Walter Deemer's

MARKET STRATEGIES AND INSIGHTS

...for Sophisticated Institutional Investors

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THE 49TH CONTRARY OPINION FORUM: OCTOBER 5-7, 2011

Contrarians gathered in early October at the Basin Harbor Club on the shores of Lake Champlain for the 49th annual Contrary Opinion Forum. My review of the presentations is even briefer than usual this year because Susan Cragin, the co-author of my book (currently somewhat-unimaginatively entitled "Deemer on Technical Analysis" with a scheduled release date of February 17th) was there, and I spent more time working with her on the book than attending meetings. I was especially sorry to have missed Rod Smyth of the Riverfront Investment Group; my computer was all set up to take notes in the meeting room that morning but something came up at the last minute. Here, though, is a summary of what the four *crème de la crème* speakers I did hear had to say. (If you want to cut to the chase and see the Keeper Line of the Year, fast forward to David Fuller.)

Barry Ritholtz (The Big Picture)

For those (seemingly-very few) people who don't know him: Barry manages a hedge fund in New York but is best-known for his widely-followed blog, The Big Picture (which may be found at http://www.ritholtz.com/blog/). As the name implies, he focuses on long-term trends, which is very refreshing in these days of minute-by-minute analysis, and The Big Picture is one of the few blogs I read every day.

Barry started by telling us he's very data-driven (or, as I'm fond of saying, he watches their feet, not their mouths). He noted the tendency of investors to get caught up in herding and groupthink and their attraction to "expert" forecasting as opposed to ambiguous uncertainty. Specific bold definitive predictions tend to engender confidence, but the more cocksure and self-confident the forecasts are the less likely they are to be right. This, in turn, makes investors tend to believe "experts" who are wrong more often than they are right.

Barry noted what he calls the "recency effect", where people tend to emphasize the

most recent data point in a series. He emphasized how important it was to look for trends, not at individual datapoints. As a for instance: Analysts consistently estimate growth at 10-12% but it consistently comes in at 6%. Even so, after each year of 6% growth the analysts still keep on predicting 10-12% growth for the following year. [Sorry; I didn't note what the "growth" specifically referred to; S&P earnings?]

Another: In May of 2008 analysts had consensus sell recommendations on only 5% of all stocks. And just recently, in August of this year not a single S&P 1500 component had a consensus sell rating; there was not a single consensus sell on any S&P Big-Cap, Mid-Cap or Small-Cap stock.

Which all boils down to the fact that "experts" (or people who are considered to be experts by a lot of people) tend to articulate groupthink.

He then shared two articles with us . The first was entitled "Exorcising the Ghosts of Octobers Past", which threw cold water on the big October declines in the past, published right at the top in October 2007. He commented that you can only get an article like that at a top. He countered that with an article from May of 2010 entitled "How the Flash Crash Echoed Black Monday", which you can only get at a bottom. The point is that most investors – and virtually all the media – are always looking backwards a lot more than forward.

Barry warned that politics and asset management don't mix. Politics bring emotions into play – and emotions are the greatest enemy of investors. The market is going to do what it's going to do whether you happen to personally agree with current policy initiatives or not.

Great salesmen, he noted, are always great story-tellers -- but if you look at the numbers, they don't always support the story. [This reminded me of Tsai Management's Bob Edwards, whom we wrote about in the book. Bob was a great skeptic and a real expert in poking holes in the stories being pitched to him all the time. In the few cases where he wasn't able to find flaws in the story, he usually bought the stock.]

Barry then made an interesting point: The crowd is right most of the time -- because

the crowd is the market. (The old "Why is the market going up? There are more buyers than sellers!" adage is really quite accurate.) The crowd thus often misses the first 10% of the up or down moves but is pretty right during the middle 80% of them.

He next turned to the markets and compared secular vs. cyclical markets using a 100-year chart of P/E ratios. He observed that P/E's go up during secular bull markets and contract in secular bear markets. During a secular bull market, in other words, people are willing to pay more and more for a dollar of earnings, and in a secular bear they pay less and less.

He then observed that "100 year floods" seem to occur far more often than the name implies. Similarly, major stock market dislocations that are supposed to take place only once in a great while now seem to come along every 6-8 years. [And even more often than that – WD.]

