

E.Q Trendwatch™

Reckless abandon and mental tests



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This month stock markets celebrated the one year birthday of the current cyclical rally. There is no doubt that risk assets have made a spectacular rebound in incredibly short order. It must also be acknowledged that one year into the biggest government spending sprees in the history of the world (literally), there is a marked lack of conviction and confidence in the economic outlook from those on Main Street. This point was reasserted this month in the most recent small business and consumer surveys:

- The Feb NFIB small business optimism index, those small businesses that “expect a better economy” fell to the lowest since March ‘09.
- Those that think it’s a “good time to expand” fell to the lowest since June ‘09.
- Those that “plan to increase inventory” fell to within 1 pt of the lowest since March ‘09.
- The March Investors Business Daily Economic Optimism index (which claims a “good track record of foreshadowing the University of Michigan and Conference Board confidence numbers) fell to its lowest level since March ‘09, falling 1.4 pts from Feb.
- The Personal Financial Outlook component fell to the lowest since Feb ‘09.

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So what exactly have we got to show for trillions of freshly issued government debt?

The short answer is not much. Actually the biggest outcome is (once again) a remarkably over-valued stock and commodity market. And in countries like Canada, New Zealand, Australia and parts of Asia, dangerously re-inflated real estate bubbles. An interesting point of reference here on realty prices: the average home price in Canada (and Australia) is presently about **7.4 times** the average family income. At the peak of the US housing bubble, the average home price was about **5 times** the average income. Of course, that was just before the US real estate market began its long, ongoing descent. Canadians are forewarned. Whether individuals take any steps to protect themselves is now a matter of personal planning.

As for giddy valuations in the equity markets, it should be considered that over the 108 years from 1900 through 2008, the stock market returned just 5.8% on an annualized basis (including dividends and adjusted for inflation, see www.crestmontresearch.com.) To capture that fairly modest 5.8% return, passive investors had to suffer through a series of routine losses (10-20%) and some staggering declines, including an 89% loss (1929-32), a 48% loss (1973-74), another 49% loss (2000-02) and a 57% loss (2007-09).

Whether we like it or not, facts must be faced: today the S&P 500 Index's current ten-year normalized PE is 20.3 (group 9 in diagram A.3 below) and its ten-year normalized dividend yield is a paltry 2.1% (group 5 in diagram B.1 below).

In other words, like the late 90's (and other secular market tops) equity prices today are once again back in the historically "most expensive" range and therefore poised to deliver flat to negative returns over the next 10 years for investors that are trying to hold the equity tiger by the tail.

