Ruminations of

The Contrary Investor

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The 48th Annual Contrary Opinion Forum

It is better to debate a question without settling it than to settle a question without debating it.

~ Joseph Joubert

It has been our great pleasure each year since 1963 to host the Contrary Opinion Forum — a unique investment conference founded by seminal contrarian thinkers Humphrey Neill and Jim Fraser to encourage the exchange of ideas and instill the notion of thinking for one-self in the process of making investment decisions. Our 48th annual Forum was held at the lovely Basin Harbor Club in Vergennes, Vermont in early October.

I am honored and humbled by the quality of the speakers who give so generously of their time and talent, as well as the quality of our guests. More often than not, folks attending say that their most valuable and enjoyable time at the conference is at meals and receptions, renewing longstanding friendships and making new connections, but our speakers provide the fodder for conversation.

Traditionally, the November issue of *Ruminations of the Contrary Investor* has offered a summary of the conference. This year, Walter Deemer, a seasoned stock market analyst with more than 40 years of experience and a truly distinguished track record (and a long time friend of the Forum as both speaker and attendee), has made my task easy! Walter's *Market Strategies and Insights,* published on October 14th, does a far finer job than I ever could of distilling key takeaways from the conference. With his permission, his comments (unedited) on the Forum follow.

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 who 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.

<u>David Fuller, FullerMoney.com (London).</u>

David and I first met when we both spoke at the Conference on Technical Analysis in Cambridge, England in 1974. David 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 environ-ment and a lot of worried people. The other world, however, is <u>not</u> worried; their economies are booming and their problem is inflation, rather than deflation.

What is that "other world"? David says that the old labels — old world, new world, developed, developing, emerging — are misleading; nations and economies are either <u>progressing</u> or <u>regressing</u> 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 and educated workers. David singled out Singapore, a country which is 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 (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. And 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. David left it up to the attendees to decide which countries fell into each category and why.

As far as the stock market is concerned, David 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 <u>"secular valuation contraction"</u> — 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 which enabled valuations to catch up to price rather than a huge decline. David 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 here is not a depression but, rather, the worst credit crisis recession since the 1930s. "100 years of history show that it takes 5 to 7 years for an economy to recover from a credit crisis recession." [Note: If so, and if we are now two years into the recovery, this means we have another 3 to 5 years to go — or until 2013-2015.]

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

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

Summing up, David 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 US will avoid a double-dip recession with the help of progressing economies.
- The three-decade bull market in US 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.
- US and European multinationals leveraged to the global economy will outperform.
- Leading or promising sectors include technology, healthcare, mining, agriculture, global infrastructure and dividend increasers.

<u>Ian McAvity, Deliberations Research (Toronto).</u>
Ian is an excellent, well-seasoned technical analyst who's also been involved in 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 gold is going but, rather, how low are currencies going to go. (He did note, however, that the old inflation-adjusted high in gold is $2388.)
- 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."

<u>Jeffrey deGraaf, ISI (New York)</u>
Jeffrey 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, meanwhile, Jeffrey noted that October volatility contracts and skews positively after a very positive September.

Jeffrey then noted that the flattening of the funding curve has put immense pressure on banks, who 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 that banks have to deploy six times as much money (i.e. use leverage) in order to get the same total return. Jeffery observed that whenever the relationship inverts — whenever the Fed fund 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.

Jeffrey defines a secular bear market — which he thinks is where we now find ourselves — 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!] And, with regard to the secular bear market case, Jeffrey 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 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 Jeffrey 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. Jeffrey replied that it was pushed back to 2008 by credit conditions and that 2008 was the last four-year cycle low.

The Contrary Investor extends his sincere thanks to Walter for his permission to present his cogent summary, and for his longtime support of our conference! Go to www.walterdeemer.com for more information on his services for sophisticated investors. His work and track record speak for themselves, and he is a true gentleman. His wife, Bobbie, is a lovely person too!

Alex Seagle

Words to Consider

Age does not diminish the extreme disappointment of having a scoop of ice cream fall from the cone.

~ Jim Fiebig

Common sense and a sense of humor are the same thing, moving at different speeds. A sense of humor is just common sense, dancing.

~ William James

A diplomat is a person who can tell you to go to hell in such a way that you actually look forward to the trip.

~ Caskie Stinnett

Bad politicians are sent to Washington by good people who don't vote.

~ William E. Simon

As you walk down the fairway of life you must smell the roses, for you only get to play one round.

~ Ben Hogan

Day, noun: A period of twenty-four hours, mostly misspent.

~ Ambrose Bierce

If you want to be found, stand where the seeker seeks.

~ Sidney Lanier

Good judgment comes from experience, and experience comes from bad judgment.

~ Fred Brooks

Any idiot can face a crisis — it's day to day living that wears you out.

~ Anton Chekhov

An economist's guess is liable to be as good as anybody else's.

~ Will Rogers

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