

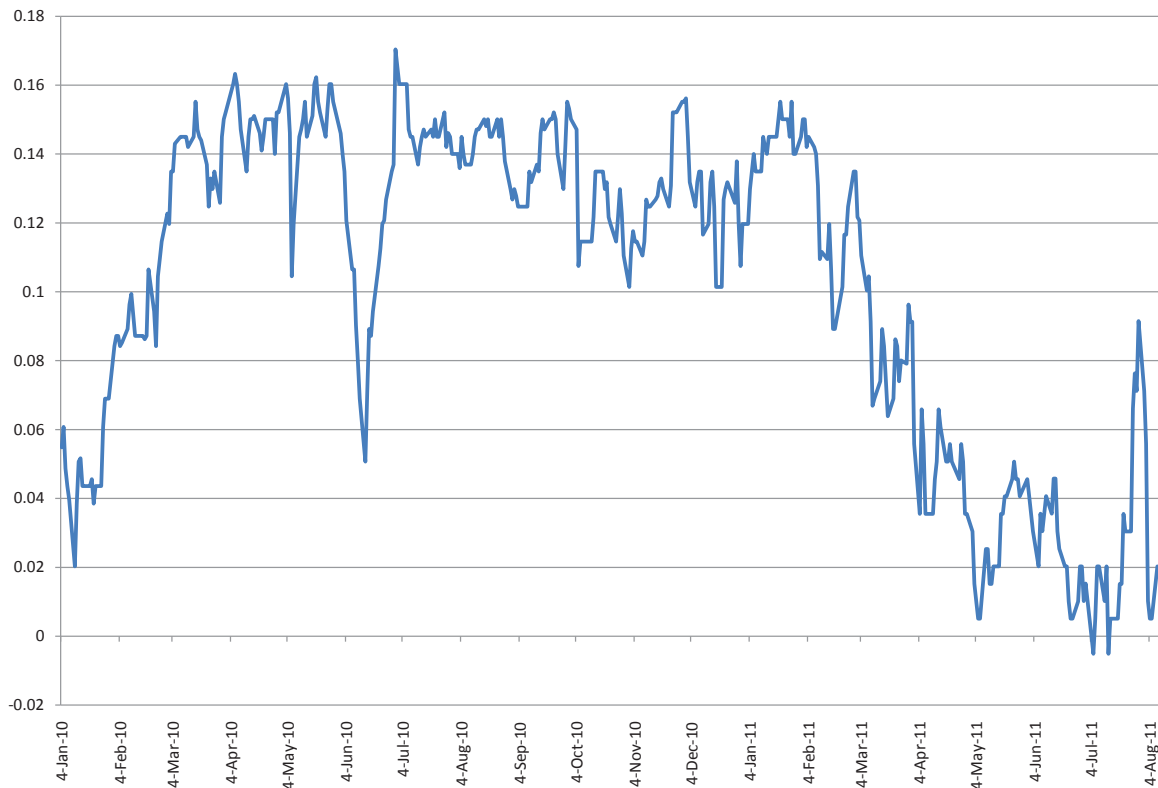
## IS THE BUSINESS CYCLE OVER ALREADY?

by SANDY MCINTYRE  
*President and Chief Investment Officer*

August 9, 2011

Over the past two weeks or so, we have had street theater in Washington over very modest spending cuts and an increase in the debt limit. The European bond market has been in disarray with an effective default on Greek debt, and with Italian yields rising sharply into the pain threshold of over 6%. As former AAA credits fall in value and rating, the solvency of the European banking system is being called into question. A flight to “safety” has driven short term US T-bill yields to essentially zero. All the while, a dysfunctional Washington drove Standard and Poor’s to reduce their rating of US long-term government debt by a notch to AA+. Investors can be forgiven for believing we are returning to the summer of 2008.

