Real life needs active management

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E.Q Trendwatch™

False prophets

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"For my own part I did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the S.I.V.'s — I didn't see any of that coming until it happened."
--Janet Yellen, FOMC Vice Chair and frontrunner to replace Bernanke in 2014

Over the past three years the world has lived through an epic era of misplaced faith and confidence in Central Banks. There is no question—this period is one for the history books. The mania generated has been reminiscent of the dot-com hype of 2000 and the housing and credit bubble of 2006. Historically such euphoric phases have always bred indeterminate momentum of their own until suddenly, reality dawns and over-inflated prices collapse on participants.

Rather than recognize and hedge themselves against downside in the economy and over-exuberant asset markets, participants have been preoccupied with nonsense like who will head the Federal open market committee (FOMC) when Bernanke comes to the end of his term in January. Odds now favor current Vice-chair, Janet Yellen, who has served on the FOMC since 1994, under Bernanke and Alan

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Greenspan. Unfortunately for the real world, a shuffle in Fed leadership among like-minded maestros is effectively no change at all. All of the candidates have just one policy idea: credit expansion. And this has already been the go-to solution for more than 30 years. <u>More importantly, none of the learned members have ever seen a recession or bear market coming.</u> Not one—a deficiency famously noted by Queen Elizabeth in 2008 when she posed the question to financial leaders: "The problems were horrible and huge. Why did none of you see this crisis coming?"

Foresight deficits however, are not something for which most financial gurus wax apologetic. A point exemplified by the highly esteemed Ms. Yellen in her 2010 testimony to Congress (quoted at the outset of this month's letter) when she listed key precursors to the 2008 financial crisis and then added: "I didn't see any of that coming until it happened." Ms. Yellen is now to be rewarded for her prescience with promotion to the top policy job overseeing the largest economy in the world.

The monetary theory that more credit expansion is always best has truly run to extremity over the past 3 years of "quantitative easing". In the most recent weekly data, the Fed's balance sheet rose to a record $3.646 trillion—an increase of *$61 billion in the week*, and $813 billion--30% rise--over the past year. What has traditionally been a short-term, liquid balance sheet, has now become a longer-skewed, interest sensitive portfolio susceptible to significant capital loss as interest rates rise.

<u>Moreover Central Banks around the world now find themselves amid the next global downturn with less stability, liquidity and policy room to ease than at any other time in history.</u>

Business cycle review as we enter the final quarter of 2013

Six months ago in our March letter we included the below table comparing relevant economic data from the peak of the last business cycle in the fall of 2007 with the same readings as at the end of March 2013 and observed:

> *"In theory, the stock market is a leading indicator of the economic cycle. As we survey the following chart of historical comparisons between the 2007 and 2013 market cycle peaks we must ponder: do today's economic readings suggest financial healing and rebirth after the crisis of 2008? It is now widely acknowledged that US stocks were over-valued in the tech bubble in 2000 and the credit bubble in 2007, so can we rationalize the rapid resurgence of US markets to similar levels over the past 4 years? Let's look at some facts."*

We thought it might be instructive to update this same table now for our readers and we include it below with a third column added as of this month showing the latest data available for each.

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Indicator	October 2007	March 2013	Aug 2013
Dow Jones Index	14,165	14,500	**14,824**
TSX Composite	15,000	12,700	**12,607**
TSX Venture	3,192	1,100	**938**
Gas price/gallon	$ 2.75	$ 3.73	**$ 3.54**
US GDP growth annualized (yoy)	2.0	1.6	**1.63**
Cdn GDP growth annualized (yoy)	2.7	1.9	**1.40**
Cdn $ to US $ (FXC)	1.11	.98	**.94**
World GDP growth annualized (yoy)	4.0	2.5	**2.5**
Chinese GDP growth annualized (yoy)	14.2	7.5	**7.5**
American unemployed	6.7 million	13.2 million	**11.5 million**
Americans on food stamps	26.9 million	47.7 million	**47 million**
Size of Fed balance sheet	.8 trillion	3.01 trillion	**3.646 trillion**
US Fed debt/GDP	-38%	74.2%	**72%**
US deficit (LTM)	-97 billion	-975.6 billion	**-744 billion**
Cdn Fed surplus/deficit	10 billion	-25 billion	**-26 billion**
US household debt	13.5 trillion	12.87 trillion	**12.9 trillion**
Cdn Household debt	1.1 trillion	1.67 trillion	**1.77 trillion**
US Consumer confidence	99.5	69.6	**82**

