The BOECKH INVESTMENT LETTER

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Global Tensions and the Market Correction

- U.S. recovery will surprise on the upside.
- Market correction underway.
- Key risks remain, particularly eurozone debt problems, emerging market overheating and currency warfare.
- Bonds remain over-priced and gold volatility and downside risk is on the rise.

The G20 meeting in Seoul has highlighted the intractable divisions between surplus and deficit nations. As the closing communiqué so bluntly put it, “uneven growth and widening imbalances are fuelling the temptation to diverge from global solutions into uncoordinated actions *(i.e. QE2 in the U.S. and currency manipulation by China).* Uncoordinated policy actions will only lead to worse outcomes for all.”

An amicable resolution to these problems is about as unlikely as a return to the gold standard. Nevertheless, limited rebalancing of the global economy is occurring. The question is, will it be enough to head-off a damaging currency and trade war and support Europe during its restructuring? Already, excess dollar liquidity in China resulting from its dollar purchases to hold the RMB down artificially has pushed China’s inflation rate up to 4 ½% (much higher in key urban areas) and triggered global fears of the consequences of a tightening of China’s monetary policy (Charts 1-3).

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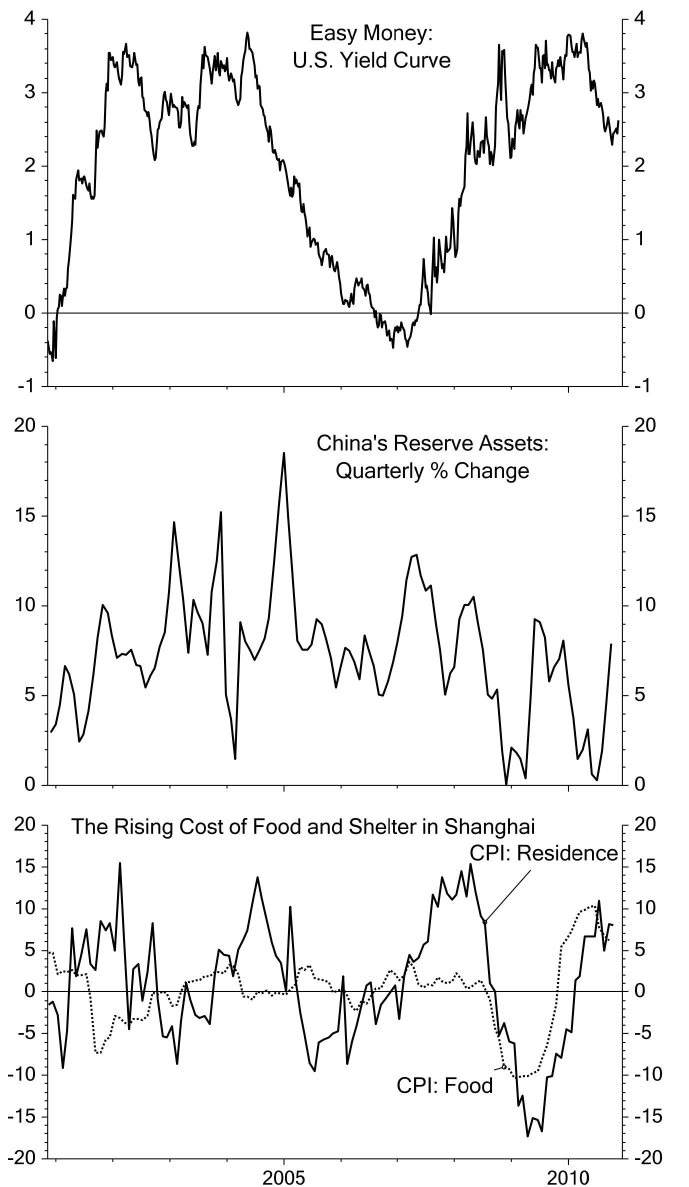
Potentially more ominous is the unholy alliance between France, which now holds the Presidency of the G20, and China. Sarkozy and Hu have come up with a strategy to try to displace the dollar as the main reserve currency of the world. Sarkozy hopes to gain by weakening the euro and improving his dismal political fortunes at home by the often used formula of picking a fight with a foreign country (the U.S. in this case) to distract voters from domestic issues (Chart 4). The Chinese stand to gain by getting the U.S. to back off pressuring them to revalue the RMB. The big risk is miscalculation, triggering an end to the "balance of financial terror" and leading to a sharp decline in the dollar.

Charts 1 - 3



Another developing risk stems from Federal Reserve bashing by the Republicans and some of their private sector economists. They are trying to stop the Fed from further bond purchases. This throws the Fed into the political ring big time, caught between the Democrats and President Obama on the one hand and, on the other, a resurgent Republican strength in Congress, bent on destroying the former.

Chart 4

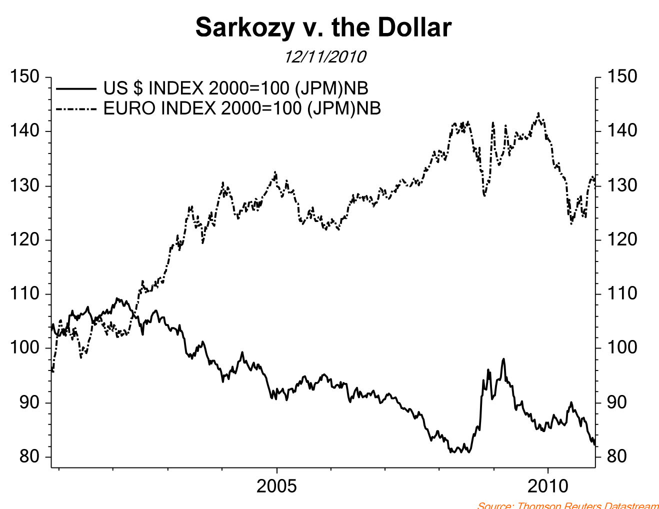


Chart 5

The escalation of these risks is not good for the dollar and financial markets more generally; volatility is certain to rise in this uncertain environment. However, beneath these high profile, front page tensions, there are some positive developments taking place.

The lagged effect of the dollar's 20% slide over the past 10 years (Chart 4) has helped U.S. exports significantly. Chart 5 shows that they have risen from about 6.5% of GDP in 2002 to close to 9% today. As a result, the U.S. current account balance is looking a little bit less apocalyptic. Incremental improvements in U.S. competitiveness and a continuation of the tepid recovery may be sufficient to prevent a destructive trade war.

In our last few letters, we have flashed the idea that there are some early signs that U.S. growth may surprise on the upside over the next few quarters. Beginning in mid-2009 we saw a string of good corporate earnings reports resulting from a surge in productivity (Chart 6) related to lay-offs and cost-cutting. Latest data show that

productivity has faded but the weak dollar is creating an offset. Chart 8 shows that new factory orders are growing at a good clip and corporations are reporting that banks have eased credit conditions. However, it is worth noting that loan demand has lagged orders, despite the surge in fixed investment beginning in late 2009 (Chart 9). Many corporations delayed borrowing for investment purposes due to an overly pessimistic outlook. They positioned themselves for a depression that did not materialize and built up excess liquidity. Thus, the current round of investment is being financed in good part with cash rather than borrowing. Business confidence is improving and profit margins are back to healthy levels (Chart 7). This will soon translate into increasing loan demand from the corporate sector as sales continue to strengthen while inventories relative to sales are at a very low level and will soon have to be increased (Chart 9).

