

INTERVIEW

Secular Cycles In Gold, Currencies, Equities

Juggling Dynamite With Danielle Park

With more than 18 years of professional consulting experience, Danielle Park is an attorney as well as a Chartered Financial Analyst (CFA) and finance author. Park is a regular guest on North American news media and a popular keynote speaker about investment markets and money. She is the author of the best-selling book Juggling Dynamite and a popular financial blog, www.jugglingdynamite.com. She is a member of the internationally recognized CFA Institute, the Toronto Society of Financial Analysts (TSFA), and she continues to be a member of the Law Society of Upper Canada. STOCKS & COMMODITIES Editor Jayanthi Gopalakrishnan and Staff Writer Bruce Faber interviewed her on February 8, 2010, via telephone.

Danielle, how did you get interested in the markets?

I was an attorney for a number of years before I was recruited by a sell-side securities firm in the mid-1990s. I became a portfolio manager, finished my CFA, and cofounded our current company, Venable-Park Investment Counsel, with my partner and market technician, Cory Venable, in 2003.

Doing historical research in the late 1990s, we came to see that the 1980s and 1990s were the best and smoothest secular bull in stocks ever in human history.

We also saw that the “easy gain buy & hold” period was not likely to continue, and we were likely headed into a much more challenging environment within 15 to 20 years, of almost the opposite conditions that the world had known in the 1980s and 1990s.

We came to this realization because I am a macro-market analyst and my partner is a Chartered Market Technician (CMT), and we both have a passion for market history and cycles in human behavior, so between our training and studies from other periods in history, like the 1920s, 1930s, 1940s, and 1950s, we put two and two together and said, “Oh, no, look what market conditions may be coming our way!” Then we asked, “What kind of an investment strategy will people need if they are going to retain their capital and get some growth in this difficult period?”

So what did you think would be a good strategy?

We came to the conclusion that the passive buy & hold, the passive allocations to equities that individuals, mutual funds, and pensions were using in the 1980s and 1990s, were going to be a *disaster* in this coming period.

This was, of course, all supposition on our part, or educated guessing; no one knows the future until it actually arrives, after all. But we reasoned that probabilities favored that we were going into a long or “secular” bear period like we had seen in the 1960s and 1970s, and the 1920s to the 1940s, and that a fundamentally different asset allocation approach was required. We came to a number of basic principles.

Which were?

That you needed to have tactical allocation to risk assets, you could not just buy & hold anything, you had to have a set of rules for when to buy and when to sell again. In this environment, when to buy and when to sell became the most important call. Commodities were likely to be in a secular bull period during this time when stocks were in a secular bear period. So that could be good for the Canadian market, for example, but it would be extremely volatile. If people tried to passively allocate to stocks or commodities during this environment, it was likely to be very painful, a lot



It's a myth that governments can step in to save the market.

of risk and volatility with very poor returns. Timing was going to be more important than stockpicking or pretty much anything else.

So we came up with an approach using exchange traded funds (ETFs) for broad market and sector-specific exposure instead of having individual company risk. We then designed our own grouping of technical filters to monitor money flow and about five other key elements.

Maintaining objectivity is paramount, so we don't love risk assets. We don't love commodities, stocks, or any particular sector. We follow our universe on a very objective count basis using our filters. That is where my partner's CMT training comes in.

Even within secular bull or bear periods, you are going to have the business cycle within it. During the business cycle, you get this economic bottoming phase every four or five years, where you have a recession, and risk assets sell off. This is a normal part of each market cycle, but during secular bear periods, these are

INTERVIEW

really profound downturns. They tend to be much longer and steeper than people are used to during secular bulls.

During these times, you cannot afford to be lackadaisical. When money flow is leaving, you need to get out of the long side of the market by selling or hedging to avoid the big losses. If you can avoid losing chunks of money with each of the cyclical downturns and participate in even a portion of the recovery expansions, we can survive and get ahead during these secular bear periods. Without a method like that, you would do better to just stay out or risk markets completely until this period finally ends. This secular bear period began in 2000 and is likely to last until 2017 or so, so we may be just about halfway through it.

