Real life needs active management

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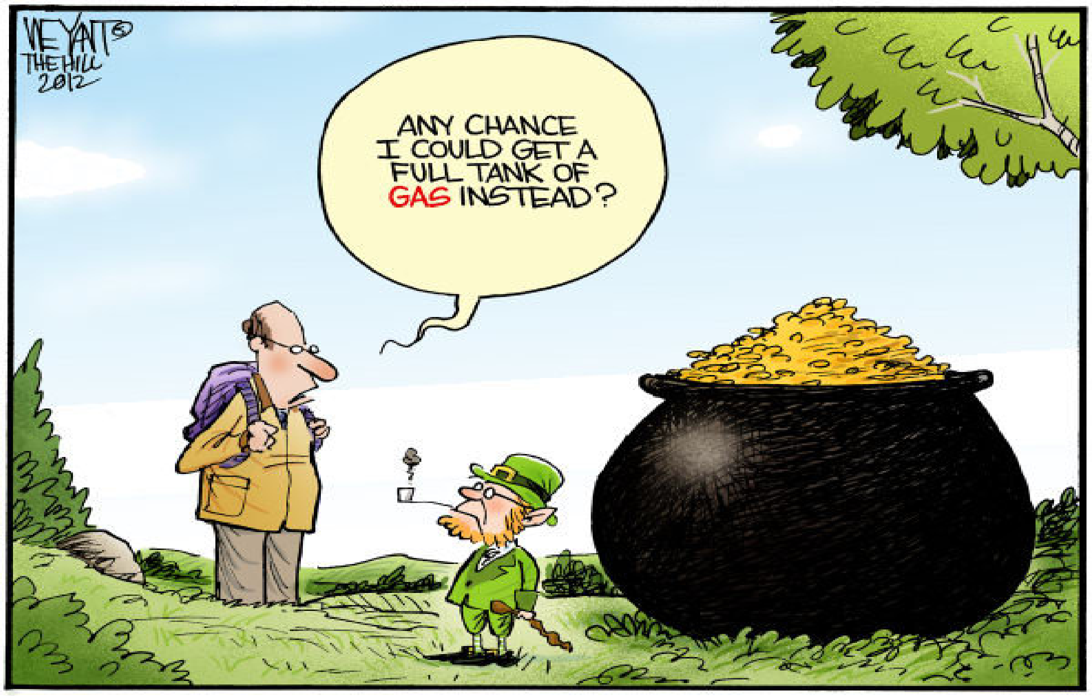
E.Q Trendwatch™

Reality strikes back



"I don't get paid to be an optimist. I don't get paid to be a pessimist. I get paid to be a realist – and a prudent fiduciary of the capital…"
--Kyle Bass, manager, Hayman Capital

In the fall of 2011 Danielle was speaking at a conference in Toronto and a familiar face approached after the speech. It was a man who had done plumbing work for us a few times over the years. He said he enjoyed the speech but wondered why we weren't more bullish on gold and silver: "I'm putting everything I have into precious metals," he said, "I'm also thinking of going to work in sales for Sprott Precious Metals funds." This struck us as a pretty radical departure from plumbing, and following 11 years of upward price movement in gold, the old adage 'don't quit your day job' came to mind. We kindly suggested he be careful not to assume indefinite up cycles in asset markets—especially precious metals—as they have a history of long secular price swings up and down. This gentle suggestion appeared to upset our plumber and we recognized that he was heavily invested in passionate beliefs. We wished him well and said our goodbyes.

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About the same time, several blog readers who were fully committed to silver contacted us. One man had mortgaged his home to buy physical silver that had run up to a paper value of $2 million. At age 55, he had no other savings, but if he sold his wager then, he would be able to pay off his debts and bank a million dollars. Another was holding shares of two junior silver companies that had run up to a value of $10,000,000 between 2008 and 2011. Both had quit their jobs because they now considered themselves full time “investors”. In both cases, when we asked them why they had not cashed out such rapid gains, each explained that they had not sold because they were sure that before long, the 2 million would become 4, the 10 million—15. When we asked what their plan was if prices began dropping—neither had one. The thought was simply too improbable in their view to even consider. We could write a book full of such stories.

Two years ago the consensus was near unanimous in recommending an investment over-weight in the commodities and mining sectors. Since then the price of gold fell 22% (so far), the price of silver by more than 50%. Most mining companies have fared much worse, losing an average of 60-80% of their market value. We are saddened to think of the real life suffering these predictable losses have caused many. Recently, we have been asked to review the account statements of people at other investment firms who have lost more than half of their life savings over the past two years (again). We are reminded of very similar situations witnessed following the market crash of 2008 and the tech wreck years of 2000-2003.