Chart 6

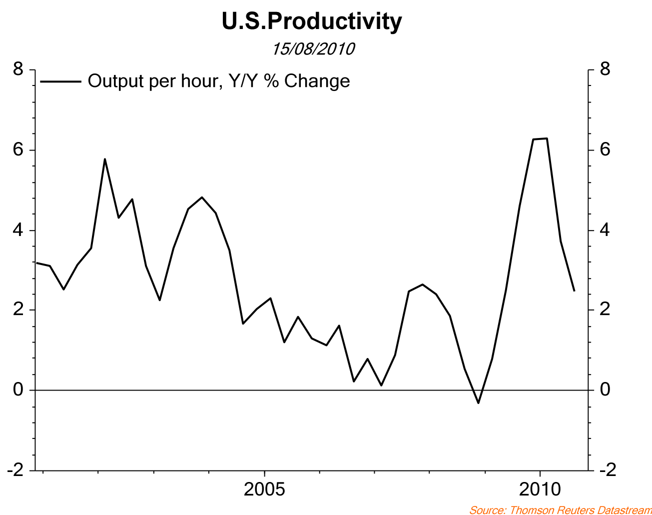


Chart 7

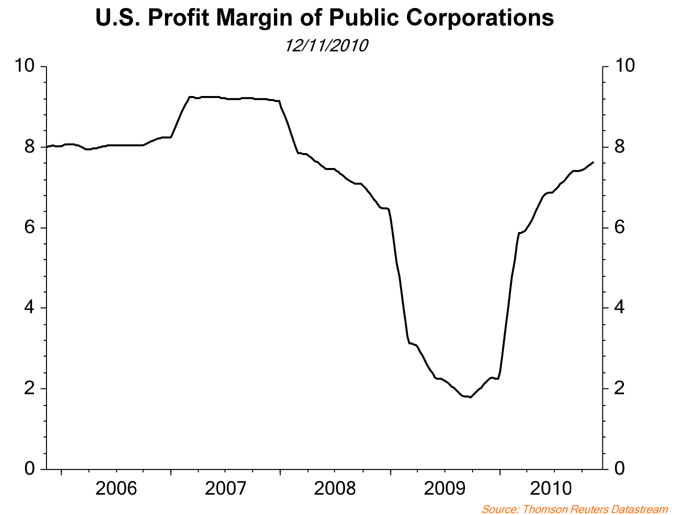


Chart 8: Credit conditions are easing and factory orders are up. Loan demand will soon rise with increased investment.

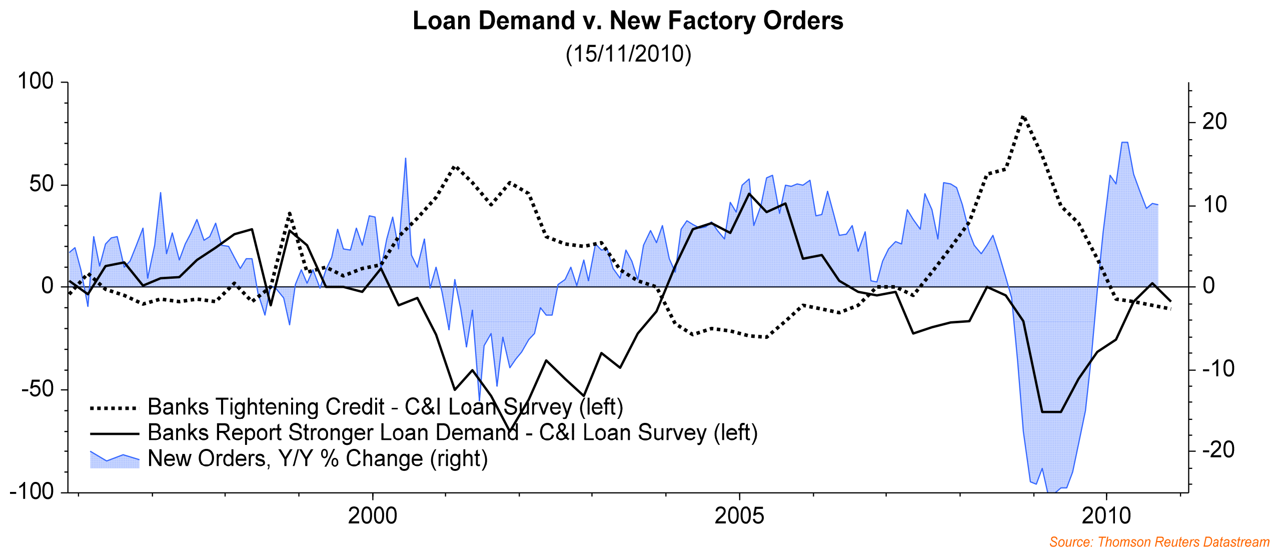
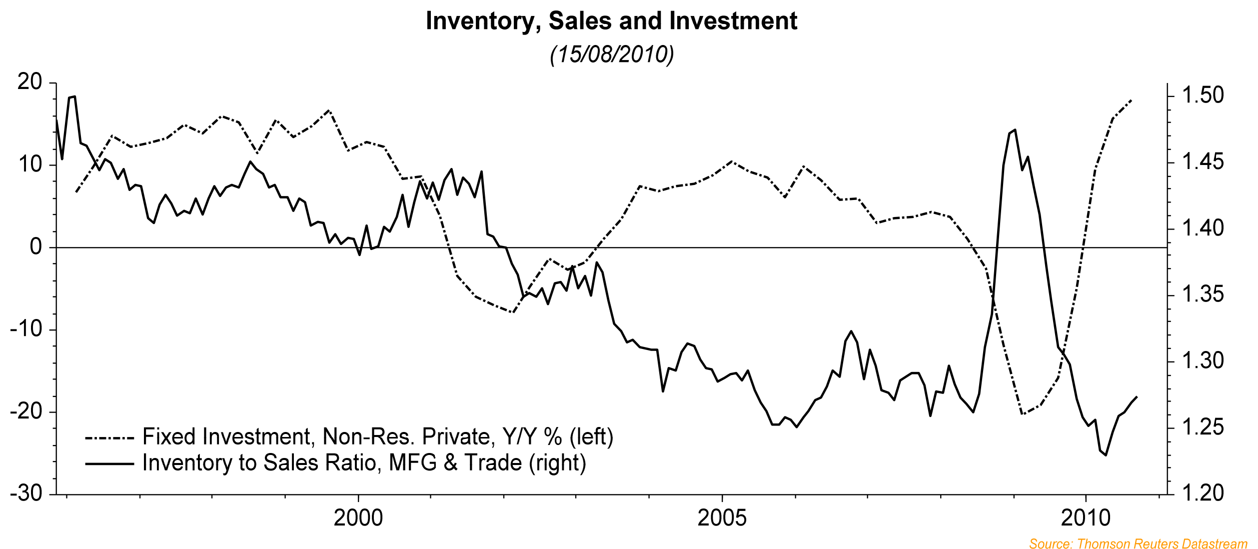


Chart 9: The ratio of inventory to sales has collapsed and fixed investment is increasing at an 18% Y/Y rate.



In the U.S., consumption is holding up remarkably well despite pessimistic consumer sentiment (Chart 10). The two main factors behind weak consumer sentiment are housing and employment. House prices continue to bounce along the bottom, and excess inventory of homes is showing no sign of clearing as home sales remain depressed (Chart 11). Unemployment remains stubbornly high, and the large number of discouraged and marginally attached workers guarantees a very long road to

full employment. Yet despite all of these negatives, personal consumption expenditures are remarkably robust and retail sales have been growing at 7-8% this year. There are early signs that the labour market is turning the corner: initial claims have fallen well below peak levels, job openings are showing improvement and hours worked have picked up over the past 14 months (Charts 12 & 13). The message is that fears of persistent household deleveraging have been overblown. Personal disposable income is growing at a 3% annual rate.

