Walter Deemer's

MARKET STRATEGIES AND INSIGHTS

...for Sophisticated Institutional Investors

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REPORT FROM THE 50TH CONTRARY OPINION FORUM

Here's a summary of some of the presentations which were made at this year's 50th Contrary Opinion Forum in Vergennes, Vermont that I attended last week.

Eoin Treacy -- FullerMoney: "Running To Stand Still"

FullerMoney's David Fuller coined the term "secular valuation contraction" some time ago to describe what has been going on in the stock market since 2000. I think it's a much better term than the much more widely used "secular bear market" -- especially since the price lows are typically seen early in the process (1932, 1974, 2009) while the valuation lows -- which are higher lows in terms of price but lower lows in terms of valuation metrics thanks to the subsequent fundamental strengthening -- aren't made until much later (1947-1949, 1982 and ????).

David wasn't able to attend this year's Forum, but his very able junior partner from Killearney filled his shoes more than adequately. It was an especially interesting presentation because David and Eoin use very few indications and simply rely on price charts; to them, price is everything.

Eoin described the current market environment as a generational-long correction with declining valuations. He noted that buy and hold doesn't work in that type of environment -- although it will work again once the secular valuation correction is over.

The market, explained Eoin, is really a mob. Mobs are manic-depressive, which means they lurch from one extreme to another over time. Currently, the market is populated by two opposing groups of extremists: inflationists, who cite the money supply expansion and debt levels, and deflationists, who cite the slowing velocity of money and the debt unwinding.

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Eoin then reminded us of Central Banking 101: Ensure there is enough money in the system to promote growth. Significantly, however, <u>central banks do not control where all this money ends up.</u>

Much of the recent money supply expansion (the QEs) has gone into Treasuries. "If you are buying bonds today you are not early." The current move in Treasuries is momentum-driven, not value-driven.

Prudential has a billboard in Boston boasting: "We manage a trillion dollars". But what do they own? Bonds! Everyone who's owned bonds for the last 30+ years has made money -- consistently. And what causes people to sell something like that? "A big haymaker (which we haven't seen yet)!"

What causes big bull markets like the one in bonds to end? Not a decrease of demand -- but an increase in supply. Governments are currently issuing bonds at record amounts... and people are falling all over themselves to buy them. [Junk bonds, too! -- WD]

Bonds are the last real bubble. Yields are so low that investors have to leverage themselves to get a decent rate of return. This will ultimately lead to trouble, and when bonds finally reverse (and they haven't yet) they will enter a lengthy bear market.

Fixed assets are a good alternative to cash. Homebuilders have just completed a four-year base, but are short-term extended and due for some sort of consolidation.

Gold is <u>the</u> hard asset. Gold has had a positive return every year for the last decade. Gold ETFs have had net inflows during the past year-long consolidation, which is a positive tail-wind for gold. Gold is going higher... above $2000. Eoin thinks the move in gold is likely to end in some sort of bubble. Gold shares, meanwhile, have bottomed and are probably going to go significantly higher.

For the first time since the late 1950's, stocks yield more bonds. The perception is that stocks are riskier than bonds... but stocks have MUCH stronger balance sheets than Treasuries. And the supply of bonds is increasing, as governments and corporations

lock in the lowest cost of capital in generations while the supply of stocks is decreasing as corporations buy back their stock as they optimize their weighted average cost of capital. [And the value of their stock options! – WD.] Would you rather own what they are selling (bonds) -- or what they are buying (stocks)?

Eoin then turned to his next theme: High-quality equities are an undervalued asset class. We are living through the greatest age of humanity (global population levels) that is ever likely to occur. More importantly, the global standard of living is also increasing. This means that companies leveraged to the growth of the global capital class consumer -- and who dominate a particular niche -- will benefit over long run.

For example, the first thing people do when their wages go from $1/day to $5 is to buy food.

Food stocks to buy:

Want-Want (yes, that's what it’s called), a big Taiwan food company.

Nestle (yields 3.29%).

Coca-Cola (2.59%). It had a 57 P/E in 1997; it's 12.5 now.

HNZ (3.68%).

PG (3.25%).