What stands out from this table is that with all of the news and market noise of the past 6 months, so little has been accomplished in terms of price improvement or economic healing. In the most important indicators such as economic growth and debt, trends have weakened since March and remain still significantly worse than the prior cycle peak in 2007.

<u>Most important for investors, after 6 years of wild gyrations, North American stock markets have remained stagnant to negative, stuck in a range of inflated, unattractive valuations, low dividend yields and untenably high risk to capital invested.</u>

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Macro US economic indicators and interest sensitive sectors have been falling in sympathy with the weak global economy this year (yellow and red below) while the S&P 500 levitated in a world of its own June and July, before turning down again this month.

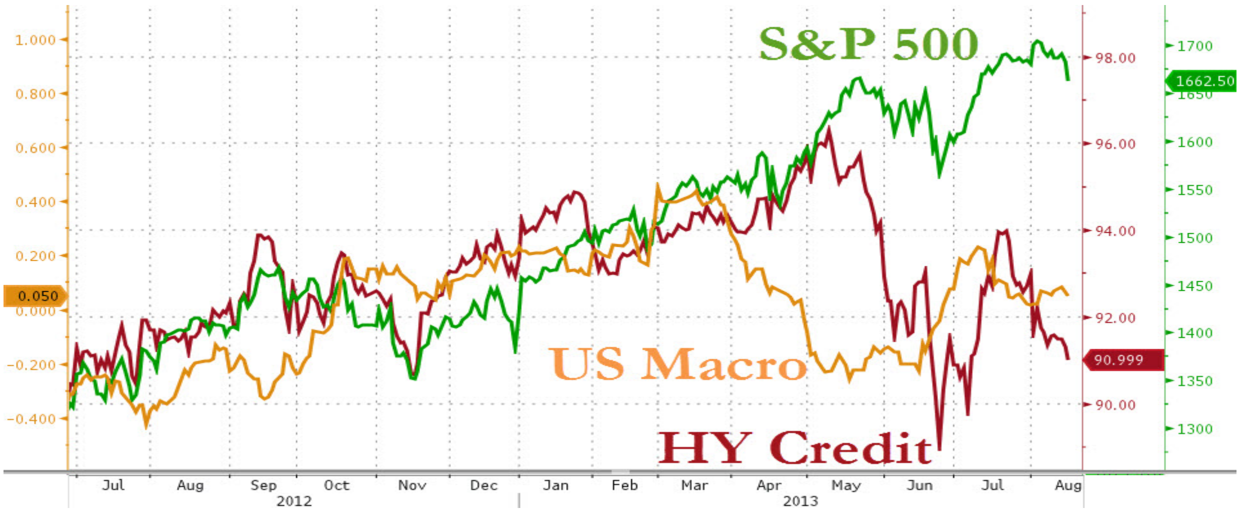

Chart: zerohedge.com Aug 15 2013

US stocks the odd one out (top blue line below) plotted against MSCI Emerging markets index, MSCI Latin America, Asia Pacific and Eastern Europe stock indices since 2010