Chart 10

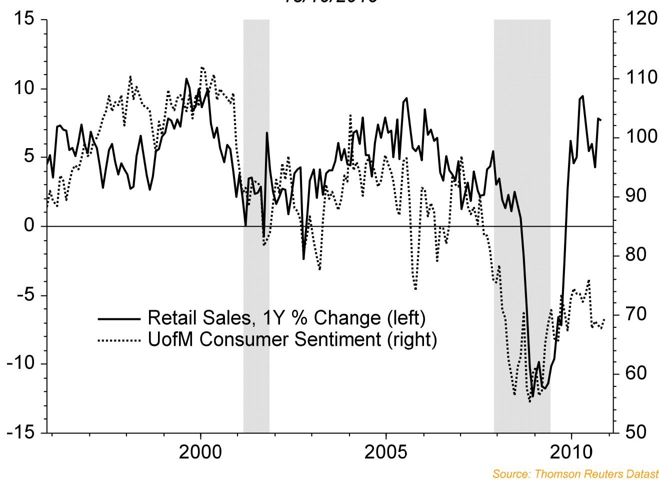


Chart 11

Chart 12

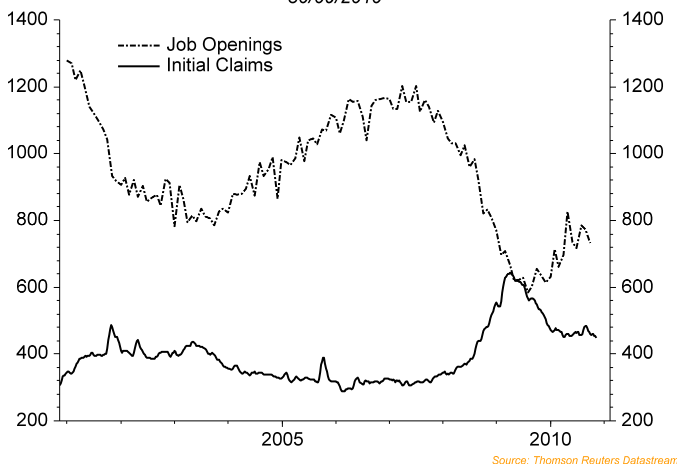
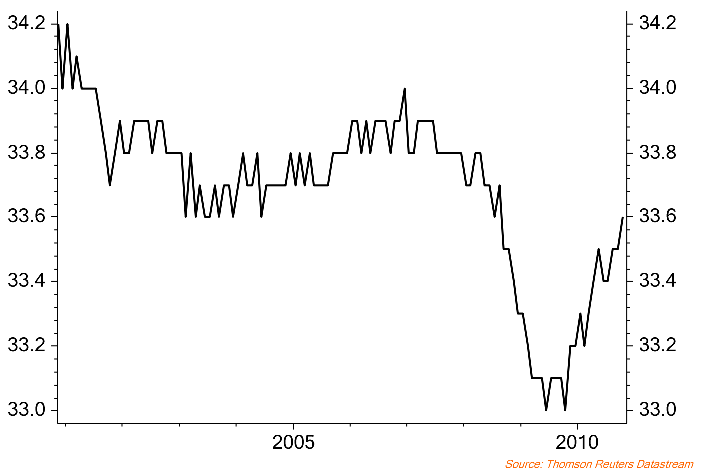


Chart 13



These indicators from the U.S. corporate and consumer sectors are showing that it is likely that the U.S. economy will disappoint the bears in the months ahead. However, there is little chance that any pick-up in growth will improve the unemployment rate significantly and that is the Fed's key target variable at present. Moreover several key risks remain, including resurgent European debt troubles in the peripheral countries and hot money flowing into emerging markets driving up their inflation rate and triggering more widespread monetary tightness.

Given these risks, the uncertain outlook for U.S. unemployment and continued weak loan demand in the banking system, the Federal Reserve will almost certainly continue to pump liquidity into the U.S. and world financial systems. Therefore, the recent sharp market correction will be just that, a correction, although possibly quite painful. It is unlikely to be the start of a new bear market.

Investment Conclusions

Stocks: To put our current view into perspective, we need to refer to issue # 2.15 of the Boeckh Investment Letter, dated October 6, 2010. We stated then that it was time to back off somewhat from the bullish view that we had held since the spring of 2009. We stated then that the S&P 500, around 1100 in early October, would probably move into a trading range of +/- 10% of that level. Investors had an opportunity in the past month to reduce exposure during a rising market, always the preferred way. The S&P reached a peak of 1226 in early November, 11.5% above the 1100 level before correcting sharply on the negative news of China's surging inflation, deteriorating sovereign debt problems in peripheral eurozone countries and the busted G20 meeting

in Korea over how to deal with global imbalances and currency warfare. The reality is that those risks have been with us for some time. The heightened attention paid to them has come after an 80% rise in the S&P from its March 2009 low and more dramatic gains in gold, silver, many commodities, bonds and emerging market equities. That is why we suggested to start taking some money off the table in early October.

Markets always correct after a big run-up. In terms of stock prices, a correction after 18 months and an 80% gain in prices following a major bottom is something to be expected. Whether the correction will be sharp or shallow is anyone's guess right now but our sense is that it will be in the 10-20% range, and will depend on news that has yet to unfold. However, it is not the start of a new bear market for several reasons.

1. Liquidity trends will remain expansionary in both the banking system and the corporate sector. The Federal Reserve will maintain a simulative policy until unemployment starts to fall sustainably and price inflation picks up. That could take 1-3 years to happen.

2. The economic recovery is less than two years old. Its sluggish path, which has left output far below capacity levels, should ensure that it will be substantially extended. This will sustain profit growth and strong corporate balance sheets.

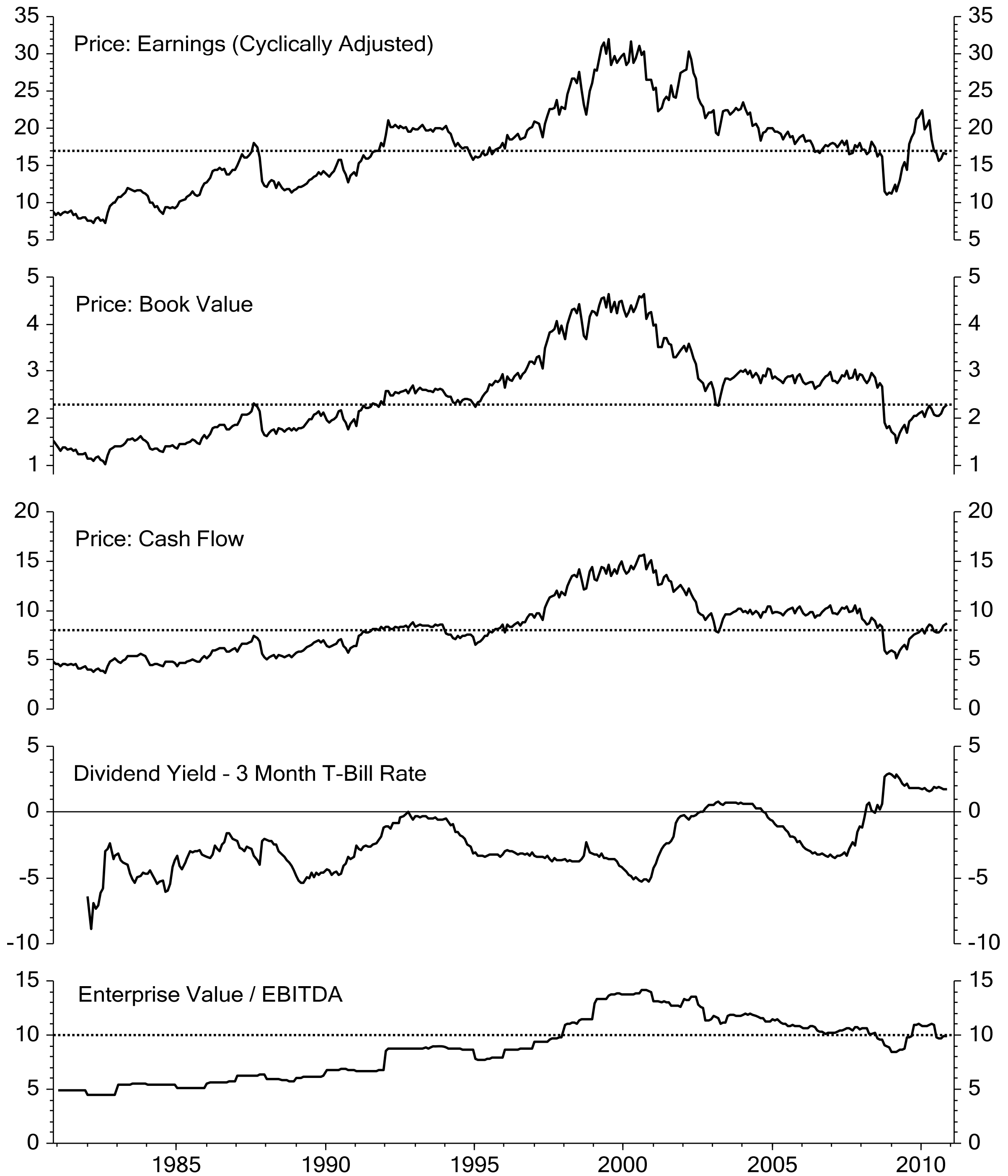
3. The driving forces behind the economic recovery will continue to be exports and capital spending, both essential to help in global rebalancing, which still has far to go.

