

The Artificial Economic Recovery

Economic recovery in the U.S. and elsewhere has slowed rapidly and private and some public forecasts are being downgraded accordingly. The Federal Reserve is sounding much more cautious, although they are not yet prepared to talk of further monetary easing. The most optimistic observers are now having to face reality. The massive stimulus packages did the job of stopping a self-feeding downward spiral but they have given us an artificial recovery.

Growth is now gravitating back towards 1% in the U.S. and Europe, close to what final demand has been. In the U.S. the inventory cycle has stopped adding growth, state and local governments are slashing expenditures and jobs, the nascent housing recovery has gone into reverse, and deleveraging continues. Realistically, it is difficult to picture where any new growth surge may come from.

One of the most important implications of this dampened outlook is that government tax revenues will be disappointing and expenditures will remain elevated. The cyclical component of the deficit will remain high and the structural component will be hard to cut in a weak economic environment with unemployment likely to rise further.

The doomsday government debt dynamics depend crucially on getting economic growth above the rate of interest. That is currently close to 2% in inflation-adjusted terms against the

likelihood of 1% real economic growth—a recipe for a continued explosion in the government debt:GDP ratio. It is currently close to 70% on a net basis on its way to over 100% in a few years. To get off that trajectory, the U.S. will have to slash the structural deficit and risk even further damage to economic growth.

Are the politicians up to the job? Not likely, until there is a fiscal crisis. Fortunately or unfortunately, depending on how you look at it, the U.S. does not seem close to such a crisis. With most of the rest of the developed countries and their currencies in bigger trouble, the world's excess savings will manage to find a home, in good part, in U.S. Treasury securities, allowing the day of reckoning to be postponed by electorally motivated politicians.

Thoughtful people are not suggesting that the authorities slash the structural deficit now and in one shot. Rogoff and Reinhart point out that after financial crises, countries experience weak growth for a long period, deficits remain high and debt:GDP ratios continue to rise. However, that does not mean deficits should be neglected. They must be tackled credibly over time and on a sustained basis. If not, then an eventual crisis will provoke demands for a ferocious up-front slashing, as is the case in Greece and Ireland where GDP has or will drop 15% or more and the risk of social disorder spirals.

Money and Credit

While the economic outlook is less than rosy, there are the beginnings of some potentially positive developments in the financial system. First, the euro crisis has abated, at least for the time being. There are two main reasons. The first is the European Financial Stability Facility (EFSF), which, together with IMF money, totals U.S. \$1 trillion for potential

bailouts. The second is the stress test being performed on large European banks. While this may reveal a few problems, it would be shockingly incompetent of the authorities to publish this without announcing a recapitalization plan. It should be assumed that the test results will end up as a net positive, as was the case in the U.S.

There are tentative signs that U.S. monetary constipation is easing. Even though the Federal Reserve has sharply slowed its rate of balance sheet expansion, the money multiplier has stabilized (Charts 1 & 2). M2 has rebounded, a positive sign, as has the improvement in the rate of change of business demand for credit (Charts 3 & 4). The latter is measured as the rate of change of bank loans to businesses plus commercial paper. It has rebounded from -35% per annum to zero.