US Government 3 Month T Bill Index

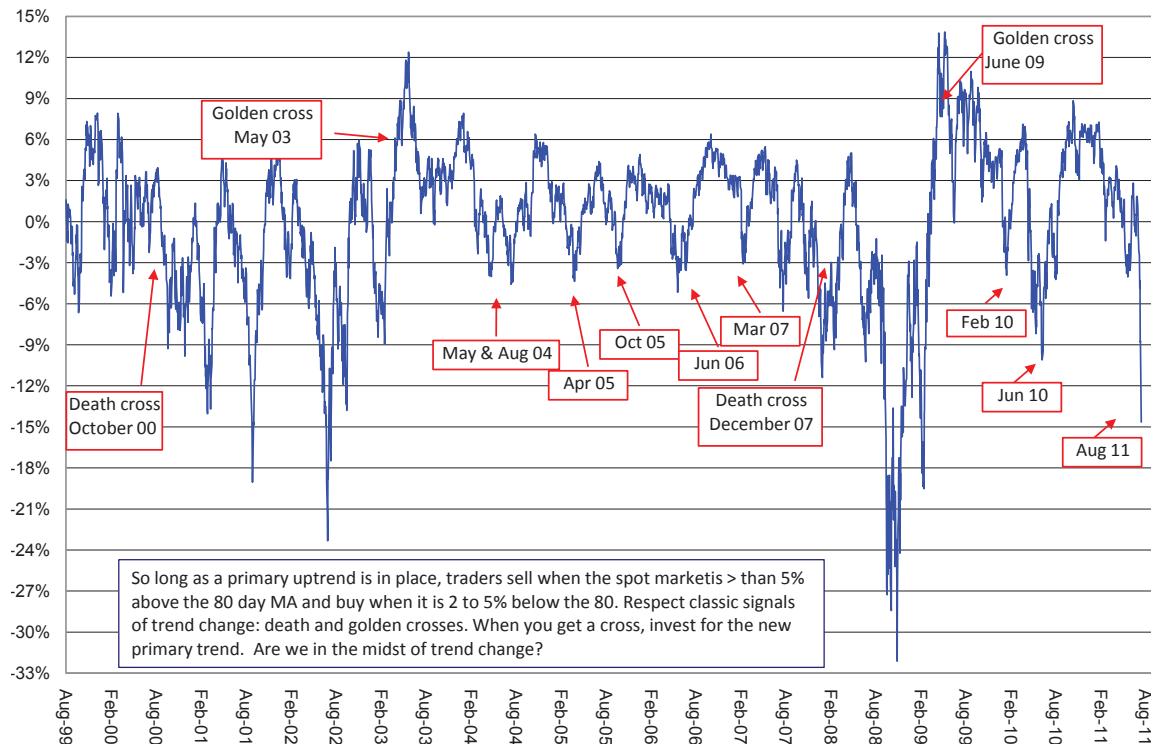


Source: Bloomberg LP, Sentry Investments

The flight to safety has removed overnight funding that was being provided by large US institutions to the banking system through overnight deposits and sharply increased deposits in the most secure US institutions. This has prompted the BNY Mellon to start charging large depositors a fee. Removal of overnight funding in 2008 resulted in a loss of liquidity and was linked to margin calls in the prime brokerage community. While listening to Bloomberg radio on August 4, the subject of margin calls was a consistent theme. Margin calls are a risk to the system.

As of the end of June, margin levels at NYSE broker dealers were back to June 2008 levels. Cash balances in cash accounts were one third higher. Retail investors have been raising cash in an orderly fashion for over 3 months. This corrective phase started last winter, and experienced its first low in March co-incident with the earthquake off Japan. The market bounced back in April, but began to struggle with a series of negative economic events including the crisis in Europe. I use an oscillator to measure when markets are elevated and in the right range to look for a bounce during corrections. The short-term oscillator measures the spread between a market daily close and the 80-day moving average (MA), as well as measuring whether or not short-term positions are in or out of the money. The oscillator tends to give decent reduce signals when it is 3% to 5% above the 80-day MA and buy signals around 3% below, so long as you are in a primary uptrend. The key question is: what is the primary trend, bullish or bearish?