History tells us that during these conditions, you get a range-bound market where, for example, the peak of 2000 becomes the peak of 2007 and is likely to be the peak of 2011 or 2012. In between, you are going to revisit similar lows each downturn. So we saw the same 2002–03 stock market lows again in 2009. In fact, we got a slightly lower low in 2009 than we did in 2002, and we are likely to retest that same low at least one other time, perhaps twice in the next few years.

Because of that market pattern, you need to think of yourself as operating in the midst of a hurricane throughout this entire 15- to 20-year period. You can never fall asleep at the helm because you are in the middle of a hurricane and you are trying to row your way through it without capsizing.

Income-paying assets are a big help during this period, but it also means you have to avoid overpaying for income assets because where they are equity-based, they still have a tendency to correct violently with the down cycles and take your capital with it. On top of this, as I say, “People’s deposits come to them lumpy in life.”

What does that mean?

Typically, people have very little money when they are young. They gain the bulk of their capital later in life as they amass a nest egg, sell a business or property, or inherit. By the time they

have the bulk of their life savings, their investment horizon is shorter and its capital can’t be easily replaced. The typical advisor mantra is, “You have a long investment horizon because you don’t need this money for 20 years,” but the secular periods have to be taken into account because if you had put money in the stock market in 1920, in 1940 you would have actually lost money for 20 years.

It was roughly the same thing in 1960 to 1980; you would have lost money for almost 20 years. The same thing is going on now. From 2000 to 2010, passive allocations to stocks have lost money. Even in the Canadian market, which is rich in resources, and within the idea of a secular bull in commodities, the Toronto Stock Exchange (TSX) is now below where it was in 2000. So it is this kind of investment climate where you can’t be passive, you can’t relax and enjoy; it is just too violent.

If you don’t have a mechanism for controlling your market risk in this sort of hurricane, you should stay away from risk assets altogether. That is because high-quality government deposits or things that pay modest income and take no market risk have always outperformed *passive* risk investments in these periods. Not losing money becomes much more important than how much the markets gain in each up cycle. This can be a challenging concept for traditional “investors” to understand.

At our firm, all of our accounts are balanced. We have a fixed-income component and we have an earmarked-growth component, but that growth component can be as little as zero percent invested if our readings are flashing our sell signals. And when we have buy signals, we can be fully invested again up to our target weight. So in a 50/50 mix, you would never have more than 50% of the account fully invested in equities and you could have as little as nil or anything in between.

For an example of this, we started to get sells in our rules in early 2006 beginning with the financials first. At the time, everyone was madly in love with financials, and they enjoyed a remarkable run, but we got sells and so we sold.

They are a leading sector for the overall market. By 2007, we had pared back all of the equity exposure in our portfolio, except for our sector weight in gold and Canadian energy companies. In early 2008 they came up as a sell as well.

We did not get any buy signals on the equity side again until February 2009, so we missed the bear market of 2008–09 completely and then reentered in February 2009. Those positions worked well for a 10-month trade, but we recently confirmed sells again on our rules. Now we are basically down to zero equity exposure again. This does not mean that risk markets can’t continue to rally from here, it just tells us that downside risk is now higher than further upside reward and so prudent risk management requires caution and capital protection again.

Of course, this approach is completely at odds with most of the rhetoric that the investment industry espouses. I speak at a lot of investor shows and hard-asset conferences. The error I see a lot of people making is the “recency effect,” or presumption that a recent market trend will continue unabated.

For example, when oil was at \$147 a barrel, there was an expectation it would continue from there to \$200 or more. There was no consideration for the violent nature of the pullbacks within these cycles. People remained heavily exposed even as prices went off the charts in gains and risk.

Copper at \$4 was a bubble-like price, and people kept holding, thinking, “We are in a secular bull in commodities, prices can only go up.” Of course, that is a horrendous misunderstanding of market history. Copper corrected to \$1.37 from \$4.00. That is a hell of a correction, right? So price always matters. It is not good enough to say we are in a secular uptrend, so pile in and forget about price. No price is always our greatest risk; we can’t fall in love with a story and forget about price.

So where are we right now?

At the end of January, the uptrend since March 2009 has been broken in most markets around the world. We don’t know the extent to which a pullback will take prices down, but we do know that most assets seem to be at least 25% to

30% overvalued again. That would be pretty much across the board, so those who are concerned about protecting their capital have to be pretty defensive until this contraction plays out.