Chart 1

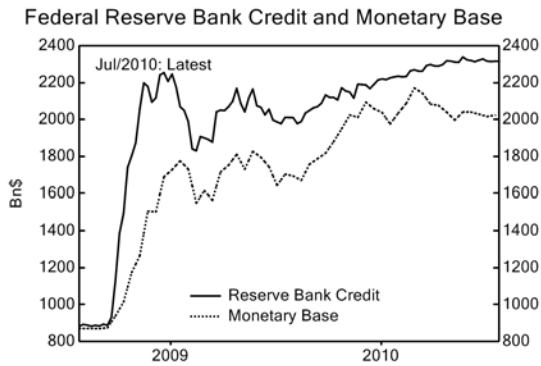


Chart 2

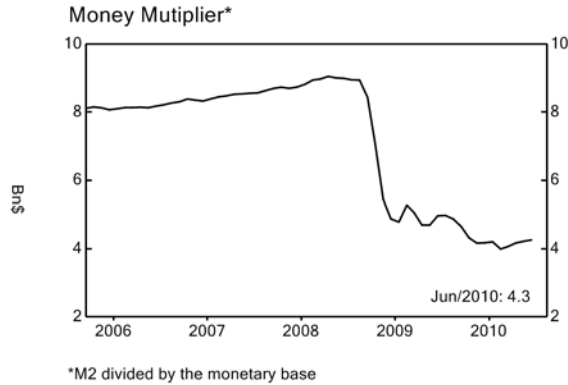


Chart 3

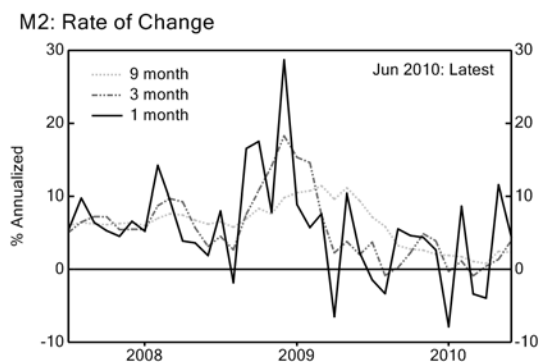
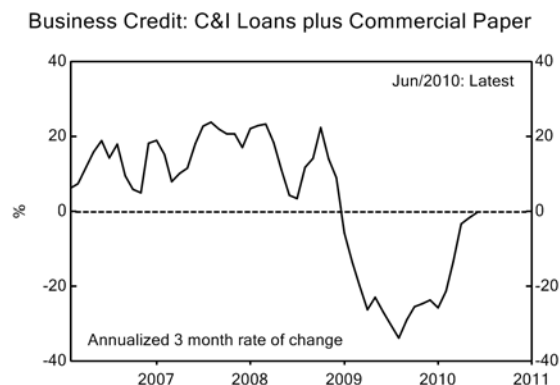


Chart 4



Investment Conclusions

The implication of the tentative improvement in money and credit is that investors should avoid getting overly bearish as a result of the economic indicators. Forecasting stock prices based on a forecast of the economy has almost always led to disappointment. Rather, the stock market should be seen generally as a good predictor of the economy—although not always. It is still a dangerous and fragile world out there, vulnerable to shocks. But the positives from the world of money and credit, the continuation of near-zero interest rates and the relatively strong performance of the corporate sector in terms of profits, productivity and liquidity should not be ignored.

Our investment thesis over the last year and a half is that a fragile economy should not push investors away entirely from risk assets. However, high levels of risk and uncertainty argue for continued focus on wealth preservation, an important component of which is sound diversification.

The investors' great dilemma was, and still is, the near-zero return on safe, liquid, short-term assets and the heightened, uncomfortable risk associated with attempts to get higher returns. The level of risk, however, fluctuates and there are a number of variables which are helpful in making assessments. Some of these are: 1) changes in liquidity; 2) valuation levels; 3) psychological extremes and 4) the technical position of the market.

At the bottom in March 2009, these were aligned in a very positive configuration and our bullish posture was based on that. As readers know, we have maintained our overall positive stance on equities and risk assets in general, because most of these factors have remained favourable. The one questionable issue is the technical state of the market and here, there is disagreement. Trend followers point to the weakness of the market vis-à-vis its long-term moving averages, suggesting the trend is down. Followers of some other methods believe there is a good chance that the market has found support and could soon rise. Given the disagreements, from a technical perspective, the outlook is not clear.

The four sets of indicators should be read as a whole. Our inclination, at this point, is not to put undue weight on the trend-following indicators because valuation is positive and central bank liquidity remains very expansionary. Near-zero interest rates create a powerful impetus for investors to seek out better returns in higher risk assets. Following the euro crisis (which has abated for now) investor psychology became extremely negative. Investors, in general, have built up huge cash positions to protect against another 2008-2009 meltdown. The media is full of bad news on the slowing economy. While a weak economy is never good for profits, it does guarantee sustained low interest rates and central bank expansion. These will provide an important offset.