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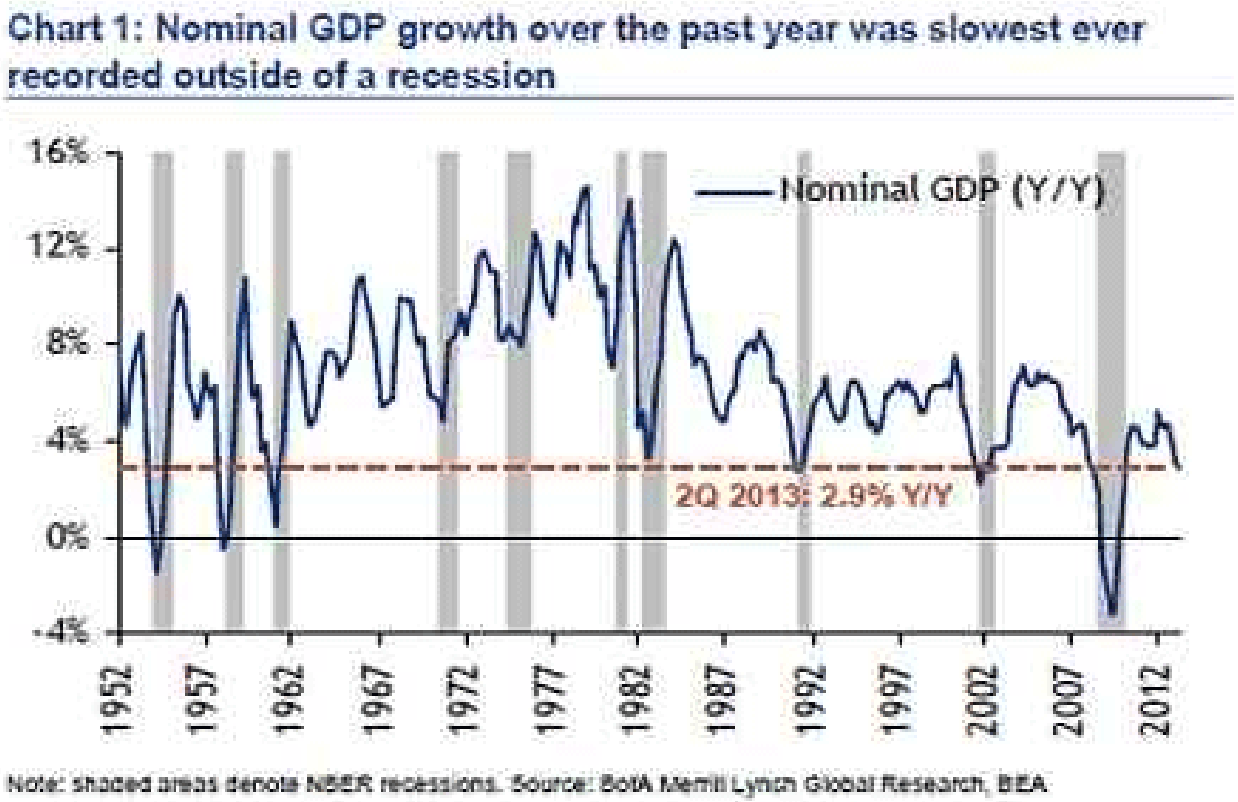
US nominal GDP (before inflation) slowed to 2.9% in Q2, below the stall speed of 3.7% that has always been indicative of recession in the past –charted below since 1952



Stagnating GDP has also reflected in falling corporate revenues, as a host of companies have lowered sales forecasts quarter after quarter.

For a while, earnings (revenue after expenses) were able to decouple from the downturn in sales and continue to impress with profit margins on S&P 500 companies averaging a record 9.3% (courtesy of low wages, low investment and low effective tax rates)—nearly 40% above the low term average of about 5.9%. But over the last 9 months, with accounting tricks exhausted, earnings growth has reversed. With more than 90% of companies now reported, 2nd quarter earnings growth year over year came in at 2.2%, down from a 3.4% growth trend in Q2 and 5.6% in Q4 of 2012.

In the third quarter of 2013, earnings growth (ex-financials) is now negative at -1.3% for S&P 500 companies, while QE-hyped-leverage and debt financed buy-backs compelled US stocks to all-time-highs. As shown in the chart below, as a broader indicator, there have only ever been three times in history when the Wilshire 5000 stock index has achieved a market cap above 100% of nominal US GDP: **2000, 2007 and now in 2013.**