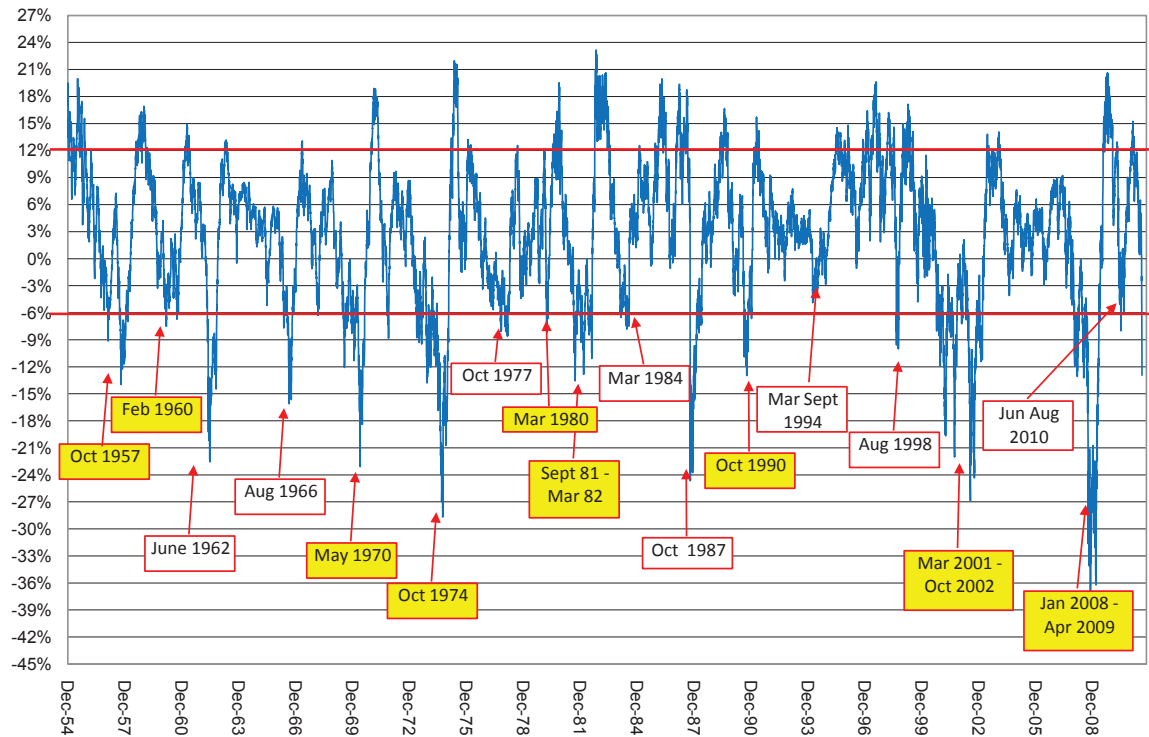
Spread between the daily close of the S&P 500 Index and the 80 Day Moving Average



Source: Bloomberg LP, Sentry Investments

When you look at my buy “3% below the 80-day” assertion, it has some validity in primary uptrends. It does not appear to be valid in material mid-cycle slowdowns. What I think has been developing in the spring and summer of 2011 is a mid-cycle slowdown that many fear will turn into an economic recession. Mid-cycle slowdowns are often the result of inventory corrections. For primary market moves, I use another oscillator based on the daily market close and the 200-day moving average. The following is the spread measurement versus the 200-day MA for the modern period.

Spread between the daily close of the S&P 500 Index and the 200 Day Moving Average



