CastleMoore News

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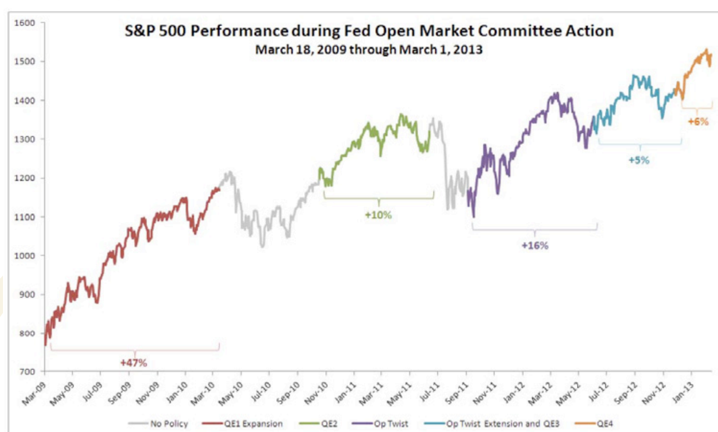
THE LAWS OF DIMINISHING RETURNS

By Robert 'Hap' Sneddon, FCSI, President

I watched the most fascinating documentary recently on the properties and nature of the universe. How big is it? What's its shape? How fast is it contracting? What are the properties of dark matter or all the space that lies between all the physical things we can see or measure in the universe? What I learned was that the universe appears to be infinite, with no with boundaries, that its expanding (this theory has been around for some time but now its an accepted state) not contracting, that dark matter is being stretched with the expansion and is finite, and that a newer discovery, dark energy, accounts for the expansion and pace of acceleration of the universe, and more than 70% of the universe's density. The point is that principles, even as they are updated, reaffirmed or refuted, must guide our understanding of things about us, including economics.

We may disrupt economic trajectories, but we cannot suspend them. Since 2008 the US central bank, led by Benjamin Bernanke, has attempted to engineer certain outcomes – full employment, growth or inflation, and an increase in equity valuations - based on its management of interest rates and, in part, it's "too big to fail" policy with regards to businesses. Today, this can be said of other global central bankers too, but not to the extent shown by Bernanke, or his predecessor before him, Edward Greenspan, for that matter. In the past two weeks, the Japanese have pulled out all the stops in providing stimulus, which has pounded the Yen and JGB's. Besides Wall Street, it seems that all streets lead to the US Federal Reserve, when truly, all participants and stakeholders should understand that upside consumption or demand can appear to be bolstered by centrally managed planning only for a limited amount of time. For a recent example we can look at the government policies to push up housing in the mid 2000's. Like gravity or dark energy there are economic principles that are inviolable.

Effects of QE on the S&P 500



QE = Quantitative Easing programs.
Source: Bloomberg, DoubleLine Capital

I have written before about the diminishing effects of quantitative easing or government stimulus. The chart now provides simple visual proof. Each successive and larger quantitative easing package is having less and less impact on equity returns yet costing more and more each time to enact. The ratio of stimulus-to-growth in first QE was 1:1, that is to say the Fed spent a dollar and got a dollar of growth. Most recently we are north of 4:1. True, the US unemployment figures have firmed from a high of 10% at the end of 2009 to the current 7.6% today. Two significant attributes of the decline are the quality of the jobs created and the employment participation rate. The jobs being created are of lower pay and benefits. High quality positions will return with secular societal innovation and breakthrough. Over the last 150 years we have had three such game-changing periods: the industrial revolution and introduction of mass production; the Western demographic explosion post-WWII from the birth of baby boomers and the advent of suburbia and consumerism; and last, the positive economic and societal radiation of computer technology. (Facebook, Linked-in et al are really just testament to the fact computer technology in general has run out of ideas) With the participation rate (those eligible to work) falling it has a positive but misleading impact on the unemployment rate. Less people in the workforce reduce the denominator and, hence the overall figure, distorting some of the improvement in the job pictures.

