

# E.Q Trendwatch™

## More hair of the dogs that bit us



"MUCH LIKE THE FEDERAL GOVERNMENT,  
MY WIFE HAS A PLAN TO SPEND US OUT OF DEBT."

Source: Cartoons by Rick Mckee

Data compiled by Bloomberg shows that since 2007 more than 50 regulatory overhaul proposals for the financial system have been submitted in the U.S. and Europe. Lawmakers and regulators have debated new rules for capitalization and leverage, central clearing for derivatives trading, oversight of hedge funds and ways to monitor systemic risk.

But two years after the start of the deepest recession since the 1930s, no U.S. or European authority has put in force a single measure that would transform the financial system.

Speaking in England on Dec 8, 2009, Paul Volcker, now 82, legendary Chairman



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of the U.S. Federal Reserve during the late 1970's offered this assessment of efforts to date:

*“Bankers and regulators have not come anywhere close to responding with necessary vigor to the worst economic crisis in 70 years. There is a lot of evidence that financial weaknesses brought us to the brink of a great depression . . .the proposed changes are like a dimple.” -- Paul Volker*

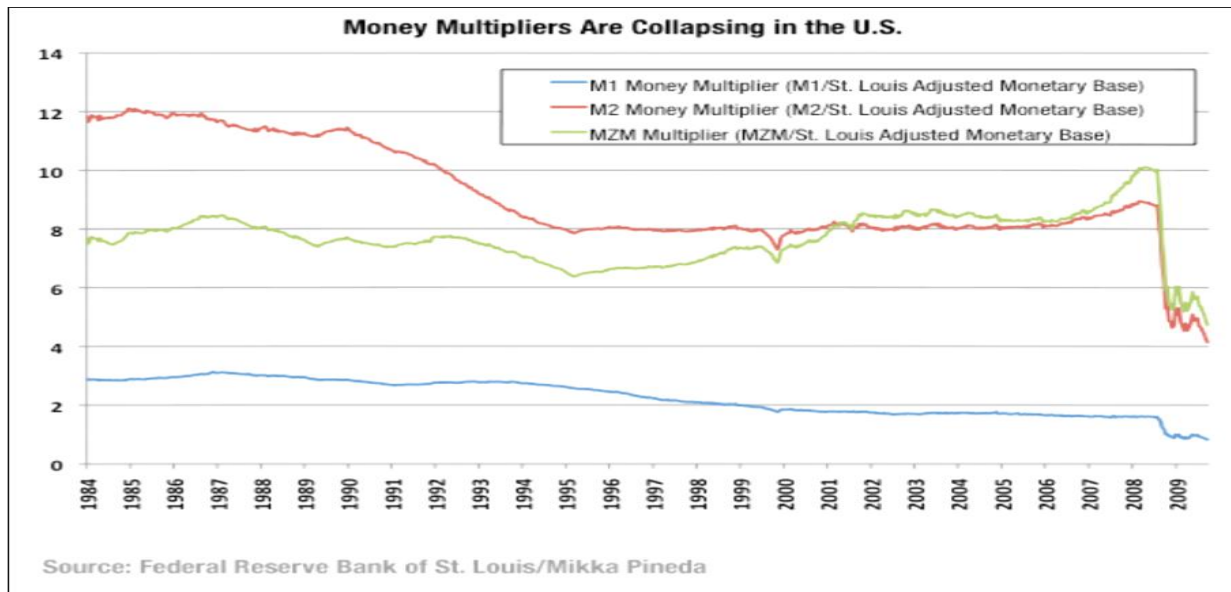
The challenges today are global and require systemic changes in the way that finance is conducted, perceived and marketed. So far, politicians are not finding the strength to make the tough decisions, preferring instead to navigate toward the next election rather than a long-term fix. Meanwhile debt is not disappearing, but rather is being moved about between the various players and continues to hang over the world economy.