In our experience, once a person has gone to the “dark side” on a financial speculation there is very little probability of changing their mind. “A man convinced against his will is of the same opinion still,” is a timeless truism a mentor once told us. The lesson for all of us to remember is that we human beings are highly susceptible to the slippery slope of speculation and capital-destruction—often repeatedly. No one is necessarily immune, and therefore we must commit to constant care and objective discipline, using defined investment rules maintained through a lifetime.

Economic reality hit hard this month

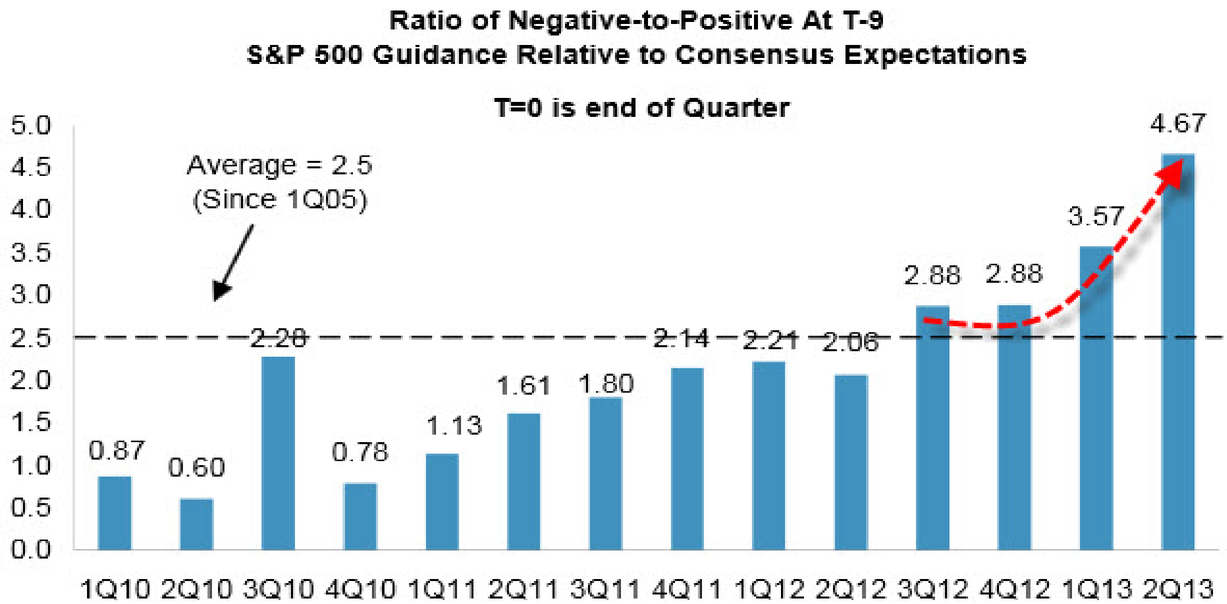
> *“The US economic data are getting softer by the day. The Richmond Fed survey was truly awful. The manufacturing index swung from +3 in March to -6 in April, the first negative reading in three months and the weakness was broadly based. New orders went from -4 to -8. Backlogs eroded to -21 from -14. While jobs fell to +3 from +9…Capital spending intentions for the coming six months were sliced from +17 to +8. Hiring plans fell to a three-month low of 0 from +16 in March…”*
>
> --Economist, David Rosenberg, April 24, 2013

The most followed data releases came in below consensus in April, dashing theoretical hopes that strength in the US stock market would translate into economic recovery. Since the third week of March some 70% of economic indicators have come in below consensus expectations. US Conference Board leading indicators declined, while coincident indicators fell at an annualized rate of 3% over the past 3 months. Such a move has historically always been consistent with a US recession. Plunging commodity prices and bond yields have also been corroborating recessionary readings, forcing margin calls and losses on to those who had been banking on a continued disconnect between economic reality and asset prices. The below chart captures this plummet in US macro economic indicators and the glaring overshoot and then wobble in US stock prices over the past two months as Central Bank faith fades some more. **So far, the S&P seems to be saying that this time is different, and economic weakness doesn't matter to stock prices.**

Source: Zerohedge

Apparently a high number of earnings disappointments are irrelevant this time too. We note that the market had a similar misconception in 2006-2007 (first red box below) just before prices collapsed**.**

Corporate revenues have also weakened dramatically over the past year with just 38% of S&P 500 companies beating revenue expectations to date in the first quarter compared with an historic average of 60%. Looking forward, large US companies were also unusually pessimistic in their guidance, with 4.67 negative announcements for each positive surprise—a cycle high –shown below.