In a secular bear market, investors need to 1) preserve capital and 2) have some dry powder for the occasional cyclical buying opportunities

According to data compiled by Morgan Stanley–Europe, the average secular bear market has a 56% selloff in 29 months, a rebound rally of 70% in 17 months (which nonetheless leaves it 25% below the high), another 25% decline in13 months (which leaves it 12% above the low), and it then evolves into a trading range that lasts several years. Post-2009, the "average 70% rally" that was supposed to take place (it was actually 83%) was extended to 105% by QE II.

Barry's favorite current data set is from Reinhart & Rogoff. The reason: they track post-credit bubble environments like we're in now rather than the much, much different economic recession cycles. Credit unwindings last much longer than economic recessions, and we're probably only halfway through the current post-credit crisis contraction

Basically, there are two ways to deal with credit crises: the Japanese way and the Swedish way. The Japanese way failed to force banks to take writedowns and created zombie banks and the lost decade. The Swedish way recapitalized banks via prepackaged bankruptcies a la GM and made shareholders take losses. The FDIC works the same way

as Sweden does, so we basically have a hybrid system here: half Japan, half Sweden.

Finally, Barry opined that the only way for the Occupy Wall Street movement to get anywhere was to push to get campaigns publicly-financed and thereby take big moneyed interests out of the political process.

David Fuller (FullerMoney.com)

I have known and respected David since we both made presentations at the now-defunct Conference on Technical Analysis in Cambridge, England in 1974. His comments this year were entitled "Where Are We In Today's Global Market Cycle?"

David believes we are in what he calls a secular valuation contraction [which I think is a much better descriptive phrase than the much more commonly-used secular bear market] that began in 2000 and is likely to last until at least 2016. He defines a secular valuation contraction as a long-term phase where P/E's go down and yields go up. David expects the yield on the S&P 500 to eventually double from its current 2.25% -- but probably more via dividends going up than prices going down

On a somewhat shorter-term basis, we're experiencing a cyclical bear market within a secular valuation contraction. The cyclical bear is probably in its latter stages but there are still downside risks and no clear signs yet that the lows have been seen. Nevertheless, long-term investors should be gradually accumulating into weakness.

[I inserted a comment into my notes here that says FEAR AND GREED IS A CONSTANT in response to both David's comments and Barry's presentation the night before.]

David believes that high frequency trading (HFT) is gradually driving people and corporations from the marketplace. Ultimately, this will have bad consequences for the markets as the machines have fewer and fewer players to work against.

David, who is based in London, has a truly global approach to the markets. In this

vein, he noted that commodity price inflation is arguably a bigger problem for Asian economies than the West's economic problems.

He believes that the key European indicator is the Euro STOXX Bank Index, and thinks it needs an upward dynamic like the one we saw in March 2009 to give an all-clear signal. The key European stock market index, meanwhile, is Germany's DAX Index, which is potentially building support above its 2009 base.

His European forecasts:

The reports of the Euro's demise are premature (as long as Germany wishes to remain a member).

Greece will have an "orderly" controlled default.

Portugal may have one as well, although not immediately.

The European Financial Stability Facility should contain risk of further contagion.

The necessary financial union for a single currency will be negotiated and eventually ratified.

Europe will remain a slow-growth region but has a number of world-class multinational companies.

And here's the Keeper Line Of The Year:

"The Autonomies are Fullermoney's moniker for the world's most successful multinational companies."

Many Autonomies have become quasi-autonomous, mobile principalities. Western corporate Autonomies are the antithesis of their home countries, most of which have high debt, high unemployment, slow growth, crumbling infrastructure and questionable governance. Fortunately, though, as investors we buy companies, not economies, and the

Autonomies have strong balance sheets and improved governance – especially since 2008. Most pay dividends and many are Dividend Aristocrats. He reminded us that excluding the financial sector, dividends of the S&P 500 are now 20% higher than they were at the 2007 peak.

[Walter here: As I listened to David ticking off these points, I was struck by the thought "It's the Nifty Fifty all over again!" David's points are <u>exactly</u> the ones Putnam made to justify paying what ultimately became excessively-high P/E multiples for the strongest, best-capitalized, self-financing and (usually) multinational growth companies in the world. Substitute dividends for earnings and you have the Autonomies.]