Source: Sentry Investments, Bloomberg LP

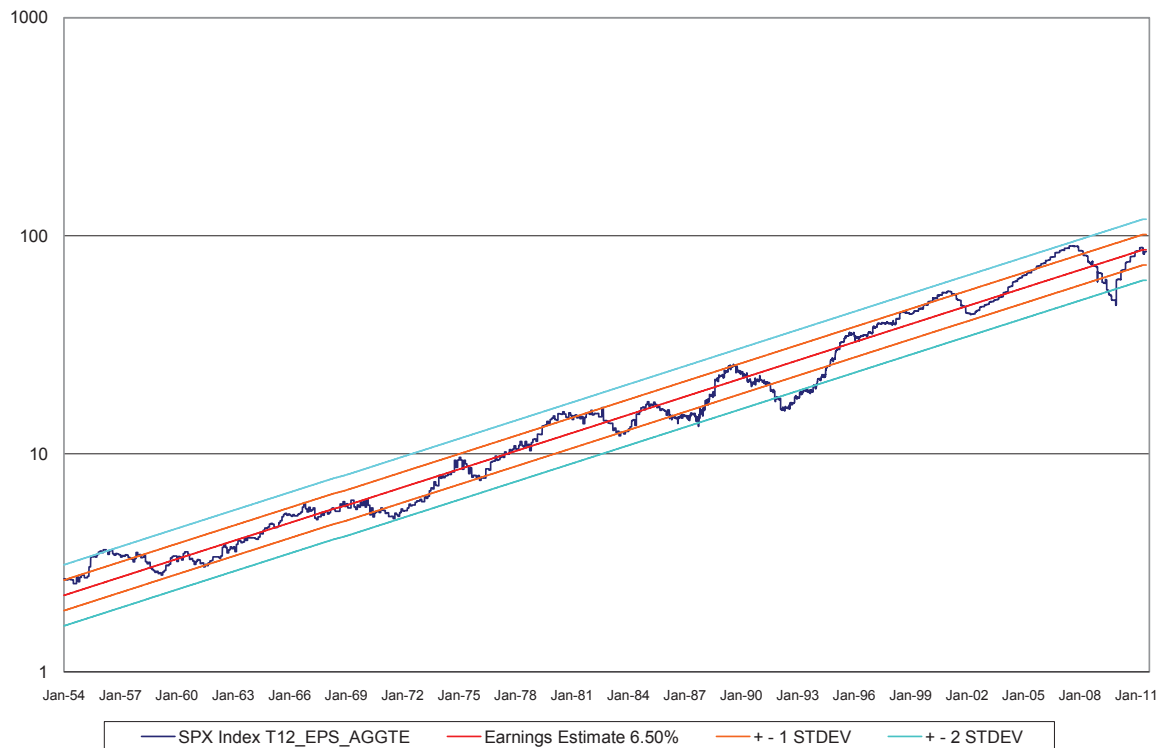
Recessions are yellow callouts. Inventory cycle slowdowns of note are 1962, 1966, 1977, 1984, and 1994. Market panics are October 1987 and August 1998. The market always forecasts more recessions than actually occur. I have highlighted two areas with red lines where, in my view, risk exposure deserves examination. When the spot market is greater than 12% above the 200-day MA, a market move is elevated or extended. It can live there for a while, but it eventually becomes exhausted. This is an area for profit taking. When the correction reaches 6 to 9% below the 200-day MA during mid-cycle slowdowns, markets tend to begin the bottoming process. If the downturn turns into a full-fledged recession, a countertrend rally frequently launches from this area before the final wave of the bear market.

I should point out that the market moves are much more extreme during the down phase of a secular bear market (1968 to 1974; 2000 to 2009) than in the recovery phase (1974 to 1982; 2009 to ?). Also, after a sharp decline, the bottoming process is volatile for a period of weeks before the next market move takes hold. A process of dollar cost averaging is correct. We expect to be allocating new

cash in our balanced and balanced growth mandates to equities during this period. As we get further clarity as to the slowdown/recession outcome, we will likely consider a more formal asset mix shift. The reduce signal in February prompted a shift in allocation in our balanced mandates, in terms of reducing equities and increasing fixed income, as well as the allocation of all net new cash to the fixed-income portfolios.

Supporting a shift towards equities at this time is relative valuation. While the recovery phase in S&P 500 earnings is largely behind us, they have recovered and are on the verge of taking out the 2007 earnings peak.