4. A weakening U.S. dollar will help to sustain export growth, investment and profits.

5. Stock market valuation is not excessive (Chart 14).

6. Stocks, relative to gold, most commodities, bonds and emerging markets have lagged. We think they will outperform now.

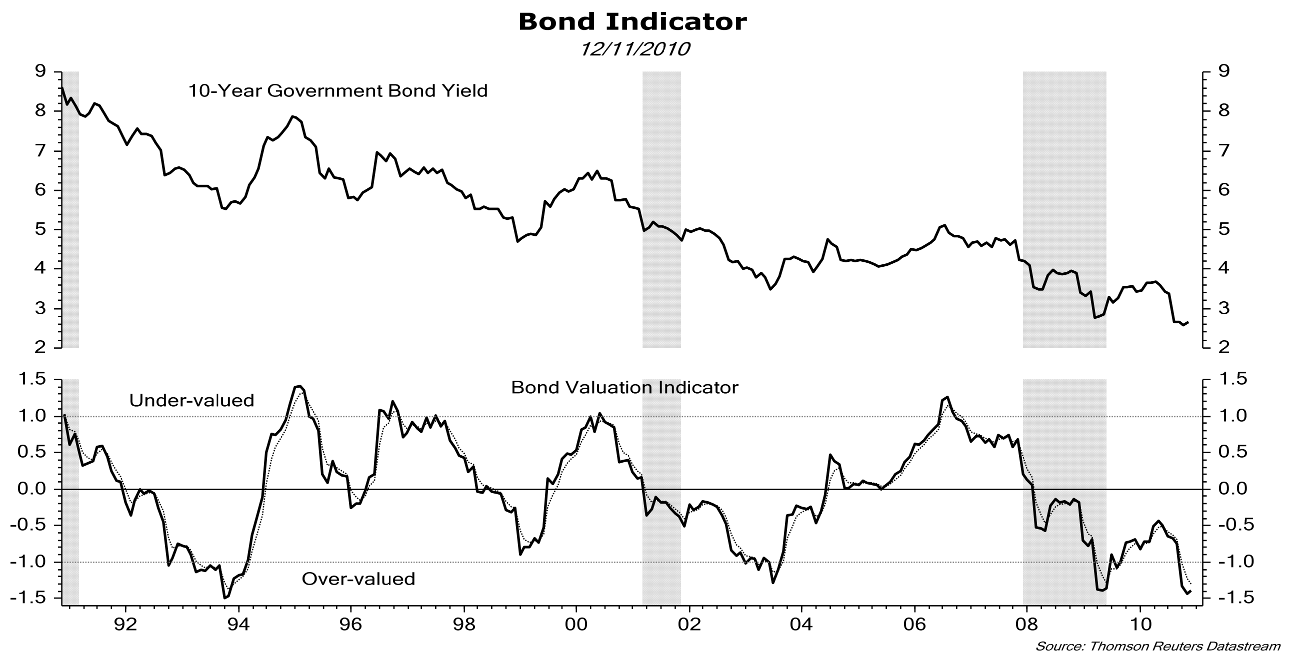
Chart 14



Bonds: We remain bearish on U.S. government bonds for several reasons. The economy is likely to surprise on the upside, the dollar is likely to be weak (a negative for inflationary expectations) and monetary tightening in China and other fast growing countries will continue.

Yields have been suppressed below equilibrium levels and, as a result, U.S. bonds are overvalued (Chart 19). Value still exists in corporate bonds and there is room for spreads to narrow somewhat further relative to governments.

Chart 15



Gold: The dilemma for investors is trying to decide whether gold is in a speculative blow-off or just in a good bull market. We have leaned toward the former view, although recognizing that the trend has been, and probably still is up. However, while basing one's view on moving averages and momentum can be profitable, gains can turn to dust very quickly if speculators all jump to the other side of the boat at the

same time and price declines turn to panic. This happened in February 1980 when gold collapsed literally overnight. The tech bubble in the late 1990s similarly burst in early 2000, ten years later.

Chart 16 shows the two gold bull markets and other manias. While such graphics prove nothing, they do illustrate that when markets go exponential, trouble is brewing. However, it is very unlikely that the current bull market in gold is anything like as dangerous as the 1970-1980 one for many reasons. One of those is that volatility is far lower than it was then, and high and rising volatility is very often a precursor of an imminent top.[1] Other factors driving the near hysterical bull market then were the recent legalization of gold ownership in the U.S., serious geopolitical tensions and seemingly out-of-control general price inflation, a collapsing dollar, a first in peace time U.S history. It was frightening for millions of people. None of these extreme conditions prevail today, and as a result, the bull market has been somewhat more sedate. No one in their right mind would argue that the price can't go higher. Nonetheless, it is clear that it is very advanced and seemingly based on unrealistic fears of U.S. inflation prospects and another collapse in the dollar.

The real issue is the risk/reward trade-off. Our sense is that it is not very good at the present time because gold has risen relatively far and fast in recent months and years compared to many other assets. For example, gold is far above the peak achieved in 2007 and up 400% since 2000. The S&P is down roughly 20% from both these points in time.

[1] This is a point Andy Smith of Bache Commodities, London has been making.