What about other commodities like gold?

Gold seems to be in a slightly different category because the whole “fiat currency, fear of government default” theme is driving gold at the moment, but you can have a secular uptrend in gold and still get a correction to \$700 within that uptrend.

Anyone not realizing that leaves themselves very risk-exposed. Others may be piling in more capital, but late in the story. Maybe you bought some gold when it was \$250 or \$500, but then you became very confident and piled in a bunch more when gold was at \$1,000. The question you need to define is, when would you sell? You need to have something more than just an optimistic buy idea.

What’s an example?

Chinese demand is one that everyone hyperventilates over. They say, “China’s one billion people want to be middle-class, so they are going to be voracious consumers of all the goods and services and commodities in the world!” But that doesn’t seem to be the case. Yes, there is a lot of people there, but they are not good at consuming. They are not a vibrant middle class. You might have 150 million people there who would be close to Western-style capacity for consumption. The rest are basically still trying to survive. They don’t have a social safety net. So they tend to be people who save and don’t spend. You have to be mindful of those realities within all of these long-term arguments that people make for why demand should continue to surge, even with a Western world decline.

You mentioned in your blog that you expect several financial aftershocks in 2010. Is that because we are still in a secular bear market?

Partly. However, the secular bear market is really a symptom or an outcome of the erroneous policies that went on during the secular bull climate. What

you had from 1982 through to the early 2000s were falling interest rates, falling inflation, declining regulation, falling tax rates, all of which were extremely good for business and risk assets — at the time.

Now, what happened was — and this is what always happens — we are facing the great unwinding of these easy conditions into a period of increasing regulation, increasing rates, increasing taxes, and eventually increasing inflation. These now become our secular headwinds for the world economy.

There were, for example, the Glass-Steagall Act, which came in after the credit crisis of the 1930s, and the Investment Company Act of 1940 came in to restrain and define obligations for banks and the investment advising population in the United States. These policies were introduced in response to a period of unbridled risk-taking and leverage that led to the financial disaster of the mid-1920s and 1930s. Today, we are having to reinstate similar regulations to safeguard the system once again. Yes, these regulations will constrain growth, leverage, and profits for market participants, but that is the point. Without these constraints in place, individuals and the system overheats and blows up. We have enough history now to know the dangers inherent and plan ahead to protect us from ourselves.

Economist John Galbraith used to say, “Every generation’s memory is exactly as long as its own experience.” That is it in a nutshell. So what we have found is that periods of smooth sailing don’t build great sailors. Instead, you had people who hoisted sails and went to sleep and thought: “Who needs regulation? It all looks after itself. You don’t have to worry about bubbles, because they can’t happen.”

Of course, just as risk is peaking, people are the most complacent, and just as you need the most government intervention and regulation to pull things back from the precipice, legislators are slashing all the rules and saying: “We don’t need this anymore. We are bigger, brighter, better.” And they forget everything that was learned the hard way in the last debacle.

We are now in this period where we

have to pay back what we overleveraged. So you are seeing credit contraction. You are seeing consumer debt that was excessive beyond belief now downloaded onto banks in the form of bad loans, and then downloaded onto governments in the form of bailouts and sovereign debt. So far in this process we have not actually accomplished much since the credit crisis hit in March 2007, which was not when risk appeared, by the way — it was when risk was recognized.

When was that?

Risk was mounting for many years before that, particularly from 2005, when Federal Reserve chairman Alan Greenspan cut rates after the 2003–04 disaster and left them at 1% for a year. You saw the predatory lending because they cut all the regulation that was constricting leverage. What you had was this systemic bias in favor of reckless risk-taking. That is why we got into this disaster. Now it is going to take quite a while for the system to get cleaned up, written down, and written off. A while ago, there was all this talk about how the US is different than Japan, saying, “We will *never* be like Japan because they didn’t want to recognize their banking losses. Their pride got in the way. Their honor didn’t allow them to admit mistakes!”

But they were wrong!

