Infomail
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Signs, Signs, Everywhere a Sign

"We think any company that has an economist has one employee too many"
Legendary Investor Warren Buffet

The global financial markets have been sending confusing messages all year. I believe that the market action has been mixed because market decision makers are confused from the data which has been inconsistent to say the least.

This year's action has proved once again why forecasting is usually a worthless exercise. Legendary Fidelity manager Peter Lynch agreed with Mr. Buffet when he said "if you spend more than 13 minutes analyzing economic and market forecasts, you've wasted 10 minutes."

So given we are in the middle of the summer doldrums, let's take a look at the various asset classes and indicators and see where we are at (in no particular order):

1. Bond Yields

Focusing on US yields, for the third to fourth year in a row, the forecasts were for higher rates. The Fed was going to for sure raise in the spring, then for sure in June, now its September and if not then, for sure December.

Guess what? As I write, the US 10 year Treasury closed at 2.16% and though off lows, lately has been heading down. This is NOT the sign of a strengthening economy.

I've been saying for some time that the Fed will err on the side of keeping rates lower for longer, for fear of creating another hard landing or even a recession. Really, what is all the hype about?

Rates are at zero (and have been for years), and might go up 0.25%. There are even whispers the Fed might only raise 10 to 15 basis points. Even if the 10 year was to go to 3-3.5%, we would still be at some of the lowest yields in history.

In Canada, we've dropped rates twice this year alone, and I doubt they are going anywhere for a bit, lest the Bank of Canada lose all credibility.

2. Energy Prices

Oil prices have come down from $110 to $43 as of Friday's close. The rig drilling count keeps falling, but production seems to hold. How is that possible? In one word: technology.

Technology has affected every sector in the world. It has made companies more efficient and added efficiencies everywhere. No different in the energy patch. These companies are finding more oil with better accuracy, lower risk and technology is making it more efficient to get it out.

There is much talk as to what happens to prices if and when Iran come on stream, adding possibly 300,000 to 500,000 barrels per day? Well, a few things:

A) The deal isn't done yet and may never pass
B) It will take many months for Iran to ramp up production once the deal is passed
C) Global demand is expected to increase in 2015 by one million barrels per day anyway

In the end, I've heard all the talking heads state that it's all about too much supply. Supply this, supply that, blah…blah…blah. I am starting to believe that sure, maybe there's too much supply, but maybe, just maybe, it's a demand side issue……which means global economic weakness, not strength.

3. US Dollar/Currencies

So the strong US dollar seems to have no upside limit, this week hitting an eleven year high versus the Canadian dollar. Every other major currency (the Yen, the Euro) among others keep dropping as countries race to the bottom, hoping a lower currency will boost exports and improve their economies. There is no doubt a lower Yen has boosted Japan's fortunes, and the collapsing Euro's biggest beneficiary is none other than Germany.

In Latin America, collapsing currencies are creating hyper inflation not seen since the early 1980's, in Russia, the Ruble's decline has created huge budget deficits and empty shelves.

4. Gold

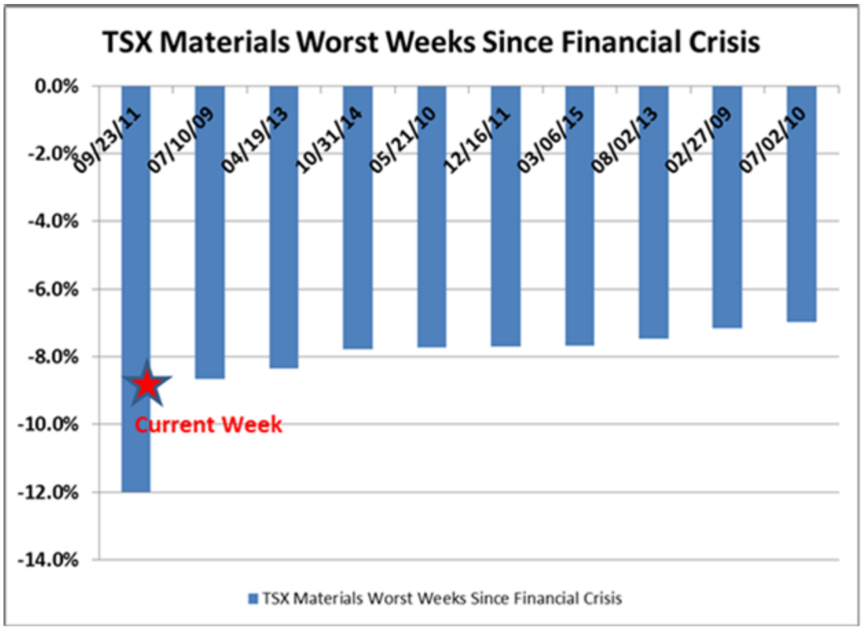
Over the past few months, gold has completely broken down. There are many reasons credited for it, a high US dollar, Chinese selling, lack of inflation, etc. But as gold achieves five year lows this past week and is down over 40% since in 2011 highs, it reminds me a lot of gold's fire-sale opportunity as we went into the first rate hike in June 1999, which ultimately became gold's bear market secular low one month later.

I remember going to the Chicago Investment/Money Show that summer, and the presentation on day-trading was beyond standing room only, while the poor soul presenting on gold had a grand total of five people (including two of us from London) to present to. Talk about contrarian indicators.