Reeckitt Benchiser (a big European stock which yields 3.64%).

All these stocks' secular valuation contractions have ended. Many of them are extended short-term, though, and the best way to buy these stocks is to buy them on dips to their 200 day moving averages.

How about when their wages go from $5/day to $25?

Diageo (2.76%).

Heinekin.

Kimberly-Clark (3.45%).

YUM (2%).

Starbucks. (These last two stocks have huge potential in China.)

Retailers: WMT has just completed a 12-year base and secular valuation correction (57 in 1999 to 15.5 now).

All of these stocks represent the polar opposite to Treasuries! They also all have commonality... "which is how we get our best market calls".

And when wages go from $25/day to $100?

Google... just surpassed its 2007 high.

IBM -- which is starting to become a collector's item due to its consistent share buybacks.

JNJ (3.54%).

BMY (4.03%) -- and it consistently increases its dividend) has just completed a 9-year base. "Would you rather own BMY or Treasuries?)

LLY (4.13%) -- 200 million people in India have diabetes and the number of Chinese with it is increasing rapidly as their diet becomes more Westernized (i. e., sweet).

Mastercard.

"We classify these types of companies as Autonomies. We liken them to Medieval fortresses: they are leveraged to the growth of global consumer buying power, dominate their respective niches, and have strong balance sheets."

Wall Street will eventually complete its secular valuation contraction but will have to meet a number of conditions beforehand; improving standards of corporate, civil and economic governance are prerequisites for the secular bear to turn into a secular bull.

Two areas of opportunity: Natural Gas and Factory Automation (GE, 2.99%)

[WD comment -- I was struck by the similarities of the "autonomies" to the "Nifty Fifty" of the early 1970's, which were the strongest consumer growth companies in the world. Nobody then, of course, cared about dividends, so the P/E multiple was the only yardstick investors used. So if McDonalds sold at 60 times earnings there was no reason why it couldn't sell at 75 times -- which it did at its peak in early 1973. But buying the autonomies on a yield basis is not nearly as open-ended a proposition; a stock that yields 3% is clearly not as attractive an investment at 2.4% -- especially if interest rates return to more normal levels in the process. This suggests that the autonomies are eventually going to be valued via their growth rates rather than their dividend yields -- although their current yields and dividend growth rates are clearly the main driving forces behind them right now.]

[Also, as I pondered the Nifty Fifty's ability to generate spectacular performance during the early stages of the 1968-1982 secular valuation contraction, I remembered that something always managed to do well during the secular valuation correction's cyclical advances: the Nifty Fifty in 2000-2003, basic industrials in 1974-1976 and energy stocks in 1978-1980. My takeaway from all this is that even during a secular valuation contraction there is something that outperforms the market.]

[Right now, it's autonomies.]

{And an aside to David Fuller: Eoin filled your shoes with great honor. You should be very proud of him. -- WD]

Ned Davis: "Ruminating on Conventional Wisdom"

The conventional wisdom: "It pays to be contrary". As far as the Investors Intelligence poll is concerned the answer is a qualified "yes"; more bears do generate better performance than more bulls do, but the difference is not great. (Extreme bullish or bearish readings, however, do generate good performance in the opposite direction.)

"The public is always wrong." Yes, at turning points; witness the big equity fund inflows in 2000 and the big outflows at the 2008 low -- but if you look at each month's reading the track record is not worth following.

Ned concludes it doesn't pay to be contrary to public opinion except at extremes.

How good a forecaster is the Fed? It makes regular economic forecasts wherein it predicts that GDP will be up (or down) within a certain band. (Right now, for example, I think the band is between +2.5% and +4.25%.) Ned gleefully noted that since 2000 the GDP has been within the Fed's forecast band just 28% of the time.

Ned said that wage changes correlate much better with inflation than changes in money supply.

"Deficits do/don't matter." Since 1963, rising deficits are bullish for stocks -- and bonds.

"Rising interest rates are bad for stocks." Not really; the economy has higher real growth when real interest rates are rising than when they are falling.

Finally, Ned Davis's Three Main Rules:

"Don't Fight The Tape."

"Don't Fight The Fed."

"Beware Of The Crowd At Extremes."