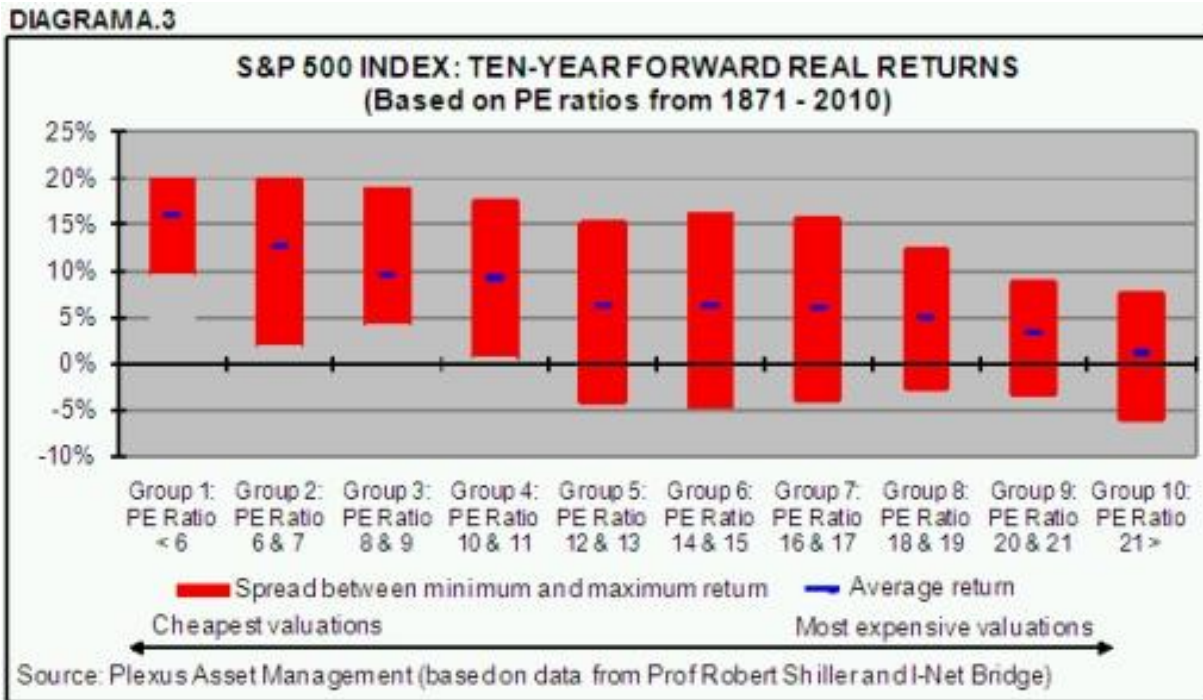
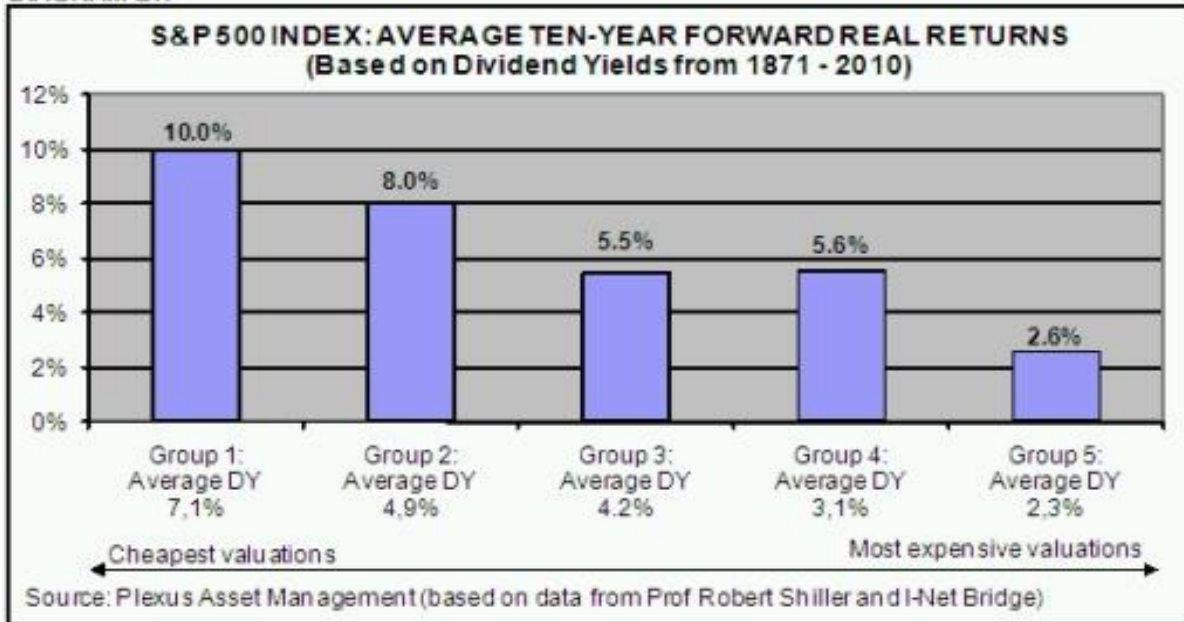


DIAGRAM B.1



Delivering this promise of so little is the incredible volatility and risk that invested capital must face for the hope of anemic gains. Any way you slice it, equities are presently very unappealing on rational metrics.

Still, even for those committed to prudence over reckless abandon, these can be mentally trying times. Although the stock market real gains have now basically stalled out since October, there has been an awful lot of sound and fury over the past few months vying to incite the animal spirits of those who allow themselves to succumb. Intoxicated market prices beckon to suck in every penny from those who will let it. Everybody would like to ride a speculative wave up. The problem is how to know when to get out. Without principled buying one tends to lack principled selling too. Ignorance makes many oblivious. But for those that know better, choosing to partake in speculation is a reckless wager deserving of typical losses. No one said that responsible behaviour was easy, but it does tend to render more enduring rewards over time.

