

E.Q Trendwatch™

The earnings recession arrives

"Dec. 3 (Bloomberg) -- U.S. corporate profits are in a recession, and the entire economy may not be far behind. Slower sales and higher energy and labor costs are forcing companies from Bear Stearns Cos. to Pitney Bowes Inc. to reduce spending and hiring. Their efforts to keep earnings from eroding even further raise the risk that the economy, already weakened by the steepest housing slide since 1991, may shrink sometime next year.

"The earnings recession has already arrived," says David Rosenberg, North America economist for Merrill Lynch & Co. in New York. "We are going to see an economic recession in '08." Corporate profits, as measured by the Commerce Department, fell at an annual rate of \$19.3 billion in the third quarter from the second, as domestic earnings dropped by \$41.2 billion. The drag from sagging U.S. sales and huge write-downs offset robust earnings abroad, fueled by the weak U.S. dollar. The fourth quarter may be an even bigger bust. "

Third quarter earnings data now confirms that the 500 largest US companies are in the midst of an earnings recession, with earnings down 25% from the second quarter and more than 9% year over year from the 3rd quarter of 2006. It is clear that the slowdown will continue to reduce overall GDP over the next few quarters.

The only questions now are how long and how deep will this contraction be? For investors it is important to realize that we do not need to register a classically defined recession at this point—i.e., two quarters of back to back negative GDP growth --in order for stock markets to lose significant value. Most of the damage to stock markets historically occurs well before the economy is confirmed to be in a recession. This is why market losses



Cory Venable CIM, FCSI, CMT
Technical Market Analyst



Danielle Park LL.B., CFP, CFA
Portfolio Manager

**Venable Park Investment
Counsel Inc.**

Venable Park Investment Counsel Inc.



www.venablepark.com

33 Clapperton St.
Barrie ON L4M 3E6
Tel: (705) 792-3991
Toll Free: 866-792-3991
Fax: (705) 792-3992

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so often take people unaware. We cannot actually confirm an economy is in a recession or even the depth of a slowdown until several months later when back-ward looking data confirms it in retrospect. At this point it is important to realize the vast majority of economists and forecasters you will hear or read are notoriously optimistic and hopeless at calling recessions until several months after they have already hit.

An Economist magazine poll in March 2001 (when we now know that the recession had already started) showed that 95% of such forecasters believed that a recession would be avoided as the aggressive Fed easing would lead to a second half growth rebound. On this erroneous hope, the stock market launched into its final sucker's rally (or last dead cat bounce) up 18% in April and May 2001 only to be followed by the massive bear market starting in June 2001.

So we must be prepared for lots of people espousing hope that interest rate cuts will save us, that the economy will avoid a serious slowdown, and that the stock market will recover strongly from here. We must also be prepared that even within the longer technical downtrend which has now been in play since the markets peaked in July, there will typically be a number of apparent bounce days or weeks when the bulls will be urging us to buy the dips. There is a reason they call these days sucker rallies. Such gains tend to be fleeting and illusionary before the next down leg begins in earnest.

We will continue to monitor the longer trend carefully, daily, weekly and monthly, as this will give us the most reliable indication of when the down trend is finally bottoming as we look to buy. Only in doing it this way, can we keep risk to capital lowest and be ready for meaningful opportunities.

At this point we know that at the end of November both the broad market indices, the Dow and the TSX in Canada, each breached their long term support levels which had been in place since the economy last bottomed in 2002. We also know that if the US slowdown that has now begun, accelerates into a recession, the stock market has historically fallen by about 1/3 rd before it begins to recover in the later stages of the recession. The stock market will turn up again before it is obvious that the recession has ended. This is why most people miss the most advantageous buying opportunities.

As a point of reference, it is possible that the coming bear market will take back all if not most of the market gains that have occurred in this expansion cycle since 2004. Time will tell. Perhaps this makes some sense, as we now know that the vast majority of "growth" in our economy since 2004 has been based on the false demand created by funny money, or levered loans that in more rational times would never have been made in the first place. As billions and billions of these levered loan

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pools are written down in the coming months, perhaps we can expect that a good amount of the growth mirage of the past few years will be written down with them.