Steve Leuthold:

Steve showed us a number of very long-term valuation studies from the Leuthold Group's BenchMarks publication:

Average S&P P/E: They measure earnings over a five-year period: 4 1/2 years of prior earnings plus two quarters ahead. Currently, the reading is 20.6 times normalized earnings, which is in the ninth decile historically -- just one decile from the highest normalized P/E ratios since 1926. Stocks are not cheap currently.

The average (median) yield since 1926 is 3.72%. It's currently 2.22%, which is also in the ninth decile.

Price/Sales: Median (since 1956) 0.96; currently 1.36. Ninth decile.

Profit margins on S&P Industrials: Currently at record high (8.5%); median is 5.65%

Bond yields: Record (1.77%); median since 1926 is 4.19%. He ultimately expects them to get back up to 5%.

(The problem with the not-cheap stock market here is that back in the late 1970's and early 1980's you had a choice, since bonds were yielding ~10%. There are no such alternatives now.)

Commercial Paper rates since 1831: Median 5.23%; currently at record low.

Inflation Rates (annual) since 1792. Median +1.7%, which is where it is currently.

"I'm afraid this is all going to lead to some sort of monetary debasement caused by the excessive printing of money."

Real GDP from 1850: Median +3.7%; currently +2.2%. "This, very clearly, is not dynamic growth."

Five-Year Stock Market Performance (quarterly since 1926). Median +10.5%. Currently +0.2% (which includes 2.8% in dividends).

Steve -- one of the smartest investors I know -- is currently net 20% invested. Most of his equity positions are hedged... and 70% of his equity positions are overseas.

He likes clean energy... especially nuclear; he noted that China is building 30 nuclear plants. He also likes land, which “may be the only hedge you really have against runaway inflation”. Farmland is overpriced... but you can buy things like JOE and TRC. He also has 10% in gold but thinks it's too volatile to take a bigger position. These positions are mostly hedged via shorts in the S&P, Russell 2000 and Dow -- as well as in Treasuries, “which may take a long time to work out”.

In summary: Be cautions, be careful, and look at interesting plays. Not just Emerging Asia; look at countries like Turkey and Poland, too.

Ian McAvity (Deliberations Research and a key player in the Central Fund Of Canada, which holds lots and lots of physical gold and silver):

In the long-term, stocks always go up -- but sometimes you have to wait 20 years for them to do so.

The S&P and the Euro Stoxx index have been diverging since 2000 --and especially since 2006.

What bull market? 13 of the 15 major global markets peaked in 1H 2011.

The secular decline in the savings rate has reversed or is in the process of reversing.

In 2002, stocks went down big but housing prices kept going up, so the public's wealth effect was mitigated. 2007-2008 was the real killer; both stocks and housing prices collapsed.

The market now: From March 2009-April 2010, 147 billion shares were bought on balance (net up/down volume). Since April of 2010 the number is zero.

A study has shown that if the DJI is up more than 1% from Aug 31st to Oct 31st of a Presidential election year, the incumbent party will win. If it is down more than 1%, the challenger will win. (The numbers this year work out to above 13220 or below 12960.) Since 1900, this has worked in 25 out of 28 times.

Gold in Euros has already hit new highs... gold priced in dollars should follow.

Senior gold mining shares are generally unattractive because they are gradually depleting their reserves. It's better to buy junior gold mining shares, which are discovering reserves rather than depleting them – and the only way the seniors can get significant new reserves is to buy them via the acquisition of juniors. GDXJ is a junior gold mining ETF, but Ian much prefers a Canadian juniors-only ETF that's traded on the Toronto Stock Exchange: ZJG, the BMO Junior Gold Index ETF, so he's not exposed to political risk embodied in some of the GDXJ components.

Two final observations:

1) During the general question-and-answer session the subject of insider trading came up. Steve Soukup, a political analyst, responded by saying that the worst insider trading abuses currently are by members of Congress.

2) At lunch, a gentleman from Fidelity observed that nobody who has come into the investment business in the last twelve years knows what a really good market looks like. Someday... someday... this will lead to the next secular bull market, as all secular valuation corrections ultimately do.

-- *Walter Deemer*