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Our view on global investment markets:

August 2010: Oops!... I Did It Again

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Party like it's 1999...

In 1999, "Baby One More Time" was a huge hit for the up and coming singer Britney Spears. The debut album managed to successfully transition the former Mouseketeer into an overnight pop sensation. Albums flew off the shelves, the concert list grew – first Cleveland, next Detroit, Chicago and then LA. Britney had finally made it to the big-time.

One day after a pause in the celebrations, her agent nervously asked, "what's next?" Tilting her head and smiling, Britney replied "why mess with a good thing" and with that her second album "Oops!...I Did It Again" was released. The album was a bigger success than the first, and so too was the pay day.

In early 2000, with the help of her financial advisor, Britney invested her winnings and couldn't help but to be excited about her stock and real estate portfolio. Life was going to be good.

On August 10, 2010 the Chairman of the Federal Reserve, Ben Bernanke tilted his head, smiled and calmly announced that he will once again wet his pants. *Oops!* This time instead of Britney, Ben did it again. Ignoring the opportunity to once and for all end his quantitative easing experiment, "Helicopter Ben" couldn't resist to do it one more time. The only thing missing from the announcement was a Britney Spears song playing in the background.

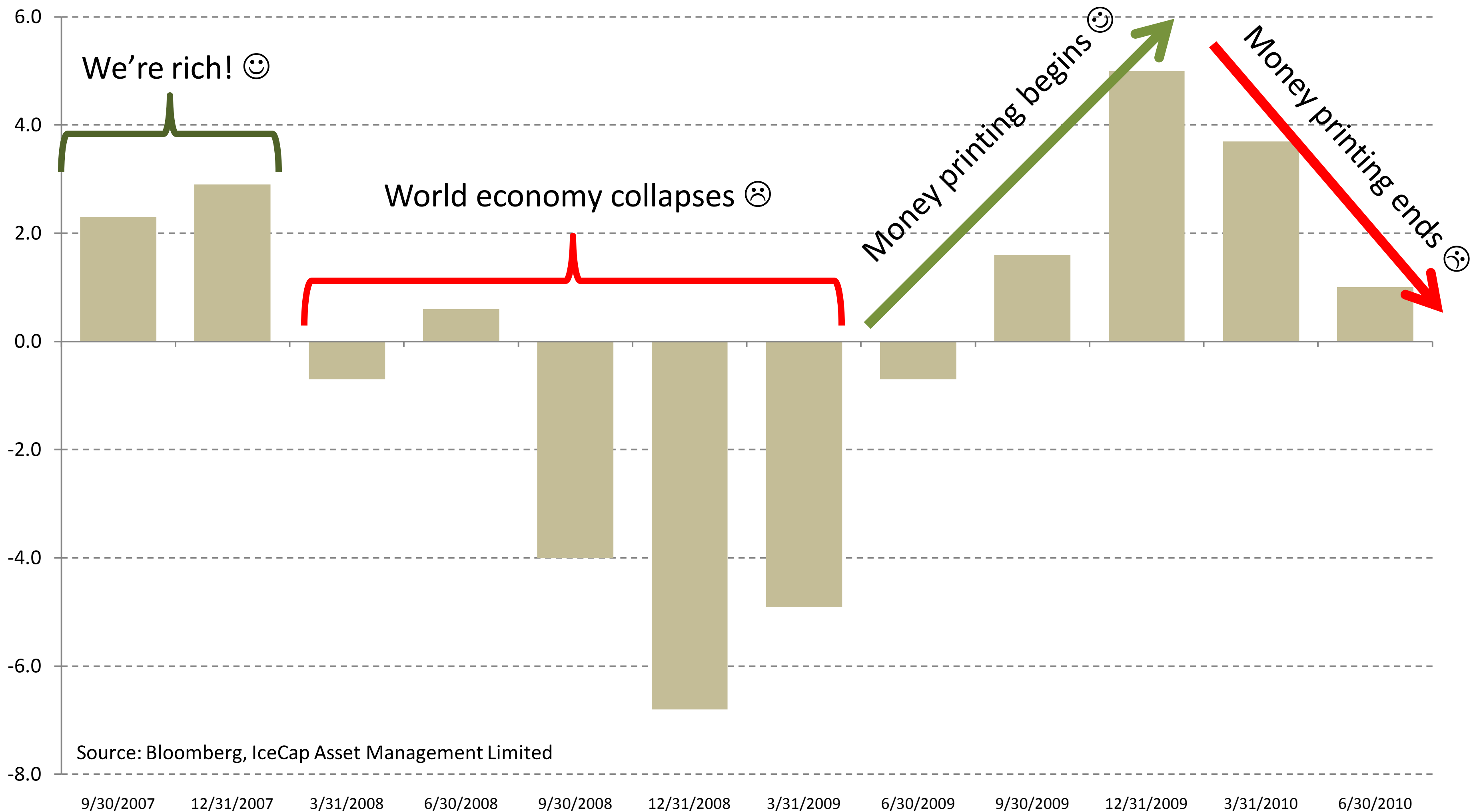
As you'll recall from our July 2010 Outlook "Somewhere Over the Rainbow", an enormous debt burden has fallen on top of the US economy rendering it lifeless. With banks refusing to lend and people doing everything in their power to hold onto their jobs and their homes, the US central bank decided to print money, or as they call it – quantitative easing. This is the master plan to kick start the economy. Two years and trillions of dollars later, it still isn't working.