**In the past 110 years interest rates have only been this low once –after WW2**

Although rates are extremely low over-indebted consumers are not able to benefit because banks are not working with them to re-finance. As a result, money velocity—the rate which it moves through the economy-- is stagnating (see chart below) [New York Times](#):

*“Mortgage rates in the United States have dropped to their lowest levels since the 1940s, thanks to a trillion-dollar intervention by the federal government. Yet the banks that once handed out home loans freely are imposing such stringent requirements that many homeowners who might want to refinance are effectively locked out.*

*The scarcity of credit not only hurts homeowners but also has broad economic repercussions at a time when consumer spending and employment are showing modest signs of improvement, hinting at a recovery after two years of recession.”*

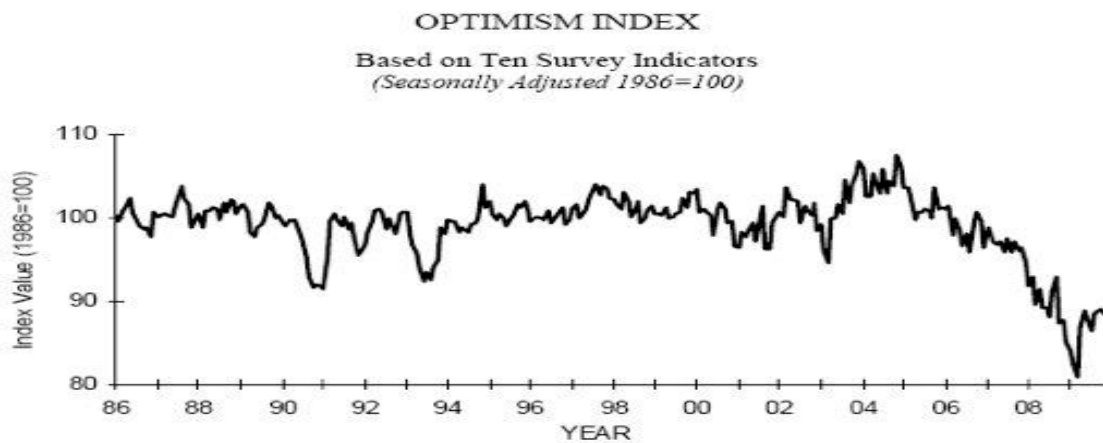


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So far the government's plan to have lenders re-work existing mortgages with homeowners has been a flop. This month the Treasury Department announced that lenders have permanently modified just 31,382 of the 4 million mortgages targeted for loan relief under the Obama administration's main foreclosure prevention plan through last month.

Home owners are not the only ones struggling to access capital. Banks have also been cutting back on credit lines available to small business owners. At the same time, any business that can manage it is looking to decrease rather than increase their debt at this point. A lack of financing coupled with still stagnant order demand across most sectors has left small business owners with historically low optimism even 2 years after this recession began.

## OVERVIEW - SMALL BUSINESS OPTIMISM



**Source: NFID Small business trends**

The fact is that business people (like individuals) who have been through “near-death” financial experiences typically exhibit very conservative behaviours: they look to cut costs, they do not hire new workers, they do not look to expand or re-tool, they look to survive. Until the overall economy shows some sustainable recovery in demand, business sentiment is not likely to rebound. Until business sentiment begins to rebound private sector spending will be hard to stimulate. And until the job losses stop and job creation returns, the unemployment rate will continue to undermine consumer confidence and recovery.

### **China: huge imbalances linger**

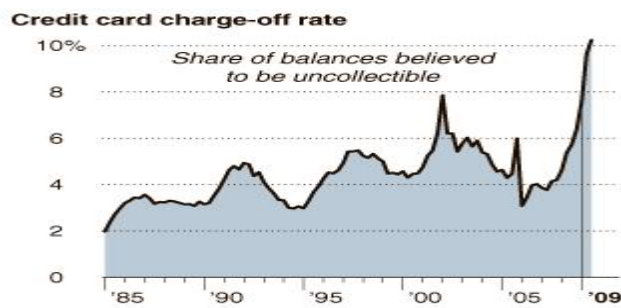
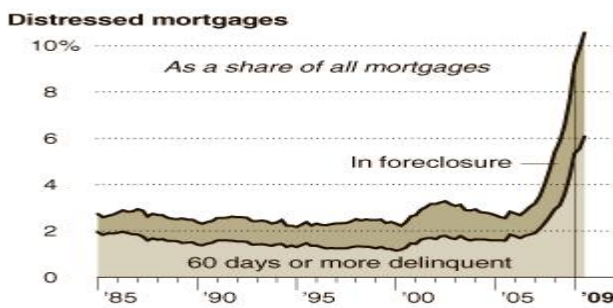
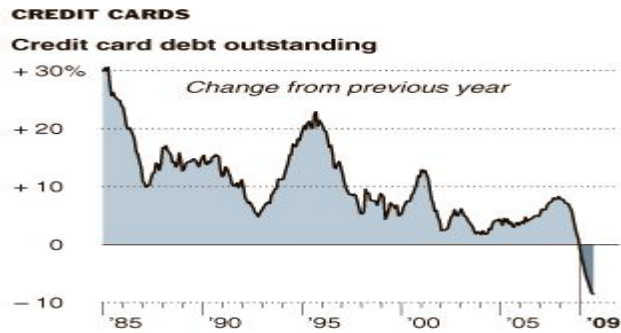
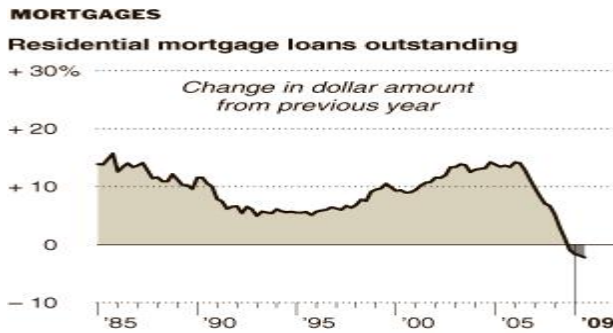
Because the excessive spending of the credit boom temporarily inflated demand all over the world, there is virtually no where now that is immune from bubble deflation; certainly not China. A recent article: [China's Two Turning Points](#) makes this point well:

