

E.Q Trendwatch™

Maintaining perspective and a plan to succeed

There is a billboard we drive by on the way to work each morning advertising the services of a local business, with the tag line “personable service.” “Boy”, we think to ourselves, “if personable was all it took!” It takes a lot more than personable to be good. In our business we need to be personable, honest, diligent, transparent, prompt, client-focused, accurate, cost-effective, wise, and correct on our overall market calls. There is a lot of care needed for all of these elements. But it is the ‘market calls’ piece that presents the greatest challenge. If we get market calls wrong or even just wrong-looking in a certain time-frame, all of our other efforts can be undermined.



Cory Venable CIM, FCSI, CMT
Technical Market Analyst

2010 has been a disappointing year for us. With low single digit gains across most accounts, this has actually been the worst performing year we have had since VPIC’s inception. We know that to do our job properly we have to look wrong sometimes, but boy the last 4 months have been humbling. For those of us looking for value, the challenge this year was that the few assets that were low and looking poised for a rebound (like natural gas and the Euro) moved lower. Assets that were over-valued, over-priced and correcting through August suddenly catapulted into a parabolic spike over the final few months.



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

In hindsight, of course, we wish we could have seen the extent of the stock pop coming and found a way to rationalize “playing the bounce” as they say on financial television. But apart from blind luck, meaningful investment rules really can’t trigger like that. And even if we were riding this latest wave, we would still need our rule set to tell us when to get out again. Once one goes ‘off road’ so to speak, then really all bets are off as to likely outcomes. Wild abandon may look like fun, but it doesn’t exactly suit a pension mandate.

**Venable Park Investment
Counsel Inc.**

And while we are beating ourselves up about low returns this year, we revisited some recent stock market data to remind ourselves (and hopefully our clients) that flat to low returns are not really a “bad year” in investing. Truly bad years for investing, the ones that demand extreme care in trying to avoid, look like this:

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Stock market returns in bad years over the past decade

	<u>TSX(Canadian)</u>	<u>S&P 500 (US)</u>
2000		-10.14
2001	-14.87	-13.04
2002	-14.08	-23.27
2008	-31.08	-38.49
2011	??	??

The negative years above are enough that stock investors have actually lost money over the past 3-10 years, (depending on their asset allocations) despite some double digit annual gains in the intervening years. Overall our compound client returns have been positive throughout this period, despite our missing out on some interim moves. To be fair, performance assessments should be made over 5+ years not 1 or 2. Thanks just to the past 4 months, many equity markets are now showing an annual gain for 2010. In reality however, investors do not hold one market, or one asset class, but a basket of various instruments and sectors, some of which are up and some of which are down for the year.

As a point of reference, a fully invested balanced composite of 50% bonds and 50% domestic and international stocks (our benchmark) is showing a gross gain of +3.8% year to date (before any fees). So for a ton of volatility that saw markets lose money for the first 8 months and then spike up in the final quarter, average investors are up less than 3% net year to date. So yes, we feel bad that we have under-performed a couple of percent in 2010 (depending on an individual client mix) but big picture perspectives are useful. Short term under performance for us is par for the course while we are trying to control our exposure to risk. It is also something which can be easily recovered going forward. Most important is trying to anticipate correctly where market prices may be heading next and have a plan flexible enough for various outcomes.

The question of the hour: is the stock market rolling over again, or finally breaking out?