In the “You took the words right out of our mouth” category:

We were struck by the following passage from a market letter written by fellow US money manager John Hussman this month who manages about 5 billion in assets out of Maryland:

“Over the past decade, it has been an uncomfortable lesson to accept that investors can be relied on to behave in ways that are ultimately unsustainable and destructive to their wealth, as long as market internals are temporarily supportive. It’s one thing to say, “From every historical precedent, we know that this is going to end badly, and investors will lose a great deal of their wealth, but for now, they are speculating anyway.” It’s another thing to add, “and since they are, we are actually going to rely on investors to continue behaving dangerously, and join them.”

Money manager John Hussman, March 8, 2010

And so we must wait for the inevitable to happen and for unsustainable prices to finally correct. We do this knowing full well that there will be some who think us cowardly or inept for our abstinence. Such is our lot as fiduciaries of our clients' net worth; we embrace our duty fully, because we know that we must. The other way 'lies madness.'

This month 85% of S&P 500 stocks are technically over bought— trading well above their 50 day moving average. Being this overbought and over-valued on such notoriously low volume, the odds of sudden and dramatic price drops over a matter of short days or weeks must be considered possible-- even likely.

And just as prices are hitting their most over-bought in 18 months, the options speculation index this month hit a fresh record high for bullish sentiment (30% higher than in 2007 at the market peak!) and the Volatility Index (VIX) or "nervous sentiment" (see \$VIX chart below) fell to less than 17. We note that the VIX last fell to 17 when the stock market was peaking in 2007-2008. It seems the well established 'recency effect' of investor psychology is in full bloom once again. 12 months since the last market bottom, market participants apparently see only the likelihood of more gains.



Source: Venable Park Investment Counsel Inc.

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Overall the economy is still sick

This month's report showed that new family home sales for February fell to a fresh record low of just over 300 thousand units. This compares to a peak rate of 1.4 million units sold in 2006. After a little rebound in sales in late 2009, this historical engine of the US economy is now heading back down. It is particularly stark that new home sales are still falling even after three years of emergency rescue spending from the government via credits and staggering commitments to back the mortgage market.

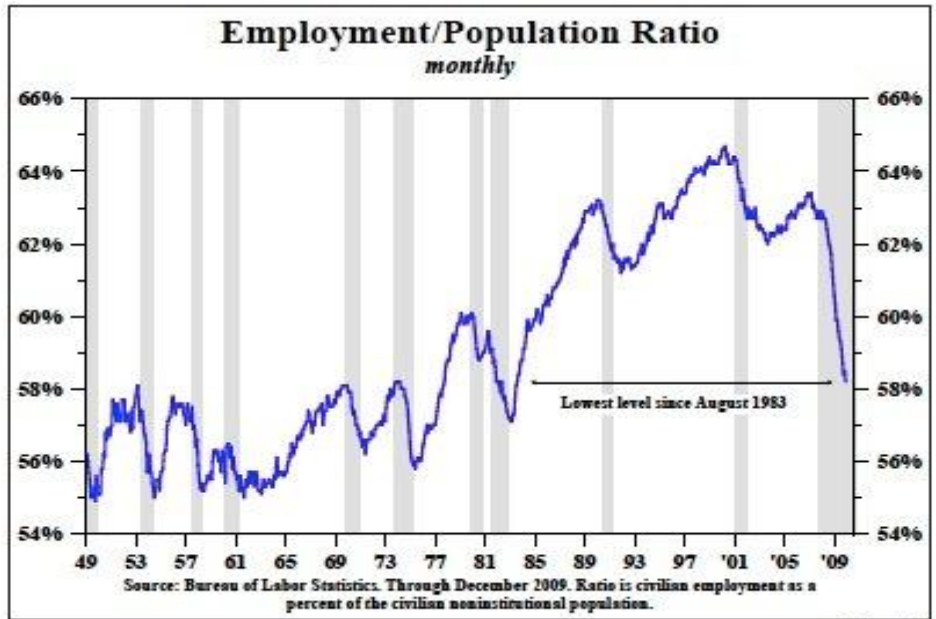
CHART 2: NEW RECORD LOW

United States: New Single-Family Home Sales
(thousand units at an annual rate)



Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Systemically weak employment is another major impediment to economic recovery. Today the percentage of the US population that is employed is at a 30-year low. So far, the economy is still shedding jobs each month.



Source: Bureau of Labor Statistics. Through December 2009. Ratio is civilian employment as a percent of the civilian noninstitutional population.

Chart 5

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Over the next few quarters there will be some short-term census hiring which will temporarily inflate job creation data. But unfortunately these won't be lasting jobs and will therefore tend to overstate the overall employment picture.