*[In China exports] will never again be the driver of growth that it has been over the past two decades. From 1989 to 2008, exports grew at an annual average of +19%. This growth was divided into two distinct phases: 1) up through 2001--a dividing line that coincides with both China's entry into the WTO and the start of the American housing bubble--Chinese exports grew at +15% a year, and were highly cyclical; 2) in 2002-08, they grew at an astonishing +27% a year, with no cyclical dips. This year, exports are estimated to fall (for the first time in China's three-decade reform history) by around -15%. Even after the global economy recovers, it is unlikely that exports can sustainably exceed +8-10% growth per annum, given the very high base, and the weakness of the rich economies. In short, future export growth will be less than half the average of the last 20 years, and less than a third of the past seven years.*

The retraction in export demand coupled with an aging population within China will dictate a naturally lower growth rate. At the same time the government's mammoth efforts to keep growth going has resulted in a still growing glut of products that is likely to take years to absorb.

**At least US consumer debt levels are falling; banks are writing off their bad debts**

It is without question that debt is retraining the rebound of the all important US consumer. So the fact that US debt levels are falling and savings rates rising, should be seen as good long-term steps toward eventual recovery. This next set of 4 charts tells this story:



Note: Mortgage loans outstanding are based on dollars owed. Mortgage delinquency and foreclosure rates are based on numbers of mortgages outstanding, regardless of balance.

Sources: Federal Reserve Board and Mortgage Bankers Association, via Haver Analytics

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## **Better for consumers, but worse for banks**

In 10 American states, mortgage lenders are largely prevented from going after the other assets of borrowers who default. Walking away from one's bloated mortgage can suddenly free up cash flow for rent and other consumption. This is one way to expand consumption in the economy.

The only trouble with this solution is that it leaves banks with many more large write-offs which so far have been absorbed by the government. As we discussed last month, shifting private debt onto the public purse, does not extinguish it, it only transfers the hang-over from debtors-- to the banks-- to the government—to tax payers.

This recovery is a multi-phase process. The lull in mortgage resets between March and November 2009, as well as a pause in bank foreclosures on defaulted real estate, left many of us with an unsettling sense of calm in the midst of the storm. This month the VP of US housing data firm Realty Trak warned of a “false-positive” in recent housing data:

*“I think that first quarter of next year we'll see a new wave of foreclosure activity. Delinquencies have been going up – we have five and a half million homeowners who are late on their mortgage payments right now, and many of those, under normal circumstances, would have already been in foreclosure. But the Treasury is asking lenders to make doubly sure that anybody who qualifies for the HAMP program or other modification program gets in those programs. We think we'll probably hit the historic peak next year, in 2010, as a lot of the Option-ARM loans reset, as unemployment related foreclosures peak, before numbers finally start to settle down a little bit in 2011. We're expecting the first quarter to be pretty ugly.”*

---Dec 10, 2009 Rick Sharga on Bloomberg

## **Meanwhile The Bank of Canada is warning Canadians to prepare for higher interest rates**

On December 16, BOC Governor Mark Carney warned that Canadian household debt levels are a rising risk to Canada's financial system. This year's increase in mortgages and car loans lifted the ratio of household debt to income to a record 145% according to Stats Can ( higher than the US where it is 125%; down from a US peak of 139% in 2007). Canadians have become accustomed to the lowest interest rates since the Korean War and have continued to increase their debt loads. Governor Carney warned that the coming rise in rates back to “more normal” levels will leave some borrowers unable to pay: “It is the responsibility of households now to ensure that...when the recovery takes hold and the extra-ordinary measures are unwound, they can still service their debt.” (Did Mr. Carney read our newsletter last month?)

