

# Market Timing

## With cash comes opportunity

We thought it was a good time to recap where we are at in the current business cycle and how we intend to have our clients benefit from what comes next.

By our analysis, we are in the final up-leg of a cyclical Bull market that started in October 2002. Typically Cyclical Bulls last 2 to 3 yrs. That would mean that if this is the case we should see the market (DOW 30) peak somewhere in early 2005.

Many Economists and Technicians suggest that during the final stages of a Bull Market the best performing assets tend to be *Basic Materials* followed by *Energy* and *Consumer Staples*.

We can all vividly remember the cost to fill our cars only a few short months ago as crude oil peaked at \$55.00 per barrel. The peak in oil is inline with its traditional position in the market cycle, just as Basic Materials had been the previous out performer.

As we write this, Proctor and Gamble is trading close to it's cycle high of \$55.00 and the company has made a bid to purchase its main competitor Gillette, taking advantage of its recently inflated share price in an all stock no cash deal.

The connection we draw here is simply that the timing of the all-stock purchase would suggest a short-term top in the value of P&G that is also consistent with our perceived stage within the business cycle.

The next sector we watch for in this phase known as "Early Contraction", is the relative out-performance of the Utilities group. The best sector performance numbers over the last 65 days are as follows: Consumer Staples first, followed by the Healthcare sector (considered defensive), and you guessed it, in third place and gaining ground, is the Utilities Sector.

In past communications we have referred to the US presidential cycle and its historical correlation to market performance. The presidential cycle is precisely what you would think it is. In an effort to be re-elected politicians will use every possible means to stimulate growth in the economy via tax cuts and corporate incentives in the hopes that by election time the economic environment will be supportive of their re-election.

Typically in this 4-year presidential cycle, we find that years 3 and 4 of a term tend to bring much greater investment returns growing out of campaign promises delivered. Years 1 and 2 however, are the years that unpopular but necessary government policies are implemented. If it holds in this case, that would be negative for 2005. The market also has a strong history of bottoming every four years, 1990, 1994, 1998, 2002, etc. These bottoms usually occur midway through the presidential cycle, which again, if the theory holds this time, would put the next major bottom sometime in the autumn of 2006, with the major indices possibly correcting significantly from current levels.



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So these factors and more have us watching specific areas for potential purchase as the current cycle plays out. **The good news as you know, is that our approach will have us waiting out the bulk of a major correction on the sidelines so that we have cash to take advantage of opportunities that will arise after the storm.**

### Income Trusts

Anyone who has been with us for the past few years will know that we have owned and made good returns on income trusts in the past, but we have not been in that market for some time now. Many people, especially those in need of taking income from their investments, have been asking us when we will be able to add this asset class back to portfolios. Our answer--- as soon as we get a buy signal that they have become cheap enough. Income trusts are equities; their income flows are nice but not guaranteed. As with all investments the price you pay for the asset is an enormously important factor in determining your investment experience. In a time of low interest rates, the cash that flows through to unit holders has made income trusts immensely popular with investors looking for yield. This demand has fuelled an enormous surge of new issues in this market as investment bankers stumble over one another bringing new trust products to the market.

Recently you have no doubt read that the S&P/TSX composite index has given into lobby pressures and plans to add income trust companies to its benchmark by the middle of this year. They will not be added to the TSX 60 Index that we currently hold. Some people argue that adding income trusts to the broad market index is a signal that these companies are now widely accepted and more attractive. But the reality is that institutional investors will not overpay for these stocks, and adding already overvalued stocks to an index does not make them or it more attractive. The fact that an already high market attracts new inflows of money from cash hungry investors does not mean it is worthy of smart patient capital. Again, as always, we must stick to our discipline and not get caught up in the tulip mania of the day.

The price we pay for an investment plays a primary role in whether we end up with a capital gain or loss. When interest rates increase, which they inevitably will from here, income trusts will take a drubbing. And when this happens we will no doubt have a chance to buy this sector again at cheaper levels and higher yields than currently available. Only then will the prospect of reward be worthy of your capital.

### Currency and rates

One of the main catalysts for rising rates by the way may be linked to the US dollar. Many Asian countries have been investing heavily in the US dollar over the past many months, in an effort to keep their domestic currency artificially lower than it would otherwise be. In doing so, the foreign governments seek to keep their goods "cheap" to consumers and promote their exports. When these countries reduce their investment in the greenback, there will be a negative impact on US bond and equity markets. The Federal Reserve will have little choice but to hike rates in an effort to soak up the oversupply of US dollars. Rising interest rates present serious liquidity problems for assets like real estate, income trusts and longer-term bonds, not to mention for consumers with the highest debt loads and lowest saving levels in history.

Although we may wish to rush in and buy something just to get on with investing, we must restrain these emotional responses and do the right thing. Which in this case, at least for now, is to wait a little longer, and realize that in times like these cash is our ally not an enemy.

Warren Buffet has commented many times throughout the years, that at times like these he finds it hard to invest in anything as nothing looks particularly attractive and he has to sit on his hands and wait. When the corrections have taken place, he finds himself as giddy as a schoolboy running around the place scooping up companies at rock bottom prices.

We heard Warren interviewed last week where once again he reiterated his frustration with current prices being too high, and the virtue of patience coming to the fore.

Of course, things selling at a discount are only a benefit when one has the cash to take advantage of the sale. And we will. With our cash will come great opportunity.

### Housekeeping

We are just in the process of sending out capital gain and loss reports as well as annual performance reviews for all clients who request one. If you would like to set up an in person or phone appointment, please contact us to arrange it at your first convenience.

Lastly, we wanted to answer a question some clients have raised about referrals. Yes it is true as our web site states our minimum account size is 500K for new clients to join us. That said however, if you have a friend or family member that is in need of some independent advice, please feel free to refer them to us. In some cases we are just able to offer them general information or suggestions without actually taking them on as a client, in other cases we may be able to make an exception based on their relationship with you as an existing client of our firm. In any case, we are proud to be referred by our clients and are grateful for your confidence in doing so.

Happy February!! Spring is just around the corner.

*Since common stocks, even of investment grade, are subject to recurrent and wide fluctuations in their prices, the intelligent investor should be interested in the possibilities of profiting from these pendulum swings. There are two possible ways by which he may do this: the way of timing and the way of pricing. By timing we mean the endeavour to anticipate the action of the stock market—to buy and hold when the future course is deemed to be upward, to sell or refrain from buying when the course is downward. By pricing we mean the endeavour to buy stocks when they are quoted below their fair value and to sell them when they rise above such value.*

**Graham, Benjamin. ( 1973) *The Intelligent Investor*.**  
New York: HarperCollins, p. 189.

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