*Real life needs active management* AUGUST 31, 2008. ISSUE 8

# E.Q Trendwatch™

## *The centre of 2002-2007 "boom" was never China*

*"Just two years ago, the Shangxing Furniture Co.[in China] was expanding as fast as it could. Almost all of its profits—about $4 million-were plowed back into new warehouses for the wooden furniture it churned out for North American and European customers. And then the slowdown hit. Costs soared and exports slumped. Since then profits have virtually disappeared, "We're spending our savings to keep it running," says the company's export director…"*

*–Globe & Mail, ROB, p. B4, Sat Aug 30, 2008*

Much hope has been laid at the feet of China and India over the past five years; hope was that their enormous populations would fuel enough demand to abolish the business cycle and carry the global economy indefinitely. In Canada this hope became widely held optimism that our economy would continue to expand by selling our exports to Asia notwithstanding the contraction in western world demand. Central to this thesis, was the argument that the centre of the demand boom, over the past few years, has been Asia. In truth, this theory was a hope that was never based in reality.

To see the reality of the 2002-2007 boom, we must put the cart, where it belongs, behind the horse. China's growth has been the cart pulled behind the horse of western consumption. Western consumption was extraordinary for 5 years following the recession of 2001. But western consumption was not fuelled out of deep pockets of savings and excess income. It was fuelled primarily on cheap credit, reckless borrowing and crazy lending. With credit markets now in violent contraction, and global housing markets plummeting, the Asian growth cart is falling suddenly idle at the roadside. Because despite it's incredible population, China is not a country of consumers. It is a country of savers. With a savings

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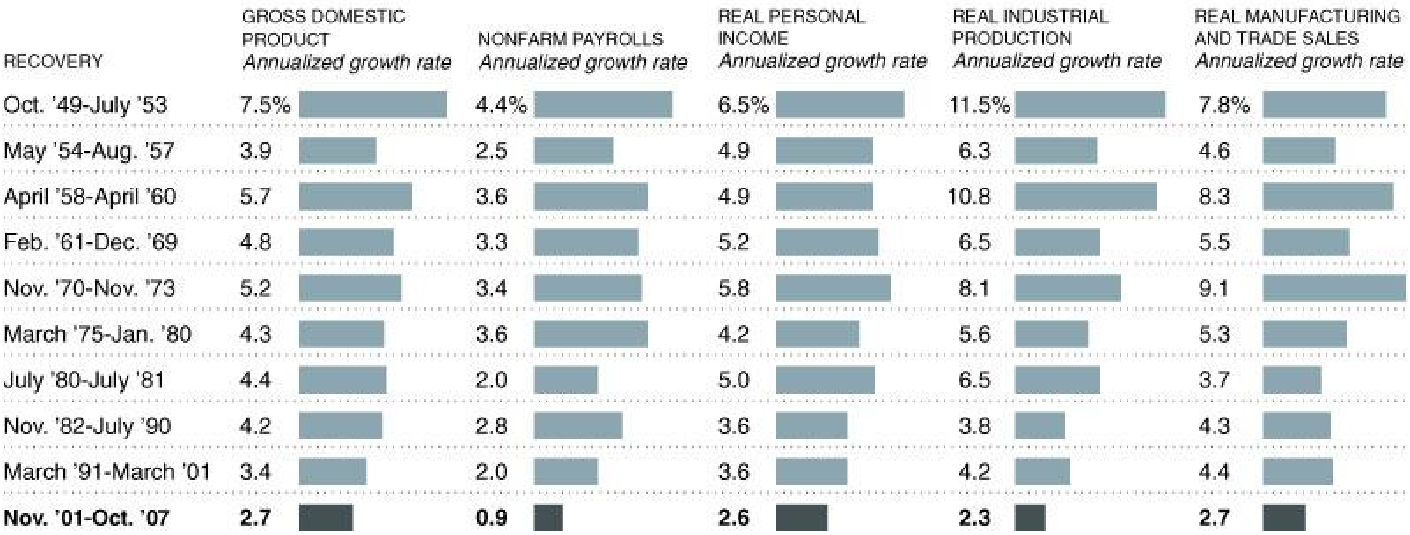
rate of 35% of its GDP, Chinese domestic consumption is the lowest of any economy in modern times. In fact, per capita, western consumers in Europe and North America have historically been 10 times better at consuming than China and India. At best, China is a country of consumers in training. So far most are still concerned with basic necessities like food, shelter and personal security.

When we look past hope to the actual numbers, we can see that although the North American economy's expansion of 2002-2007 was elongated, it was in truth, the weakest post-war recovery ever in history.