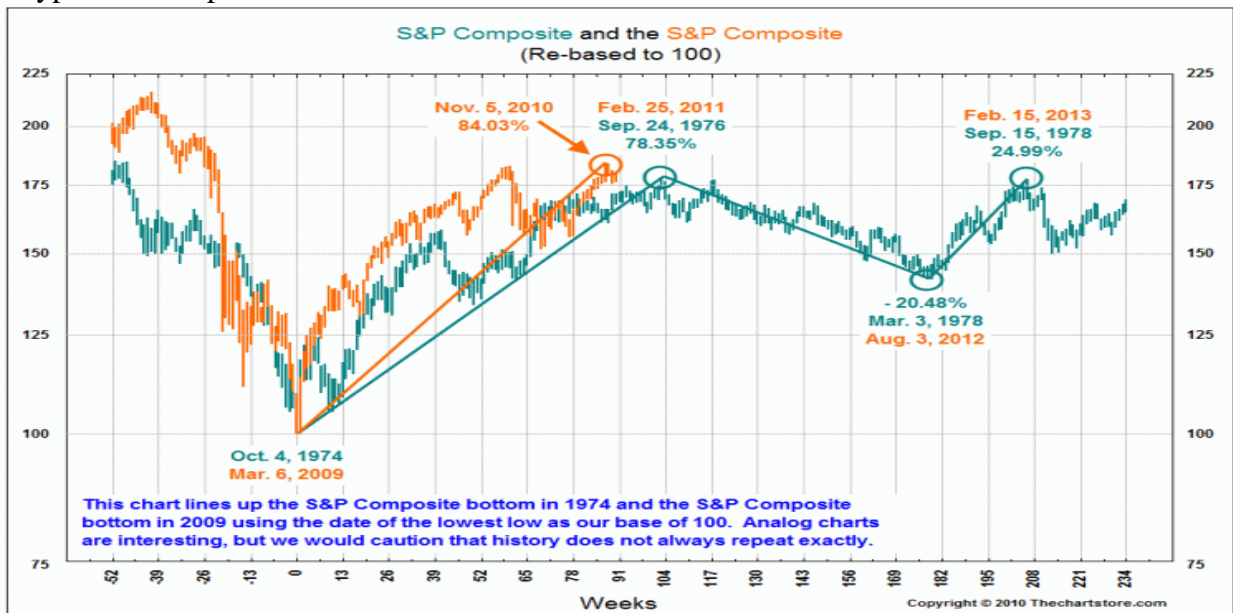
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The above long term chart of the Canadian stock market (XIU) tells the story of the past 10 years. The question of the hour here is whether the market advance spurred by QE2 has just completed the right and final shoulder of a secular top that is about to break down, or whether it will now finally break through long term resistance to test the prior high of 2008. Based on all the evidence, we think that a roll over is probable. But we must acknowledge that in these days of unprecedented government support, a breakout of at least some duration may be possible. If the overall market is able to break out, we will add target weights in the Canadian and US broad markets. This would give us on average a 30% overall exposure to equities while maintaining a cash balance of about 20%. We favour indices that are the most liquid. Maintaining liquidity is important because we know that we will also need to exit these positions again at some point ahead when the secular bear trend re-asserts itself.

As shown in last month's newsletter, we at VPIC are not looking for the end of the free world here or a time when all the world's problems appear magically solved. We know there will always be risks. The issue today is not that there are risks in the world. The issue is that government 'rescues', momentum traders, and suspended fair disclosure accounting rules, (not to mention a ban on naked short-selling) have all inflated asset prices such that near-term movements have become highly irregular.

If this is a real economic recovery and world GDP really can grow in a self-sustained cycle that leads to new jobs and increasing demand from here, then that's great. But stock market history and our valuation work suggest that a typical downside correction to what has been an abnormal 'v shaped' rally since 2009 is long overdue. It is likely to happen in 2011; it may take longer. Whatever the time frame, we seek to be ready.

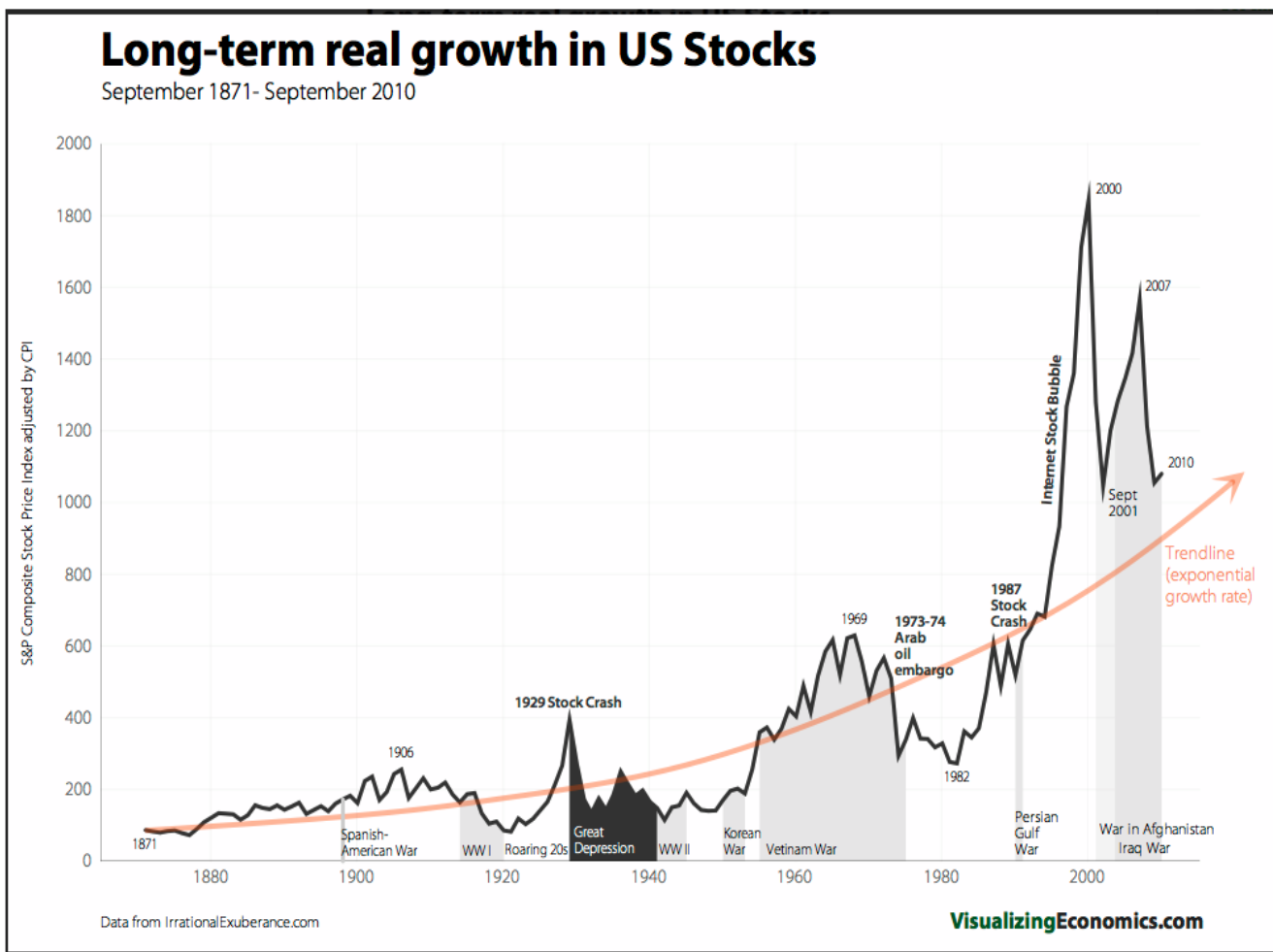
As an interesting comparison, the below chart graphs the rise of the S&P 500 from the cycle low in October 1974 (blue) and this present cycle from March 2009 (orange). We can see that after QE2 talk arrested the cyclical downturn in August (week 78 below) the present rally jumped back to the peak it reached in April 2010. Best case scenario: maybe stocks can rally further from here. Worst case would be a dramatic drop that gives back most of the gains since 2009. Somewhere in the middle of the road, a market pullback of 20%+ would be typical and expected.