Chart 16

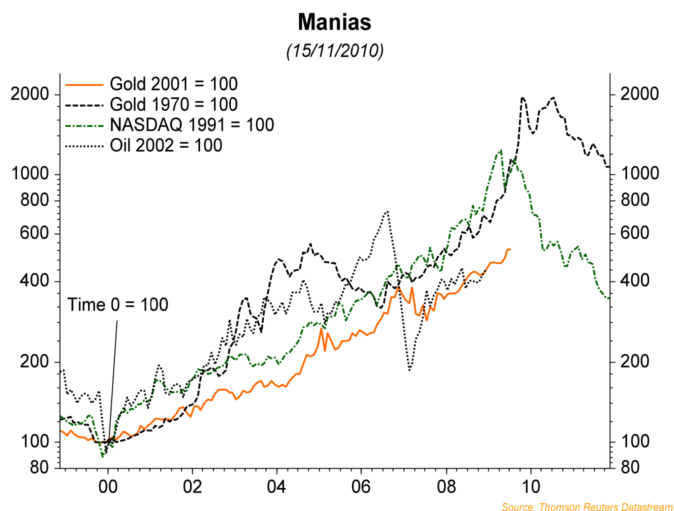


Chart 17

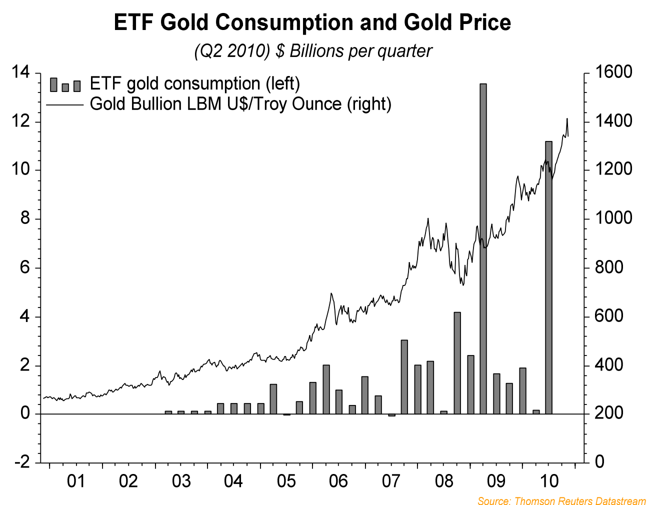


Chart 18

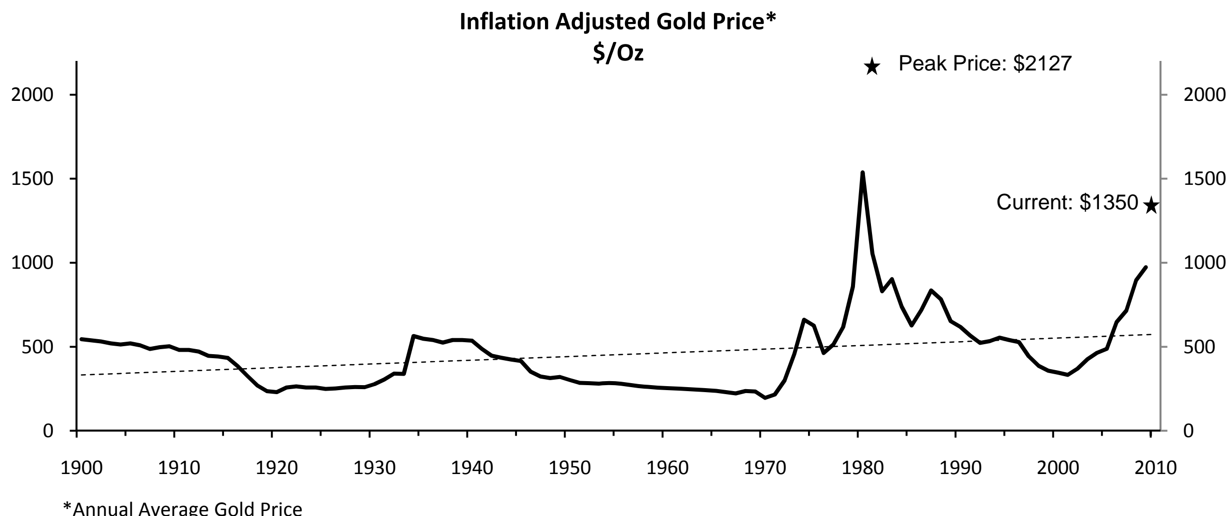
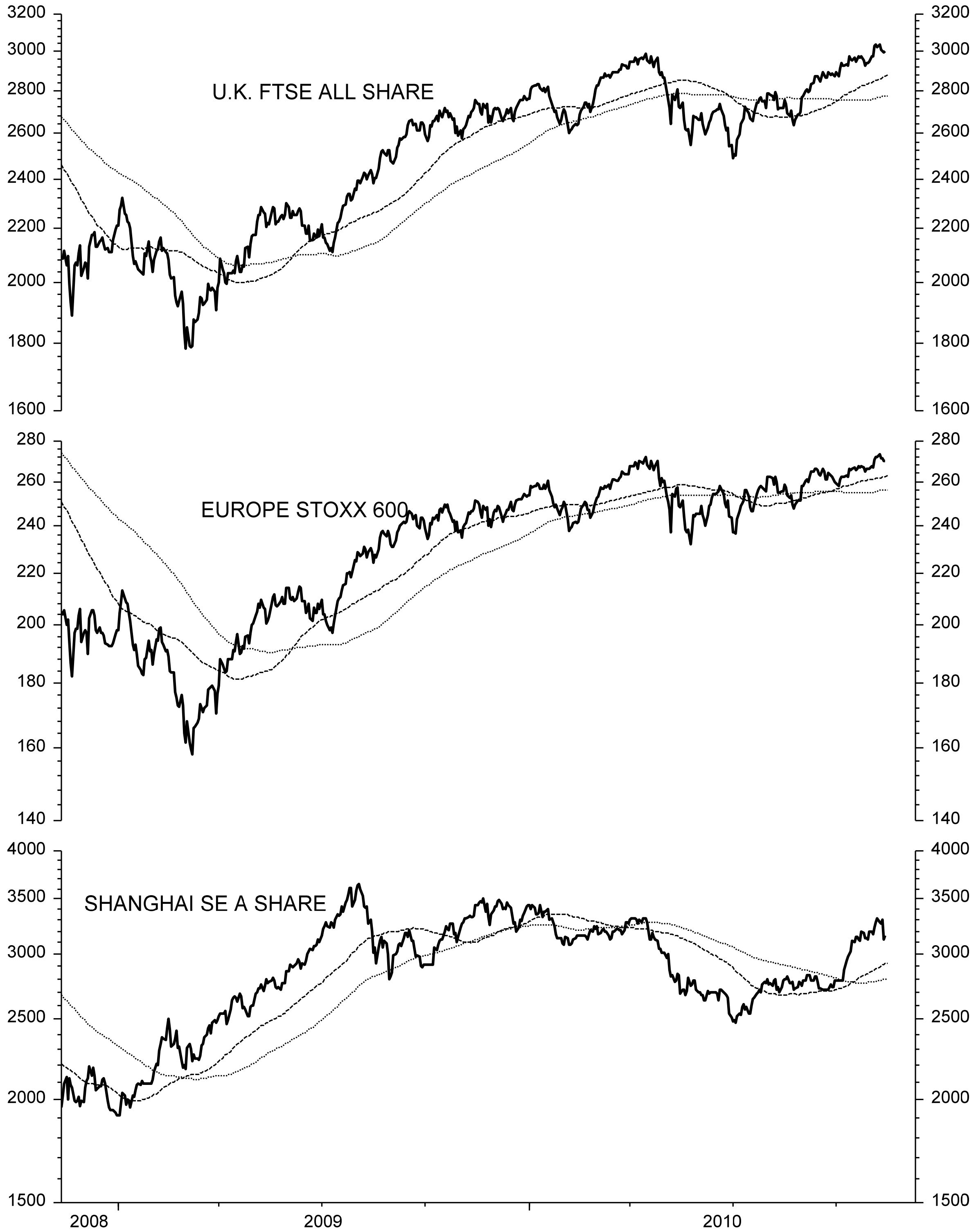


