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Build Knowledge/Market & Economic Commentary

Walter Deemer: What Contrarians Think About Today's Markets

By Walter Deemer
Oct. 22, 2010

Contrarians aren't optimistic for the near term. While they think the U.S. avoided a double-dip, we are in a secular value contraction that could last another one to five years. But they do see opportunities in progressive economies, Asia, gold, uranium, and Australian CDs.

I once again attended the annual Contrary Opinion Forum, which is held at the Basin Harbor Club on the shores of Lake Champlain in Vermont just as the foliage is peaking. The following is my traditional summary of the proceedings, although this year I decided to separate the wheat from the chaff and only report on the speakers I thought were worth writing up. I'm therefore afraid that you'll have to go elsewhere to learn what the portfolio strategists nobody watches on CNBC and the economists who make astrologers look good had to say.

Two different global economies

David Fuller is global strategist of FullerMoney.com, an institutional research firm, and I first met him when we both spoke at the Conference on Technical Analysis in Cambridge, England in 1974. Fuller thus brings both his long experience and an international perspective to the table.

His presentation was titled "Two Different Worlds." He began by saying that the media coverage of our world—the United States and Europe—yields a picture of a sluggish environment and a lot of worried people. The other world, however, is not worried. Their economies are booming and their problem is inflation rather than deflation.

What is that "other world"? Fuller says that the old labels—old world, new world, developed, developing, emerging—are misleading. Nations and economies are either progressing or regressing on an absolute or relative basis (with most people wanting to be invested in the progressing areas). These progressing economies have superior economic governance, relatively strong GDP growth, current account surpluses, low levels of government debt, high personal savings rates, sound banking sectors, and young, motivated, educated workers.

Fuller singled out Singapore, a country determined to become the Switzerland of Asia, in this regard. Regressing economies, on the other hand, have poor economic governance, relatively weak GDP growth, current account deficits, increasing government debt, low personal savings and high debt, weak and dysfunctional banking sectors, and a shortage of skilled workers.

How do countries transform from regressing to progressing? Governance is everything. It starts with good leadership and is a top-down process. Luck also helps (favorable climate, water, and industrial resources). Other factors include the empowerment of women and minorities, education and equal opportunity, a can-do attitude and strategic planning, and favorable demographics.

How do countries go from progressive to regressive? Mainly via a failure of governance: pork-barrel spending, short-termism, CEOs gaming the system, and a morally bankrupt financial sector. Other factors include bad luck (drought, floods, few resources), deteriorating educational standards, an entitlement mentality, impoverishment by military commitments, and social divisiveness that leads to a loss of confidence. Fuller left it up to the attendees to decide which countries fell into each category and why.

As far as the stock market is concerned, Fuller believes a secular bull market ended in 2000. Rather than calling what has happened since then a secular bear market, though, he calls it a "secular valuation contraction"—which I think may be a much better description of what we are now going through.

In the 1930s and 1970s, for example, the prior excessive valuations were corrected by a long, generally sideways, movement that enabled valuations to catch up to price rather than going into a huge decline. Fuller thinks something similar will happen here. He then pointed out that the low point of those secular valuation contractions was hit somewhere around the middle of the 15-year or so corrective process: 1932 in the 1930s, and 1974 in the 1970s. In his opinion, then, the risk here is an extension of the generally sideways movement of the past 10 years rather than a big decline that takes the market below its 2008-2009 lows.

From a long-term standpoint, he thinks what we are experiencing is not a depression but rather the worst credit crisis recession since the 1930s. "One hundred years of history show that it takes five to seven years for an economy to recover from a credit crisis recession." If so, and if we are now two years into the recovery, this means we have another three to five years to go—or until somewhere between 2013 and 2015.

With regard to the bond/stock question, Fuller quoted Mike Lenhoff of Brewin Dolphin Securities: "Bond markets are taking their cue from the developed economies, equities from the developing." Fuller thinks this is an especially astute observation that explains why investors in bonds see little recovery, unlike investors in equities. And, not surprisingly, Fuller much prefers stocks to bonds, given the rising risk premium and the issuance of 100-year bonds.

Fuller also made one notable comment regarding commodities: uranium is the cheapest metal in the world right now.

