



Temporary Dip, or Rebel without a Pause?

Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favourable business conditions. The purchasers view the current good earnings as equivalent to “earnings power” and assume that prosperity is synonymous with safety.

BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR, (FIFTH EDITION, 1973)

Our subject, of course, is not the iconic 1955 American film about emotionally confused and disaffected suburban youth (although there are more investing parallels than one cares to admit). Instead, we are concerned with the recent rebellion by economies to standard post-war monetary prescriptions. Despite record stimulus and interest rates tethered to near-zero, recent growth figures are now showing renewed signs of slowing.

Indeed, we are again at a critical crossroad. The Fed’s main monetary backstop ends June 30th and the “risk off” trade has gained traction. Fortunately, client portfolios have been positioned defensively — and rewarded for this posture. Yet, at this stage, the S&P 500 has recently closed lower for a record six straight weeks, and, at one point, was down almost 10% from its April high. Powershares’ flagship commodity ETF (NYSE: DBC) has fallen more than 10%. And, the US dollar index — still clinging to the status of global “safe haven” currency — looks to be carving out a bottom.

Is this just a pause in an ongoing bull market, or has the rebound in risk assets since March 2009 run its course? And, are we reading the last rites over the economic expansion that began, as demarcated by the NBER, 24 months ago?

The analytical community is divided on the issue;

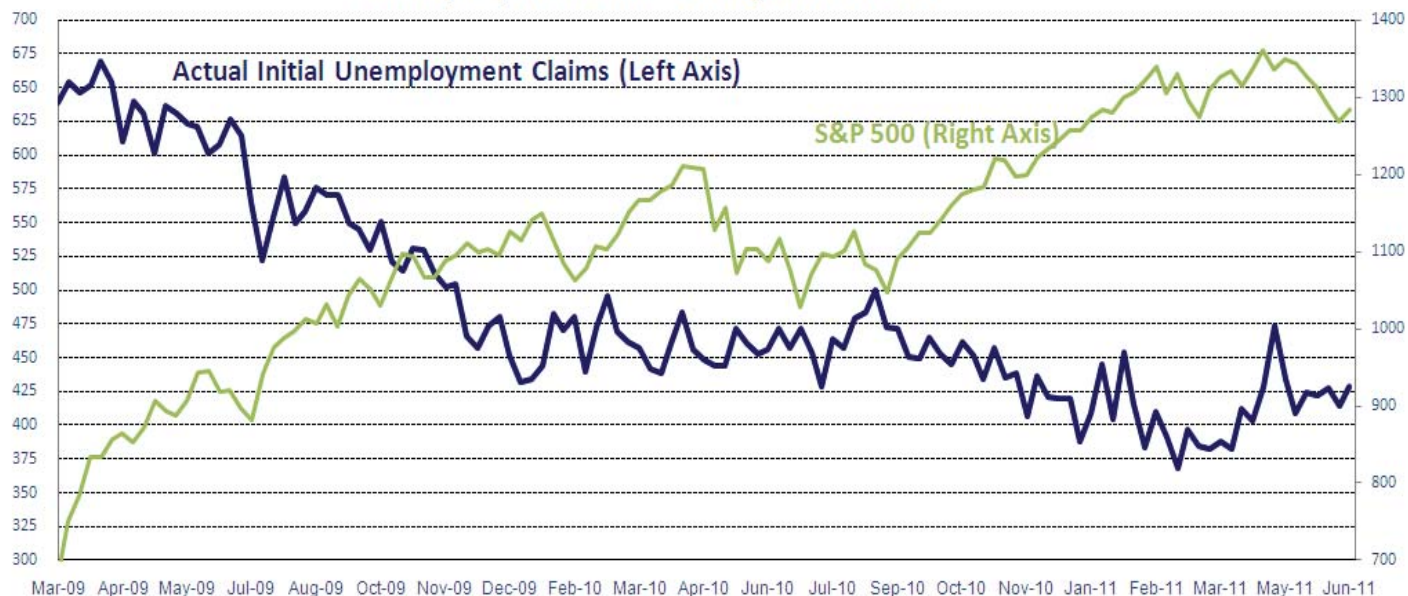
but a growing consensus believes that a second-half 2011 recovery awaits and the current correction is simply a pause rather than something more protracted.