Aside from the S&P, recently we have seen defensive areas of investing pick up strength such as Canadian, US or German government bonds, utilities and infrastructure, consumer staples, healthcare and preferred shares, and pro-growth or cyclical sectors such as consumer discretionary, base metals, energy and financials weaken. The TSX, which is resourced based (and very pro-cyclical), has lagged the S&P of late, yet it should be a confirming indicator of growth. The Fed has always hoped to stimulate the cyclical areas to generate "escape velocity" for the economy, to raise economic activity to such a level that it creates consumption demand and thus supports increases in employment and housing, and leads to a reduction in debt levels, both at the individual and state level. A sort of "fake it, until you make it" strategy. Chairman Bernanke's lesson from the Great Depression was that in 1937 and 1938 the government ended the stimulus too early, that the austerity measures, including spending cuts, actually prolonged and worsened conditions. He is adamant in staying the course of further stimulus until the unemployment dips below 6.5%, evidenced by the recent FOMC statements. Others camps reflect back on the period and point to the increase in taxes and regulation as the culprit. Opposing views seem to illustrate that the force of economics may be beyond our abilities to always understand causes and solutions, and certainly to manufacture permanent fixes.

The principle that the US Fed or the European Central Bank too do not appear to understand is that there is no deus ex machina (Lloyd Blankfein, doing "God's work", aside). Economics, like the universe, have principles that govern. Just ask the Japanese about screwing around with the natural order of things – they've been mired in the mud for 20 years because of policies to avoid any pain, anywhere, by anyone or any business. Their recent efforts are not something they have simply overlooked in the past and are just now getting around to enacting, but an attempt to simply overwhelm or suffocate the deflationary forces.

To be fair, it's harder to appreciate that some policies may help with employment and people's lives, but to what extent do the policies used to create jobs, any jobs, far outweigh muddling through the period of time that is required to purge the system and let innovation fill our cups? I don't know the answer, nor would I ever dismiss, academically or otherwise, the notation that governments should help their citizens when in duress, especially across a wide spectrum of citizens and industries.

The tell tales today that centrally planning economies is ultimately an ineffective strategy are the softening of global economic data (you should be hearing about Slovakia soon), the recent weakness in the cyclical stocks and the strength in defensive themes, including the US dollar. While a short-term bounce this spring in "risk-on" assets is probable, positive investible momentum is present in the areas where government stimulus is already discounted, has the least impact. Secular change that leads to a new path for humanity will come – this is a principle of humanity - and sooner than we may think. My soft thesis for the next systemic change comes from biotechnology, and healthcare in general. But that's just a guess. In the meantime, our client portfolios are invested in securities that are inherently strong, whatever government planning desires.

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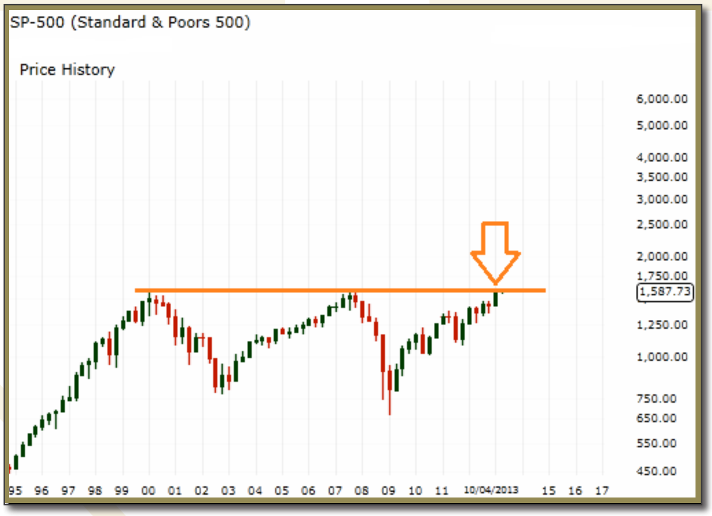
RECENT MEDIA