A 20% correction from recent highs would take the TSX back to around 10,500 and the S&P back to 990. Depending on where we are at in the economic recovery (not government bailouts— but real private sector jobs, spending, and capital investment) then these levels may prove to offer reasonable value points for stock investors. What we are saying is that until we get to see what governments and financial institutions are hiding behind their backs, it is extremely difficult to assess fair value.

Why do we believe we are still in a secular bear?

This next chart shows the after-inflation price growth of US stocks since 1871. It is a picture of the forest over the trees. Here we clearly see the incredible valuation peaks in 2000 and 2007 and the significant downside action that followed each. More importantly, it also shows how far we still have to go before stock valuations get back below mean to the discount pricing that is so rewarding for investment capital. We look forward to the day (when we will be the most bullish analysts on business television!) In the meantime, we know that no valuable risk manager can afford to lose sight of where we are in this secular big picture.



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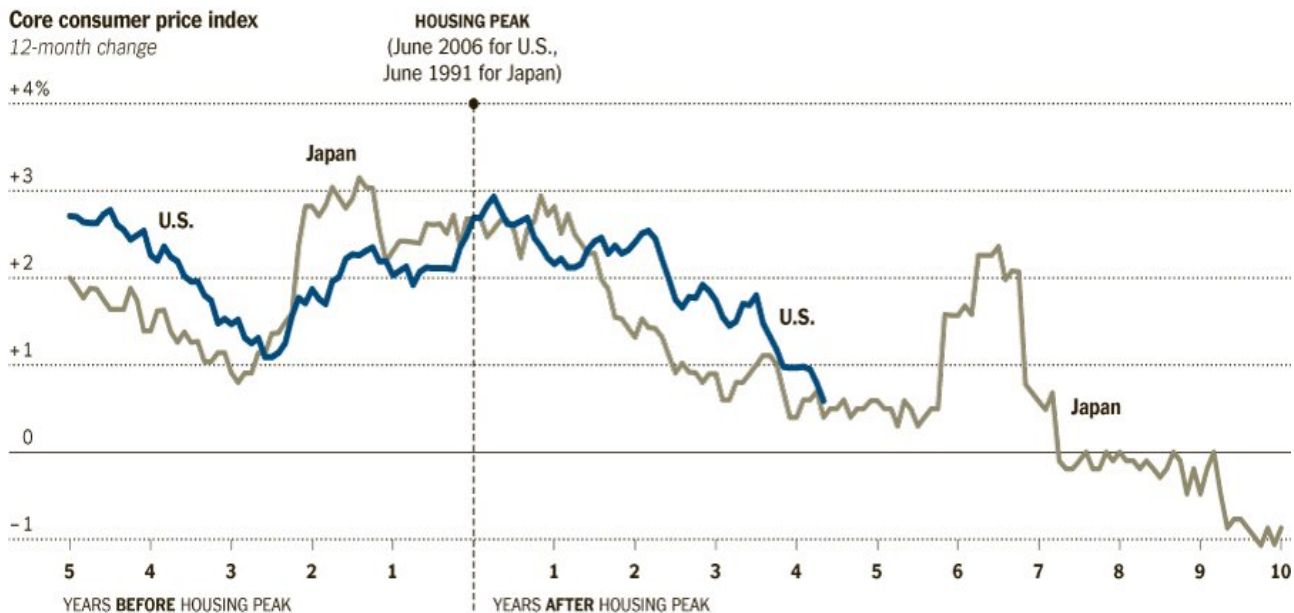
Deflation or inflation still hotly debated