Trying to avoid civil revolt spurred by the massive contraction in global demand, the Chinese government has stimulated its economy into a bubbling frenzy.

This month, Edward Chancellor of GMO (Jeremy Grantham's firm) wrote a piece called [China's Red Flags](#) which succinctly surveys the typical earmarks of bubbles that China now exhibits:

China Bubble?

1. Great investment debacles generally start out with a compelling growth story (The China Dream)
2. Blind faith in the competence of the authorities (In the Communist Party of China We Trust)
3. General increase in investment (Chinese investment Boom)
4. Corruption (Rampant in China)
5. Easy money (Money supply grew by nearly 30%, interest rates maintained well below nominal growth rates)
6. Fixed currency regimes (Chinese currency, the Renminbi, is pegged to the U.S. dollar)
7. Rampant credit growth (New bank lending increased by nearly RMB 10 trillion, a sum equivalent to 29% of GDP)
8. Moral hazard (China's leading banks, among the world's largest by market value, are seen as too big to fail)
9. Precarious financial structures (Chinese banks are particularly reluctant to report problematic loans)
10. Strong credit growth and rapidly rising property prices (A widespread belief that the property prices can only go up)

The whole article is worth a read. Overall Chancellor offers a lament that we at VPIC share:

"It would be pleasant to think that the wrenching experience of the Global Credit Crunch and Great Recession would have brought a return to financial sobriety around the world. Unfortunately, this doesn't seem to be the case. Another bout of easy money hasn't succeeded in reflatting the moribund U.S. housing market. On the other side of the world, however, China is showing many of the classic symptoms of a great speculative mania alongside several of the leading indicators of financial fragility...Forecasts for urbanization and economic growth make for a compelling Wall Street pitch...Yet like the projections for internet growth back in the late 1990s, there's a possibility that these forecasts may be exaggerated. As with the dotcom mania, investors seem to be adopting an uncritical attitude to China's growth forecasts."

While the risk salesmen of the investment world are running wild with the promise of insatiable growth in China, the facts suggest China has a good deal more risk than reward at present levels in this cycle. Moreover, because China's quick rebound this past year was one of the few signs of life in the global economy, the realization of reality there is likely to have a strong negative impact on sentiment and risk markets around the world. Another analyst James Welsh recently

expressed the likely fallout this way:

“The coming slowdown in China’s economy later this year will probably surprise most economists and investors, since the long term China growth story is so compelling. If I’m right, it will have a profound and negative impact on commodity prices, since Chinese demand for ‘stuff’ is seen as unquenchable. It will also have a deleterious effect on equity markets around the world, as investors have come to consider the Chinese economy as the locomotive of global growth.” -- E. James Welsh, *Welsh Investment Letter*, Feb 2010

Makes sense to us. This is one of a host of reasons that we at VPIC are leery of equity markets and especially Canadian equity and commodity markets at present. It is also why we suspect that the Canadian dollar will see a reversion back to lower levels against the US dollar in the months ahead. Our concerns about an over-valued C\$ are evidently not the consensus view at the moment as shown in the following chart of net speculative long positions in the Canadian dollar. The number of trades speculating on a higher C\$ from here has only been higher than present once before—that was in April 2007 right before the C\$ and all other risk assets (stocks and commodities) plummeted. Yes, yes, maybe this time will be different. But we don’t feel like banking our money on those odds.

CHART 1: NET SPECULATIVE LONG POSITION IN THE CANADIAN DOLLAR

Noncommercial Long minus Short Position in the Canadian Dollar

(number of contracts, contracts of 100,000 Canadian dollars)



Source: Haver Analytics, Gluskin Sheff

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Deflation and then inflation: the two sides of our coin

As anyone with deposit accounts today knows, interest rates in 2010 are at 75-year lows. At 0.5 percent today, the present Bank of Canada rate is 4.8% below its 75-year average (a similar story in the US). The last time rates were anywhere close to present levels was during the last years of World War II (1944 -1948), and even then the bank rate was kept at 1.5% not our present 0.5. This is of course one of the reasons that over-indebted people and governments have been able to stay afloat over recent years. But since rates cannot reasonably go lower, it also begs the troubling question: how will today's debtors manage when rates eventually trend back toward historical norms?

