

E.Q Trendwatch™

The world has “suddenly” changed

For the past couple of years money has been dirt-cheap and in wide supply and so it has been treated in general, with very little respect. As bond manager Bill Gross aptly put it last week,

“Covenant-lite deals and low yields were accepted by [investors] as if they were prisoners in an isolation ward looking forward to their daily gruel passed unemotionally three times a day through the cellblock window. "Here, take this" their investment banker jailers seemed to say, "and be glad that you've got at least something to eat!"

“Well the caloric content of the gruel in recent years has been barely life supporting and unhealthy to boot...Over the past few weeks much of that has changed.”

Suddenly it seems that investors are waking up and beginning to demand more payment for placing their capital in harm's way. Suddenly we see (again) contracting liquidity in unison around the world as international markets plunge together. The selling volume has been sudden and awesome.

Is this the start of a 1957 like rout that saw the Dow lose 20% between July and the end of October? Maybe. 50-year market analyst Richard Russell is one of the few investors who remembers 1957 personally, and he tells us that the similarities between July of 1957 and market conditions now is more than a little eerie. Or maybe irrational exuberance will rebound here strongly again and continue the gravity defying advance a while longer. Only time will tell. But time also tells us that periods of great exuberance and disrespect for risk to capital have always ended painfully for investors.

Meanwhile, our conservative approach has maintained positive portfolio returns in 2007, while international stock and bond markets for Canadian investors have all now clocked negative gains year to date:



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World Market returns year to date (ending July 27, 2007): source API Asset Performance Inc.

	Yr. to date in \$Cdn
S&P 500	-6.5%
NASDAQ	-3.6%
MSCI EAFE index	-4.0%
Europe	-1.2%
Japan	-7.0%
Asia Pacific	-1.9%
Broad Bond Index	-0.4%
All government bonds	-0.3%
All corporate bonds	-0.7%

To the end of July the TSX Composite was still up for 2007 +6.5%. But given that it had lost -5.6% just last week, we see that recent gains are neither permanent nor necessarily secure.

For some time fundamental valuations have been very poor with equities and bonds over-priced, and over-bullish. One thing the market still had going for it over the past several months was buying momentum. It looks like that last leg of its stool is now teetering. Last week's action inflicted significant damage to the market internals on a technical basis.

James Howard Kunstler author of a new book called "The Long Emergency" sums up the series of events that have lead to present problems:

"Last week's stock market meltdown suggested that a financial sector rigged for the falsification of reality eventually enters a danger zone where reality implacably reasserts itself, expectations dissolve, and all that remains is the sour odor of fraud.

This long episode of market mania, running for seven years, was based on the idea that non-performing loans could be turned into money by removing them from their point of origin and dressing them up in respectable clothes -- like taking all the winos in downtown Los Angeles, putting them in Prada suits, and passing them off as the faculty of the Harvard Business School. It was a transparently ludicrous racket and the wonder is that America proved to be so utterly bereft of regulating authority -- not to mention plain decency and self-restraint -- at every stage.

It's really hard to account for the stunning failure of responsibility. What you had was a whole industry that surrendered the standards and norms that brought it into being and enabled it to function in the first place. Mortgage lenders stopped requiring house-buyers to qualify for loans;

bankers stopped caring what stood behind the paper they issued; dubious loans were bundled and resold like barrels of rotten anchovies -- in such numbers that no individual stinking minnow would stand out -- and the barrels were traded up the line, leveraged, hedged, fudged, fobbed, and fiddled until, abracadabra, they were transformed into so many Tribeca lofts, Hampton villas, Piaget wristwatches, million-dollar birthday parties, and Gulfstream jets.

It worked for the Goldman Sachs bonus babies, and the private equity scammers, and for the corporate CEOs and their board members, and for the politicians who parlayed their votes into cushy lobbying jobs, and even for the miserable quants in the federal government's termite mounds of statistical reportage. It even worked for about 18 months for millions of feckless US citizens gulled into contracts for houses they could never hope to pay for, under arrantly false and ruinous terms . . . "

These are harsh words but they accurately capture the broad scope of the players that have been complicit in creating present problems. Acknowledging the truth about what happened is the first step to protecting ourselves and to implementing improvements in the financial system going forward.

How this all resolves itself, we cannot yet tell. It will all work out some how, eventually. It always does. What we do believe though is that the risks at this point still favour further downside in world markets. There are so many fundamental and technical indicators that signal caution at this point in this cycle that it is truly remarkable. This week we came across a technical metric from the 60's known as the Coppock Guide (a measure of price momentum in the S&P 500). This indicator too has been flashing alarm at a foreboding double top in momentum to July 2007. It turns out that this precise technical formation has occurred just 6 other times in the past 80 years. These 6 occurrences all preceded the following declines in the broad US markets:

Oct 1929	(-86.2%)
May 1946	(-28.8%)
Feb 1969	(-36.1%)
Jan 1973	(-48.2%)
Sept 1987	(-33.5%)
April 1998	(-18%) followed by a further (-45%) 2000-2002

We are not saying these types of losses are inevitable this time, but the risks at this point are not in favour of the bulls. Successful investing has always been a process whereby those in panic sell at rock-bottom prices to those who are ready and waiting with prescribed criteria. You can rest assured that we are ready.

Remember to visit our Blog at www.jugglingdynamite.com for interactive daily commentary and discussion of key market and world events as they unfold.

And remember to enjoy your last month of summer!!!