February 20th:	**BUSINESS DAY**	**http://watch.bnn.ca/#clip868813**
March 1st:	**MARKET CALL TONIGHT**	**http://watch.bnn.ca/#clip876137**
April 8th:	**MARKET CALL TODAY**	**http://watch.bnn.ca/#clip900986**

BNN BUSINESS NEWS NETWORK

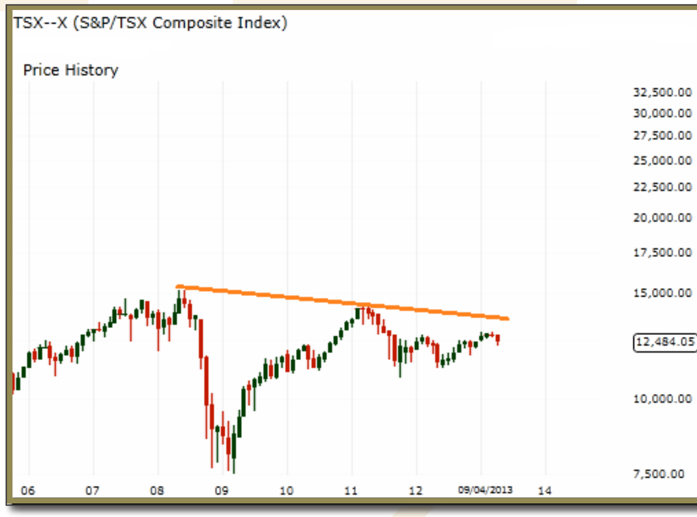
THE CHART PAGES

US EQUITIES



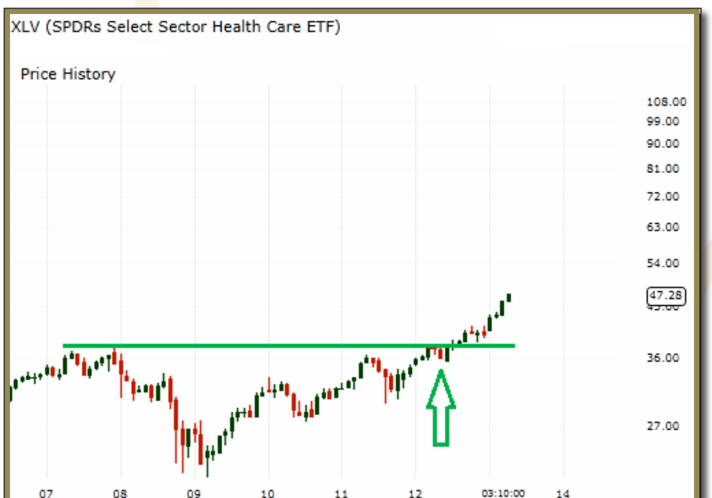
US equities, as represented here by this long term chart of the S&P, are trying to poke through resistance of the last 13 years. In 2007 the index broke through the 2000 resistance of 1552 when it hits high at 1576. This past week the index broke through that 2007 resistance to reach 1587 (so far).

CANADIAN EQUITIES



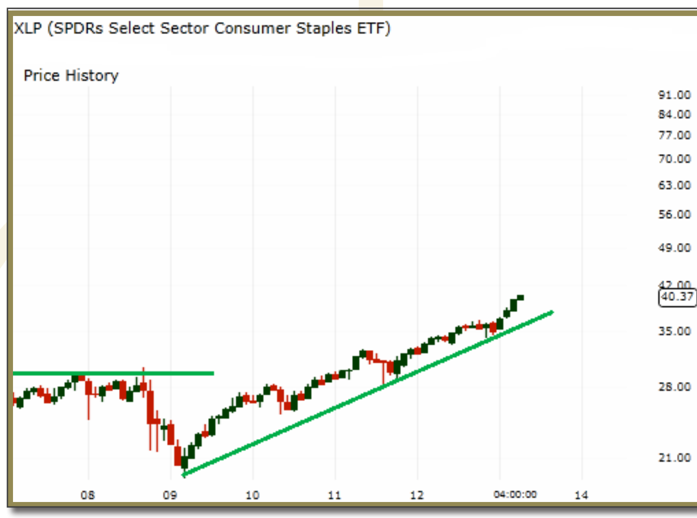
The TSX has lagged the S&P substantially since 2008, down 17% over the span. Of late the resource sector, particularly base metals and most oil stocks, and financials to a degree, are dragging on this market. Acceleration in these areas would confirm a longer investable move in global indices. Brazil a very focussed resource market is down 45% since 2008.

