

E.Q Trendwatch™

Crisis? What crisis?



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Watching hundreds of thousands of barrels of oil flooding the Gulf on the CNN spill-cam 24 hours a day this month has been unnerving to say the least. Hearing the early assurances from officials that the leak would be relatively contained, conjured for us some painful memories of other containment promises uttered in the spring of 2007:

“At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seem likely to be contained.” –Ben Bernanke, before the Joint Economic Com., March 28, 2007

It is a critical first step to cap the leak, but the damage of flooding the Gulf with heavy oil for several weeks will now take several years of patient work, care and better controls to repair. In a similar analogy, the damage of flooding the world economy with credit derivatives over the past 10 years will also take several years

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to repair. In 2010 we are now in year 4 of the global credit crisis. Amazingly many today seem still remarkably unaware of the breadth of its aftermath.

In 1975 Supertramp released their “Crisis? What crisis?” album with the above pictured cover. The image of the sun bathing man dozing in the midst of chaos provides we think a useful image for many of the world’s politicians, bankers and business leaders over the past dozen years. Interestingly in 1975, this album cover was making a similar observation on its own time.

In 1975 the world was struggling to pull out of a period of broad systemic upheaval: the OPEC oil crisis had run energy prices up 70% in 1975 alone, inflation was double digit, the Vietnam War was just ending; the Watergate scandal had dethroned Richard Nixon and the public trust. Private and public debt levels were near record highs. The stock market had fallen more than 50% over the preceding 2 years and was yet just 9 years through a secular bear market that would punish passive equity investors for another 7 years before finally ending in 1982. Investor and voter confidence fell to generational lows. People, it could be fairly said, were ill at ease. All over the world, civil unrest was building. **While history shows us many cycles with these recurring themes, it also assures that seemingly insurmountable problems have always been eventually overcome.** It has typically taken several years, but eventually the world and its economy do recover. In the meantime though, it is important to reassess some of the previously held models and beliefs. Income needs, savings levels and spending rate assumptions are all up for mass review in this post-credit-bubble era.

Pension plans are starting to blink

Ten years into an era of disappointing investment returns, much of the developed world is moving beyond 50 years of age. “Freedom 55” was a good marketing slogan for the financial services business 10 years ago, but after years of bad investment decisions and bad financial advice, “Modest 70” is more likely to be the slogan over the next 10 years. Stepping away from the weight of these numbers, most private employers have replaced guaranteed income plans with contribution-based plans that offer no minimum retirement income and leave the investment return risk squarely with the employees. Employees, however, are not equipped to navigate these challenges on their own. Meanwhile, the public pensions that have continued with guaranteed benefits are now admitting great strain.

The majority of guaranteed benefit plans today are about 40% un-funded. Recent US studies suggest that state pension plans alone faced a \$3 trillion dollar deficit at the end of 2008 and that the shortfall has grown steadily to date despite the rebound in equity markets in 2009. To fund monthly payouts, it is very common for pension funds to be structured with a minimum of 60% fixed income exposure. With interest rates at rock-bottom levels, and passive stock market allocations garnering negative returns amid massive volatility, pension capital is eroding. In recent years, pension boards tried to jump-start returns by augmenting traditional asset holdings with an exposure to commodities and commodity ETF’s. Results have proven disastrous; losses have been

compounded. Capital simply cannot keep pace with the massive bulge of baby boomers moving into retirement. Given that challenging conditions are likely to persist for the next few years, the only rational solution is to dramatically increase contributions on all sides. At a time when revenue and income have stagnated, this is not the answer that anyone wants to hear. Increasing contributions (saving more), means decreasing spending which means less economic growth for a few years.

In Canada, OMERS (Ontario Municipal Employee Retirement Savings Plan) reported last month that their pension deficit had grown from \$279 million at the end of 2008, to \$1.5 billion in 2009 and is projected to balloon to \$12 billion over the next three years. This is the shortfall notwithstanding investment gains of 9.9% in 2009. The long-respected Ontario Teachers Pension Plan is [facing similar deficit issues](#). Notwithstanding a 13% return in 2009, the Teachers' Pension Plan saw its funding shortfall balloon to \$17.1 billion in 2009, almost seven times higher than the \$2.5-billion shortfall at the end of 2008. So bad are current shortfalls, that even if funds were able to earn back 20% a year for the next three years, capital deficits would remain in the billions.