Last month (Volume 2.8 - *Asset Allocation Thoughts*, June 29, 2010) we indicated that our overall stance was still bullish but suggested the market could go lower in the short run. Since then, the market has been pretty flat on balance. We still think there is a risk of further weakness in the short term but we do not see a major bear market at this point. Rather, a more likely scenario is market recovery after the period of seasonal summer weakness and then a wide trading range. The S&P 500 has been in a trading range between 1550 and 750 since the top in early 2000. The mid-point is around 1150, slightly below the current price level. The average P/E based on expected earnings over long periods is about 15, well above the current 13. However, the long-term average includes periods of high interest rates and inflation. When these periods are removed to make comparisons with the current low inflation and interest rate environment, the current level appears even more favourable.

While we have often stated that value does not help with timing, it does provide a cushion. Hence, we do not see huge downside at this point. But we must remember that the world is fragile—surprises, shocks and volatility should be expected. Therefore, be sure that your “risk” assets are of the highest quality. Balance sheet strength is critical and you should focus on value.

A portfolio positioned for capital preservation requires allocations to other assets. Bonds of the highest quality do not yield much but they offer good diversification. In the current environment, risks to the economy are all on the downside and highest quality bonds will improve in price if the deflation threat increases. The global economy is depressed, operating far below potential and choking on excess savings. These savings must find a home. Sovereign

bond issuance, on the whole, will be absorbed. Individual countries may have a problem but not the world as a whole.

In keeping with heightened risk aversion and wealth preservation, investors should hold above average liquidity, either in cash, near cash or liquid funds that are either market neutral or negatively correlated with risk assets.

The currency of choice remains a complex issue in today's highly unbalanced and fragile world. The big four—U.S. dollar, yen, euro and sterling are all a dog's breakfast and, hence, deciding on which is like choosing the best looking horse in the glue factory. The saving grace is that they can't all sustain devaluations. The euro, for example, seems to have found a recent limit at U.S. \$1.20 and has rallied strongly. The best approach is to have a balanced portfolio of all four and rebalance when one or more becomes too cheap or too dear. For those with more flexibility, we continue to favour the currencies of those countries which are financially strong, resource based and have low inflation. These would include the Canadian & Australian dollars and Norwegian kroner.

Gold deserves a place in most portfolios as insurance against ultimate monetary debauchery. This will occur if governments are unable to get their fiscal houses in order but it is still a distant threat. For many, living in countries with suspect banking systems or governments financially too weak to bail out banks in the event of another financial meltdown, gold provides protection. This assumes, of course, that desperate governments don't try to confiscate it.

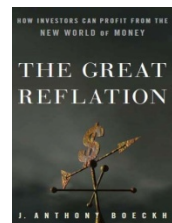
Gold has an evidence-based track record of protecting wealth for thousands of years. Ask almost anyone if they would rather have a hundred dollar bill or a hundred dollars worth of

gold coins and you will get the answer as to how deep the psychological attachment to gold is. At present, gold has other positives going for it. In a world of near-zero short-term interest rates, the cost of carry (opportunity cost) is negligible. It has a nicely rising trend behind it, which is attractive to the herd. Production appears to have peaked (“peak gold”) and demand in emerging market countries is strong. And, very importantly, it has been negatively correlated with risk assets during each crisis spasm in recent years.

However, all of this is well known, triggering massive financial demand, which could increase with more fear; or, it could reverse if fear subsides and the trend reverses. In other words, gold has lots of risk now. The quadrupling in price in ten years has made gold expensive to everything else and expensive insurance.

In short term, it looks topy and the next run may have to wait for another crisis. In the meantime, it could correct further.

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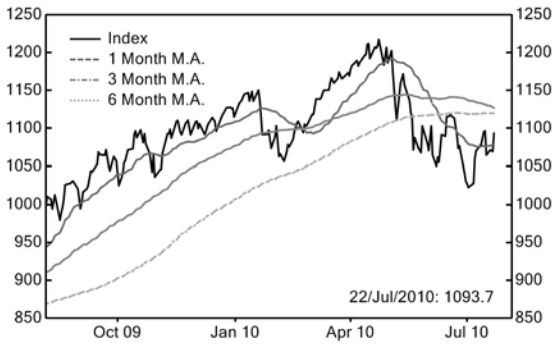