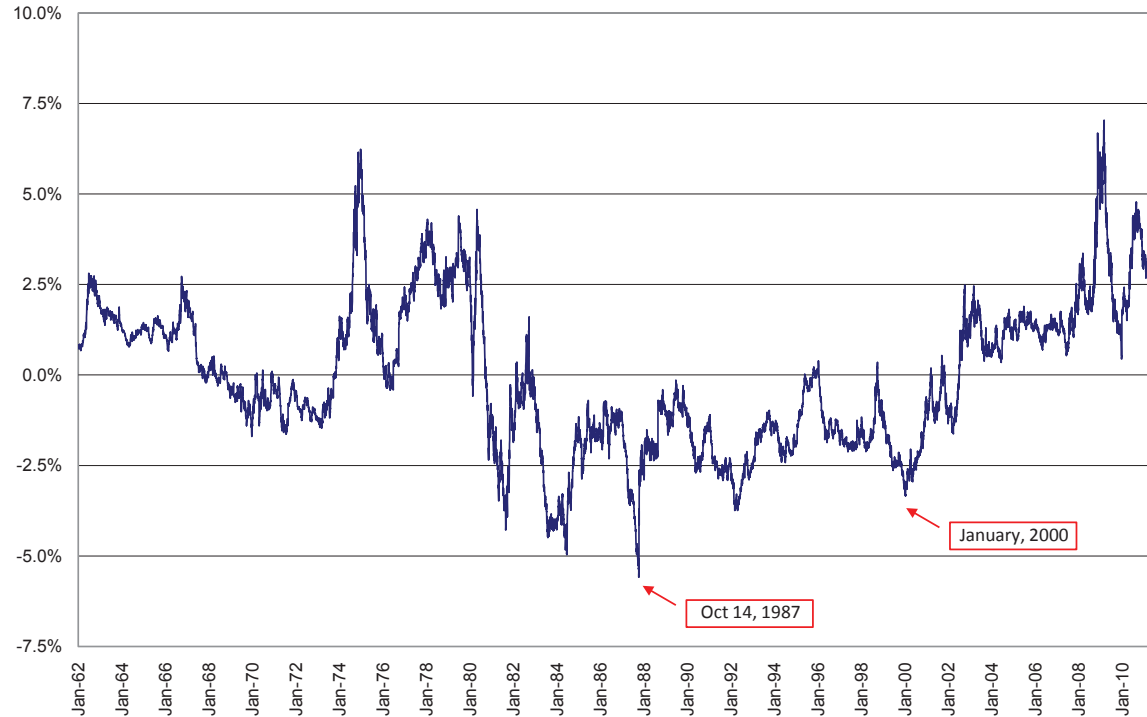
### S&P 500 Recurring Earnings



Source: Sentry Investments, Bloomberg LP

What is clear from past cycles is that once the recovery phase is behind us, earnings can dip before resuming their uptrend. The question is: how dearly is the market valuing those earnings and what growth premium is built in? If the growth premium is high, I would worry. Using the earnings yield (the inverse of the P/E ratio) for the S&P 500 and the 10-year treasury yield, I can take a snap shot of relative yields. The Bloomberg ticker for the data series is: T12\_EPS\_AGGTE and USGG10YR Index.

## S&P 500 Trailing Recurring Earnings Yield less: 10 Yr US Treasury Yield



Source: Bloomberg LP, Sentry Investments

Relative valuation change is driven, in my view, by structural shifts in asset mix. The bear markets and massive re-risking of equities in 1974 and 2009 were driven by major asset mix shifts in both retail and institutional accounts. The subsequent increase in equity risk premium after the initial market recoveries of 1975/6 and 2009/10 was primarily driven by increased index earnings not being rewarded by multiple expansion. What this chart does not show well is that the increased risk premium in equities (falling price/earnings multiple) during 1976 to 1980 was partially offset by a bear market in treasuries that really began to get out of control in 1977. What it does show is that the risk premium currently accorded to equities is greater than at any time since the heart of the 2008/09 crisis. Yes there is risk, but there is also opportunity. For each seller there is a buyer.