HEALTHCARE SECTOR



Last issue we highlighted Pfizer specifically as an example of a security in a secular bull market. Here we show that the entire healthcare sector too has only recently broken out from being in a long downtrend since 2000. Though the space is overbought at present any softness would not change this trend.

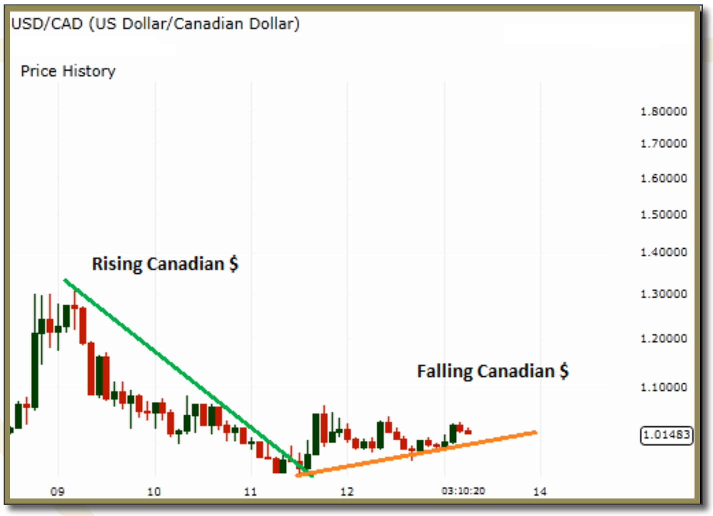
CONSUMER STAPLES SECTOR



Consumer staples are now at all-time highs owing to the fact of more predictable income, and less dependency on government stimulus. Like healthcare, staples may come off a bit, but should quickly find buying support.

THE CHART PAGES

CANADIAN/US DOLLAR RATE



The Canadian dollar weakened against the US dollar beginning in 2011, though there have been some sporadic upwards bursts throughout 2012. Greater strength would be seen if metals, mining, and oil stocks were truly strong. This inverse chart shows the Loonie increasing vs. the greenback since March (last two candles).

US GOVERNEMENT 10 YR TREASURIES

We maintain significant client holding in Canadian government bonds. This chart of US bonds is illustrative of the downtrend in AAA yields and uptrend in their prices. The majority of economists and Fed watchers expect rates to rise, breaking the back of deflation as they did in 2008 and 2010. We have recently begun adding to longer dated maturities in our pure bond portfolios and expect to so do in our asset allocation models soon.

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FROM THE KITCHEN TABLE…ERRR…FLOOR

By Thomas Kleinschmidt
Executive Liaison, Assoc. Portfolio Manager

Often, financial advisors meet prospective clients at their kitchen table. Perfect place…that's where most of the important family decisions take place, so it is from that perspective which I write.

Why the heck am I on the kitchen floor?!?

Toronto Star, Thursday February 21st. Business Section, page B2. "Retirement dream on hold". That's why.

This article shows a few survey findings, all quite disturbing, but starts with "Only 27 per cent of Canadians expect to quit working at age 66". I knew the reason – the crushing hit most retirement investments took and keep taking – not that folks are loving their jobs and simply don't want to quit.

Beyond the survey answers of "very satisfied" through "very dissatisfied" about their portfolios, the real issue is that folks like you are simply worried about their investments and not having enough cash to live planned lifestyles, or worse, outliving those funds.

YOU SHOULD BE WORRIED. If you are heavily invested in equity/stock based products (see below chart of the S&P500 index) if history is a guide get ready for YOUR fiscal cliff. You might, after looking at the picture below, be asking yourself, will I lose 50% of my savings in the next year?!?