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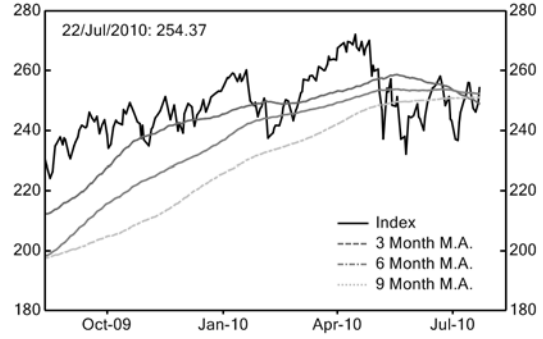
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Charts: Stock Markets

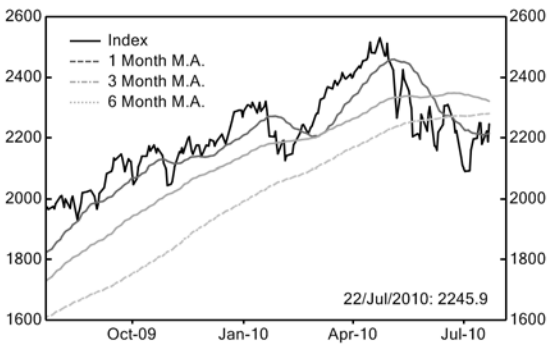
U.S. S&P 500 Composite



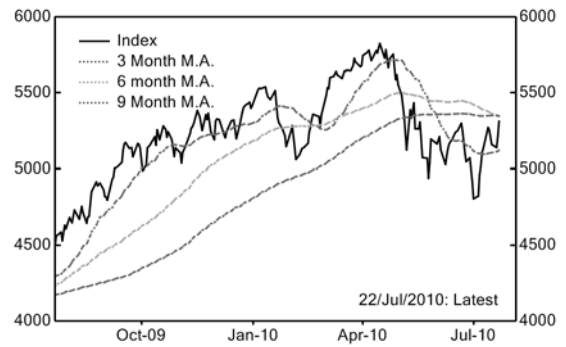
Europe DJ Stoxx 600



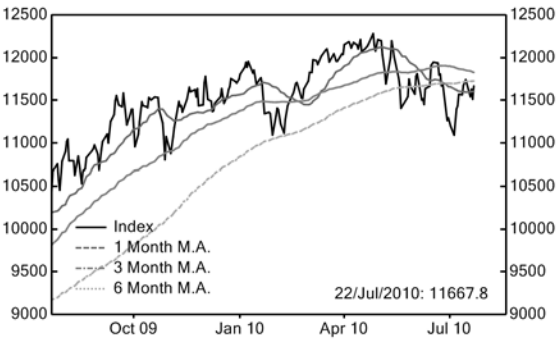
U.S: NASDAQ



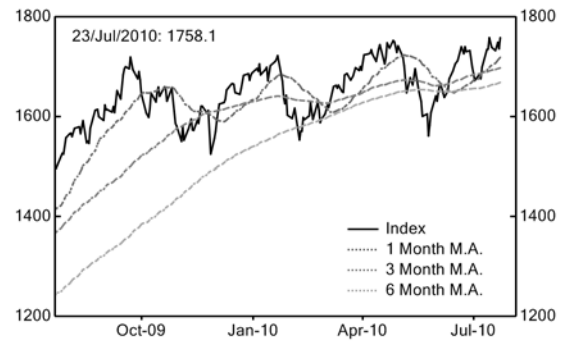
UK: FTSE 100 Cap. Index



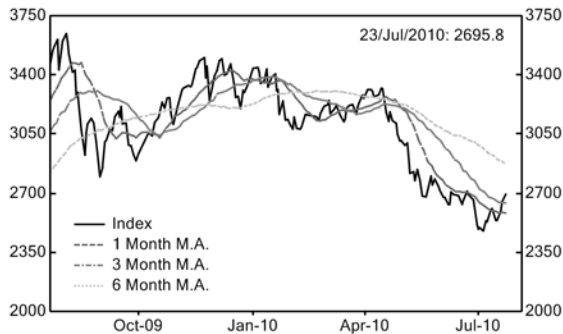