We are not entirely convinced. Rather, there is mounting evidence that growth — on a global basis — will enter a sustained slowdown over the next few quarters ... very likely into 2012. Admittedly, divining the major inflection points is no easy task. As those labouring in the money management field come to know, cycles begin, and end, unceremoniously. Often, the significance of certain data points and trends is only clear in hindsight. Yet, for tactical macro investors, the turning points are the ones that matter.

2010 Redux? Many are drawing a parallel between 2011 and 2010, recalling the temporary soft patch and accompanying market dynamics. Last year, the US economy did enter a short-lived slowdown, prompting the S&P 500 to suffer a 16% setback (the emerging market broad index was down by 18%). However, economic growth soon returned and risk assets resumed their upward march.

Now, it is tempting for investors to expect a repeat of last year’s experience. After all, “buy the dip” has become today’s Pavlovian response to any stock market setback. But the set of circumstances today are markedly different than in 2010, particularly when looking at the wider

Unemployment - A Leading Indicator?



global economy. Consider some of the key differences:

1. No Double Dipping! Last summer, Lakshman Achuthan, Chief Economist of the Economic Cycle Research Institute, issued a stern rebuke to the double-dipper camp, who were using ECRI's proprietary indicators to forecast a renewed recession. According to Achuthan, many were misinterpreting their widely followed WLI "weekly leading index" (which had gone negative). Historically, a negative WLI reading, on its own, did not signal a recession. Rather, the institute needed to see a "pronounced, pervasive and persistent" decline in the level of the WLI, following a similar decline in their "long leading index" of industrial growth.

Where are we at today? The ECRI's global long-leading indicator topped out earlier this year (importantly, it did so before exogenous events like the Japanese tsunami and Arab Spring), while the WLI has now declined for 9 straight weeks. Indeed, a "pronounced, pervasive and persistent" trend.

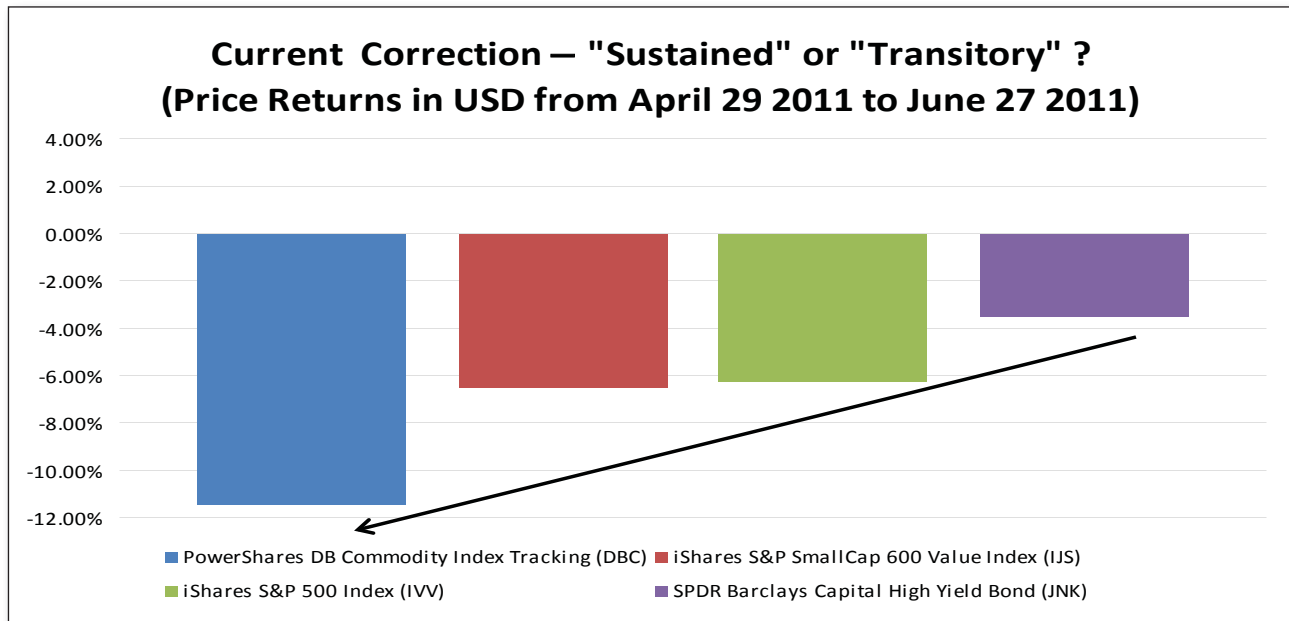
2. The Secular Bear Roadmap (or Live Fast, Die Young). It is no secret that government activism has surged since the onset of the global financial crisis. But, less known, is that deficit-driven economies will experience more frequent bursts and lapses in growth, speeding up the cyclical rhythms compared to "normal" cycles (recent austerity measures are also accelerating slowing trends). Why? Because private sector driven expansions produce more