US Dollar Buy in November

During the ongoing slowdown in the US, clients will note that we added half of our target US\$ weight to accounts in November. At first glance this may seem counter-intuitive. If the US economy is slowing and US rates are cut surely the US dollar may weaken further as against other global currencies? The answer is maybe. But the more meaningful question for Canadian investors is if the US economy continues to slow, such that the Federal Reserve has to cut rates further, what will be happening to our Canadian economy and our Canadian dollar? The inevitable answer is that our economy will slow significantly too, as our largest trading partner retreats. Notwithstanding some improved demand from other countries like China and India, 78% of our exports still go to the US. In addition even a large percentage of the remaining 22% that goes to other developing nations will be curtailed by a US and European consumer led slowdown. People in developing nations are not buying the majority of their own products. They may order base materials and commodities from us but it is largely to create goods for export to Western nations. This is a very large inter-connected circle that leads back to the Western and especially the US consumer. If they are fighting off insolvency and having to reign in spending, the world will feel it. Canada will feel the US slowdown more than any other export country.

So it was not surprising to us that after more than a year of being out of the US \$, and after it had declined 22% as against our Canadian dollar, we recently registered a buy on the US dollar. We will be looking for confirmation from other indicators before adding the remaining target weight to portfolios. But keep in mind that just because we have a buy on the US dollar, does not mean that we have to buy US based equities investments with the dollars. We will wait for our buy signals on the equity side separately; at this point we are parking the US dollars in a US treasury bill ETF called the SHV or Lehman short term bond fund. In this way we have exposure to the dollar without yet taking on exposure to the US stock market or subprime issues.

Some thoughts on the financial media

Last month we were asked to participate in the keynote line up at the Canadian Resource Conference, where 80% of the speakers were analysts and independent commentators from the US. It was an interesting experience for us to spend a few days with some of the most well-known and respected independent analysts in the business. It is fair to say that the US speakers were a *little bearish* on the economic prospects for their home land at this time.

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Many echoed now common concerns about Government deficits, the housing recession, over-indebted consumers, the falling greenback and a rising health crisis. On top of these issues however, several articulated concern about the increasing commercialization of the media in the past several years and its atrophy away from objective, balanced reporting, particularly in financial news. Many said that they had been forced to boycott CNBC, the main financial news network in the US. They refused to appear on CNBC they explained, because the station sought to quash anything but perpetually bullish commentary. Several mentioned that we were fortunate to still have a couple of relatively objective news networks in Canada like BNN and CBC that would at least tolerate more diverse commentary from their guests, notwithstanding that the lion's share of their ad funding and sponsorship comes from the broker dealers.

This was unusual perspective for us about our Canadian networks. We have long noted that the vast majority of commentators and content heard in Canada also come from the long always, buy and hold industry. It was a wake-up call to be told that our media was still a comparative democracy compared to the US. Freedom of speech is apparently not so free anymore, at least when it comes to national networks. For some time now news has become a profit franchise more than a reporting service.

This week another independent US money manager, John Hussman relayed a similar story in his weekly newsletter:

"I appeared briefly on CNBC last week to discuss recession risk, but beforehand, I was asked to put a positive tone on my comments, to which I responded – "Look, my interest is in making sure that investors have positions that they are able to hold through the complete market cycle, including a potential 30% bear market loss off the highs, without having their financial security endangered. If they're carrying more risk than they could endure through the course of a bear market, they should cut back now. I'm not going to wave my arms around about doom and gloom, but I think it's a crucial time for investors to think about the risk they're taking, and if you don't want me to say that, please don't have me on. "Dec 4, 2007

Good for you John. Standing up to the machine is not the path of least resistance. Last week we appeared as guests twice on BNN and both times reiterated similar themes to warn of present risks. To their credit, no one at the network suggested that we should tone down the message. Off camera a few said they were glad we kept bringing the message in the midst of the preponderance of industry cheerleaders. Perhaps when the next bear market hurts their viewers once again, the long always stations will suffer some backlash from a disgruntled audience. One can at least hope.

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