Canada S&P TSX Composite



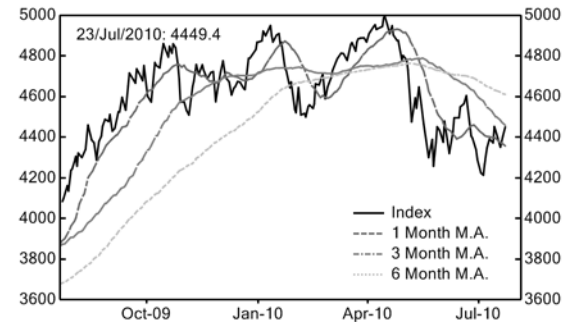
South Korea: KOSPI



China: Shanghai A Shares

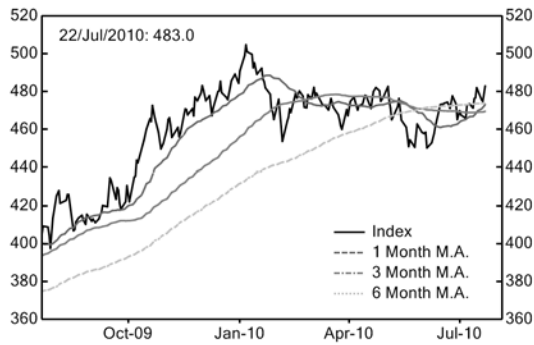


Australia: S&P/ASX 300

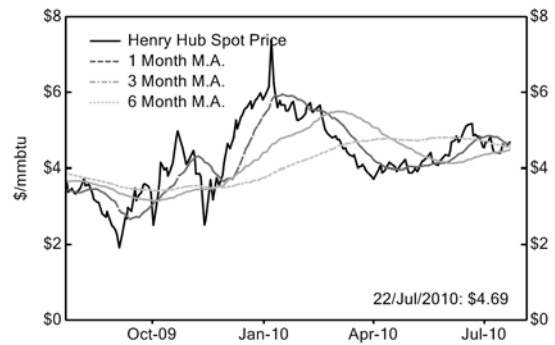


Commodities

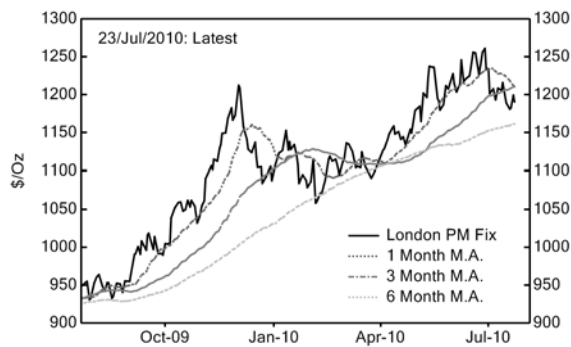
CRB Futures Commodity Index



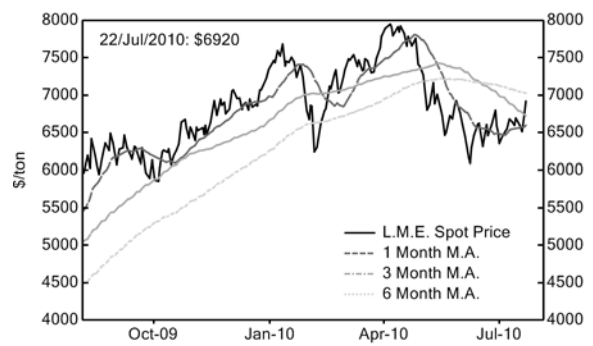
Natural Gas



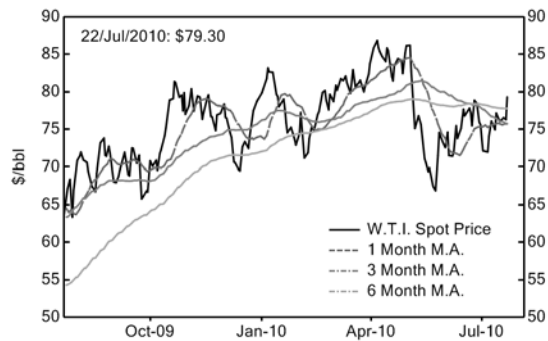
Gold