Summing up, Fuller thinks:

- The Asian resources and tech-led global stock market recovery is resuming.
- The current cyclical bull market should have several more years to run, provided energy and food prices do not spike higher.
- The U.S. will avoid a double-dip recession with the help of progressing economies.
- The three-decade bull market in U.S. government bonds is ending, and yields will range higher over the medium to long term.
- Gold's secular bull market has at least several more years to run before it is halted by higher rates.
- A secular bull market for industrial commodities will continue, punctuated by recessions.

- Progressive Asian and resource-economy stock markets will continue to lead.
- U.S. and European multinationals leveraged to the global economy will outperform.
- Leading or promising sectors include technology, health care, mining, agriculture, global infrastructure, and dividend increasers.

Gold is for rich people

Ian McAvity, editor of Deliberations on World Markets, is an excellent, well-seasoned technical analyst who's also been involved in the precious metals markets for decades. He was a key figure, for example, in forming the Central Exchange Fund of Canada, the first investment vehicle to physically hold gold and silver, back in the 1980s. He had several interesting observations:

- The question isn't how high will gold go, rather how low will currencies go? (He did note, however, that the old inflation-adjusted high in gold is $2,388.)
- Gold is a very long-term, intergenerational, preservation-of-wealth vehicle.
- So far, the much-heralded debt reduction has mainly come about from the writing off of bad debts.
- "Gold is for rich people who want to stay rich rather than poor people who want to get rich."

How contrary opinion works

Jeffrey deGraaff, head of ISI Group's technical analysis research team, first reported on how well contrary opinion works in various financial markets:

- Stocks: Extremely bearish sentiment is a bullish sign—but so is extremely bullish sentiment, which turns out to be a long-term momentum signal.
- Bonds: Historically, they have not provided a good contrarian call.
- Natural gas: Contrary opinion works.
- Copper: Contrarian calls are horrible and will kill you.

As far as the stock market is concerned, deGraaff noted that October volatility contracts and skews positively after a very positive September. He then noted that the flattening of the funding curve has put immense pressure on banks, which have been able to borrow from the Fed at no cost and invest the proceeds in risk-free two-year Treasuries and pocket the spread. When the game first started, the spread was as much as 200 basis points, but it is now only 30—meaning banks have to deploy six times as much money (i.e., use leverage) in order to get the same total return.

DeGraaff observed that whenever the relationship inverts—whenever the Fed funds rate is above the two-year yield—there is trouble within a year "like clockwork." He also noted that when quantitative easing ends, the market goes down a month later, likening quantitative easing to a morphine shot. When the morphine wears off, it gets very painful.

DeGraaff defines a secular bear market—which he thinks we are now experiencing—as a long

period when stocks are not a good asset class (the 1870s, 1930s, and 1970s). Stocks, he notes, have been underperforming in terms of gold for years. Gold has not yet gone parabolic—but even when it first does go parabolic, you can still buy it, because it has another 100% to go from that point. (So he says!)

With regard to the secular bear market case, deGraaff noted that correlation is supposed to be very high in bear markets and very low in bull markets—but it is still very high now, which is another reason why he thinks we are in a secular bear market.

What to buy? How about Australian CDs? They're yielding 4.5%, and the Australian dollar is strong. I asked deGraaff where we were in the four-year cycle. He responded, "We are about to start the third year." Since that was his complete answer, I asked him later what happened to the low that was supposed to take place four years after the late 2002-early 2003 low. He replied that it was pushed back to 2008 by credit conditions and that 2008 was the last four-year cycle low.

Walter Deemer is a market strategist with more than 40 years of experience and a rare talent for spotting market trends. He is a founding member and past president of the Market Technicians Association. The daily updates are provided through a special arrangement with Horsesmouth and excerpted from his daily subscription service to institutional clients. Mr. Deemer was interviewed as one of 13 technical analysis experts in Bloomberg Press' January 2009 book, The Heretics of Finance: Conversations with Leading Practitioners of Technical Analysis. He's also been recently published in The Journal Of Wealth Management, co-authoring "A Way Forward," a commentary using long-term market cycles to put recent market behavior into historical context.

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