Chart 18 shows the price of gold adjusted for inflation back to 1900. It is evident that the price fluctuates substantially around the trend line. There are four periods when the price was high relative to the trend. The first was the early 1900s (and before), reflecting a falling general price level (i.e. deflation) at a time when the monetary price was fixed. The second was in the 1930s when a combination of deflation and a rise in the official price to $35 pushed the inflation adjusted price above the trend line. The last

two, which took the price far above the trend line, reflect the bull markets (manias?) of the 1970s and the 2000s. The latter is not quite as extreme as the former but is not far off. Given that both bull markets were driven by financial demand as opposed to jewellery and industrial demand, the risk seems evident. We view financial demand that exceeds insurance needs as essentially speculative and it can go into reverse easily. ETFs are the new vehicle of choice for the general public to "invest" in, reinforced by the rapidly growing availability of mutual funds, gold trusts and gold-focused hedge funds for the macro players. The flow of new money into gold ETFs can be seen in Chart 17. Further evidence of speculation in gold and related assets is evident from the enormous deal flow of small highly speculative mining companies tapping the public markets for funds. This is typical of late stage bull markets. Investors should hold some gold as an insurance reserve in the 5%-10% range. Anything more than that is very speculative.

Tony Boeckh / Rob Boeckh
Date: November 16, 2010
www.BoeckhInvestmentLetter.com
info@bccl.ca

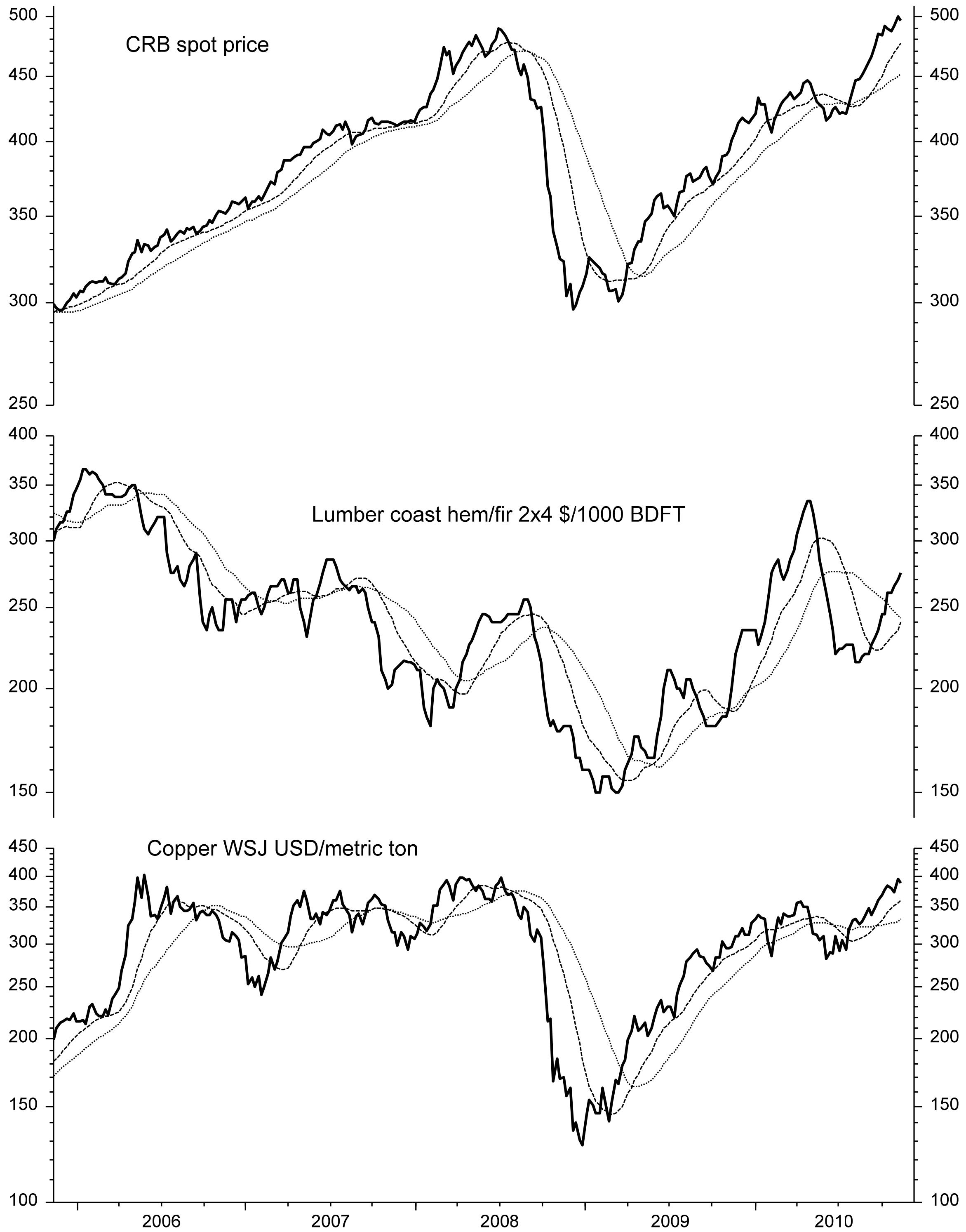
EQUITIES
Latest: 12/11/2010
1 & 2 Quarter Moving Averages
S&P 500 COMPOSITE
NASDAQ 100
CANADA S&P/TSX COMPOSITE INDEX
x 1,000
2008
2009
2010
Source: Thomson Reuters Datastream