The bank lending rate and 10 year treasury yield also indicate mortgage rates. Over the past 59 years, a five-year fixed rate mortgage in Canada has averaged 8.8%. Today it is quoted as 4.4%, with the best national rate being quoted at 3.9%. Even if the bank rate just trends back to a still historically low 4% (from present 0.5) 5-year mortgage rates would rise to approximately 7 percent. Importantly, and little understood, is that a **2.5% increase** in mortgage rates equates to a **24% increase** in monthly mortgage payments. If the bank rates trend higher than this "best case scenario", mortgage payments will increase by more like 35%-55% a month. Very few people today can absorb mortgage payment increases of 24% let alone considerably more.

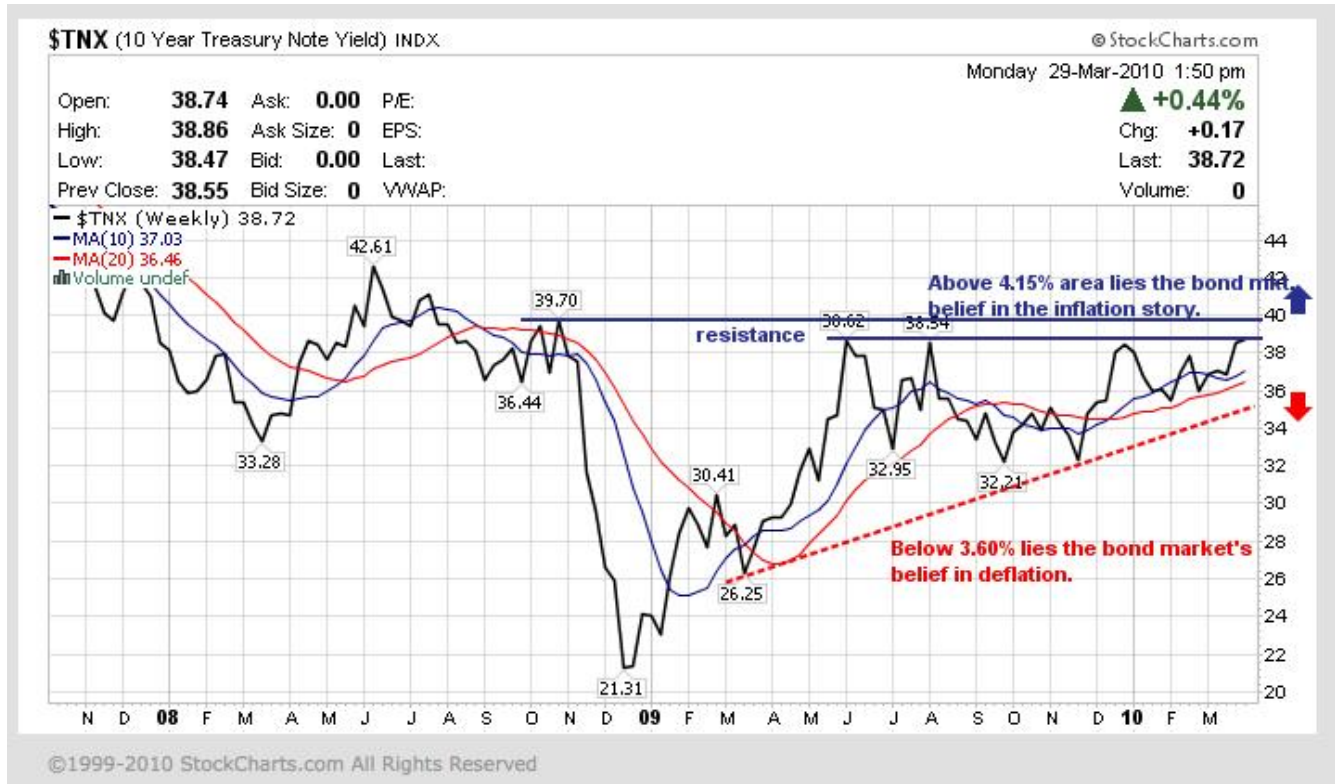
Those who do not owe money are also challenged by today's circumstances. The over-lending, and over-levering of the past 10 years, has now painted us and our economy into a debt-encumbered corner. It will not be easy or quick to work our way out. Rock-bottom interest rates are punishing those who have built up savings. Bonds over the past year have been feverishly bought as risk-averse, income-needing investors covet return of their principle above the allure of riskier promises. This brings us to the related troubling question: how will today's bond prices fare when rates eventually trend back up toward historical norms?