If you look at what has happened in the last two years, it is remarkably similar. The leaders who led us down the rabbit hole are still trying to lead us in the same direction. Even President Obama, who came in on this pledge of change, has not changed anything. Really, there has been no meaningful regulation brought in. We had the Volcker rule proposed a couple of weeks ago. That was the first effort to define anything that would actually be meaningful regulation, and it didn’t look like it was going to fly, even though you had a big civil uproar around the world. Political risk and sovereign risk are part of the aspects I am speaking about when I say that the aftershocks will reverberate through 2010–11 because of the realization that the politicians have spent all this money to help but haven’t. In fact, the politicians have really just added to debt

INTERVIEW

and not been able to salvage the economy or restore demand in the economy in a meaningful way. So you get a lot of public outrage and anger because they have realized it is not a quick fix.

Nothing is.

There is nothing easy that can be done to get job creation back in the economy and people spending again. A lot of politicians will not get reelected. A lot of the plans that have been proposed to date will prove to be ineffective. It will just take this long period where slowly but surely things get written down, losses get admitted, assets get revalued, and new consumption levels are established, which is below where we were three years ago.

At the peak of the credit bubble, you had demand at record levels. You had profitability of companies at record levels. You had world GDP north of 5%. Now you are in a world where even a recovering economy is going to have a GDP of something like 3.5%. Even with massive stimulus spending, 3.5% world GDP would be a fairly optimistic outcome for 2010. Yet compared to where we were previously, it is not going to feel like a great outcome. It is not going to feel like everything is rosy again. As you go along through that, you get into the tough slog of it, which is just work hard, save more, build up your personal savings rate, pay down your debt, spend less, and learn to be happy with less. That is the frugality that ultimately becomes the generations' behavioral shift.

My grandparents were in the Great Depression, and they had that mindset ingrained into them. Unfortunately, the generation in between theirs and mine was born into economic halcyon days where conditions were relatively easy and so fewer people developed the tough slog skills. Now we are all learning them the hard way again. It was like everyone was in this drunken orgy and you were like, "They are going to wake up and see what a mess we've made!" And then they did wake up, and now they are starting to say, "Oh, wow! We have to fix this!" It's going to take a few years.

It's not going to be quick at all.

So most investors did not understand

we were going into this profoundly different climate. They kept doing the same old passive allocation to risk. They have lost money now for 10 years. They've lost half their money, twice in two bear cycles. But you don't have to keep doing that. Do yourself a favor and don't even try to be into the risk asset market unless you can do so with strict rules about how much of your allocation can go into any one sector or asset class and when.

A couple of weeks ago, a gentleman from the Netherlands came up to me and said, "I run a family trust, and I'm here to get investment ideas at this conference." He told me how he has 60% of his money in gold because he has no confidence in institutions. So I said, "So where is this gold? Is it in your basement?" He said, "Some of it, but mostly it is in vaults at financial institutions." I said, "Aren't those the institutions that you have no trust in? Isn't that why you are accumulating all the gold?" People have been like automatons again, saying: "Banks are bad. Government is bad. No trust." The reality is that a global economy without a fiat currency system, whether it is the US dollar or otherwise, is not possible.

Humans are prone to emotional decisions in response to recent developments rather than following an objective practical rule set to keep them out of trouble.

The rally we've had since March 2009 until recently was disconnected from economic fundamentals. While the fundamentals were weak, you saw the markets rallying and saw that same euphoria again. I would think that now this is another time when people are going to start realizing that when it goes down, it goes down really fast.

If you look on my blog, juggling-dynamite.com, on Friday [February 5, 2010], I put up a chart of copper. This chart makes the point, which is that risk assets in the world have been driven up since March 2009 on a falling US dollar. That is the top reason. If you think it has anything to do with Chinese demand or rebounding economy, all that, you are sorely mistaken. The fact of the matter is the dollar was falling. People could borrow the dollar at next to zero and speculate in other places, and that is

what they did.

Our indicators were coming up fairly bullish last February, so we started accumulating assets, but by June we noticed that the volume was not increasing with the trend. Fewer and fewer dollars were buying it. That is not the precursor for a lasting rally. That is the precursor for some kind of a head fake and then a retest. That is why we were carefully watching the trendline from the March bottom because once it was breached, you know things are way overdone to the upside. You have to look at "what-if" scenarios. What if it holds support at different levels? What will you do, and what is your exit strategy? No one seems to have within their realm of possibility that we could retest the March lows.