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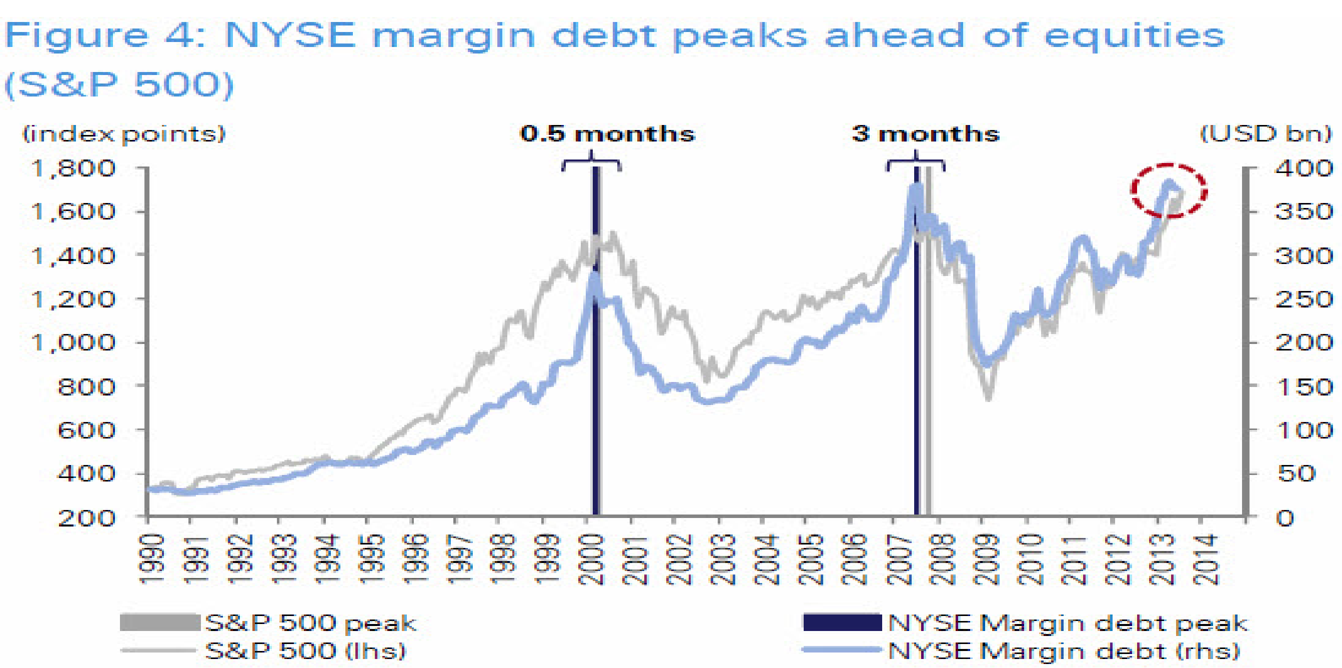
A broad stock barometer 1970-2013: Wilshire 5000 stock index divided by nominal US GDP now above 100%

In addition, **April NYSE Margin debt rose to the highest level since records began being kept in the 1950's** as shown in this next chart. <u>It is noteworthy that in 2000 and 2007, the stock market peak occurred within 3 months of this market debt level.</u> (Chart source: Deutsche Bank)



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Moreover, an exponential surge in month over month margin use preceded the final speculative top of each of the 2000 and 2007 market peaks within 6 and 7 months. Most recently this exponential margin surge occurred 7 months ago in January 2013.

False profits prove fleeting

Ultra-loose monetary policy extrapolated ad infinitum led to a rapid rise in some stock and bond markets into May of this year, before mounting a dramatic reversal. In the month of August alone, the S&P 500 lost 4.6%-- 3 months of prior gains evaporated in 1.

The effect on interest rates has been even more significant. At the start of May when the US Fed began talking about the need to taper its bond buying, the U.S. government could borrow money for 10 years at 1.6%. Today they must pay above 2.75%-- a carrying cost increase of nearly 72% in less than four months.

Some have argued that an increase of 1 or 1.5% in interest costs is not significant since interest rates are still relatively low on a historical basis. Unfortunately this understates the dramatic effects felt when rates are moving off the lowest base in 100 years.