organic, sustainable, and longer-lasting recoveries.

Nautilus Capital Research has crunched the numbers on cyclical bulls within secular bears. Looking at 7 cycles since 1907, it turns out that the average duration of the cycle is 26 months with an average S&P 500 increase of 85%. As of last month, we reached month 26 and returned 102% for this cycle (high set in April). Last year, we were only 14 months into the cyclical bounce. Taking the view that we have remained in a secular bear since 2000, the current recovery is certainly long in the tooth.

3. Unemployment — A Leading Indicator? We have long argued that the current economic climate is different primarily because of credit dynamics — the Western private sector faces a longer-running deleveraging period as household balance sheets are repaired (an ongoing "balance sheet recession"). Ray Dalio of Bridgewater has theorized — correctly, in our view — that in these post credit-crisis environments, where leverage levels remain dangerously elevated, unemployment figures are likely to be leading indicators of the economy (rather than lagging indicators, as they have been during normal cycles). The logic is that increases in job losses lead to further mortgage foreclosures and bankruptcies.

Recent employment trends have not been robust. Since March, unemployment claims have trended higher (429,000 as of last count), while payroll numbers have not been recovering quickly enough to close the



output gap and restore full employment any time soon. During 2010, unemployment claims were trending downward, while payrolls were more robust mid-year.

4. Renewed Credit Stress. While credit strains were mild in mid-2010, there is now mounting evidence of heightening pressures. Euroland's sovereign bond space is clearly the epicentre (both Spanish and Portuguese cost of borrowing just hit new highs), but damage is migrating to other credit sectors. For example, during the first half of 2011 the US high yield space yielded just 6.5% (at that rate, "high yield" was clearly a misnomer). Since then, however, spreads have again begun widening, backing up about 140 bps since mid-April.¹ Inflows into US high-yield ETFs and funds have also reversed. After record inflows this year, last week saw record net outflows of USD 1.6 billion. The problem, of course, is that when credit markets turn, they don't creep — they gallop, and in unfavourable directions.

5. An Emerging, "Emerging" Slowdown. For many Western consumers, the opiate of near-zero interest rates has lost much of its initial punch. The main issue is that consumers, already loaded with debt, are not choosing to increase their borrowing even though monetary spigots remain wide open. As they say, you can lead a horse to water, but you can't make it drink. Bernanke, not surprisingly, is gnashing his teeth while the office he holds becomes even more impotent.

Meanwhile, in the developing world, policy-makers face the opposite problem. While official inflation figures have soared, central banks have

responded in force. Brazil's central bank has raised its policy interest rate 4 times this year to 12.25%, while India has increased rates 10 times in the last 16 months to 7.5%. In fact, both yield curves recently inverted (i.e. longer-dated government yields are now lower than short ones). In normal environments, monetary policy tightening works with a time lag, so impacts are likely to be felt for the remainder of this year and into 2012. To be sure, an emerging market slowdown has huge implications for the world economy — the majority of world growth originates in these regions (last year, they accounted for 66% of global growth). The key point here is that monetary tightening is much more advanced than it was in mid-2010.