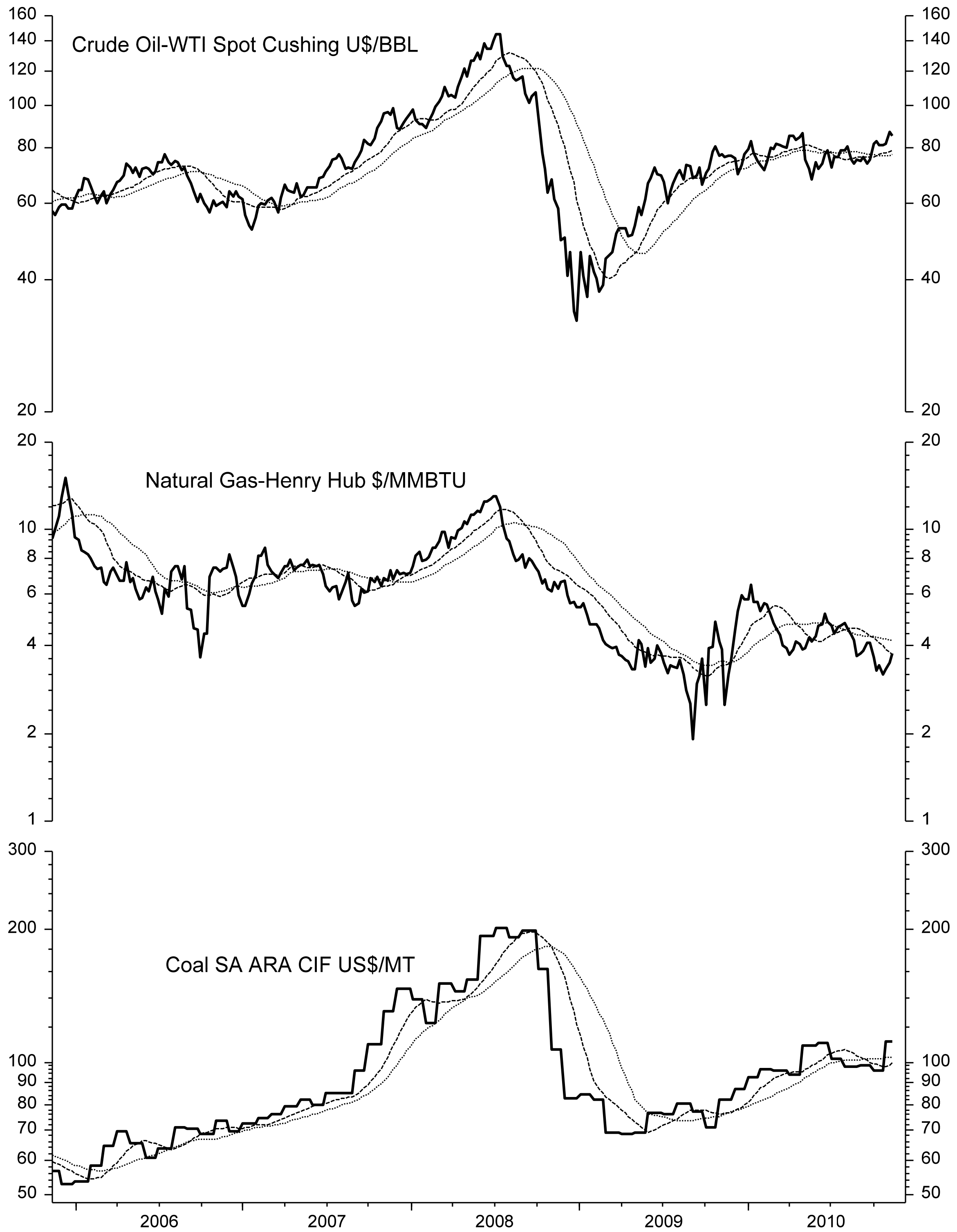

EQUITIES
1 & 2 Quarter Moving Averages
Latest: 12/11/2010
U.K. FTSE ALL SHARE
EUROPE STOXX 600
SHANGHAI SE A SHARE
3200
3000
2800
2600
2400
2200
2000
1800
1600
280
260
240
220
200
180
160
140
4000
3500
3000
2500
2000
1500
2008
2009
2010
Source: Thomson Reuters Datastream