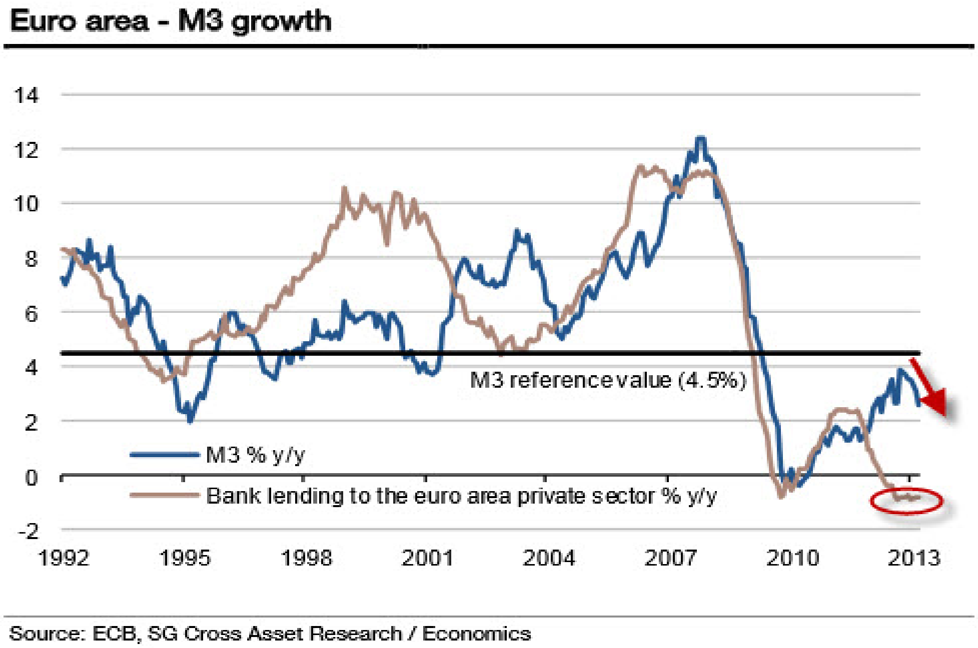


The fiscal issues confronting the world are pretty consistent: slowing global growth is putting a fresh wave of downward pressure on corporate sales and employment levels. As revenues decline, more cost cutting and layoffs are required in an effort to maintain profit margins and earnings. Cost cutting by corporations and governments at the same time that consumers are focused on debt reduction and increased savings, is a formidable antidote to near term growth prospects.

Simultaneously, outstanding commercial loans fell for many large and small US banks in the first quarter of 2013 as business owners became even more reluctant to borrow. This trend is just one more in the host of other data throwing doubt on economic strength this year.

While the Eurozone continues to sink further into economic contraction in 2013, some have declared this good news, because it may prompt the European Central Bank to cut its lending rates again from .75 to .50%. But as shown in the chart below of the Euro area money supply, emergency low rates over the past 5 years have not been successful in reviving either loan demand or the movement of money through the real economy. Just like in the US, 5 years of incredibly slack monetary policy have had no visible multiplier effect.

Emergency low rates in the Euro area for the past 5 years have not fuelled demand for credit



The International Monetary Fund joined other bodies like the Bank of Canada this month in lowering its global growth forecast to 3.3% in 2013 (compared with a cycle peak above 5% in 2007).

Even countries previously considered bastions of strength, like Germany and China, reported weak and contracting data in April. As an example, German car sales fell 12.9% over the first quarter compared with 2012.

While North American car makers continue to stuff inventory onto bloated dealership lots, customers are now being offered previously unimaginable loan terms in an effort to book sales.

As we have seen in other efforts to force near-term consumption, it really only serves to bring forward demand from the future. In other words, those who buy cars today on 8-year loans will not be likely to buy another car for many years.

Historically, car companies have sought to keep loan terms at 3 to 4 years max, for precisely this reason. "E-Z Terms" will mean even lower sales going forward.