We are watching bond market indicators very closely. Our concern about a fresh resurgence of the credit crisis in the months ahead has made us maintain a bias to high quality credits. And our concern about the likelihood of rising longer-term rates has prompted us keep our overall bond weighting to a relatively short duration of less than 4 years.

We do see the potential for higher inflation and possibly significantly higher interest rates over the second half of this decade. However over the next year or two, we see the likelihood of continued price and wage deflation as the world works through its massive hangover of over-supply: superfluous goods and workers. The world is literally awash in goods at the moment. Meanwhile workers in North America have not had any real wage gains in more than 20 years. This is really the opposite conditions of those that the boomers remember as prompting dramatic inflation and rate hikes in the early 80's. This is not the stuff of near-term inflationary pressures. This is much more like the run-down period that the economy encountered in the mid 60's coming out of the 1950's real estate and credit boom.

So, yes, we are aware that inflation may be the inevitable by-product of the government's "free-flowing" money. But we think it is down the road some from here. And before we get there, we will need to soak up a lot of excess supply and slack in the world economy. This would take time in a "normal" recovery; it is sure to take longer in a post-credit bubble economy that is still barely sputtering out of recession.

The good news is that we do not have to guess at the future outcome, but rather will continue to track the yield curve for evidence of the prevailing climate. One of the key guides we will be charting is the US 10-year treasury yield (TNX). If the TNX manages to break through overhead resistance at yields of 4.15% (shown as 41.50 on chart) then this will suggest that the inflation story is taking hold and we will begin to look for buying opportunities even shorter on the yield curve. If the 10-year yield falls below 3.60% (36.0 on the chart), it suggests deflation is still in charge and we will look for opportunities to move farther out the yield curve where good opportunities present.



Source: Venable Park Investment Counsel Inc.

Housekeeping re our existing bond ETFs

Just a reminder on the structure of the bond ETFs that we hold in accounts: every 3 months at the end of each quarter the bond ETFs pay a dividend payment which comes off of the market price of the shares. This dividend decreases the market value of the unit during the last week of each quarter which is then replenished by the cash dividend received into the accounts the first week of the following month. The cash dividends received re-adjust portfolios back up toward the pre-dividend unit value. Because there is a gap of a few days between the last week of the quarter and the dividend payment date, clients may notice a dip in their account value at each quarter end. Some of you have asked about this when it happens. For those that have not asked but have wondered we wanted to explain.

Investing: a good game played slow; lessons to learn from inverse mentors like Jesse Livermore.

"The market does not beat them. They beat themselves, because though they have brains they cannot sit tight."

-Jesse Livermore (1877-1940)

The above quote is one of many wise and insightful comments now recorded from the late, great stock trader Jesse Livermore. It is all the more poignant when one knows something of Livermore's life.

Livermore was a Massachusetts farm boy who ran away at the age of 15 to find his fortune. During his 63 years, Livermore gained and lost multi-million dollar fortunes 4 times. Most notably, he was worth \$3 million and \$100 million after short selling in the 1907 and 1929 market crashes respectively. He subsequently lost both fortunes through lavish over-spending and aggressive risk-taking. Livermore established his own set of strict investment rules, but sometimes he did not follow his own rules. He admitted that his inability to adhere to his own rules was the main reason for his repeated loss of fortunes. Facing bankruptcy in his third marriage, Livermore ended his own life in 1940.

Jesse Livermore knew vividly the human propensity to self-destruct in financial markets and commented on it famously in many interviews, articles and books. He could articulate precisely the issues and the risks but it was his failure to control his emotions and behaviour that brought his end. Livermore's life story is just one of many that can enlighten those of us that will listen. We at VPIC hear Livermore loud and clear. We can hold to our rules, and sit tight. And we will.

Happy Spring 2010. Here comes the sun...

Quotes of the Month:

"We gain strength, and courage, and confidence by each experience in which we really stop to look fear in the face. We must do that which we think we cannot."

--- Eleanor Roosevelt (1884-1962), Social Activist and First Lady of the United States

"We should enjoy mild deflation, rather than to deplore deflation as a disease. There's no way to beat the current bout of deflation, either from monetary or fiscal policy."

--- Eisuke Sakakibara, formerly Japan's top currency official. March 29, 2010

- For those that are interested, ***Stocks & Commodities Magazine*** in the US, did a feature interview with Danielle in their April addition now available on news stands. You can see an on line version of the article [on their web site here](#).

Don't forget to visit our market blog www.jugglingdynamite.com for weekly commentary, articles and media clips.