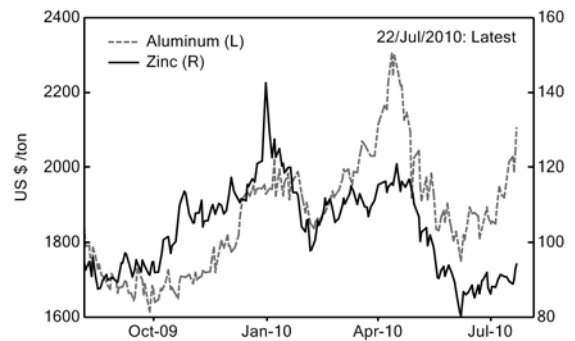
Copper



Oil

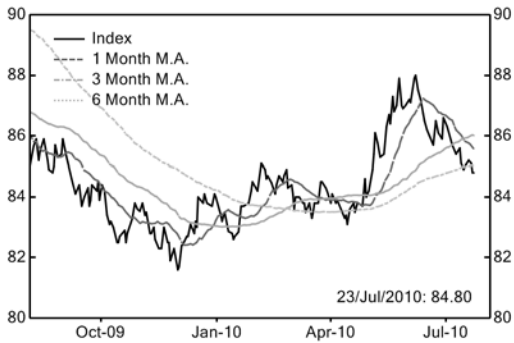


Metals

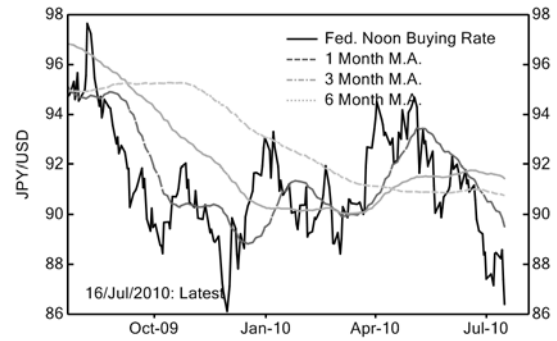


Exchange Rates

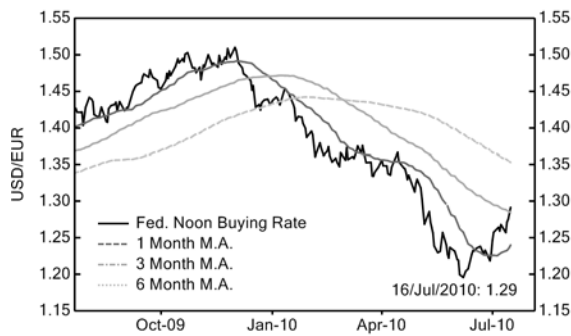
JP Morgan Trade Weighted Dollar Index



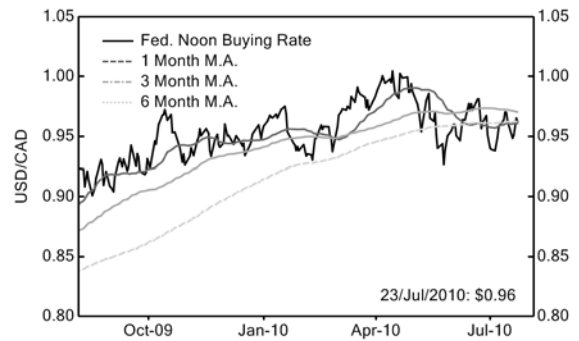
Japanese Yen per U.S. Dollar



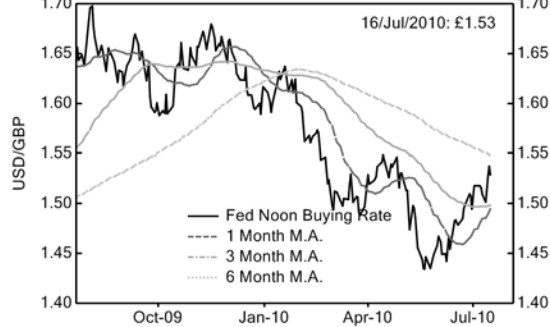
U.S. Dollar Per Euro



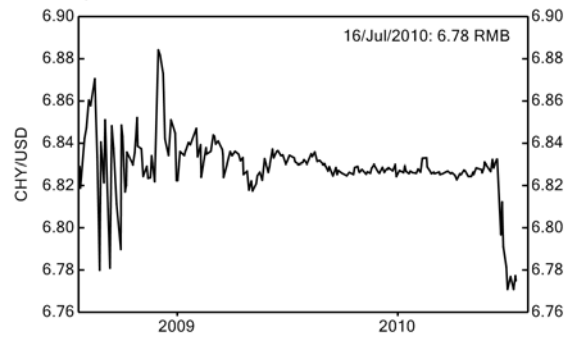
U.S. Dollar Per Canadian



U.S. Dollar Per Pound