Why write about this again? Surely there are other more interesting things to write about. Well for starters, it is August and the international business community has shut down, the lights are barely on in New York, Shanghai, and Tokyo while the entire European continent is off on holiday. However, this latest announcement by Mr. Bernanke was extremely important for the economy and financial markets and it is a shame it occurred in August.

Some analysts will argue that the latest announcement is minor and that Mr. Bernanke hasn't once again started the printing press, and I admit that this is somewhat true (the Fed announced that it would use its principal payments from its mortgage backed securities (MBS) portfolio to buy longer term U.S. Treasuries; technically, this means they are not actually expanding the balance sheet). However, it is clearly a sign that all isn't right in Pleasantville.

Mr. Bernanke had the following choices: 1) definitively end quantitative easing or, 2) keep the taps open. While his actions may only amount to a trickle down his leg, a trickle is still a trickle. Why is he continuing to do this?

Chart 1: US Real GDP (2007-2010)



Ugh..this hangover is huge...

Chart 1 (previous page) shows US GDP growth for each quarter since the middle of 2007. Recall that in 2007 the stock market was reaching new all-time highs and everyone in the World was seeing their house sky rocket in value. At the time, the Federal Reserve and Mr. Bernanke himself didn't think there was a bubble brewing in housing. A few weeks later a British bank, Northern Rock, went belly-up, followed by the venerable Wall Street investment bank, Bear Sterns.

Pretty soon, the entire economic house of cards collapsed and with that banks, and auto companies around the World were given public money to be bailed out and the central banks started to print money. **This unprecedented, coordinated global effort helped to self arrest the economy, and planted the seeds for a recovery – *or so we were told.***

For Q4 2009, initial estimates by the US Department of Commerce showed the US economy growing 5%. All the money printing, cash for clunkers, and TARP was working. Q1 2010 saw 3.7% growth – a tad bit slower, but still great growth. Then, Q2 2010 witnessed growth at 2.4% - slower, but still pretty good.

Then a funny thing happened along the road to recovery, it turns out US growth wasn't actually that strong after all. Revised estimates by the US Department of Commerce show growth being slower then previously reported and on top of this, it now looks like growth for Q2 2010 is actually closer to 1%.

Now 1% growth isn't good and when considered jointly with other current economic data the probability of a return to negative growth is rising by the day. **The much hyped economic recovery is turning out not to be driven by small businesses and the average Joe after all, but through government spending and money printing.** Hence, Mr. Bernanke's announcement to not end quantitative easing.