## USGG10YR Index Yield

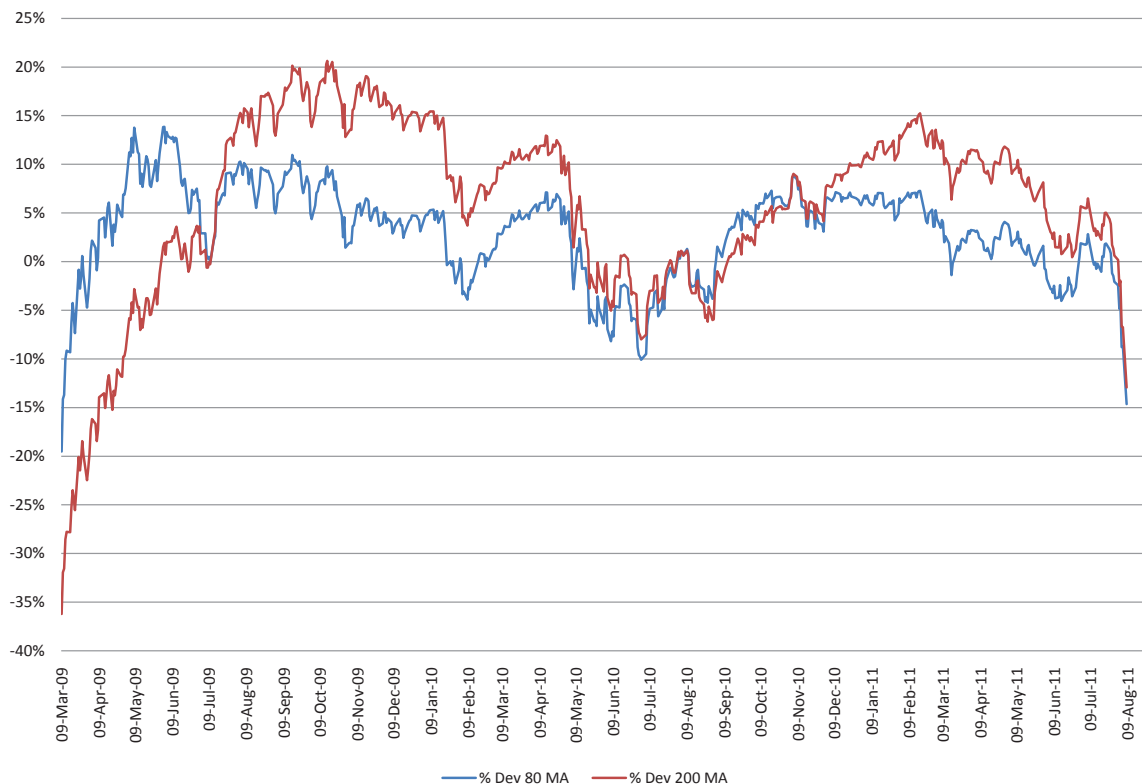


Source: Sentry Investments, Bloomberg LP

We are in a period of heightened risk. There is no denying this. Investors have reacted by seeking the safety of the most liquid and secure securities – and may well be right short-term. This flight to safety has driven the yields on short-term US Treasuries to record lows, and on the 10-year, to test levels last seen in August of last year and possibly the 2% area reached in December 2008. This is creating a price opportunity for long-term investors in the out-of-favour asset class: equities.

The following is a short-term snap shot of the oscillators from the bottom in March of 2009. If we follow last year's pattern, we should see the selling pressure abate over 60 days.

## Oscillators - Short-term



Source: Sentry Investments, Bloomberg LP

Over the past week, the most liquid names got hit hard. High beta got crushed. Commodities did not provide a safe haven when recession fears came forward, and US Treasuries (record low yields on 2- and 5-year maturities) and the US dollar rallied.

The following is a link to my June 7<sup>th</sup> comments, where I expressed my concern over some of the aggressive positioning in capital markets.