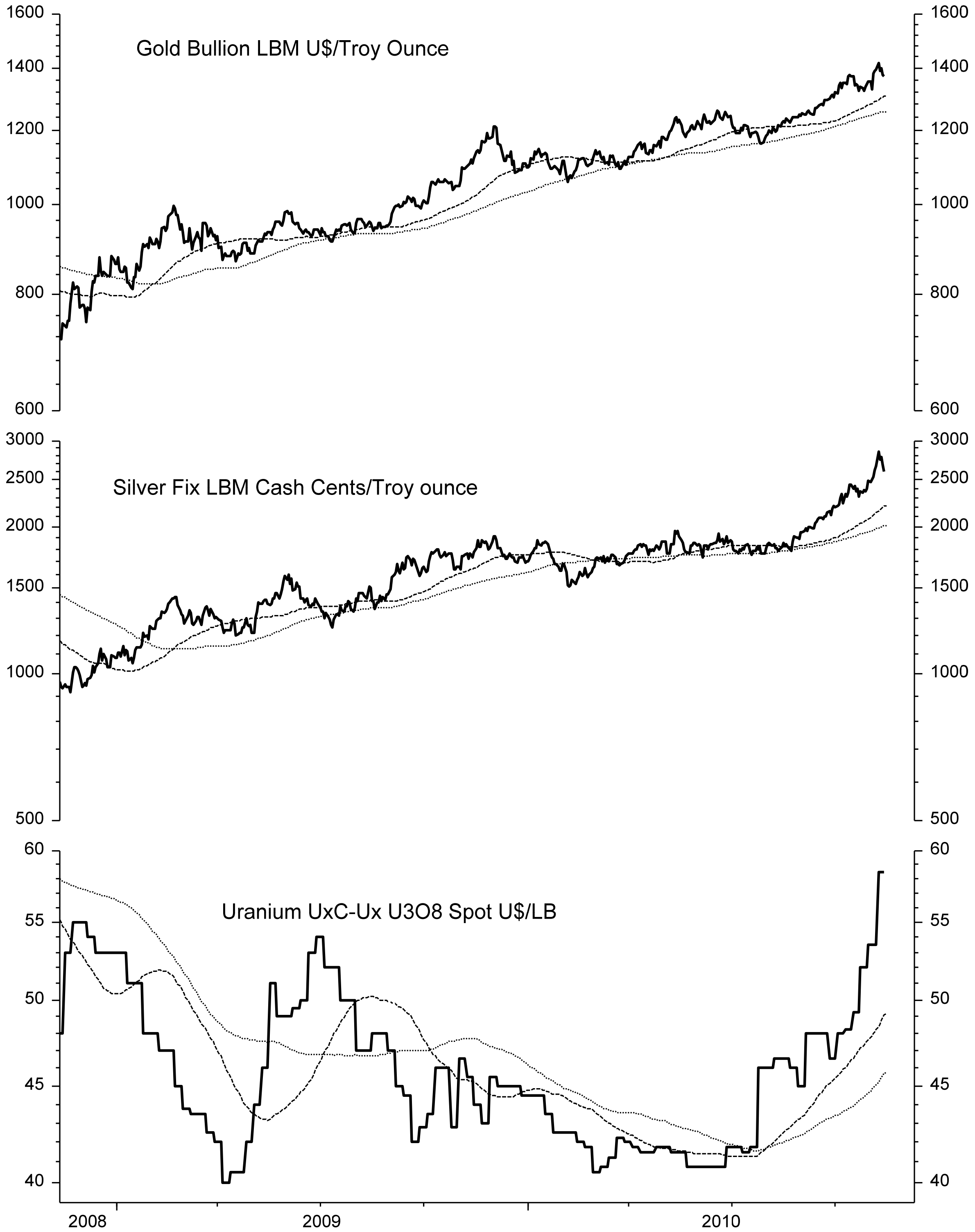
COMMODITIES

Latest: 12/11/2010

1 & 2 Quarter Moving Averages



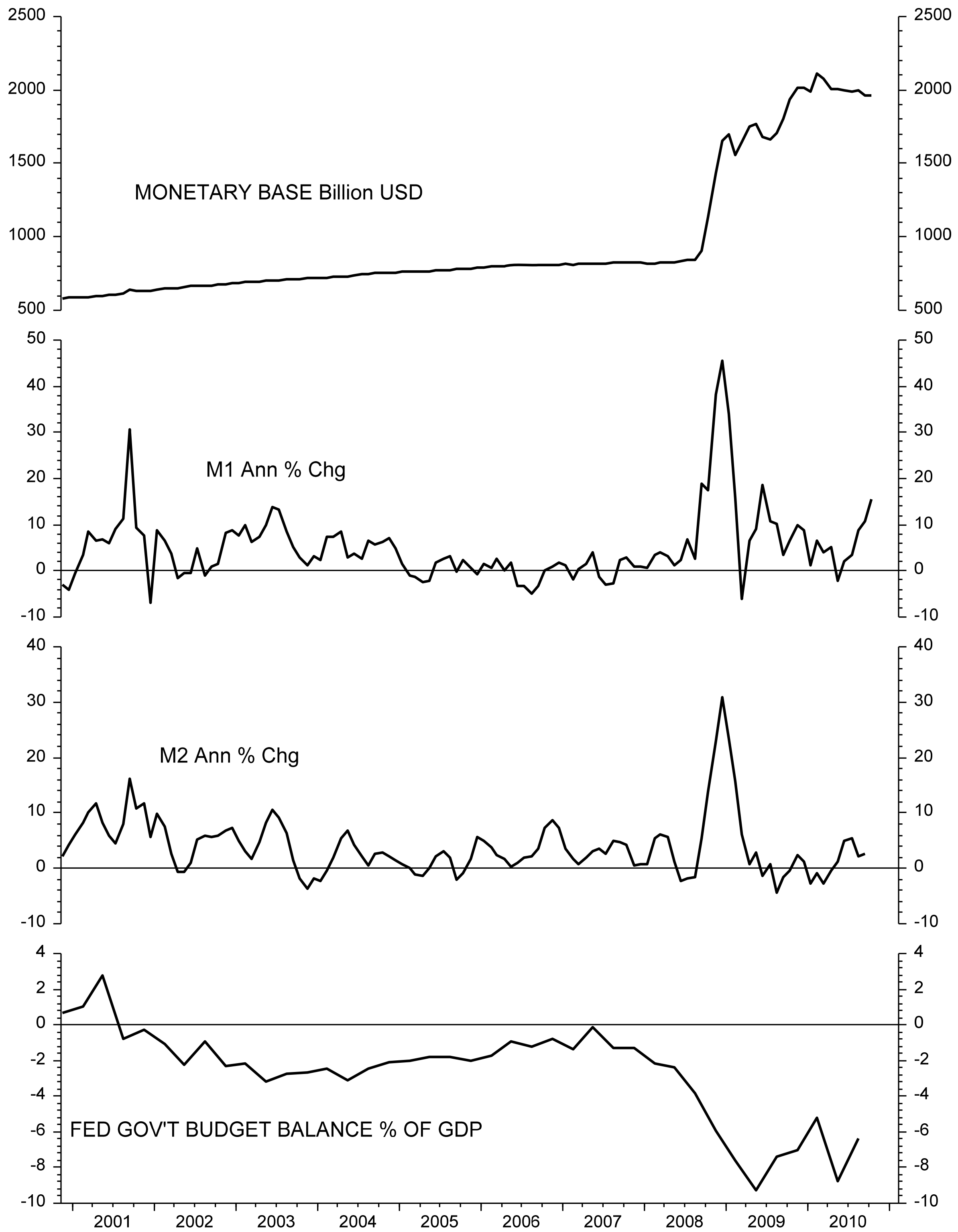

COMMODITIES
1 & 2 Quarter Moving Averages
Crude Oil-WTI Spot Cushing U$/BBL
Natural Gas-Henry Hub $/MMBTU
Coal SA ARA CIF US$/MT
2006
2007
2008
2009
2010
Source: Thomson Reuters Datastream


COMMODITIES
Latest: 12/11/2010
1 & 2 Quarter Moving Averages
Gold Bullion LBM U$/Troy Ounce
Silver Fix LBM Cash Cents/Troy ounce
Uranium UxC-Ux U3O8 Spot U$/LB
1600
1400
1200
1000
800
600
3000
2500
2000
1500
1000
500
60
55
50
45
40
2008
2009
2010
Source: Thomson Reuters Datastream

EXCHANGE RATES

Latest: 12/11/2010

Source: Thomson Reuters Datastream


U.S. MONEY SUPPLY
MONETARY BASE Billion USD
M1 Ann % Chg
M2 Ann % Chg
FED GOV'T BUDGET BALANCE % OF GDP
2500
2000
1500
1000
500
50
40
30
20
10
0
-10
40
4
2
-2
-4
-6
-8
2001
2002
2003
2004
2005
2006
2007
2008
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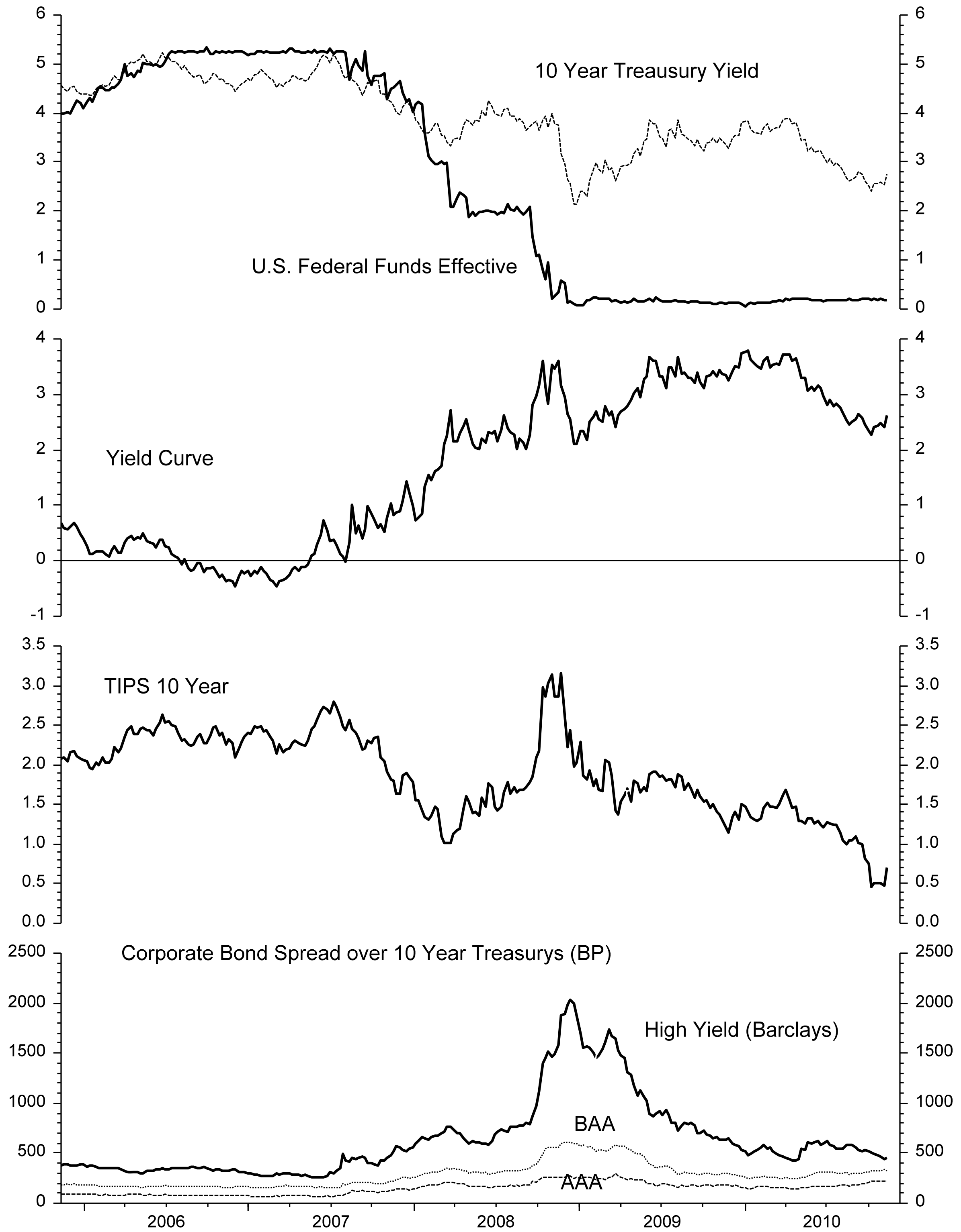
2010
Source: Thomson Reuters Datastream


INTEREST RATES
Latest: 12/11/2010
10 Year Treausury Yield
U.S. Federal Funds Effective
Yield Curve
TIPS 10 Year
Corporate Bond Spread over 10 Year Treasurys (BP)
High Yield (Barclays)
BAA
AAA
2006
2007
2008
2009
2010
Source: Thomson Reuters Datastream