Investment Implications. What to make of the above? Most still expect that the current soft patch is a transitory phenomenon. In time, that may prove right ... but how much time? At this point, the evidence points to a further slowdown ... or a much elongated period of slow, slow growth (what we have call the SSL in the past) and an attendant adjustment in risk assets.

However, it's important to note that financial markets are not the economy. Of course, there are important linkages that hold over longer periods. But, crucially, markets are forward-looking, quickly discounting the probable future. That means that a persistent slowdown can quickly revise collective expectations and present opportunities earlier than many anticipate. At this stage, global macro ETF investors should consider the following:

- Policy tightening in most emerging markets is at a late stage. Emerging market bonds (NYSE:ELD, ALD) will out-

perform stocks for now, but remember that most emerging markets remain in secular bull markets and equity markets will recover first. Stay alert to peaking interest rates and be ready to go long the equity complex then.

- Global interest rate expectations will likely downshift further as deceleration in the global economy takes hold. Already, Canada's major banks are ratcheting down their expectations for tighter policy. Messrs. Bernanke and Carney are likely to be on hold for some time yet.

- To date, this US cyclical recovery has set a post-war record. Both stock prices and earnings have soared by close to 100%, while corporate profit margins have gained more than 7% from their Q4 2008 bottom. During the past 40 years, US profit margins have only been higher in 2007 and now stand more than 50% above their long-term average. Given anti-cyclical forces, expect "earnings downgrade" and "margin squeeze" to become popular phrases in some sectors. Continue to overweight defensive companies that have a long history of steady dividends (NYSE: DLN, XLU, XLV).

- Contrary to IEA's and OPEC's forecasts, incremental oil demand is slowing on the back of weaker global growth. The wider set of economically-sensitive commodities face more downward pressure. However, stay long the "monetary" metals — primarily gold — with an overweight in the miners ETF (TSX: XGD). A cyclical commodity downturn is also bullish for import-sensitive non-commodity oriented countries like India.

- While the US dollar remains in a structural bear market, a turning point may have already arrived. Relative to other countries, the US economic slowdown commenced before other countries and austerity is only now gaining support. Both factors are supportive of a counter-trend rally.

- Watch closely the unfolding China slowdown. As capital spending and import demand recede, effects

will be felt around the world. Among the major economies, the US is least vulnerable to a Chinese deceleration as its exports to China account for less than 1% of GDP. Germany, Japan, and commodity producers are much more leveraged to China. Stay cautious on these markets.

- It is too early to begin accumulating more risk in globally balanced portfolios. Cyclical and high-beta assets should be avoided for now. However, markets may quickly discount a slower-growth outlook — remain alert to the underlying values this re-pricing will present.

The Legacy of a Balance Sheet Recession. The fact that massive fiscal and monetary stimulus has failed to engineer a self-sustaining recovery in the developed world highlights the central challenge of our time — Western economies remain hostage to an ongoing private sector balance sheet recession, relying on government support to drive growth. Over the long term, real recovery will depend on improving fiscal positions and taking some tough medicine — borrowing less, and saving and exporting more. At the same time, countries in the developing world will also need to rebalance, increasing consumption to correct savings and investment imbalances. Putting these prescriptions together, a more balanced global economy should emerge.

But in the short-term, this economic rebel is not likely set for a short pause. Clearly, a continuing downturn will present a most unique challenge in the post-war period. After ultra-low rates, quantitative easing, and unprecedented stimulus, the traditional fiscal and monetary arsenal is empty and policy options are now extremely limited. Expect policymaking to move further into the realm of the unorthodox during this next stage. Investors are advised to stay tactically nimble, seek global opportunities and only cautiously swallow the pills prescribed by central bankers.

Endnotes:

¹ Data from Merrill Lynch US High Yield Master II

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