The fictional recovery being reported by the talking heads on TV has clearly stalled. You may hear the media talk about a double dip recession – a period where the economy enters recession, recovers a bit and then falls back into another recession**. It's our view that it is irrelevant if a double dip occurs, the important consideration from an investment perspective is the *expectation* that it could happen.**

For Mr. Bernanke to leave the door open for more money printing, speaks loudly about his thoughts on what may happen. After all, if it walks like a duck and it sounds like a duck, then it must be a duck. I can tell you, if you live in the USA there are some pretty loud quacking sounds on main street. The recovery is not happening and this is why economic policy makers and investment markets are suddenly very worried again.

Caroline Baum from Bloomberg news, perhaps said it best when describing the US economy *"What we had was a government-prescribed course of amphetamines (to keep it up), antibiotics (to prevent infection) and antidepressants (to make it feel better). It*

The bear is still growling...

endured regular steroid injections from both monetary and fiscal authorities. And it still has no real muscle." Well said ,Caroline.

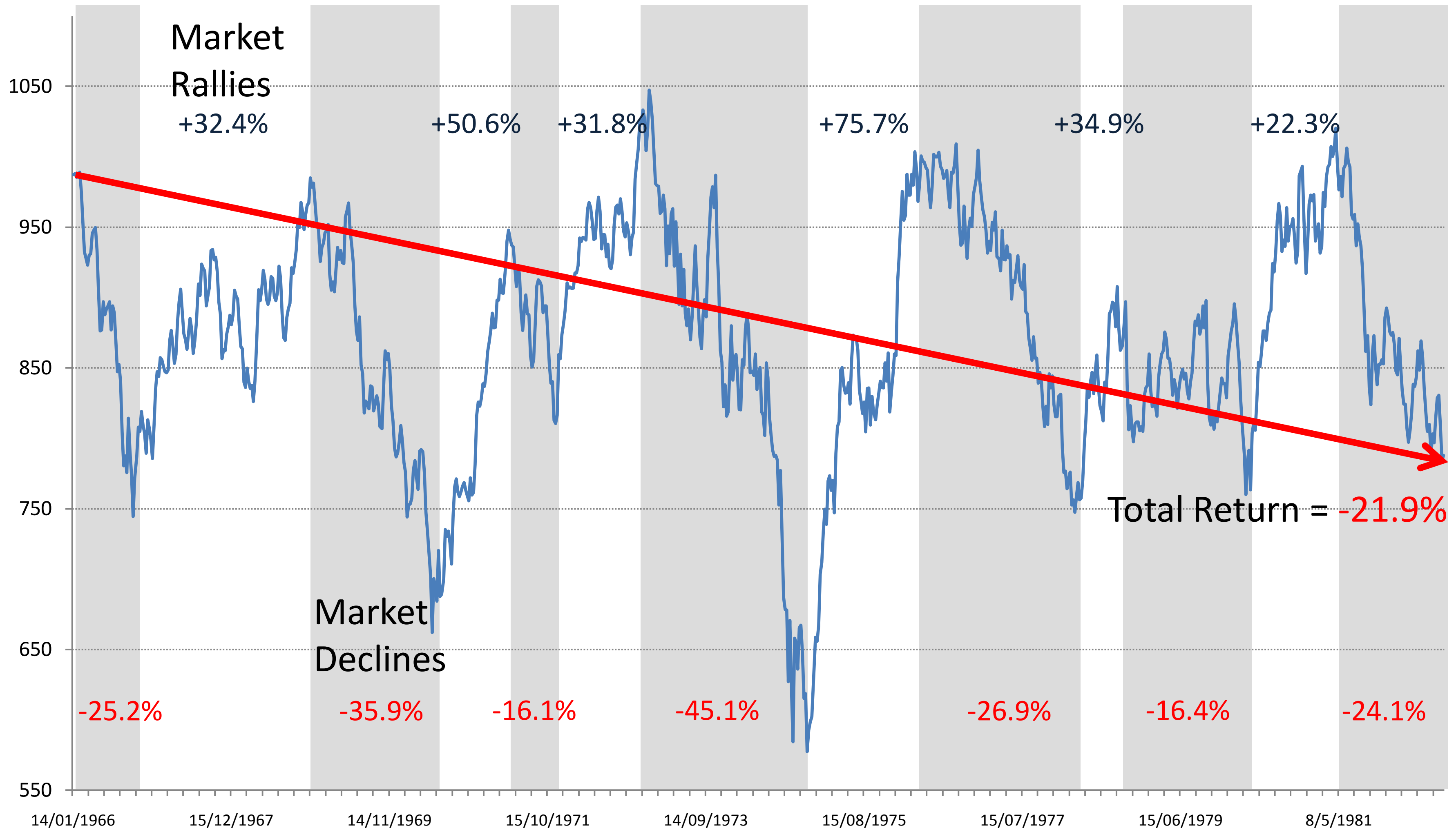
As recently as 6 months ago, the Federal Reserve was telling us that the economy was healing and that they were closer to ending their quantitative easing strategy and they were in fact considering when to next raise interest rates. At the same time, some very smart economists and investment managers were saying the opposite, a slowdown was coming; fast forward to today and you can see who was right. **You should be concerned because the dude steering the *USS Economy*, obviously hasn't anymore of a clue as to what is going to happen than a turnip**. As we said before, there are a few crazy aunts sitting around – one will come out sooner or later.