OMERS recently warned its members that they are likely to see contributions for the average worker increase 50% over the next 3 years. But even then benefit cuts will be needed. The employer side (in this case various government agencies) is opposed to contribution increases on their part without accompanying benefit reductions and this type of two-prong plan is being formulated. It is hoped that the cuts will not reduce vested benefits to those already retired. However, truthfully at this point, no one can be considered immune from changes going forward.

Not even Germany has lived within its means

The same issues of un-funded liabilities of every kind at every level—individuals, pensions, municipalities, states, and countries — are evident throughout the world. As the EU debt crisis continued to capture news this month, it is noteworthy that no government—advanced or emerging, has managed to keep their deficits within the 3% limit mandated by the Maastricht Treaty (see chart next page).

Even the most disciplined EU member—Germany, is likely to see a 5% shortfall in 2010. Countries like Australia and Canada who enjoyed above-trend revenue from export demand during the credit boom, are now racking up exponential deficits in the aftermath. The causes are the same all over: weak economic activity has brought down tax revenue at the same time that governments have ramped up fiscal spending with economic-stimulus measures. In addition, western governments face stubborn structural deficits as aging populations lead to a shrinking labour force and diminished economic potential. So far governments have tried to plug budget holes by issuing debt, but in reality lines of credit are finite. Spending cuts are coming. Entitlements will be cut and tax rates increased all over. All of these factors will be a drag on economic growth and over the next few years. Forecasts that higher economic growth will evaporate deficits in the near future are likely to be disappointed. The world has made this bed over the past 10 years—now we will all lie in it.

Fiscal Deficits and Public Debt and Expected Changes								
	Fiscal Deficits (% of GDP)				Public Debt (% of GDP)			
	07	09	10e	14e	07	09	10e	14e
Australia	1.5	-4.3	-5.3	-1.1	10	17	23	28
China	0.9	-3.9	-3.9	-0.8	20	20	22	20
France	-2.7	-8.3	-8.6	-5.2	64	78	85	96
Germany	-0.5	-4.2	-4.6	0.0	63	79	85	89
India	-4.4	-10.4	-10.0	-5.7	81	85	86	79
Italy	-1.5	-5.6	-5.6	-5.3	104	116	120	129
Japan	-2.5	-10.5	-10.2	-8.0	188	219	227	246
U.K.	-2.6	-11.6	-13.2	-6.8	44	69	82	98
U.S.	-2.8	-12.5	-10.0	-6.7	62	85	94	108
G-20	-1.0	-7.9	-6.9	-3.7	62	75	80	86
Advanced	-1.9	-9.7	-8.7	-5.3	78	99	107	118
Emerging	0.3	-5.1	-4.1	-1.3	37	39	40	36

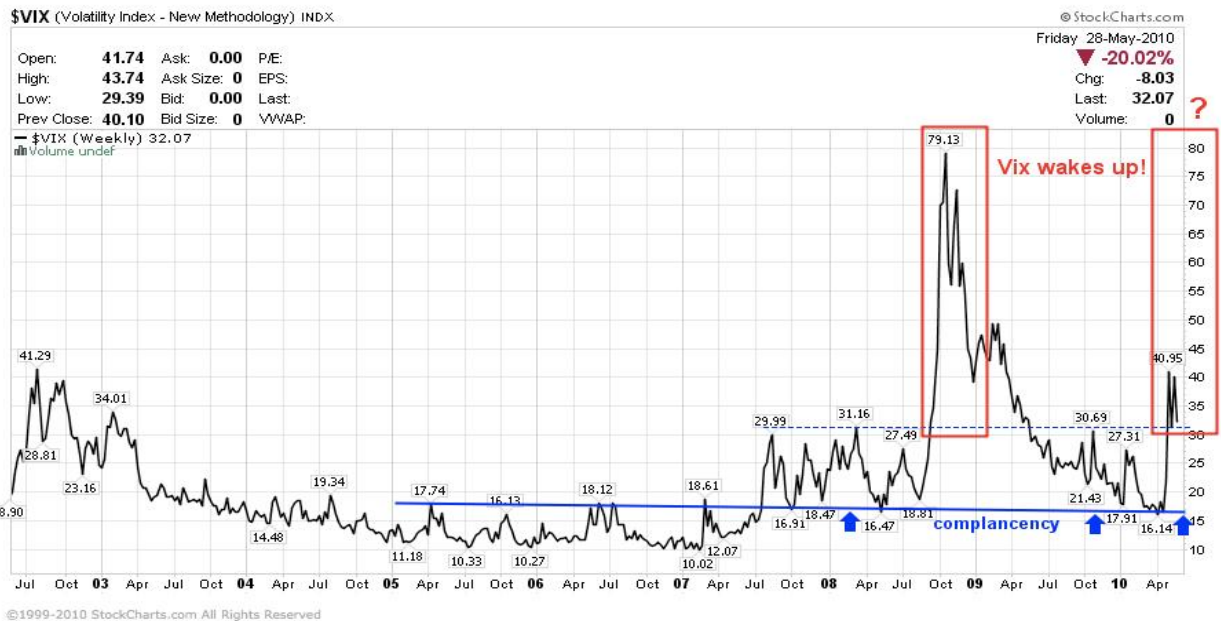
Source: BofA Merrill Lynch Global Research, IMF