Since consumer debt is priced off the same yield curve, the cost to disposable income in just the increases to date have already been huge. The interest cost of buying a home with a 30-year fixed mortgage in the US has increased by 40% since last year. At the start of May, someone buying a new home with a $200,000 mortgage was locking in monthly interest costs of $566. Today, someone seeking to make the same purchase will have to pay $792 a month in interest.

A company with a BAA credit rating has seen its bond rates spike from 3% to 4% over the same period, and a riskier company with a BA rating jumped from 3.9% to 5.2%.

This surge in borrowing costs comes as economies are more in debt than at any time in history. It's not just government debt and mortgages that are higher; other consumer credit including US student debt is up to $2.8 trillion as compared with 'just' $2.5 trillion in 2007, while U.S. businesses owe $12.9 trillion — compared with $11 trillion in 2007.

Sudden spikes in interest rates have traditionally proven negative for borrowers, bonds and realty prices—but also for stock markets –a fact that is rarely mentioned. The infamous stock market crash of 1987 followed a 45% surge in bond rates over the months leading up to October that year. We can compare this with the 80% hike witnessed between May and August of this year.

> *…We are not talking about the potential for a modest 20% to 30% drawdown in the S&P 500. If history is any indication, we are talking about the potential for a 50%+ peak-to-trough drawdown and ten-year average annual returns as bad as-4.4%."[for those buying and holding now]* --John Mauldin, Aug 3/13