You want to avoid this eventuality, and it is not an "IF" question but a "WHEN" question. As for the answer, I can assure you that you most definitely do NOT want to be in equities/stocks WHEN the stock markets break down. (Caveat: if the S&P500 actually breaks above its historical ceiling you might want to sell your bonds and buy more equities! But this is a conversation you need to have with your advisor(s). Include bonds and bullion in those talks.)

Asset classes "cycle" – that is they go up and down, taking folks for a ride – for a number of reasons. Stock sectors cycle for a number of reasons. Your portfolio should not "cycle" for any reason. Know when to sell.

So, dear investor, beyond this run on sentence, please learn what you need to learn and fix what you need to fix, or hand over the management of your retirement life savings to a manager that appreciates the simple fact that you have decided today that no longer will you tolerate your portfolio "cycling" away into the sunset without you.

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FOLLOW THE DATA

By Jason Dubbeldam

In any portfolio, there are different kinds of risk that affect its holdings and performance. To varying degrees, portfolios are influenced by credit risk, liquidity risk, interest rate risk, policy risk, etc. Two that are quickly becoming top of mind to many are market risk and economic risk, and how the two may mingle.

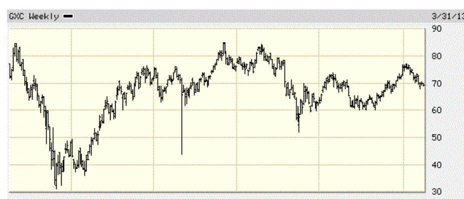
To find out what's really going on, we often have to sift through the data. Since late last year we've seen a number of economic indicators begin to deteriorate. GDP in Canada, while surprising in February, cannot form a positive trend. This is being caused by an overall softening economy, a strong CD dollar and one asset class that's already tipped over into deflation, real estate.

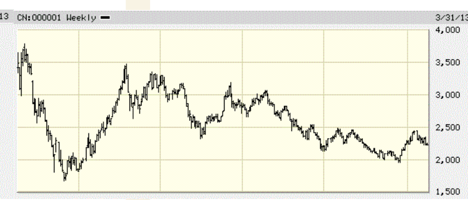
The story isn't much brighter in the US. While durable goods orders were sent soaring 5.7% in February, this was largely fueled by defense spending and aircraft orders, two very volatile components. Taking those two factors out, capital goods orders actually fell 2.7%. While deflation has yet to hit the housing market in the States like it has already begun to in Canada, the risk levels are very tangible. Prices for homes were up 8.1% year-over-year in January, the largest jump since June 2006. US home prices are now back to levels last seen at the end of 2008. In a sign of what may be to come, new home sales figure dropped 4.6% in February, double the consensus expectations.

As personal income in the US dropped 3.6% in March, individuals across North America are not turning to credit anymore to continue to support their spending habits with the fervor they once did. In March the pace of growth of consumer credit use (an indicator of consumer spending and confidence) is slowed drastically, and in the case of mortgage credit, it actually fell. US manufacturer's shipments also dipped into the red, continuing a 3 month trend.

Despite these factors, North American equity indexes have risen impressively over the last three months or so. The S&P500 is approaching levels not seen since 2000 and 2007.

Internationally, we see the disconnect as well as the GXC, a major North American ETF meant to provide exposure to the Shanghai Composite Index (CN:000001), is actually outperforming the underlying index (5yr charts shown). What do the Chinese know that we don't? How do our own economies and sentiments affect how we view and invest in other countries and regions?





Meanwhile, sentiment and technical indicators are setting bond yields up for another drop (and corresponding increases in prices.) Should these indications come to fruition, it would point to a move towards a more risk-off trade as investors protect themselves against another possible 50% removal in the value of equities.

In Canada the S&P/TSX Composite also performed well in the last few months of 2012 and, for a while, into 2013 before stagnating over February and March. Despite this, 45% of TSX stocks are now trading below their 50-day moving average, a deteriorating trend which has been evident since the New Year.