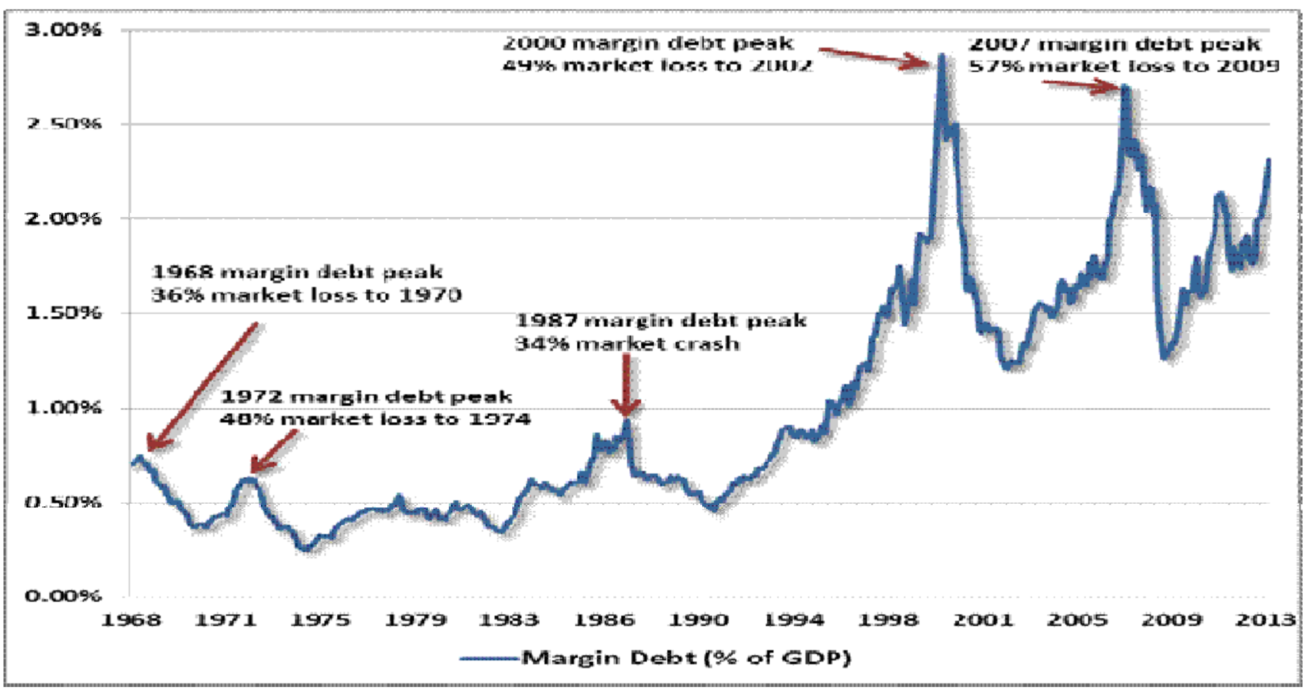
We are living in some pretty extraordinary times

Last week we learned the first read on US first quarter GDP came in below expectations at just 2.5%. Stripping out an inventory build the result was an even weaker 1.5% annualized following the .4% recorded in Q4 2012. The first quarter of 2013 is now the fourth year in a row where US economic data has started the year on a weakening trend. Today we learned that a key indicator of manufacturing in the US, the Chicago PMI, contracted in April for the first time since the recession of 2009. What is worse this year than the past four however, is that the other engines of the world economy like China, Europe and Japan are also slowing and recessing. This leaves the world economy in 2013 the most vulnerable since 2008.

Perpetually optimistic, a record 74% of Wall Street strategists say they are bullish on equities today. Prices will need to move significantly lower before the remaining 26% value skeptics, are willing to buy assets off the jubilant 74%. On the flip side, the most recent Barron's Big Money Poll cites a whopping 89% of portfolio managers as bearish on US Treasuries. From a contrarian perspective, such extreme stats encourage us since wide consensus at cycle turning points is infamously wrong.

Below is shown a reflection of animal spirits—NYSE margin debt is now above 2.3% of US GDP. This is the highest level in history after the 2000 and 2007 market peaks. Peak margin exposure always serves to magnify market downturns when levered traders will be forced to rush for all too narrow exits all at the same time.