Whether we are entering a period of deflation or rising inflation remains a topic of great importance. It matters to asset allocation decisions, because those who see deflation ahead (at least over the next couple of years) favour high quality bonds and cash and those who see inflation favour stocks and commodities. Which side wins this argument will ultimately be decided a few years from now in retrospect, but at this time we see more evidence of disinflation and deflation over the next couple of years than inflation. We know that food and energy prices have spiked again of late (thanks to QE2 speculation, and efforts to devalue the US\$ by the Federal Reserve), but these real world elements are not counted in the standard measurements of core inflation.

Core consumer inflation measures a fixed basket of products and services, including housing rents, electricity, restaurants, health care costs and transportation. And, as shown in this next chart, all of these inputs have been falling now in the US (blue line) since 2006. Comparing the path of US prices to Japanese prices after their respective credit bubbles burst is an interesting study shown in the chart below. Japanese inflation has been falling since 1991 and counting. So far price trend for both countries is still down. This is an outcome typical of all major de-levering cycles in history: contracting credit, contracting demand coupled with over-supply and over-capacity (not to mention an aging population) suggest deflationary pressures for several years.

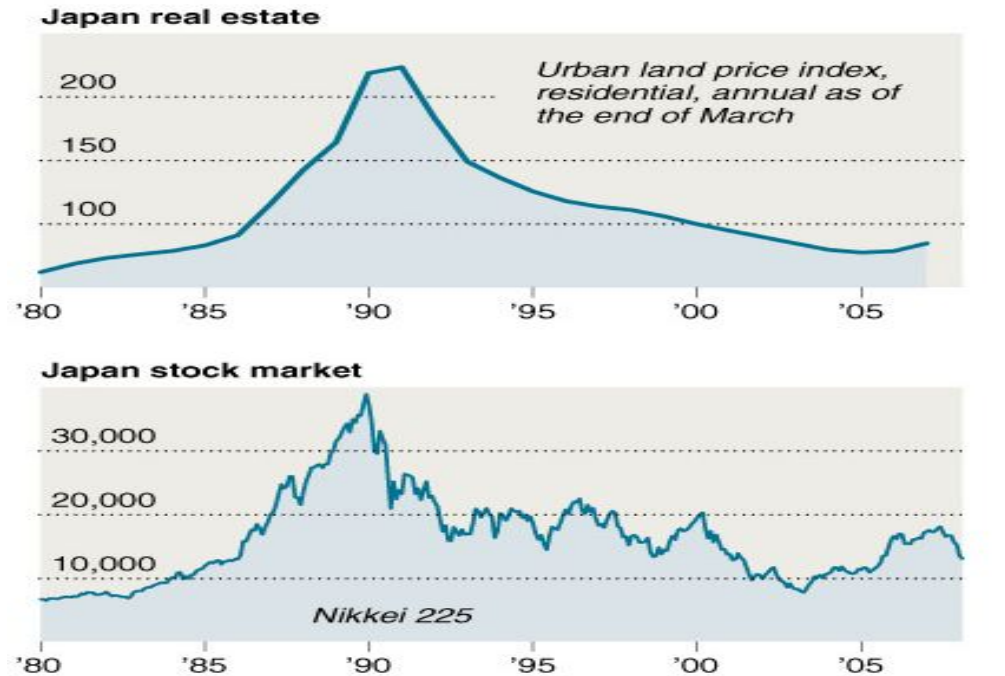
Following Japan's Path, So Far

In the United States, the core consumer price index, which excludes food and energy prices, rose 0.6 percent in the 12 months through October. That was the smallest 12-month gain since the government began calculating the figure in the 1950s. The chart shows the 12-month changes in core C.P.I. for the United States and Japan, in the years before and after housing prices peaked in each country.