Most Canadian mortgages are insured. Over the past few years CMHC has rather quietly become one of the largest financial institutions in Canada –And GROWING. (Does ballooning government insured risk make

anyone else feel nervous?) The BOC went on to remind us that households defaulting on mortgages would also likely default on other debts, leading to potential losses for Canada’s commercial banks. Carney said that Canada’s recovery will be “more protracted and reliant on domestic demand than usual” due to a “historically weak’ rebound in US consumer spending, and that private demand will recover slowly in most major economies. Consider ourselves warned!

All of this brings us back to the likelihood of a fresh wave of banking problems in 2010. And since a relief rally in the banking sector really led the remarkable rally in stocks from March to October this year, we must watch the financials carefully now for hints at the next phase of market reaction.

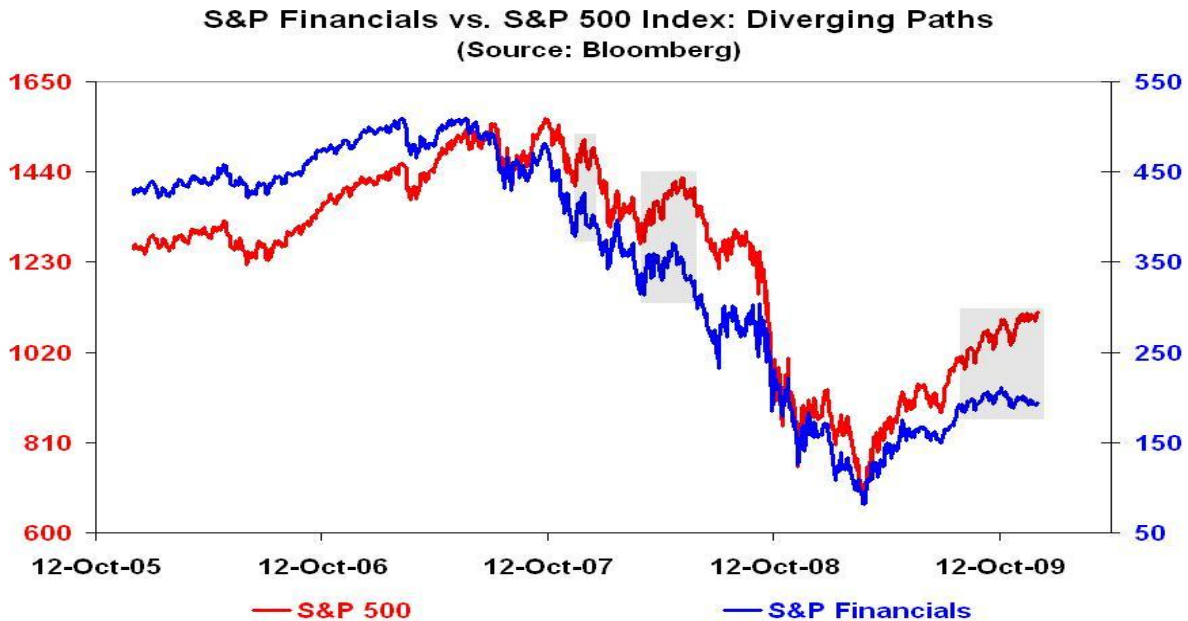
**Is the financial sector still leading the stock market?**

Goldman Sachs (chart below) led the financial sector up all year. But peaking in October the trend of the banks has been decidedly down over the past 2 months, as mirrored in the following chart of Goldman Sachs. Price has now clearly broken beneath the up-channel. The trouble with parabolic price moves on ever declining volume is that there is very little support beneath current prices. The next technical support from here would be the \$140 area some 24% below the October peak.



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The financial sector as a whole has diverged from the uptrend of the S&P since October 12, 2009.



At the same time this month, the beleaguered US dollar has finally broken out of the downtrend it has followed since the stock market bottomed in March.



Source: Venable Park Investment Counsel Inc.