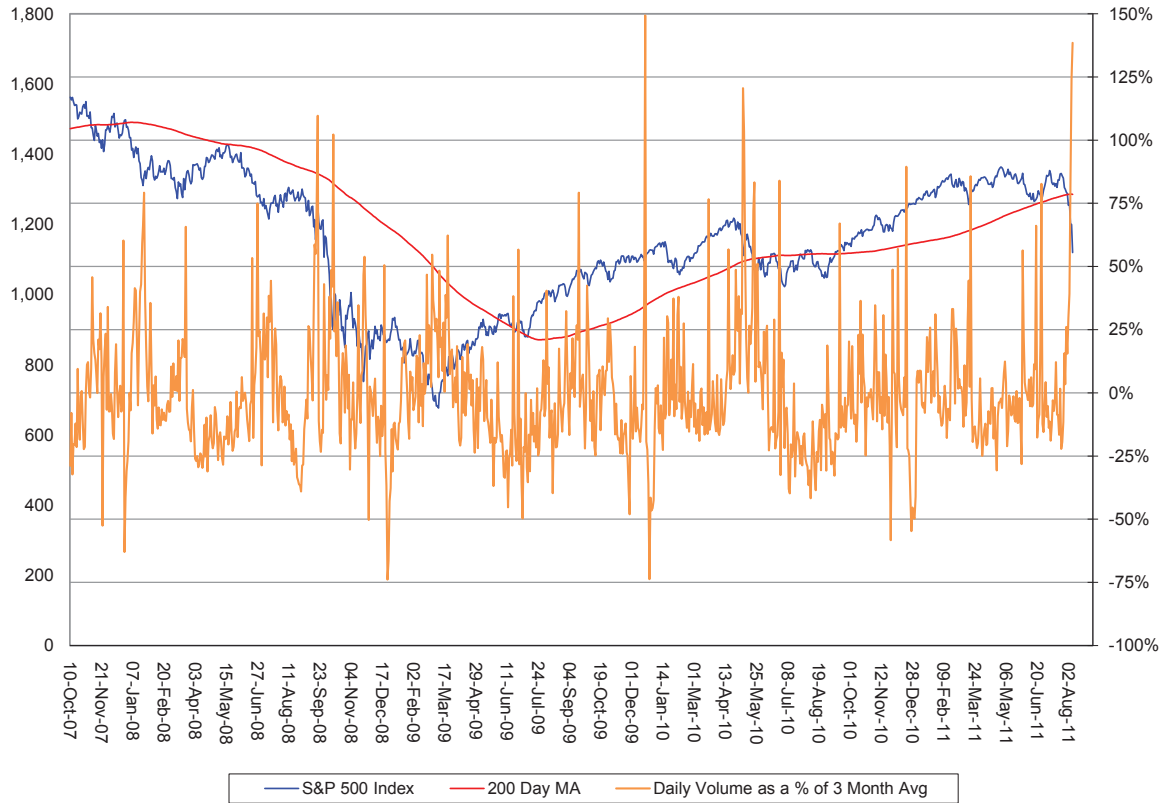
[http://sentry.ca/assets/files/pdf/Managers-commentaries/2011/8543\\_COMMENTARY\\_SandyMcIntyre\\_JUN11\\_E.pdf](http://sentry.ca/assets/files/pdf/Managers-commentaries/2011/8543_COMMENTARY_SandyMcIntyre_JUN11_E.pdf)

The unwinding of speculative bets on consumable commodities, particularly oil, should be positive for global economic growth and very positive for inflation pressures in emerging markets. Lower interest rates are also very positive for global growth.

Given the old rule of thumb that price follows volume, I should make a final comment on volumes. The correction up to last Thursday was unremarkable as to volumes; materially lower absolute and relative volumes compared to last year and miniscule relative to 2008 and 2009. I remind you that positioning by US investors going into this correction was not aggressive; inventories of stock for sale were likely quite low. Tape action up until Thursday suggested that the volumes were coming out of Europe: North American markets bottomed around European market close. US accounts followed through on Thursday with volumes accelerating into the close. Friday saw clear pressure in the morning, and again a relief rally when European markets closed. Monday's action into the close was very unusual; it looked like index liquidation orders into a market that had no bids. Were we seeing

the unwinding of ETFs? The relative volume spike was also very unusual. It was the most massive increase in relative volume since the Flash Crash of May 6, 2010.

