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$ your wealth $

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In fishing, as in the markets, there can be signs that can point one in the right direction.

Are we there yet? Have we seen the end of this bear market? It's tough to say. At the time of writing, we have experienced a good rally off the bottom. We have recently taken out the October lows only to rally strongly these past two weeks. However, more time is needed before we can call an end to this bear market. Unfortunately, the only way to confidently call an end to a bear market is glancing backwards at it, as a piece of history. Cash feels good at the moment. Perhaps, like a $6 bottle of wine, it has trained its holders well over the last year but will likely hurt at some point. Holding most of your portfolio in cash is not going to add excess returns. Anticipating the turn around or obtaining comfort about the economic environment will be worth the effort.

I enjoy fishing, fly-fishing actually. Fishing is often an exercise in probabilities; not unlike finding the end of a bear market. It is rare for you to actually sight your quarry before you get to exercise your thesis (present your fly). In fishing, as in the markets, there can be signs that can point one in the right direction. I will keep my fishing secrets to myself, but will share some thoughts on the markets. Watching these indicators may provide some investment conviction. They have been good indicators in the past and while any one in isolation may not do the trick when considered in aggregate they are most useful.

Purchasing Managers Index (PMI)

This index is published by the Institute for Supply Management on the first business day of each month. Many view it as a leading indicator of economic activity. The index surveys 400 purchasing managers across the U.S. and across different industries. The survey covers production levels, new orders, supplier deliveries, inventories and employment levels. The PMI is reported using the number 50 as an important reference number. Scores above 50 indicate that industries are expanding. The higher the score above 50, the stronger the expansion. Scores below 50 indicate that industries are thought to be contracting, and scores below 42 are indicative of recessions. The most recent PMI was reported at 34.2 up from a low of 33.3. It was last score received above 50 since September of last year. It has shown consistent weakness with a string of scores below 50 starting early 2008.

A steadily improving PMI will be one of the indicators that the base economy is turning around. Keep an eye out for scores above 43, but an ideal score is higher than 50. It is likely that the equity markets will have moved to a renewed bull when we see consistent PMI score above 50.

Unemployment

Unemployment numbers and unemployment rates are the next series of data to consider. We will, of course, have record breaking unemployment numbers simply because it has been 17 years since we have seen this kind of contraction. Both the American and Canadian economies have grown significantly since the last contraction therefore we will simply have more workers laid off. The numbers in Canada are generated by Statistics Canada as part of the Labour Force Survey. The Labour Force Survey is usually released on the first Friday following the reference month.

The survey of approximately 54,000 households is conducted during the week that contains the 15th of the month, and provides information across industrial sectors on hours worked, labour force participation and unemployment. In Canada, the labour force is defined as the civilian, non-institutional population 15 years of age and over who, during the reference week, were either employed or unemployed.

The overall number of jobs gained or lost is very important. It is also important whether those jobs created are full-time or part-time positions. Full-time employment gains are a key generator for income and confidence. Thus, strong full-time job growth indicates robust economic growth. It is important to examine the breakdown by industry and province to see where jobs are being created or lost.

Changes in the size of the labour force can affect measured unemployment. During a significant downturn, some of those unemployed may stop looking for work and as a result, would no longer be considered a part of the labour force. This could lead to a drop in the rate of unemployment even though the labour market is still weakening.

Last month we shed another 83,000 jobs and we now see unemployment in Canada running at 7.7%. Unemployment is a lagging indicator and it will most likely confirm but not predict a turn around. Simply people are usually the last thing companies turn to when cutting costs as they are the hardest resources to replace for companies and there are great costs to retrenchments and to retraining when business picks up again. These cuts do however can make a big impact on getting business turned around and leading companies back to sustained profitability. Unemployment could peak at 10% on both sides of the border. The unemployment percentage does not have to go down for things to begin to turn around but it should stabilize.

Commercial Loans

Commercial loan provisions at banks or bond default rates in the debt markets as well as spreads of these bonds to government bonds are another key indicator.

This bear market has been triggered by an absence of credit and an endemic aversion to risk. For things to turn around access to capital by all borrowers (personal and corporate) must be easier and less expensive.

Loan write offs are a lagging indicator. Typically debtors are able to juggle finances for a short period of time before the funds to service obligations dries up. Unemployment is the key indicator here as typically jobs are the last thing to go in a company (no one wants to see people lose their job). At this point productivity goes up (fewer employees at a given albeit reduced level of output) and hopefully profitability otherwise the business will be unable to turn around and thus debt defaults and actual loan losses versus just provisions. I like to keep an eye on the growth rate of provisions and realized losses. I am looking for first the acceleration of realized losses and then the reduction of the growth on loan losses or peaking of them. As they are a lagging indicator waiting for things to turn to normal will most likely mean the stock market train has left the station. ☛

Corporate Bonds

Corporate bond rates as compared to government bond rates are an indication as to how much risk there is in the system and they anticipate the risk of default. In 2007, in the US the typical US Corporation with investment grade corporate debt yielded an additional 1% over US government debt. Currently they yield and additional 6% over US Government debt. For high yield debt the difference at the moment is 14%. These levels have not been seen since the 30's in term of spreads to governments.

To put it into perspective for the high yield market the math is telling us that the market expects 1 in 10 US companies to go bankrupt and the bond yield to zero. Spreads for high yield over government bonds approached 20% last November which is the equivalent of a 1 in 7 default prediction. Clearly this is a market in distress. Current corporate default rates are in the 5% range, as we work our way through this recession they should peak north of 10%. Again we are looking at the growth in default rates as well as spreads to government bonds and then the peak where we will no longer see these spreads and defaults continuing to grow. At this point the risks will begin to drop for investors and opportunities will present themselves. It just may not feel like it at the time.

So most likely we are not there yet. We still have economic contraction as measured by the PMI, we still have unemployment numbers increasing, loan and corporate bond defaults rates rising. These indicators considered in aggregate when peaking should give us a good idea that there is not much farther to go. How much farther? We will only know that when it makes the textbooks. There is a lot less risks for investors than there were 18 months ago. The equity markets will try to anticipate the turn around and may take off before the underlying economic situation firms up. For those who want more certainty the above points discussed may be helpful. Patient long term investors will be rewarded but we still have some bumps in the system to work through.

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