I find that amazing because if you get another fresh wave of default foreclosure data in the US, and it turns out the housing market has not stabilized, which I would suggest it hasn't yet; we are going to see a fresh phase of credit crisis. We have not bottomed yet in housing and commercial real estate. You could have a risk-aversion trade that comes back with vengeance and surprises the hell out of everybody.

The other major thing that troubled us is that the rally since March 2009 had no meaningful test. That is just not the way price tends to behave in these cycles. You get some kind of a pullback or retest to define the bottom. It is a process and we have not seen that. Then we were watching the US dollar so carefully because of the rhetoric about gold and the US being such a print machine, and all that is valid commentary in the sense that we agree they are on a dangerous path to huge deficits and huge debt. The trouble is that we also track most other currencies and countries in the world, and relatively speaking, they are doing very badly as well, and in many cases worse. When you realize that currency-wise, the US dollar was deeply oversold and not as bad off as some others like the euro, then you have to believe there is going to be a rebound in the dollar, even if it goes down again in the longer term.

How?

Dollar moves historically come in

legs. We studied the dollar for many decades and it tends to do this kind of a bottoming process like it did in the early 1990s: a three-legged bottom. Once it tests, it can recover from 70 to 84 in a matter of months. The last time it did that, the stock market dropped 50%. You have to be aware of that as a major risk to whatever investment thesis you are having. The US dollar broke out in the past couple of weeks, and lo and behold, the risk trade breached the March trendline to the downside. Now we are into this wait & see mode. But always keep watching because, as I said, it does it in legs and it can be sharp and short and devastating for other asset classes.

I don't think it is the end of the world. I just think we are going to go through a reality check here, and probably a fresh wave of risk-aversion with respect to world markets.

Copper corrected again \$0.50 to under the \$3.00 level in late January. That is a significant downside test, but we still see that long-term support is about \$1.37, so we are way above that. I'm just cautious about where asset prices are. Institutions haven't been any better than individuals, quite honestly, because they were doing all sorts of passive allocations, especially to hard assets, thinking that they were some kind of an asset class you could just plop money into and go away for a quarter. And of course, that has worked out badly. So now a lot of the world's pensions and institutions are having massive shortfalls. The answer is going to be that they top up contributions, and again that is going to come right out of corporate revenues, and individual savings are going to have to be brought up through actual savings, which will be a significant drag on consumption for a while.

What are the signs that will tell us that there is growth?

Revenue will eventually trend up again. We saw earnings collapse 90% from the peak in early 2007. The S&P earnings collapsed 90% from 2007 to 2009. That is pretty remarkable! We ought to see some kind of recovery after that. We should not expect that earnings will fall indefinitely. That said, you go back to an expectation for maybe 2%

to 3% growth, and probably less than that in 2010. Then you have to look at companies, or industries, that have cash, that are defensive, that have a buffer. You watch the savings rate.

Here is a long-term trend. The savings rate went from 20% in 1980, all the way to virtually nil in 2005. You have to get that consumer savings rate back up above 10%, maybe even to 15%. It will continue to build because people now realize how vulnerable they are, now that the asset bubble has burst and government has let them down. People realize that they need cash and not just a line of credit. You have to watch for things like that. So how will we know when we are in a fantastic opportunity in terms of a secular change? We will know because savings rates will be built up again, and balance sheets will be pretty healthy. People will be spending less and saving more and have that nice buffer built up.

Corporate profitability will be coming out of the contraction time, and building slowly. People will be hiring workers again. You will most likely see some inflation eventually, but in the near term, the next year or so, deflation will have the upper hand. You will see interest rates begin to move higher. Again, I don't think that will happen for a while because we continue to see such massive deflation, and governments are scared witless. They don't want to raise rates, but dividend rates will get higher when prices are lower. The S&P is yielding less than 2% again. It's very unattractive. If we get to a period where valuations come into dividend yields of 4% plus, and price to earnings ratios of 10 or so, then investment prospects will look pretty exciting again. Then you are into a period where you have lots of ability to deploy capital at reasonable prices. It is unfortunate that it takes a while to build that up. You can't have it whenever you choose it, or whenever you happen to have cash.

