

E.Q Trendwatch™

A New Hope for 2008

Greetings on a New Year!

Our 8 year old son asked for Star Wars collectibles this year for Christmas and so Christmas holidays found us watching the first 3 movies of the old trilogy as our kids discovered them for the first time. Something we had not remembered before was that the first Star Wars movie released was not just "Star Wars," it was called "A New Hope." It struck us that this was a good subtitle going into 2008.

Sure the debt markets continue to writhe in a world wide credit crunch. Sure bank earnings continue to implode, the housing market continues to plunge and retailers are reporting the slowest shopping season since the recession of 2002. And yes buy and hold investors (not us) have generally lost money on their balanced portfolios through 2007. But we see these things as ultimately positive because they are necessary, healthy developments in order that people can wake up, admit mistakes, and embrace New Hope for the future.

It's kind of like this: for those of us paying attention, the last few years have been rather hard to watch. Foolish policies and wanton consumption at all cost have been the order of the day. Besieged by marketing, enabled by reckless lending and abandoned by regulators, people around the developed world have been rampantly consuming. Like watching a slow motion train wreck that has taken forever to impact. This period was able to last so long because even the most pessimistic analyst could hardly imagine the foolishness and sleight of hand that would unfold.

Some time ago we recommended that our readers watch the documentary "ENRON: The Smartest Guys in the Room." If you haven't seen it yet, we suggest again that everyone should watch it. The big banks advised ENRON on how to miraculously download debt off of their balance sheet and book debts as assets. This is how ENRON was able to register unfathomable profits for a few years until reality broke through and the company went down in a flurry of lawsuits and criminal convictions.

Apparently inspired by this experience, banks around the world learned from the Enron model and became the daring architects of all manner of debt that they recklessly lent with wild abandon. They had no concern for whether or when the borrowers could repay the loans. The lenders had no intention of holding on to the debt instruments they had

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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



created. They sought only to package them, market them and sell them off within months or weeks to others. It was a miracle drug while it lasted. And it seemed to repeal all of the normal laws of the financial universe with endless capital supply and rock bottom interest rates for all. For some perspective on this we note that the credit derivatives market was essentially non-existent in the early 1990's, and today has a notional value of about 50 Trillion (with a T) dollars. The proliferation of credit derivatives in our global financial system has quadrupled in the past 4 years alone.

The good news is that the bloom has finally come off of this rose. Now unable to sell their magical products to more gullible buyers, banks must hold on to the junk debt they created. The off-balance-sheet lending business is crippled if not dead for good. One can only hope. For more on this story see the Wall Street Journal: *Profit Outlook Darkens for Big banks*: http://online.wsj.com/public/article_print/SB119862981800049831.html.

Since the end of 2006 some 210-mortgage lenders in the US alone have gone bankrupt. The ranks are growing weekly. The big banks will no doubt soon be restating profits retrospectively to spread out the write-downs as against their record profits of the past few years. They have already begun selling chunks of themselves to foreign governments for needed capital to shore up reserves. We should expect more of this, as the piper will need to be paid, at long last.

So back to the new hope part. The truth about debt is now out. It is not free, endless or harmless. It is not something consumers can depend upon to live indefinitely. We are not "*richer than we think*." People are now learning to reign in their spending, pay down their debt, get off the mindless consumption train. We are in for more honest, responsible, sustainable habits ahead. This will be a much healthier trend for the future. And yes this means slower earnings growth for corporations in the months ahead and the accompanied re-pricing of reduced earnings by stock and bond markets.

This week Manager John Hussman summed it this way:

"I'll begin with a brief note about the stock market here. Suppose you're considering riding a unicycle on a high-wire that by most evidence is not secure, but it's possible that the wire might hold up for a while. If you keep riding, people will throw small bills at you until the moment the wire breaks. Once the wire breaks, you will be injured and will probably lose whatever you gained initially. Would you keep riding?"

A risk-averse investor (or even a risk-neutral one) would decline that bet, even though there's some potential for lost short-term gains if the wire doesn't break immediately. A myopic risk-seeker will ignore the risk and keep speculating, assuming that some spontaneous impulse will move them to quit just before the wire snaps."

For those interested in understanding why the recent "liquidity injections" by the Federal Reserves around the world are actually a mirage and not a rescue plan for the escalating credit crunch, see Hussman's full piece "*Vanishing Act: Are the fed and the ECB misleading investors about "liquidity"?*" at <http://www.hussmanfunds.com/wmc/wmc071224.htm>.

Feeling encouraged that the world is finally waking up, we remain your humble value-seeking analysts. Keeping our eyes wide open in '08, we send you our warmest wishes for blessings to you and your families.

Remember you can visit our blog: www.jugglingdynamite.com for weekly commentary and media spots.

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