NYSE Margin debt as a percentage of US GDP



Source: Hussman Funds

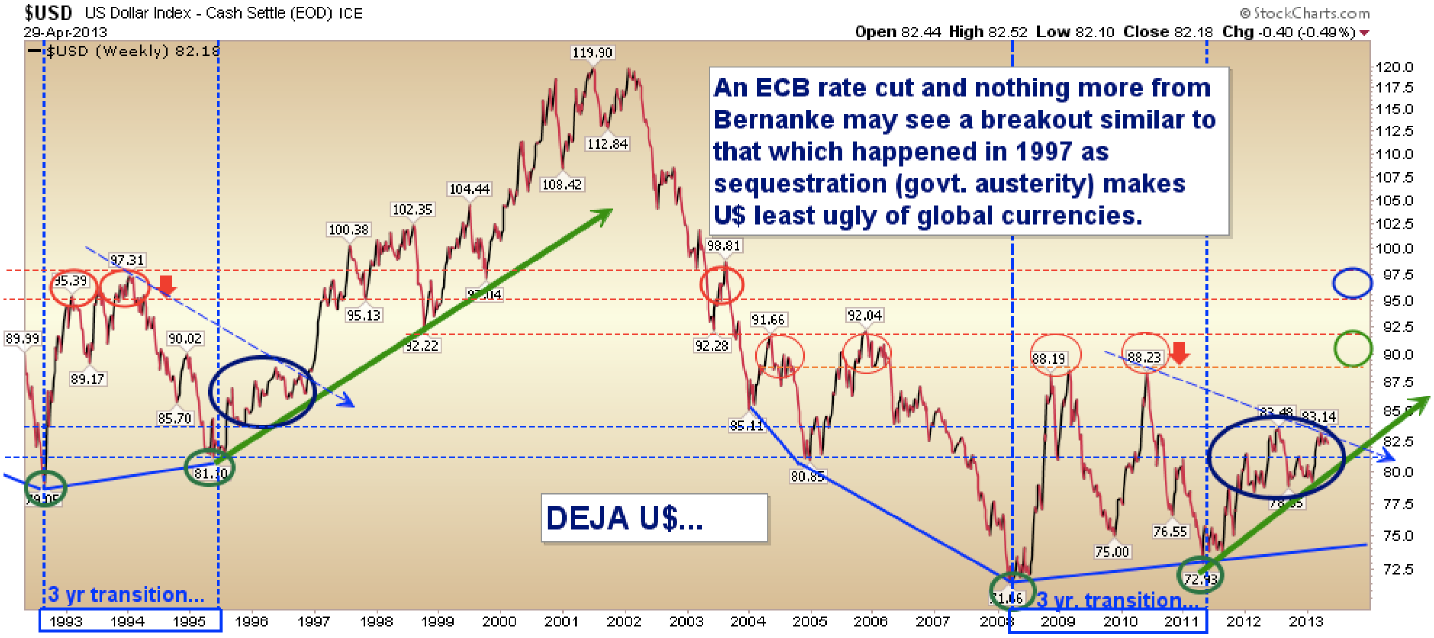
The below chart of the Canadian Venture Stock Exchange offers an overview of the price action experienced since the secular boom period in commodities, materials and mining began in 2000, crashed in 2008, rebounded to 2011 and crashed again over the past 2 years. As you look at this chart keep in mind that the vast majority of market commentators and advisers have been recommending a concentration in the commodities and mining space since 2006. Ouch, indeed. While stock prices in this area are no doubt working on a bottom, a further correction below support is still possible ahead as late cycle buyers and levered traders are finally flushed out. This will no doubt leave some attractive investment opportunities for those of us who are disciplined to buy when prices are low.

Late cycle leaders in the materials, energy and commodities space have been officially crushed

A strengthening U$ dollar has been the other key factor harming commodity prices

There are few places that nervous capital can seek refuge today. As the largest, deepest currency market in the world, the US dollar continued to see large inflows as the Euro, the British Pound and the Yen all weakened this month. We expect that this trend will continue for some time and continue to present headwinds for US $ translated corporate sales and earnings, US exports (GDP) and, of course, commodities.

US dollar continues uptrend: 88 still potential upside test



The Canadian dollar 2008-2013: still weakening with the Euro, the Yen and the Pound Sterling

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US 10 year Treasury yield 2010-2013: bonds still have a global bid (meaning higher prices, lower yields)

The truth about "high-income funds" and products

As interest rates and dividend yields have plunged over the past 5 years, we have advised that retirees not wanting to erode their principal should reduce annual withdrawals to no more than 3% per year. Periodically we have lost clients or prospective clients to other firms and companies who are promising higher levels of income. We call them 'dial-risk-for-income' advisors: *"what level of income would you like to take from your savings sir? 7-10%? No problem! We will simply allocate more of your capital to riskier markets, and you can take whatever income level you need. Happy to help, our pleasure."*

Those desperate for more income than their capital can safely provide, have been drawn to "high income funds" touted by the broker/dealer/mutual fund sellers as yielding 7 to 10% a year. "Hybrid" and "Structured" Products" have been widely marketed. Since we don't believe in fairies, we reviewed the prospectus and components of such products and confirmed that the funds and financial advisors making such promises have been sending out above-market distributions by returning chunks of the investor's own capital and calling it income.