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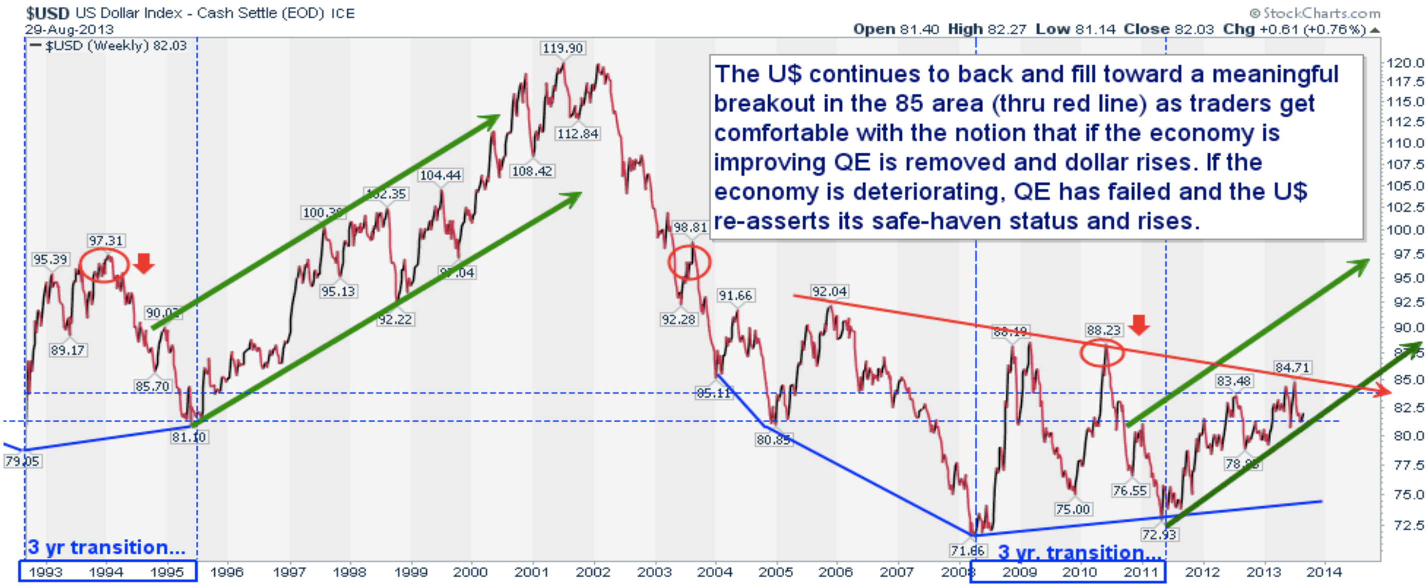
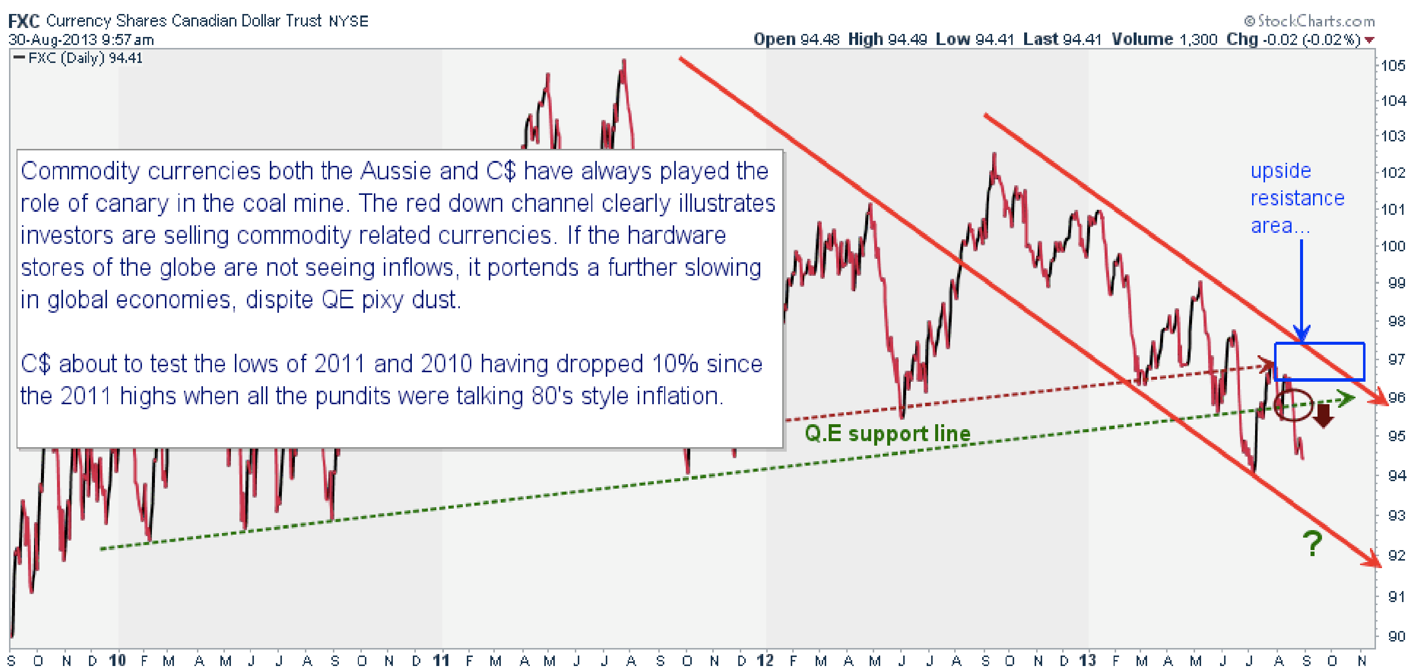
A strengthening US dollar is continuing to compress US corporate earnings as well as commodity prices

The US dollar continued to see large inflows as virtually all other global currencies weakened this month. We expect this trend may continue to present headwinds for US $ translated corporate sales and earnings, US exports (GDP) and of course, precious metals and commodities.

US dollar index still climbing: next breakout test $85



The Canadian dollar 2009-2013: now below QE support down 10% since 2011 and still falling