**A Long, but Slow Expansion**

If a United States recession began late last year, as some economists believe, it ended the slowest post-World War II recovery ever. The charts show the annualized growth in each of the prior recoveries, as measured by the gross domestic product and the four economic series that make up the Index of Coincident Indicators. The dates used are the official ones set by the National Bureau of Economic Research, except for the ending date of the last recovery, which was estimated by the Economic Cycle Research Institute.



| RECOVERY | GROSS DOMESTIC PRODUCT *Annualized growth rate* | NONFARM PAYROLLS *Annualized growth rate* | REAL PERSONAL INCOME *Annualized growth rate* | REAL INDUSTRIAL PRODUCTION *Annualized growth rate* | REAL MANUFACTURING AND TRADE SALES *Annualized growth rate* |
|---|---|---|---|---|---|
| Oct. '49-July '53 | 7.5% | 4.4% | 6.5% | 11.5% | 7.8% |
| May '54-Aug. '57 | 3.9 | 2.5 | 4.9 | 6.3 | 4.6 |
| April '58-April '60 | 5.7 | 3.6 | 4.9 | 10.8 | 8.3 |
| Feb. '61-Dec. '69 | 4.8 | 3.3 | 5.2 | 6.5 | 5.5 |
| Nov. '70-Nov. '73 | 5.2 | 3.4 | 5.8 | 8.1 | 9.1 |
| March '75-Jan. '80 | 4.3 | 3.6 | 4.2 | 5.6 | 5.3 |
| July '80-July '81 | 4.4 | 2.0 | 5.0 | 6.5 | 3.7 |
| Nov. '82-July '90 | 4.2 | 2.8 | 3.6 | 3.8 | 4.3 |
| March '91-March '01 | 3.4 | 2.0 | 3.6 | 4.2 | 4.4 |
| **Nov. '01-Oct. '07** | **2.7** | **0.9** | **2.6** | **2.3** | **2.7** |

*Source: Economic Cycle Research Institute* Figures are from trough to peak in each economic cycle. THE NEW YORK TIMES

Indeed had more rational rules been applied, it seems that the credit induced "false demand" of the past 2 or 3 years of the expansion leading up to 2007 would never have actually happened. These are the bad loans and inflated profits that are now in the process of being written down. This is likely to be a continued drag on global economic growth in the months ahead.

**And the U$ is still rallying** From the stock market peak in 2000, the US dollar suffered relentless declines against most other currencies in the world through 2007. This made some sense. As a borrower builds up debt they become a greater and greater risk to its lenders. China was America's largest lender this cycle, just as Japan had been America's largest lender during the 1970's. In buying billions of US debt instruments weekly, China facilitated US consumption aiding and abetting the US Trade deficit. In an effort to pump up its own economy, China enabled the US in their now joint financial demise. The Chinese market has already lost more than 60% of its value over the past year, crushing the hopes and fortunes of many emerging market perma-bulls.

But this is an old story. The rest of the world is now realizing that they too have been mesmerised by the consumption dance. All over the world, consumers are faltering, economies are weakening and de-levering is quickening the pace of decline. As shown in the following chart of the US dollar Index versus the remaining G7 currencies, the U$ has now been quietly rallying for the past 9 months.


Since few countries are fiscally solid, or prepared for this slow-down, realization dawns that if the US is in trouble, the rest of the world's smaller economies will likely suffer even more.

The US was the first to start into the global slowdown and they are likely to be the first to pull out of it as well. As US asset prices continue to fall, price risk in US markets falls as well. Having bought U$ near its bottom last November, as Canadian investors, we have gained about 7% year to date on the currency alone. We are watching carefully for advantageous points to put these dollars back to work in US assets.

A perfect mirror opposite of the US appreciation over the past 8 months, has been the declines in gold, commodities, energy and the Canadian dollar. Their significant down trend is captured in the following 4 charts.

Gold companies


Materials companies


Energy companies


Canadian dollar


Unlike our clients, these trends have inflicted real pain on buy and hold investors over the past many months. And they underline that the Canadian stock market is still at risk of further down side from here. Longer term the on-going decline in the Canadian dollar is part of the solution needed to reinvigorate Canadian exports and get our Canadian economy moving forward again. In the end this will be positive and set up the necessary support for our next economic expansion. We look forward to that and the opportunities it will present. But for now “wait for it” remain our watch words of wisdom.

***And now comes the fall…Remember you can visit our blog: www.jugglingdynamite.com for our weekly commentary and media interviews.***