The U. S. has far more Autonomies than any other country. They include Amazon, Apple, Bristol-Myers Squibb, Coca-Cola, Colgate-Palmolive, Costco, Google, Heinz, IBM, Johnson & Johnson, MasterCard, McDonald's, Nike and Visa.

[Walter again. If David is right, at some point some money management firm and some person are going to emerge as the epicenter of Autonomy investing – just as J. P. Morgan and Carl Hathaway did during the Nifty Fifty era (which ticked Norton Reamer off no end; he thought he, and Putnam, deserved all the press Hathaway and Morgan were getting). What that firm and who that person will be, though, remains a mystery at this point. The problem we're going to face, though, is how to measure the exploitation of the Autonomies. With the Nifty Fifty, disciples could justify any P/E they wanted to, and send the stocks' prices up as high as they wanted. If dividends are replacing earnings, though, the exploitation process will be a somewhat self-defeating one.]

Re the U. S., David thinks we're not in a depression but, rather, the worst credit crisis recession since the 1930's – and "100 years of history show that it takes 5-7 years for an economy to recover from a credit crisis recession". If the U. S. recession ended in the second quarter of 2009 we are less than halfway through the convalescence

Other comments re the U. S.:

U. S. corporate success shows that the current decline is not systemic.

Inspired governance will be required.

Shale oil & gas will help make US self-sufficient in energy in 10-15 years

Asia, meanwhile, remains the global GDP growth engine but has been slowed by the fight against inflation (those rising commodity prices again). A change in Asian monetary policy from restrictive to accommodative is needed to revive global growth – and a shift in Chinese monetary policy to neutral would be a huge buy signal. Also, lower commodity prices would enable monetary easing in Asia.

I found the following slide from David's presentation particularly intriguing:

fullermoney.com Our theme: Empowerment Through Knowledge

Rising yields make equities increasingly attractive – index yields:

- Asia Pacific: Australia AS51 5.0%, Hong Kong HSI 3.8%, New Zealand NZSE 5.5% Singapore FSSTI 4.1%
- Europe: France CAC 5.4%, Germany DAX 4.3%, Sweden OMX 4.7%, United Kingdom FTSE 3.9%
- South America: Brazil IBOV 4.4%
- North America: Canada SPTSX 2.9%, United States S&P 2.2% Note: in 2Q 1982 the S&P yielded 6.2% as the last secular valuation contraction ended

On another front, David thinks that commodities remain in a secular bull market but will continue to be very volatile in both directions. Gold, meanwhile, has been remonetized in the eyes of investors

David concluded with what he termed the most important comment in the presentation for equity investors:

"Wealth is created in down markets... and realized in bull markets"

Evelyn Browning Garriss, The Browning Newsletter

Evelyn Garriss and the Browning family have been following climate changes for decades, and as a self-confessed weather weenie I was eagerly looking forward to seeing her for the first time. I was not disappointed.

Climate change, she began, is not linear; it ebbs and flows. But watch for the big changes, especially huge volcanic eruptions -- if the ash reaches the stratosphere. (If the ash is interfering with airplane flights it's too low in the atmosphere to affect the weather – but if it gets up into the stratosphere the result will be greater precipitation and cooler temperatures beginning about three months afterwards.)

She noted that climate factors recently reached a tipping point because the Pacific Decadal Oscillation, a 50-70 year cycle, peaked in 2006 and has started to create more extreme weather. (And note, she said, that it doesn't take much of a change to have a profound effect on the climate; the average temperature only dropped 1 degree Celsius from 1000, when Greenland was really green, to the Little Ice Age of the 1700's. And, since warm air holds more water than cold air, the warm period was accompanied by drought and the Little Ice Age was a wet period.)

Volcanic ash is the most important shorter-term determinate of the climate. "What goes up must come down" – and therefore volcanic ash in the stratosphere leads to a wet period several years later. Unfortunately, several eruptions (in Iceland and Russia) have put ash into the stratosphere this year and will lead to a very cold winter. In addition, the cold La Nina (eastern Pacific Ocean temperatures) of a year ago has just been replaced by a new one, which is a second reason to expect an unusually-cold winter.