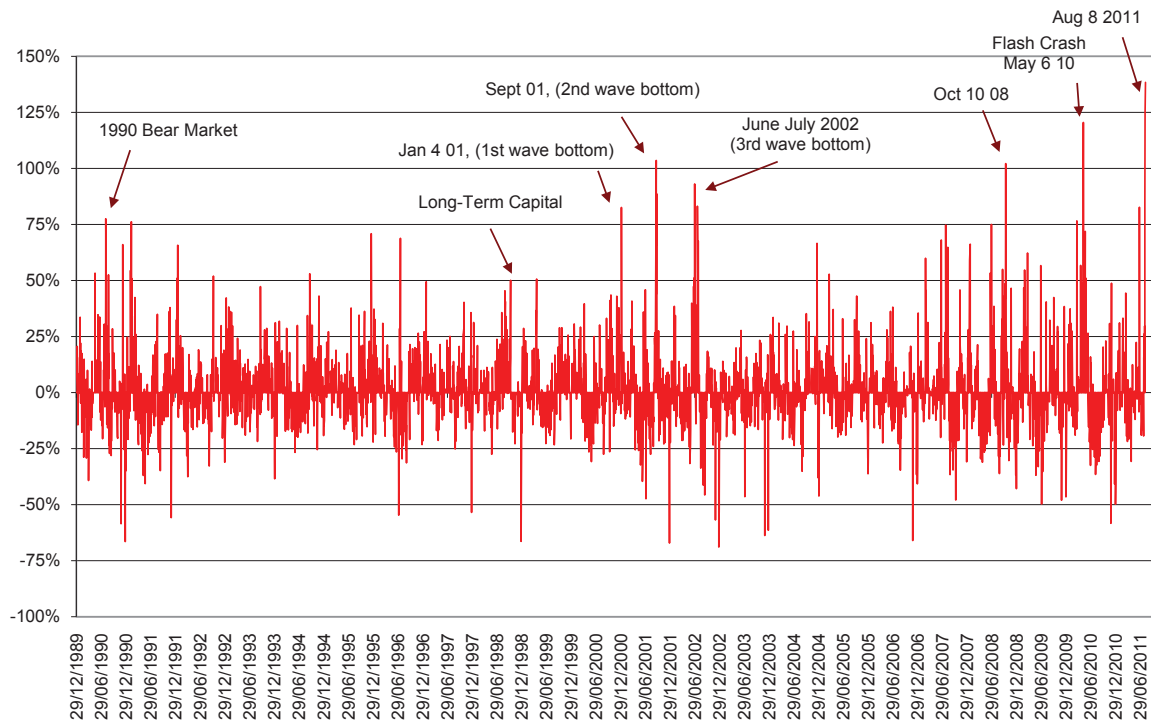
### Daily Market vs. Relative Volume



Source: Bloomberg LP, Sentry Investments

When you look at the relative volume change during selling climaxes over the past years, Thursday through Monday was consistent with a selling climax. I think investors should be getting ready to start scaling into quality positions. No one knows if we have entered recession; no one knows if we have started a new bear market. What we do know is that the tape changes directions quickly both ways, and that selling exhausts itself when emotions stabilize.

## VOLU Index: Down-Day Volume as a % of 3 Month Average Volume



Source: Sentry Investments, Bloomberg LP

On Friday, the market was volatile as rumours of a downgrade of US long-term debt ran rampant. Monday was volatile as well. While we may well be in yet another market panic, consider the following:

Before the S&P downgrade of US long-term government debt, there were 107 companies with ratings better than their country of domicile (Source: Standard & Poor's). In the view of a ratings agency, these companies have superior credit characteristics to their country of domicile. The number just went up with the downgrade. S&P specifically noted that their downgrade of the US did not affect AAA corporate credits domiciled in the US. I don't see this downgrade actually affecting interest rates beyond some possible short-term knee jerk volatility; rates are driven by fund flows and the fire hose of savings funds into debt instruments continues unabated. This phenomena is not limited to the US. In the aftermath of the credit crisis, savings rates across the OECD have risen as has the demand for secure investments that preserve capital. This search for safety is creating a major valuation anomaly in capital markets. The source of the problem is excess government debt, yet that debt is being valued as if it is risk free.

At the close on Monday August 8<sup>th</sup>, the DOW traded with a dividend yield of 2.8%, a premium to the 10-year Treasury yield of 2.4%. Its P/E of 11.6 equals an earnings yield of 8.6%. The equity risk premium is 6.2%. An American investor would get a superior yield to the 10-year Treasury, a multi-decade history of dividend growth by the component companies, and an option on global growth for decades to come for free from an investment in the DOW. Very quietly amongst all the turmoil, the S&P 500 is taking out its 2007 reported earnings peak. No-one noticed. I'd buy this news.



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