs on an already over-burdened and never-bailed-out consumer are the opposite of economic stimulus.

This chart of the 10-year treasury yield (cost of debt) clearly shows that rates actually have risen with each monetary intervention from Central bankers. The much-anticipated Bernanke speech from Jackson Hole August 31 resulted in no new QE announcements, and thus re-established a bid for bonds. The US 10 year yield that had retested the upper range of technical resistance of 1.80-1.90 in the middle of the month fell back to 1.60 right after the speech.

10-year US Treasury bond yields still bowing down to the prospects of deflation

The problem at the zero bound in rates, and already record levels of cash liquidity in corporations, is that more liquidity and even lower rates offer no stimulus. As we have seen repeatedly the past few years, after each central bank "easing" the hope for magic recedes to the reality of weakening economic data.

At the same time, the U.S dollar continues in a similar pattern: each announcement of QE reduces the perceived stability of the Greenback and forces speculation into commodity based currencies, such as the Aussie dollar and the Canadian Loonie. But notwithstanding all the hype and hope of daily gyrations, we can track a continued exodus of global capital out of most markets and currencies into a select few. As the most liquid global currency, so far the US dollar continues to receive “safe haven” inflows to the frustration of its critics.

US dollar index weakened a bit this month as the Euro rallied, but uptrend remains, $88 still upside target

Happy September, where has the summer gone?

Quotes of the month: *“The love affair with stocks had to come to a hideous and grinding denouement. 20 years of good vibrations requires almost as many of despondency and apathy for the flames of lust to be extinguished. This is how it always goes. This is what sets us up for the next bull market, the one that makes those of us who have stuck it out rich. We’re not there yet, but we are getting very close. Perhaps not on valuation, as central banks and governments still have too much invested to let it clear. But certainly on sentiment. Apathy is morphing into disgust, the longer this continues the better. Because hatred and a public perception of endless futility brings about opportunity.*

—Joshua Brown, author of The reformed broker.com, August 7, 2012

"Boomers can't take risk. Gen X and Y believe in Facebook but not its stock. Gen Z has no money."

--Bill Gross, PIMCO CIO, August 2012

"A cynic is a coward. Cynicism always takes the easy way out. It is a form of laziness that provides someone with an excuse for not making any attempt to change the world."

–Michael Crawley, British ecologist

"Those who are lifting the world upward and onward are those who encourage more than criticize."

--Elizabeth Harrison, 1849-1927, Educator

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