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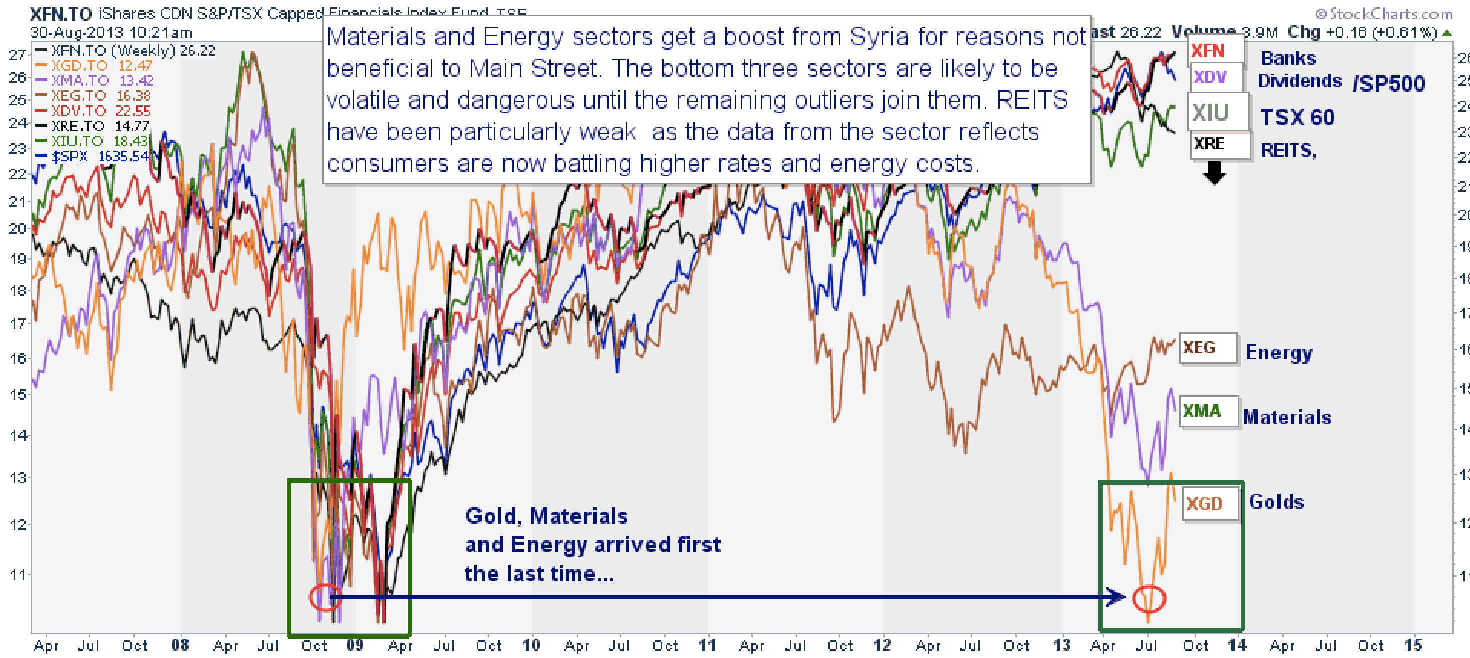
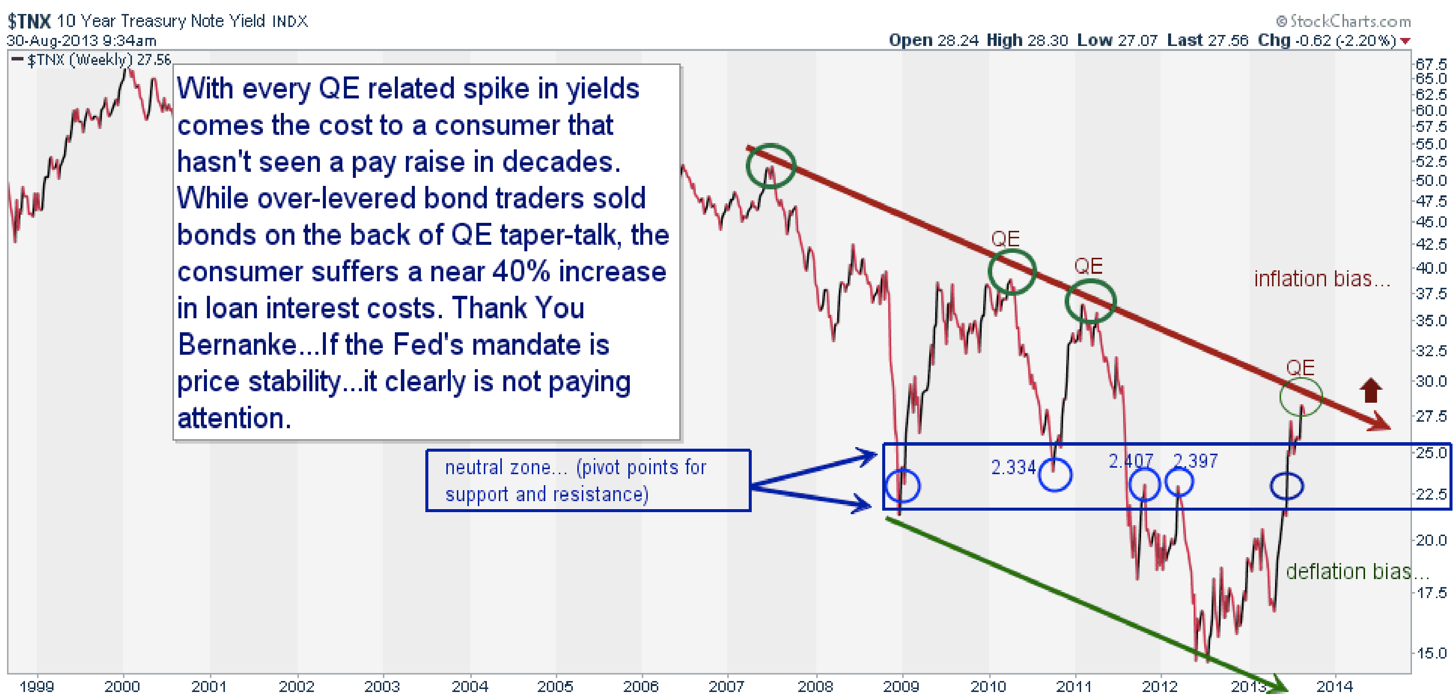
2007-2013: Note miners, materials and energy led to downside in 2008 and plummeted again with broad markets and dividend stocks in March 2009 amid panic selling. We think a similar test is likely ahead.