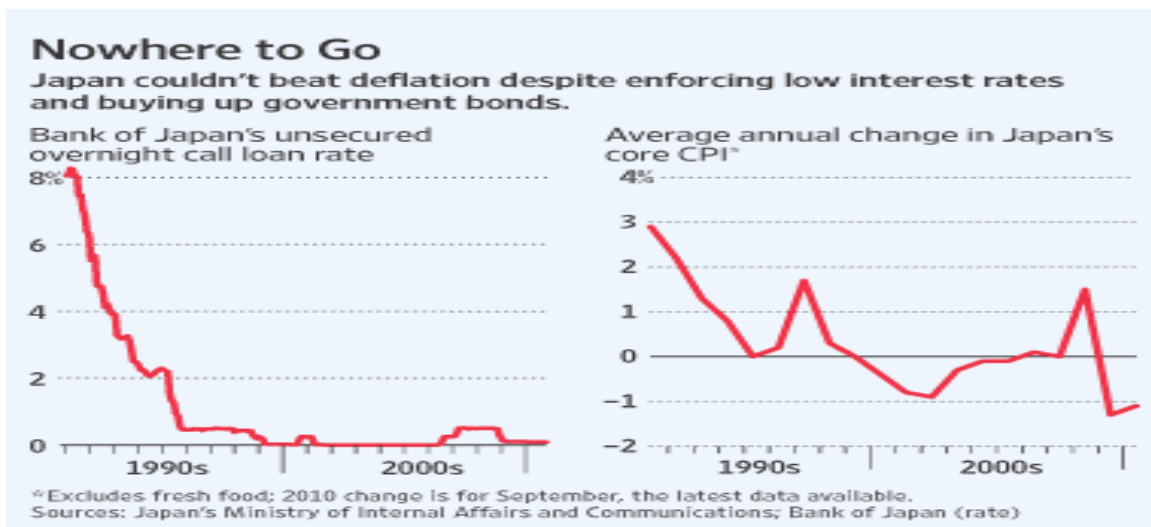
Sources: U.S. Bureau of Labor Statistics, Japanese Ministry of Internal Affairs and Communications, via Haver Analytics

These next charts show what has happened to Japanese real estate and stock prices over the same time period.



Sources: Standard & Poor's; Japan Real Estate Institute, via Japan Ministry of Internal Affairs and Communications; Bloomberg

Remarkably, asset deflation in Japan (as shown above) has persisted now for more than 20 years regardless of extraordinary efforts of its Central Bank to force down interest rates and flood liquidity into the banking system through wave after wave of Quantitative Easing (QE). Hopefully QE will work better for the US and the Euro region today than it did for Japan.



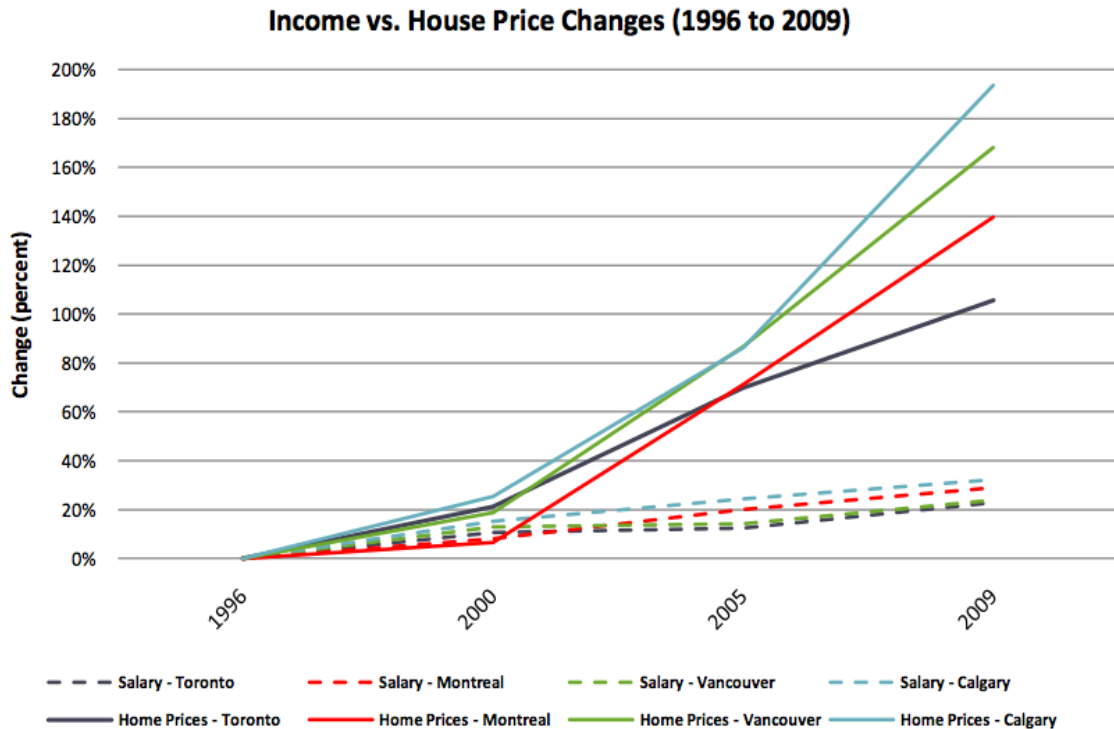
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What Japan has obtained for its years of government intervention is the highest Public debt to GDP ratio anywhere in the free world (200% vs. 98% in the US). What they have not achieved is success in stemming the relentless force of asset price deflation.