Somewhat offsetting the foregoing is the Atlantic Ocean Cycle, where there are 40 years of warmer ocean temperatures followed by 30 years of colder ones. We're currently

15 years into the warmer cycle, which makes summers hotter and winters colder.

Putting it all together:

The Arctic air mass will push deeper into the U. S. from the north.

La Nina will bring brings colder air into the U. S. from the west.

The cold air colliding with the warmer Atlantic air will lead to heavy east coast snowstorms again this winter

The warmer Atlantic air will also lead to more hurricanes.

The PDO will create drier weather in the West for the next 15-20 years.

Human construction (cities), pollution and energy use all combine to make climate changes even more extreme than they otherwise would be.

Ian McAvity, Deliberations Research

Ian is a veteran long-term technical analyst from Toronto who also has tremendous insights into the precious metals markets. (He's one of the founders of the Central Exchange Fund of Canada, the first investment vehicle to enable investors to buy physical gold and silver back in the early 1980's. And I do mean physical – Ian and his fellow CEF directors go into bank vaults every year to count the fund's holdings – bar by bar!)

Ian's very first comment: "More people I've talked to at the Forum have sold gold during the past year than bought it. What bubble?" He added a very perceptive comment he's made before: The mistake people make is to look at the price of gold. The real price is the paper currency that gold's being measured against -- which is constantly eroding. (The 1980 peak of $850 in gold is $2368 adjusted for inflation. The dollar collapsed in August-October 1978, and the massive central bank intervention following what Ian called a "colossal currency crisis" led to the final gold run from 200 to 850 back then.)

And re the stock market: Ian is also in the "cyclical bear market within a secular bear market" camp. If this secular bear trend replicates the past ones it has another 5-8 years to run. In addition, the average of cyclical bears within secular bears would take the Dow to 8500 by next August.

Banks and housing stocks are below their mid-2010 pre-QE II lows, along with the FT Pacific ex-Japan and Euro STOXX indexes. They're leading the second half of the bear market.

His comment on HFT: How can you call it "price discovery" when only two computers can see it? [I also heard someone remark that the HFT computers on the side of the exchanges' server farms that are closer to the servers have to pay a higher rent than the computers on the other side!]

Internationally, a real wave of deflation has gone through during the last few weeks, as reflected in the Canadian dollar, Australian dollar, Brazilian Real and South African Rand. Which, of course, means the U. S. dollar is going up. Meanwhile, the Chinese are asking for greater respect from the international community – and they're not getting it. This will create consequences to deal with down the road.

Gold mining stocks: The problem here is that gold mines are depleting assets, and thus (in Ian's words) "dilute the hell out of their shareholders" by paying premium prices to take over smaller producing mines to replenish their assets. The trend, then, is for major gold mining companies to take over juniors (although the juniors have conspicuously underperformed the majors this year). Ian thinks Goldcorp is the only good major gold mining stock.

Summary

Lots of bearishness; the cyclical bear market within a secular bear market case was very widely held. (One speaker had a target of 382 on the S&P 500.) This is the same thing Jeffrey Hirsch (Stock Trader's Almanac) tweeted about after attending Barry Ritholtz's Big Picture Conference on Tuesday: "Big takeaway from @ritholtz big pic conf when @atask polled 200+ I was one of 3 bulls most were neutral and bears. Power of contrary thnking."

A Final Note: The Vermont Floods

I had read about the damage in Vermont caused by the floods from Irene in late August but was shocked to see how much damage still had to be repaired over a month afterwards. My wife and I spent four days at the Woodstock Inn before the Forum – and it had only been able to reopen the day before we got there. Four and a half feet of water in the Inn's basement wiped out the telephone and electrical control panels, the function rooms and 14 guest rooms, and the rooms were a long way from being restored when we were there. In addition, our usual route from Woodstock to Basin Harbor was closed due to two destroyed bridges and a four-mile stretch of Route 107 that was still impassible. Then, after the Forum, we spent two nights in Waterbury, just south of Stowe, and learned the flooding had made 70 families homeless in that town. Vermont, as always, was beautiful, but the beauty had a lot of sadness around the edges.

-- Walter Deemer