US 10 year Treasury yield 1999-2013: no new QE triggers higher yields via bond and equity sell off



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Since June, financials, utilities and REITS all sold off along with longer dated bonds, corporates and preferred shares and we took the opportunity to pare back on our high yield, corporate and longer-duration bond ETF's. Over the past two months we have added this capital back to higher quality bonds and ETFs with shorter duration in order to be defensive against the probability of a further sell off in risk markets ahead.

When income investments (which had become the most highly valued ever in history) have corrected down once more with the equity cycle, we will look to add back our targets there.

As already explained, we doubt rates are leaping higher on sustained basis for some time, but with even just a pause to monetary interventions, yields are now in limbo. **In our view, the most significant price risk remains in income bearing equities, high yield bonds and perpetual preferred shares that have been overbought both by those desperate for income over the past 3 years, as well as levered traders looking for quick speculations. These most over-priced sectors are now most vulnerable to a sell-off as the quest for cash liquidity spreads through global markets.**

Once late buyers and levered-traders have been wrung out of these areas, we will be pleased to buy back growth and income sectors that will then be at more reasonable valuations with lower price risk, well positioned to move up with the next organic business cycle expansion coming ahead.

Ready or not, into the fall we go! Quotes of the month:

> *"I can feel it coming…. a whole new round of disastrous speculation, with all the familiar stages in order – a blue-chip boom, then a fad for secondary issues, then an OTC play, then another garbage market in new issues and finally the inevitable crash. I don't know when it will come but I can feel it coming and, damn it, I don't know what to do about it."*
>
> -- Former NYSE Chairman Bernard Lasker just before the 1969-1970 market plunge

> *"Intelligence without imagination is a deadly combination."*
>
> --Nassim Taleb (1960-) author "The Black Swan."

> *"Your time is limited, so don't waste it living someone else's life."*
>
> --Steve Jobs (1955-2011), Co-Founder of Apple Inc

> *"It is precisely the possibility of realizing a dream that makes life interesting."*
>
> --Paulo Coelho (1947-) Author

> *"It's discouraging to think how many people are shocked by honesty and how few by deceit."*
>
> --Noel Coward, Blythe Spirit (1945)

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