As we discussed in previous comments, the falling US\$ has been the wind beneath the wings of this manic rally

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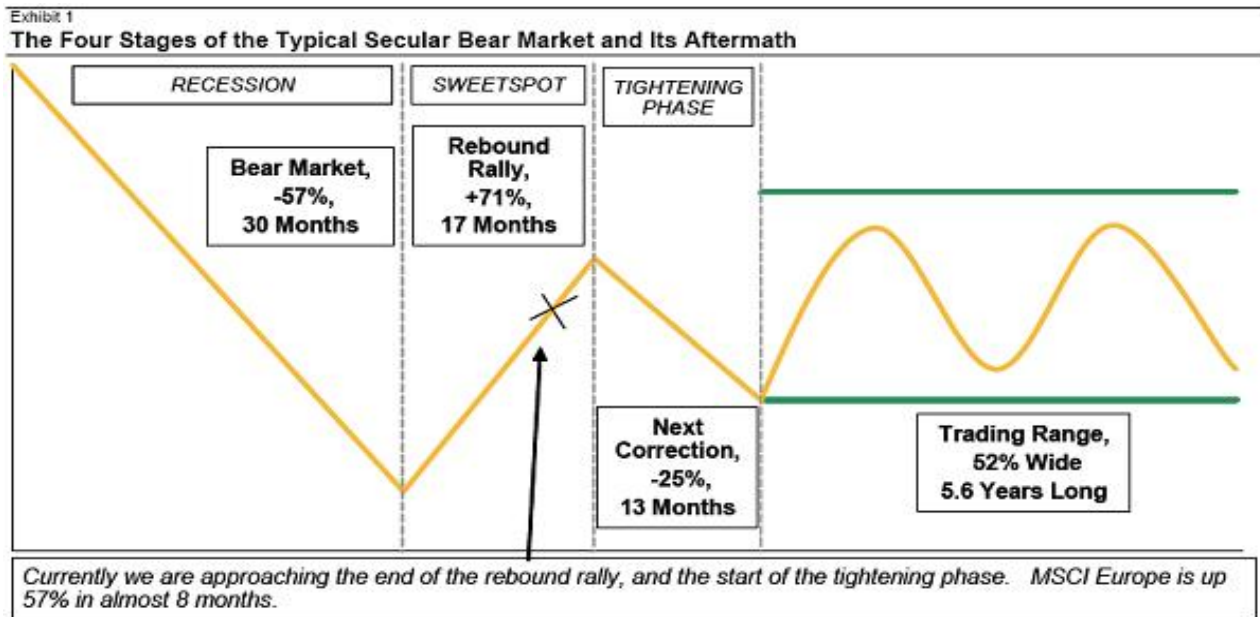
the past few months. The implications of a significant US rebound threatens risk assets so long as their strong opposite correlation to the dollar continues to hold.

**What kind of stock market might follow next in this secular bear?**

So we see near term price risk for stocks and commodities. But what are we looking for beyond that?

It's not that we don't agree a rebound rally was reasonable given the over-sold levels in March. We know that cyclical rallies are a regular feature within secular bear markets. The trouble is that this cyclical rally came out of the blocks on steroids; racing up 60% in a matter of months when a "normal" rebound would take 17-24 months. Another element that had our Spider senses tingling was the fact that this bear market began in October 2007 and bounced in March 2009, just 17 months later. The decline itself (-63%) was in the normal range within secular bear climates, but the term of the decline was just over half the average duration. The relative rapidity of the down move looked a little suspicious. Then to have such a sharp and sudden rebound rally, when the economic recovery this time (and after all previous credit collapses) is very slow, turned a declining volume "suspect" rally into downright "spooky."

For a better perspective, the following chart captures the historical average price behaviour of stock market cycles during secular bear periods during the past 100 years.



Source: The Aftermath of Secular Bear Markets, Morgan Stanley European Strategy 10 August 2009

**\*VPIC note:** the "X" and straight lines on the chart above are MSCI's thesis; we believe that we might yet see a pull back even before markets complete the rebound phase, and before entering the "next correction" leg.

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In reference to the above chart, we have been in the rebound rally just over 9 months. The average rebound period is 17 months, but as we said above, so far the market stages this time have been on steroids, making their dramatic moves in half the average time.

If this pattern is to continue it seems we should anticipate a potentially violent “next correction” in the not too distant future. Once this phase is in, we then anticipate a more normalized range bound market for a period of several years. During this period we will look to own income producing equities, and bonds as an effective way to compound growth to the end of this secular bear. After working with insane markets for the past four years, we are actually looking quite forward to a more subdued fully invested phase. There is good conservative money to be made ahead!