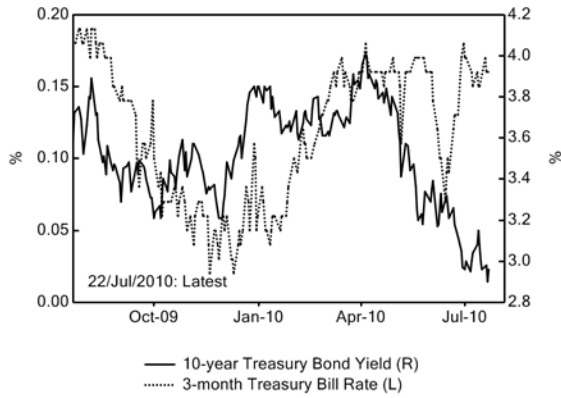


RMB per U.S. Dollar

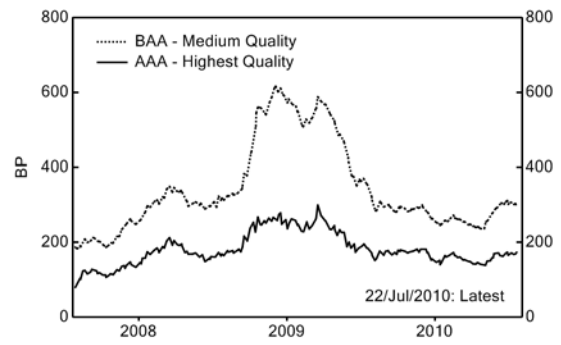


Interest Rates

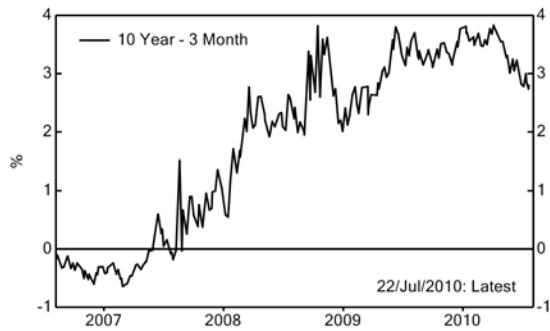
Yield: U.S. Government Paper



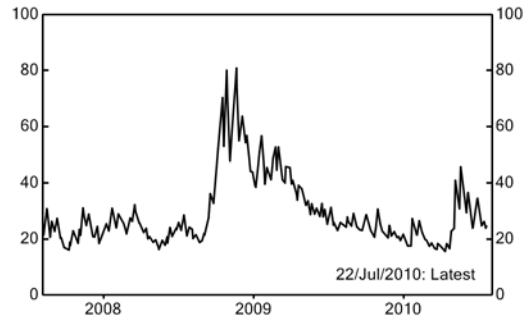
Corporate Spread over 10 Year Treasuries (Moody's)



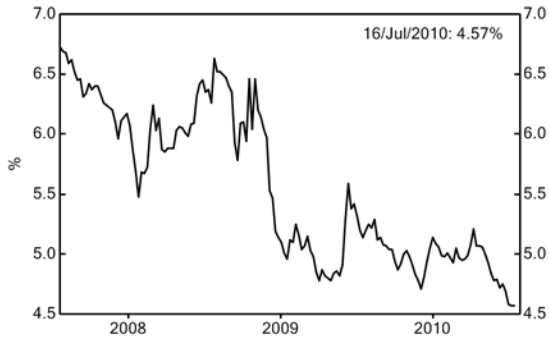
Yield Curve



VIX: CBOE : Options Volatility Index



Conventional Mortgage Rate



Source: Federal Reserve