

Market Timing

The Canadian stock market: “very high risk appetite at present”

Clement Gignac, Chief Economist for National Bank, appeared on Report on Business this morning, and warned of the very high risk associated with the Canadian stock market at present. Mr. Gignac pointed out that we have now experienced 915 days of uninterrupted gains in the TSX with “no meaningful correction”. Meaningful is considered to be a correction of greater than 10%. This is now the longest perpetual up leg in 35 years! The last time we were close to this length without a correction was 890 days from 1984 to 1987. Then came the crash of 1987. 75% of the current index is dependent upon the fate of resources and financials. Both of these sectors are at multi-year highs. He recommended that people take profits and exercise “extreme caution” at these levels. We thought we would share this with you to show that it is not just us who are averse to the risk of the Canadian market at present.



Cory Venable CIM, FCSI, CMT
Technical Market Analyst



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

Interest Rate Update: The US 10-year Treasury yield is testing 4.90 %

As you know, fixed income yields have been painfully low over the past year. We are pleased to report that this situation has improved greatly over the past couple of months. The US 10-year yield has moved from 3.4% last summer to 4.9% this week. This is getting back toward its longer-term average of 5 to 6%. Why is 4.90% an important number?

The answer is two-fold. Firstly the 10-year yield is the risk free rate that equities must compete with for investment dollars. The higher the risk free yield, the less people are attracted to the risky asset class-- equities. Secondly, the 10-year yield sets the base rate for mortgages and other consumer loans. The higher these rates, the less the consumer can spend and continue to service monthly payments. Recall that the consumer accounts for 2/3 of US GDP (gross domestic product). Consumers have been spending beyond their incomes already. They had a negative savings rate in 2005. They must now divert more of their income towards servicing the growing cost of their debt. This all translates into less demand for goods, and less support for current valuations that have been holding up our Canadian stock market. Energy and raw materials will retreat in value.

We are currently looking for a Sept./ Oct. 2006 low. The TSX 60 hair cut is most likely to start this quarter and continue into the fall. How much remains a mystery, but it should certainly provide the cash in your accounts with some nice opportunity.

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

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One of the catalysts for the pullback may well be the slowdown in the housing market now underway. There is approximately 400 lbs. of copper in every new home and the US has been the largest consumer of this commodity. Of late, some have been applauding what they call the obvious soft landing of the housing market to date. We will venture an opinion here. The housing market slow down is only just started. It is not yet done.

When Americans purchase fewer goods due to increasing debt payments, companies that sell those goods make less profit. Less profit growth in the future means that American companies need to find a way to boost profitability.

It is not surprising then that there has been a recent spate of merger and acquisition (M&A) activity. Companies realize that in order to hold their profit levels in an increasingly global environment they need to increase efficiency and market breadth around the globe. Companies are choosing to grow externally by buying up competitors more than growing internally (organically).

Growth through M&A is far more difficult as it requires smooth systems integration and the acceptance of new management styles ie. culture. The focus on M&A suggests an urgency to grow quickly. It also suggests that many of the acquiring companies believe they have less potential for internal top line growth.

Before the bottom comes the peak. During the final distribution phase of the peak, volume of assets traded on down days becomes much stronger than the volume of assets traded on up days. This tells us that there are actually more sellers than buyers in the market. Another phrase that describes this period is often stated as "from strong hands to weak hands." Professionals sell their positions to the undisciplined investors who come late to the party. The markets seem to be suggesting that the inevitable is close at hand. As always with discipline and careful consideration of your hard-earned capital, we will buy when good value reveals itself.

In last month's newsletter, we stated our belief that the Federal Reserve in the US will have to continue hiking its overnight lending rates past the previously predicted peak of 4.75 in March. With the March hike now complete, the bond market is pricing in another hike to 5% in May, and a 60% chance of 5.25% in June 2006. Inflation continues to be a dominant concern in North America and other nations. This is the first time in many years that so many central bankers around the world have committed to increasing their domestic interest rates all at the same time. The impact will be felt.

Some of our favourite John Kenneth Galbraith quotes:

"Nothing is so admirable in politics as a short memory."

"It is a far, far better thing to have a firm anchor in nonsense than to put out on the troubled sea of thought."

"Economics is extremely useful as a form of employment for economists."

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