From a technical perspective, **we view the stock market as currently being in a secular bear market.** By secular bear, we mean a long period of time where stocks are lower at the end of the period than when it started. Since the early 1900s, the World has experienced 3 such markets. With the duration ranging from 13 to 16 years. In each case, the stock market was down over the entire period with declines ranging from -15% to -75% in total. However, within each of these secular periods there have been many cyclical bull markets – or shorter time frames when the market was up. These bull cyclical markets can be quite powerful and have produced returns ranging between +41% to +79%. **Chart 2 (next page) shows what happened during the secular bear market of 1966 to 1982.** The hi-lights include a -22% return for the buy and hold investor over this 16 year period, but with mini-rallies producing +41% returns on average, followed by mini-declines producing -27% returns on average. We have similar data for the secular bear markets of 1906 to 1921, and 1929 to 1942.

Today's secular bear market began back in 2000 – just as Britney was investing her winnings. Since then, the stock market has returned -9%. Let's think about that for a moment. **The investment industry has always preached that stocks are for the long-term, with 10 years being a pretty good "long-term" period, yet this hasn't exactly worked out as the glossy marketing brochures tell us.** In fact, over the last 10 years, the investment universe has been turned upside down. If you invest in stocks, you are making an implicit agreement to accept higher risk, in exchange for a higher return. Yet over the last 10 years this deal hasn't happened. Those taking no or lower risk with cash and bonds have significantly outperformed stock investors.

How much longer can this secular bear market last? History suggests another 2-4 years. As we know, it never pays to say "it's different this time." Yet, to make it clear we would feel a lot more comfortable if the bad debt was removed from the system. Removing the bad debt from the banking system is equivalent to ripping duct tape off your arm – the point being, it will really hurt for a short period but then the pain goes away. **The challenge we face today is that no politician wants to be the one to pull off the tape. As a result, the economy could remain in this mess for a while longer, and as long as this is the case the probability of a financial accident increases as the days go bye.**

Chart 2: Secular Bear Market 1966 to 1982 (Dow Jones Industrial Average)



Validating our conservative approach

Our portfolio strategy

The economic recovery in the developed world is slowing very quickly. While government stimulus packages and bailouts did halt the economic collapse, the subsequent recovery has proven to be artificial at best. With housing, inventory re-building and employment all rolling over, it's difficult to see where the real recovery will come from. Central banks are starting to sound much more cautious which suggests their response will be more of the same – money printing.

The consequences of another round of money printing can be many. We fully expect to see heightened market volatility, as well as more troubles for different countries and currencies. And if you are a student of the Austrian school of economics, you'll agree that an inflation problem is inevitable at some point.

From an investment perspective, in this environment we do not subscribe to a buy and hold strategy for stocks– a continuation of the secular bear market will ensure your stocks will lose money for you. Strategies to benefit from volatility will outperform in this market.

Our strategy continues to be conservative, preferring bonds over stocks and commodities. And until the debt problem is resolved, we also remain positive on gold over the long-run.

If you'd like to chat further about our view and our unique investment solutions, please feel to contact:

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Thank you for sharing your time with us.