This month we were encouraged when the Globe's John Heinzl ripped the lid off of the BMO Monthly High Income fund and others in the 'high income class' revealing the truth behind their fees, spin and empty promises. We have to admit it was gratifying to read "Beware of funds that pay out more than they make":

"Back in October, 2011, I wrote about the BMO Monthly Income Fund. At the time, the fund was priced at $7.57, and the distribution was 6 cents a month, or 72 cents annually. The annual "yield" – and I'm putting that word in quotations for a reason – was therefore 0.72 divided by 7.57, or about 9.5 per cent.

Wow! Sounds pretty good, right? No wonder Canadians have more than $4-billion parked in the fund. But let's look at what has happened since…

Turns out the fund wasn't actually making anything close to 9.5 per cent. Over the previous three years it had posted a total return – from dividends, interest and capital gains – of just 3.1 per cent after fees. How did it make up the difference? By giving investors their own money back.

When a fund distributes more than it makes, the unit price – or net asset value (NAV) – declines. As recently as 2007, BMO Monthly Income Fund's NAV was more than $10. As of March 26, 2013, it had tumbled to $7.19. So, while investors were collecting those hefty distributions, their capital in the fund was gradually being eroded.

What's more, because of the falling NAV, the distribution rate has continued to climb. It is now more than 10 per cent. There is simply no way the fund – which has about 53 per cent of its assets in stocks and the rest in bonds and cash – can generate that sort of return consistently. Given the meagre returns of bonds, the fund's equities would have to shoot the lights out year after year."

So after eroding some 29% of capital value over the past 5 years, (falling from $10 a unit to $7.13), BMO finally issued a notice to unit holders on March 11 stating that it will now be slashing distribution levels by 60% to 4.2% a year. But even this dramatically reduced level is still higher than actual income earned and will need to see stocks average solid capital gains going forward in order to achieve the level of promised distributions. This has been yet another rude awakening for those who are buying the hope and hype of above-market income levels. The bottom line is that there is no magic solution to today's low-income environment. Risk-sellers cannot put us in different stock or bond markets for above-average returns. They can only put capital in harm's way in the face of extremely unfavourable odds, and hope for an unlikely best. And those who buy such promises are near certain to pay for the experience with large chunks of their own capital.

The good news is that math and common sense will always count in the end. No matter how some may try to contort or ignore the truth: reality always strikes back eventually. The trick is to never lose our heads, to know what value looks like, and to insist on getting some before we part with our hard-saved capital.

For those who may have missed it this month, we highly recommend the Frontline expose documentary on the financial advice sector called, **The Retirement Gamble**. You will find a video link and some of our comments on the piece here on the blog: http://jugglingdynamite.com/2013/04/24/the-retirement-gamble/ as well as the CBC piece **"The Monarchs of Money"** which you can also watch on the blog here: http://jugglingdynamite.com/2013/04/30/more-on-the-monarchs-of-money/.

Bring on the May flowers! Quotes of the month:

"With fame I become more and more stupid, which of course is a very common phenomenon".
--Albert Einstein (1879 - 1955)

"A sense of humour is needed armour. Joy in one's heart and some laughter on one's lips is a sign that the person down deep has a pretty good grasp of life." –Hugh Sidey (1927-2005) Journalist

"When I was a boy and I would see scary things in the news, my mother would say to me, 'Look for the helpers. You will always find people who are helping.'"—Fred Rogers (1928-2003) Educator, Minister, Songwriter, Author and Television Host

"Efforts by the U.S. Federal Reserve and other central banks to jump-start demand have failed. Each new dollar or Yuan added to the economy is having less and less of a stimulus effect and is instead further inflating asset and consumer credit bubbles. As China's economy continues to slow, commodity prices will decline further, and it's possible that China will even slip into a recession." --Jim Grant, April 19, 2013

"They chose those two animals to represent the stock market because your broker will feed you all the bull you can bear."

Don't forget to visit our market blog www.jugglingdynamite.com for daily commentary, articles and media clips.