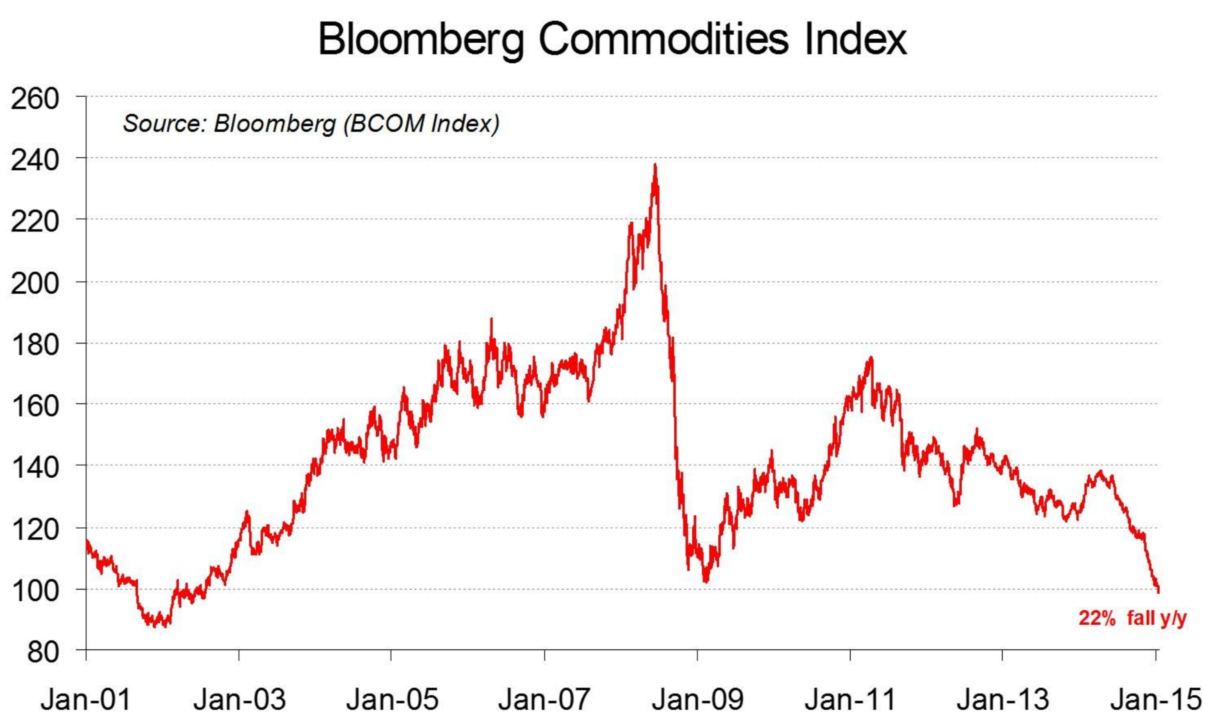
If the Fed is truly going to raise, then that should delineate that the economy is getting better which should mean the later expansion of the economic cycle which usually bodes well for commodities which typically outperform as inflation finds a foothold. Which leads us to:

5. Commodities

The TSX Materials index has had its two worst weeks since the 2009-09 financial crisis.



Globally, commodities are at their lowest level since 2002:



Inflation, as measured by the CPI Index, is virtually zero. Talking to people daily in the real world, except for prices at the pumps, we all know that's not even close to true.

6. Stock Markets

It's been a tough year, but it almost sounds hypcritical to write that with the S&P 500 but off 4-5% from all-time highs. But it has been led by a few stocks, and the average stock is down a lot.

As well, the broadly based Russell 2000 broke its 200 day moving average this week for the first time in 2015, so near term we could expect more weakness.

Canada's TSX is one of the world's worst performing markets, down almost 15% off highs due to its heavy exposure to energy, gold and materials. The banks have been no prize either, and pretty well sit where they stood over two years ago.

Europe has been a pleasant surpise (well not really if you read our comments last summer/fall) and Euro markets have performed well, up 12-18% for 2015, this despite all the noise about Greece.

China's market has literally crashed in July, down over 30%, but still up 15-17% for the year. Is this collapse simply an adjustment of "irrational exuberance" or is there something more fundamental going on?

The Russian market may very well be one of the cheapest markets in the world at 4-5X EPS, but good luck getting investors to even touch it.

We've recommended avoiding Latin America for some time and except for Mexico, they've been a disaster as the left wing politics have finally caught up to them. Continue to avoid them.

So pulling it all together:

1. Long bond yields still declining, even despite a Fed who threatens to raise rates
2. Energy prices have collapsed
3. A US Dollar parabolic rise
4. All other currencies hammered
5. Gold down 40%
6. Commodities, almost across the board, have collapsed
7. Stock Markets – mixed at best

Economics 101 would tell me that those are signs of a weakening economy, not strengthening.

Deflation is a much bigger problem than inflation right now, and that's what has central bankers lying awake at nights, and that's why rates will stay lower for longer, and why eventually (and it could be some time still), those central bankers will get behind the inflation curve as it takes off.

The contrarian trades today are:

1. There's a bond bubble formed/forming
2. Oil is not there yet, but closer to a bottom than a top
3. Ditto for commodities
4. Gold is a contrarian buy for those with a 2-3 year time horizon
5. US Dollar might still go higher, but is nearing a peak

And the big one - with short interest up 58% YTD and bullish sentiment near lows, and a very high Fear Factor:

6. We are maybe half way through a secular bull market in equities that has many years to run.

Stay tuned,

Vito Finucci
Vice President and Director
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