All of which makes us look at the following chart of Canadian home prices (solid lines) relative to Canadian income gains (dotted lines) since 1996 and think “hmmm...not looking good”...

Note that since 2000, home prices have soared while incomes have stagnated. This has made affordability ratios in Canadian housing today some of the most unfavourable on the planet.

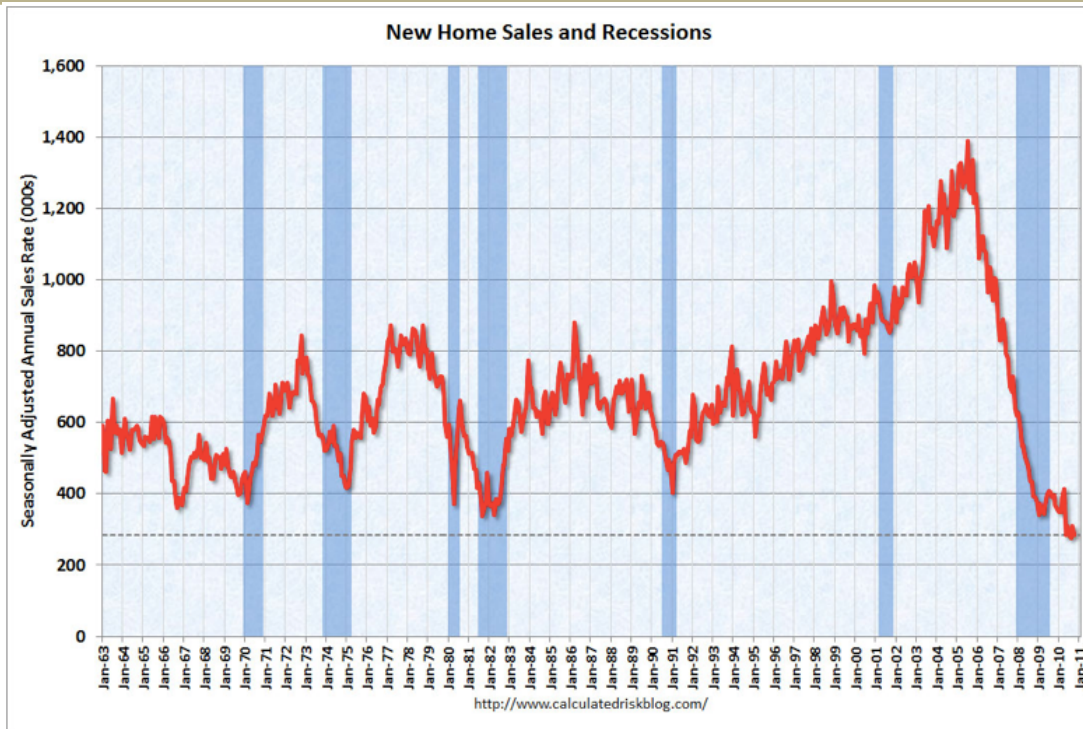
Exhibit 3.4: Comparison of Income to House Price Changes (1996 to 2009)



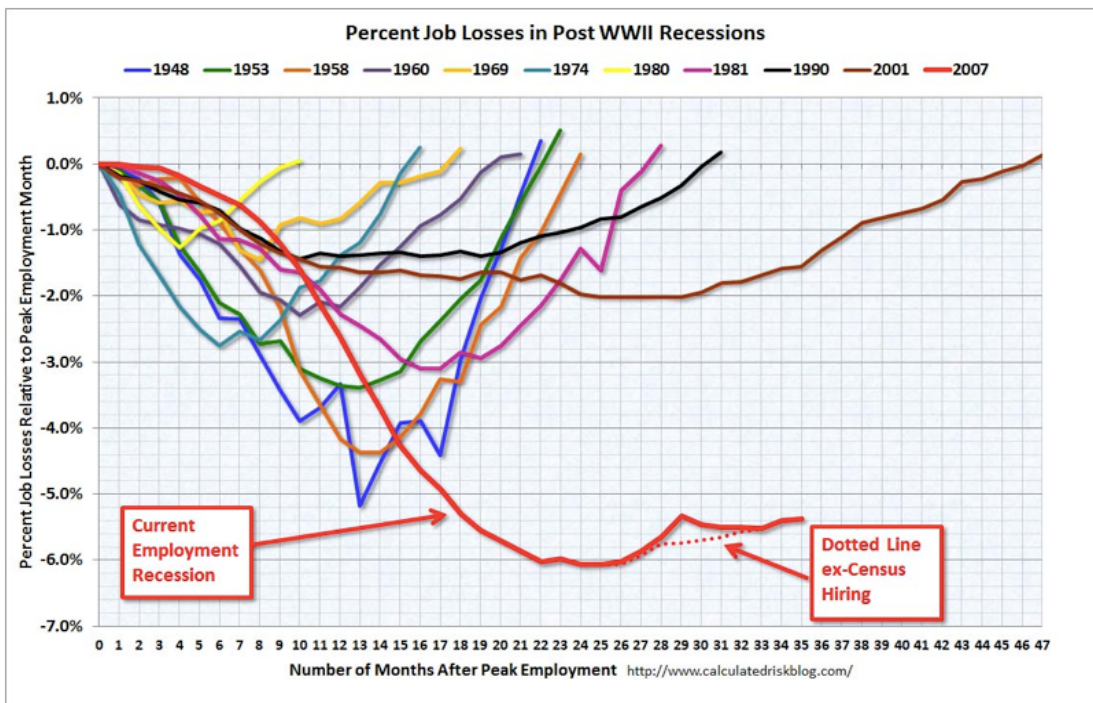
US Housing prices have been weakening again for the past six months