Chart 3

Although some have called for quick fixes that would rescue solvency problems, the “bail out” of Greece this month (giving them a couple more years of cash flow), was clearly a band-aid, not a cure.

Digesting the contagion effects from the debt crisis in Europe, risk markets sold off around the globe.

The Stoxx Europe 600 index has now fallen 12% since mid-April. Continuing the downtrend we noted last month, the Chinese stock market (Shanghai Composite) continued its fall in May with a further 4% drop, now down 24% from its peak last August. At the same time the Volatility Index which had revisited an ominous low of 17 in March, this month spiked back into the fear zone at more than 40.



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Lows in the VIX are typically suggestive of market tops, and spikes with relative opportunity. In this sense the VIX is an interesting sentiment barometer. We note however that the last time the VIX spiked above 40 it did not peak until 80 in the fall of 2008 and fell all the way into the spring of 2009 while the S&P lost a further 38%. So peaks in the VIX can come well before stock market bottoms. We think it likely that we may see significantly more volatility in the months ahead.

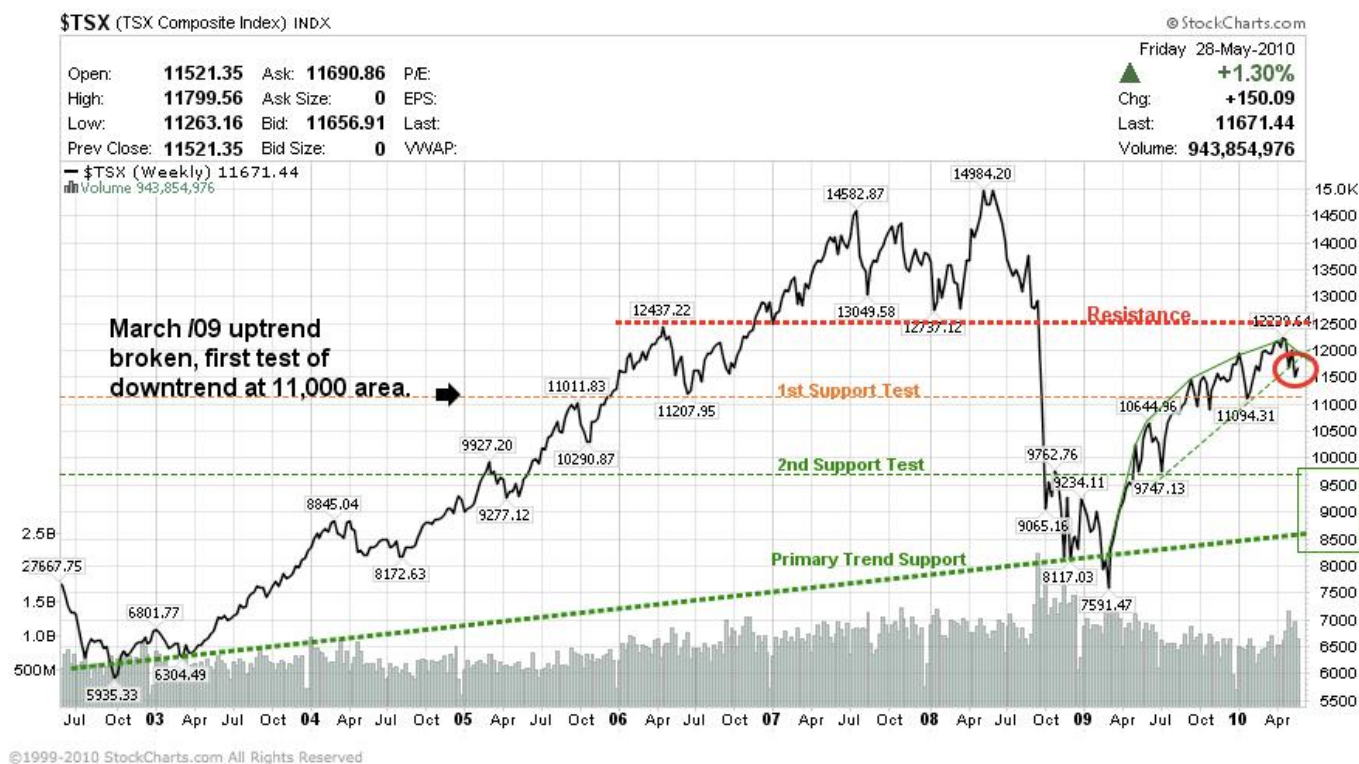
In keeping with these trends, the US S&P 500 Index closed the month below its 50 and 200 day support lines. This suggests it is now vulnerable to a retest of the 875 to 950 range (see green target area in chart below).