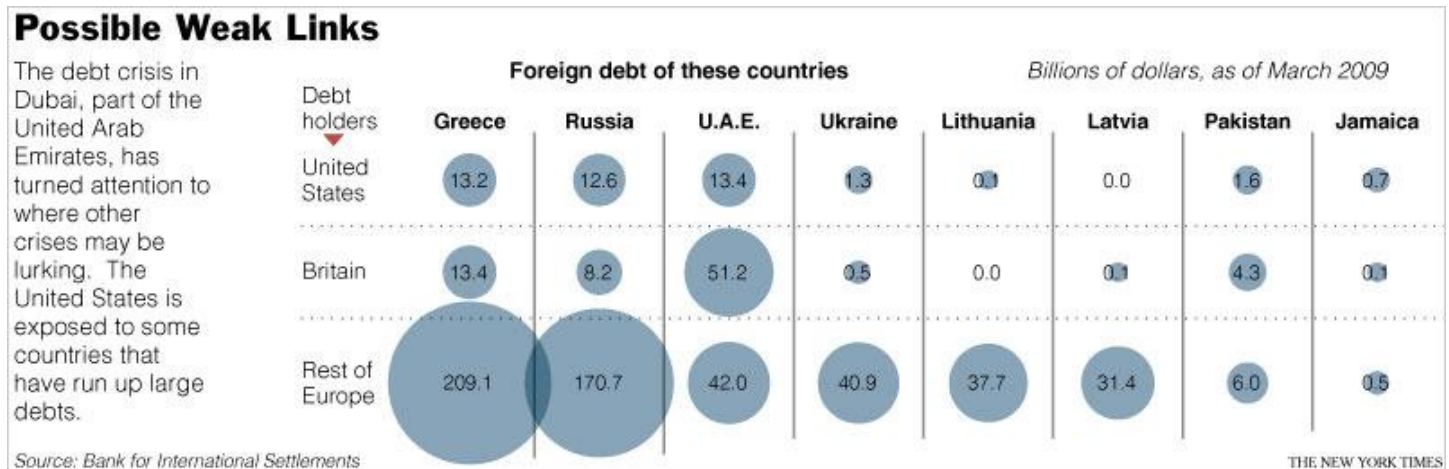
**Sovereign risk comes back into focus**

As noted earlier, individual debts have been falling back on to bank balance sheets, causing banks to pro-lapse onto government bailouts, which (coupled with other government stimulus spending) has ballooned government debt around the world. On top of this a severe recession has brought abrupt shortfalls to expected tax revenues at all levels. We expect deficits and debt to continue for a few more years and so it is no surprise that attention is now shifting towards government solvency around the world. In investment parlance this is known as ‘sovereign risk’.

While the sub-prime debacle toppled the US banking system first, we have long maintained that the US is far from the only or even most afflicted country suffering from ‘debt disease’.

In December, news of crippling debt and looming default risk went mainstream with stories of sovereign crisis in Dubai, Greece, England, Ireland, Austria, Spain and several other countries. One has a growing sense of tremors rattling under the propped up financial landscape once more.

As shown in this next chart, banking exposure to weaker sovereigns is concentrated at European banks.



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Growing realization about the outsized exposure of European banks to both domestic and foreign debt is a key reason why the Euro weakened sharply this month. We think this is a trend that may be with the world markets for some time as more and more sovereign skeletons are thrown out of the closet and into the light of day.

**In closing**, we believe that we are nearing the end of the first cyclical uptrend that began from the lows in March. In fact it may have already ended over the last 6 weeks. As the new-year opens we will get a better sense of our orientation in the present phase of this on-going secular bear. Further upside in stock prices is still possible, but having now quickly retraced 50% of the 2007-2009 bear market decline, substantial gains from this point become less and less probable without first having the next correction wave that is characteristic of these cycles. We will be watching the internals and technical supports very carefully for signs of the completion of the correction phase.

Once it is complete, price risk from there is likely to be significantly lower than from present levels, and we will look to increase our equity allocations with income paying growth assets for the medium term as we move through the next market phase. The economic recovery phase is likely to be less volatile than what we have seen in 2009, but still range bound and beneath the October 2007 market highs.

For our fixed income holdings we will be watching the yield curve carefully and managing our holdings towards expectations for a more “normal” higher rate environment ahead.

Happy New Year! See you in 2010!

#### Quotes of the Month:

*“It is our responsibilities, not ourselves that we should take seriously.”* Peter Ustinov

*“Most great people have achieved their greatest success just one step beyond their greatest failure.”*

Napoleon Hill

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