You get it when the conditions correct enough to give it to you. The real

opportunity comes when the secular and cyclical trends both turn back up and there is real wealth stored in the economy. The trick right now is to preserve capital, grow savings, get rid of debt, and get through this challenging time. Then be well-poised. Have buy lists, or have someone you trust who knows what they are doing. That is easy to say but hard to do because so many people are still brainwashed with these passive allocation ideas. I think that for the next 10 years, these people will continue to be very dangerous.

You will have to pick very carefully. Get your ducks in order. There will be opportunities coming, and there may even be another cyclical opportunity here shortly, but we have to let the test play out first. Then, if we get a rebound at a decent level, and we see money flow go back in, and we see volume supporting the trend up, then we will go back into our equity allocations again, but we will be charting daily, weekly, monthly, looking for the next breach of the medium-term trends, because we are expecting this retest of the 2007 top again sometime in the next few years, and a retest of the 2002 lows again sometime in the next few years.

When you realize you are not climbing a mountain that goes up forever, but that this is a roller-coaster full of steep drops and climbs, then you will be geared to expect the conditions as they come.

When you get out of equities, do you get into exchange traded funds (ETFs) like FAZ and DXD?

We go to money markets or cash or Treasury bills. Sometimes with short-term government T-bills, we use a US dollar ETF, but when we leave risk assets, we want to be out of risk assets. Sometimes, people will ask us why we don't pile into bonds. We don't because we have to manage the risks on bonds as well. It is a separate set of parameters. Some people go long and short but we are not that aggressive in our model. We are long, and then neutral, which means we would literally come out of equities and park in SHV as an example of US safety parking.

We are concerned right now with the



INTERVIEW

front end of the curve being overpriced because of all the government intervention. They have artificially suppressed the front end of the yield curve, so we find that short-term bonds right now are very expensive. So we stay in cash. Yes, you collect a modest rate of return while you are there, but there is no point in reaching for more yield if you are going to lose a big chunk of the capital.

Another thing you were talking about is getting the US savings rate back up. When the Japanese market crashed in the 1990s, they were a nation of savers, so that saved them. When we go down again, we are tapped out of our credit cards, and we haven't saved either. Isn't it going to be worse for us than it was for Japan?

The US can't self-fund as well as they did in Japan. One thing that the US has going for it over Japan is immigration policy and a younger workforce. Japan, and China too, have disastrous demographics. Japan has been isolationist for so long, not allowing new people to come in, that they have this huge aging population who are selling their government bonds to live on, because they have next to no income. They have to liquidate assets to provide in their old age.

It was great while they saved, in the sense that they could fund their own deficit, but when you look at total debt

to GDP of 400% in Japan and you realize you still don't have robust immigration and now your old folks are cashing out to live on their savings, you have a pretty dangerous scenario. I agree with what you are saying: it would be nicer if Americans could have their own cash to work with more. That said, they are buying their own T-bills now more than they did for years. Americans are actually saving in their own government-issued debt, which will help, in a way, to provide some of the liquidity, but not enough.

When you look around the world, there are so many governments and companies trying to issue debt instruments. At some point, who is going to buy it all? There are way more people wanting dollars than there are people willing to place it.

Do you believe in this thing they refer to as the "plunge protection team," that someone in Washington is telling the banks to buy this stuff that causes these rallies like we had on Friday afternoon [February 5, 2010]?

I am sure politicians would like to influence the business cycle. There is no question about it. They like to take credit for it when the economy is expanding, and they don't like to take responsibility for it when it is contracting. The truth is that they are not responsible for either, other than they can help avoid disasters by having decent policies in place at the outset.

What I have noticed is — and this is in my studies and readings from the different decades, Galbraith talked about it, the late Peter L. Bernstein, whom I corresponded with, was a great help to me, talked about it a lot — this idea that governments can step in to save the market is a myth! Everybody has this mythology that says there is these big men who put things up and down, as if we don't have to worry because they won't let the market crash. They haven't been able to help us for the last 10 years clearly, or the market would not have crashed more than 50% twice.

I have seen several articles where they interview Chinese people who say they believe their government won't let the stock market crash, but it crashed 70% in 2008. So if they are doing it, they are pretty poor at it. I wish some big man — some would call him God, some would call him the Federal Reserve — could save us from ourselves, but unfortunately it doesn't seem to be possible.

Too true! Thank you so much for your time, Danielle.

S&C