Source: Venable Park Investment Counsel Inc.

If this downtrend holds we should still expect days or weeks of interim rally over the next few months. But it is the longer term trends that have the most to say about lasting market returns, and so far those longer-term trends have once again turned down. The Canadian TSX is showing similar patterns below with 11,000 being the next significant downside test. The secular support tested in March 2009 now rests in the 9000 range shown in the box below, some 25% beneath the recent high of 12,200 in April.

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Source: Venable Park Investment Counsel Inc.

Attractive re-entry points could hold at the 2nd or primary support lines above. We remain hopeful that a lower test toward the March 2009 lows will not occur this cycle, as that would suggest that there has been no lasting economic benefit from the trillions in tax payer money spent in efforts to arrest the global recession. (We are hopeful; however, this possibility cannot be ruled out). Given the enormous capital deficits and damage to investor psyche that has already occurred over the past 10 years, a fresh contraction now, even to the 900 range for the S&P would doubtless create a fresh wave of investor despair and disillusionment with capital markets.

As much as it will be sad to watch the world suffer through another period of significant capital losses ahead, we should all be aware that history tells us further price contractions are highly likely to play out before this secular bear period finally ends. Assets today remain generally over-priced. There is just no other way to get to the final capitulation phase which will take valuations back down to the historic levels needed to finally start the next secular bull period. The history of investor behaviour has warned us. We stand ready.

On the flip side of risk aversion: the US dollar and long bonds are rallying again

Last month we wrote that we were on the verge of a buy on the US dollar and long bonds. This month it

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happened. The art of investing is to avoid big capital losses, in bear markets. If we can accomplish this, and hold a few assets that are appreciating while most everything else is dropping we are delighted. Since we left equity markets in January, we have avoided their losses year to date and made gains on the fixed income and currency that we hold.

As shown in this next chart of the US dollar Index (updated since we included it a few months back), the triple bottom (against a basket of other currencies) has held since rebounding at 74.98 in December 2009. As we suspected would happen, the rebound in the dollar has drained capital out of stocks and commodities in concert.



Source: Venable Park Investment Counsel Inc.

Having already rallied 13%, the next significant resistance for the dollar Index lays around 88 in the chart above. A successful break through that resistance would suggest that a rally back to the 102-105 level is possible. So long as this greenback rally continues downside risks loom large for equities, commodities and commodity-linked currencies like the Canadian and Australian dollar. We continue to watch this chart very closely.

As part of the global risk aversion theme this month, the flight back to the US dollar from other assets and currencies included a flight back to the US 20-year Treasury Index (as shown in TLT chart below). The break

out through the 97 level achieved in May suggests that a rally to the 102 may now be in the cards and would offer attractive upside gains during a falling stock market.



Source: Venable Park Investment Counsel Inc.

Ideally, we will be able to wait out the storm in appreciating bonds and the US dollar over the next few months as risk markets lower to re-price a more realistic level of economic activity in 2H 2010 and 2011. We look forward to more opportunities once this next phase of re-pricing is complete.

Warm wishes for June. Let's hope they get the damn oil leak capped so the clean up work can finally start!

Quotes of the Month:

"Givers have to set limits because takers rarely do."— Irma Kurtz

"The world is divided into people who do things, and people who get credit. Try, if you can, to belong to the first class, there is far less competition." --Dwight Morrow 1873-1931, Businessman, Politician and Diplomat

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