It's now old news that falling US home prices were the canary in the coalmine of the global downturn coming into 2007. Emergency government tax credits and temporary moratoriums on foreclosures managed to stem the price declines in 2009. Then, over the last six months, US realty prices have begun falling again. One of the more important leading indicators for the economic cycle, new home sales are now also double-dipping. As shown in this next chart, housing sales forged a similar decline before the economy re-entered recession in 1981. We are not saying we are going back into recession soon; but housing is still one of the major risks keeping central bankers on the defensive today.

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Maybe this time we will get lucky. (?) For the millions who have still not regained employment (see below) this fresh down cycle, whether it is characterized as ‘just a weak patch’ or ‘formal double dip’, is coming at a bad time.



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After some near-term pain, bonds probably have some gains in them yet

Years of rock-bottom interest rates were not able to re-inflate the Japanese economy after its 1990 top, or the global economy after its 2007 top, but that does not mean western governments have any reason to increase their policy rates any time soon. We think this means high quality bonds are likely to hold up pretty well in 2011. This month we used the opportunity of an interim sell off further out on the yield curve to add back the 20 year bond ETF (TLT) and some longer term Canadian issues below par where appropriate.

Bond yields moved higher this month



As shown in the above chart of the US 10-year Treasury yield, it is quite possible that rates could move up further. From a low of 2.10 in early 2009, and 2.38 in August of this year, 10 year yields moved to 3.25 this month. We were just over 3.84 last December and there is significant near-term resistance around 4%. The long-term resistance of 4.70 would be the top of the technical range in place for the past 10 years. We see little to suggest that rates would approach these prior peak levels any time soon. The last time 10-year rates were above 5% (2007) and 6% (2000) growth and inflation indicators were remarkably more robust than they are today.

Higher rates are the last thing the Fed, or any other over-levered debtor (government, business or individual) wants at the moment. Higher rates would be more rewarding for the savers of the world, but they will not help the struggling recovery. Lest we forget, consumer credit and mortgage rates are priced off the 10-year treasury yield. We suspect that near-term weakness may prove another buying opportunity for carefully chosen fixed income.

This month Richard Russell (analyst and author of the Dow Theory Letters since **1956!**) was writing about his first hand memories of the early 30's, after the Great Crash and the interim stock rallies that followed during that 20-year secular bear. We are always interested in historical perspective. We excerpt Richard here:

1929 AND TODAY: By Richard Russell, Dec 1, 2010, Dow Theory Letters

“During the great crash of 1929, millions of investors lost heavily. Many participants lost everything they owned — they were left destitute. It was so bad that Americans, in their defence, turned some of the horror into humor. Books of ironic humor were published, one of which was “Where are the Customers’ Yachts?” Talk of investors jumping out of brokerage house windows (mostly not true) were prevalent. “So and so was so crooked that when he died they had to screw him into the ground.” The Industrial Average, which had begun its descent on September 3, 1929 at a value of 381.17, crashed to a low of 198 in November of 1929, all along accompanied by record volume. Tens of millions of dollars were lost, and crowds filled Wall Street as the horrific drama unfolded.

Then the unexpected occurred. The stock market turned up in November amid cheers from the anxious crowd. The Dow and the Rails hit secondary highs in late-November, and then backed off, only to hit lows a month later in December. In January the market started up again, and when the November highs were bettered by both Averages, many took that as a sign that the bull market had come alive again. Thousands of investors rushed back into the market, hoping to regain some of the losses they had suffered in 1929.

The market roared higher all during the first quarter of 1930: The Dow ploughed steadily higher as confused shorts were driven to the wall. By April 1930 the Dow had climbed to 294.07, having recovered better than half of its crash losses.