What we see is that markets are generally slow to react to the underlying fundamental action occurring in the economies they are supposed to represent. This has not been helped by governments around the world jumping through all kinds of hoops to prop up their economies, jobs and equity markets. The Fed has out back, no?

What we see this painting is a picture of increased risk. Indeed some of the highest we've seen in equity markets in over four years. CastleMoore has dealt with this type of situation successfully in the past (2008, 2009), and continues to strategically position itself for the risks that are presenting themselves now. An average 42% strategic equity exposure across our portfolio range has allowed clients to participate in the recent jump in equities while protecting to the downside thanks to their largely economic 'staple' nature. We have the flexibility today to add to our bond allocations (something that produced exceptional client returns in 2011) and focus on the sectors or countries that show prudent risk-to-reward.

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INSIGHT: THE EXTREME FORECAST

GUEST COLUMNIST

by Mukul Pal

Extreme forecasts as it seems are more regular than rare

It's not the first time, but on many prior occasions I have been accused of getting too extreme with forecasts. My running forecasts of DOW 20,000, Nifty 10,000, Oil 300 dollars, Gold 10,000 dollars, Indian Rupee-USD sub-40 could also be considered extreme for the next 36 months.

With all the objectivity that we talk about and all the objectivity that investors seek, do we really need an extreme forecast? Surprise is a constant feature of the market and even ridiculous forecasts come with a probability. Remember "miracles"? Moreover when business planning can look at "What if" contingencies, why can't investors look at "what if" scenarios? Does it not force us to think out of the box? Prepare us for the unforeseen, for the uncertain.

Now mind it, it is all not irrational. Extreme forecasts are something that seems rare. It could be 100% up-move for DOW and Sensex in 36 months and 50% for a currency during a similar duration. Historically, all of Gold, Oil, Dow, Sensex, and INR-USD etc. have witnessed such large movements in periods of 36 months. Extreme forecasts as it seems are more regular than rare. This is why a Nifty move to 10,000 from 4,500 (January 2012 lows) till 2015 could be reasonable. The same logic could be extended to Oil $100 to $200 by 2015, Dow 12,000 to 24,000 by 2015, and Gold $2,000 to $4,000. The only problem here is that 100 per cent is just a thumb rule. Price action could overshoot or undershoot the 100 per cent in 36 months target.

Elliotticians find extreme forecasts very regular as price patterns work like clockwork. No wonder Elliotticians stick out their neck more often than conventional technicians. Another reason why the 100 per cent in 36 months is very regular can be also seen among inter-market pairs. If 90 per cent is the difference between the worst 20% portfolio of Sensex stocks and best 80% portfolio of Sensex top performers (The New Sensex), then it should be no surprise to see intra Sensex stock components diverging more than 100% in 36 months. In my paper on Time Fractals (SSRN), I illustrated how tight knit (high correlated) pairs like Exxon vs. Chevron could also deliver 50% annualised in a long-short strategy. The point I am making here is that there is nothing religious about an extreme forecast.

So, though every extreme forecast is out there we need some kind of filter of the 'ridiculous workable forecast' from the 'ridiculous popular forecast'. This is where the intuitive and counter-intuitive filter comes in. If a forecast seems intuitive and correct, it is probably wrong. We have made our counter-intuitive bullish case on prior occasions. For us, Gold's five times growth from $400 to $2,000 is an on-going leg, which should proceed from $2,000 to $4,000 and potentially $4,000 to $8,000.

Extreme forecasts doesn't need experts, it needs historians. It's just the behavioural bias that closes investors out of the game. Gambler's fallacy of expecting reversion to mean is trickier than it seems. Markets are always fulfilling extreme targets as investor psychology follows the Dow Theory, starting from disbelief about an extreme forecast, to shock that the forecast happened, to regret regarding missing all of the move.

In the end it's easy to say, "Who knew the story regarding euro misery?" The extreme forecast was out there, it's just that we did not want to see it. Extremities are a part of human society, wars too are very regular, and it's just that we fail to wake up from an illusion of continued prosperity and peace.

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