In April of 1930 the market turned down as the bear took over once more. After April the bear market resumed with a fury. The extended and erratic bear market continued until July of 1932. The great bear market ended in July with the Dow at the incredible value of 41.22.

As I review the events of 1929-1930 I wonder whether we’re not seeing the same scenario again. Recently we had the crash of October 2007 to February of 2009. Next came the rally to April of 2010, then a decline to July, and most recently a resumption of the advance with both Averages rallying past their April peaks and into November.

When the April peaks were bettered by both Averages, many analysts mistakenly took this action to be a resumption of the bull market. The public, many hoping to recoup their 2008 losses, came back to the market en masse. Volume surged, actually surpassing the earlier volume of July and August. Then, very recently, something gave way; something cracked wide. On November 12 the Dow dropped 90 points. On November 16, instead of the expected rebound, the Dow plunged 178 points. Seemingly, from out of “nowhere,” we saw two 90% down-day in a space of three days, (Nov. 12 and Nov. 16).”

Quest for income

We do not think that we are facing a period of adversity as bad as the 1930's. But conditions are not easy today. As we have said, our base case scenario is that the world limps along another 5-7 years as we write down bad debts and build up savings again. A best-case scenario is that the de-levering process moves faster than that. In the meantime we face a conundrum: the first rescue package from governments in early 2009 managed to support the stock market for a full year into early 2010 before prices began falling again. As soon as weakness resumed, governments promised a second round of stimulus. The question now is how long will the next rescue package succeed in supporting asset prices? Will it give the rally another year? Six months? Three weeks? Will governments then announce QE3 to propel prices further? Will that work a third time? We are quite confident that world markets are still riding the Behemoth roller coaster for a few more years; the relevant question is how long is this section of climb before the next downturn?

The sovereign debt crisis in the Euro zone as well as many US states threatens to be a major global risk for 2011. It seems that the Bank of Canada agrees with our assessment on this:

“Current turbulence in Europe is a reminder that the crisis is not over, but has merely entered a new phase. In a world awash with debt, repairing the balance sheets of banks, households and countries will take years. As a consequence, the pace, pattern and variability of global growth is changing, and Canada must adapt.”

Bank of Canada Governor Mark, Carney, December, 13, 2010

We know that capital gains are volatile and fleeting in a secular bear market. Capital preservation and income collection is the best way to gain lasting traction. Since our first goal has to be avoiding large capital drops, the definitive question is what price offers a good margin of safety when buying income investments? If dividend-paying stocks are paying 4% but are over-priced and likely to drop 20% (or 5 x the income) in the next draw down, is it worth the risk of buying?

We very much wish to add more income bearing securities to our portfolios. At this point in the cycle, our main areas of interest are in the historically more stable, defensive sectors such as corporate bonds, preferred shares, utilities, pharmaceuticals, income trusts and consumer staples. We will look to add these sectors at every reasonable opportunity going forward.

Selecting favourable entry points is likely to be of particular importance this next go around because the next market downturn is unlikely to recover as quickly as the past 18 months. The quick “V” we have seen since 2009 is highly unusual and has been bought at a high price to government fiscal health everywhere. The stimulus money is spent and the appetite for taking on more public debt is very low. This means the next bout of slowing growth will be harder to arrest with government spending. The next leg of recovery is therefore likely to be more gradual, organic and self-funded, working over a period of several years not months. This means any capital losses incurred at the outset will be longer to recoup. It also means that the income yields

more than capital appreciation will be the main source of investment gains for the next few years. Getting the right assets at a good price (and therefore yield) are key to longer term success.

New Year Resolutions

As we come to the end of 2010, we are reminded of dear clients, friends and family that have been lost to cancer and other ailments. We miss them. As we look toward a new year, their memory inspires us to enjoy our lives (no matter what the stock market is doing!), to laugh, to live each day with hope and love; to be generous and to keep looking for the potential in humanity through all our faults.

In our work we are resolved to continue searching diligently for favourable reward opportunities for our clients. We have come up with a few tweaks to our technical rule set that we think could help us to participate more in interim market rallies going forward and we will make every reasonable effort to do so. At the same time however, we remain resolved to never sacrifice good risk management rules just because they are temporarily out of favour. We resolve to never forget the trust our clients have bestowed in us to protect and grow their hard-saved capital. And in keeping with Ben Graham's quote below, we resolve to keep on learning and to never forget what we have learned.

Best wishes for a wonderful holiday season and Happy New Year!

Quotes of the Month:

“Wall Street people learn nothing and forget everything.”

—Ben Graham (1894-1976)

"The future belongs to those who believe in the beauty of their dreams."

--Eleanor Roosevelt (1884-1962)

“Christmas gift suggestions:

-To your enemy, forgiveness.

-To an opponent, tolerance.

-To a friend, your heart.

- To a customer, service.

-To all, charity.

- To every child, a good example.

-To yourself, respect.” — Oren Arnold (1900-1980).

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