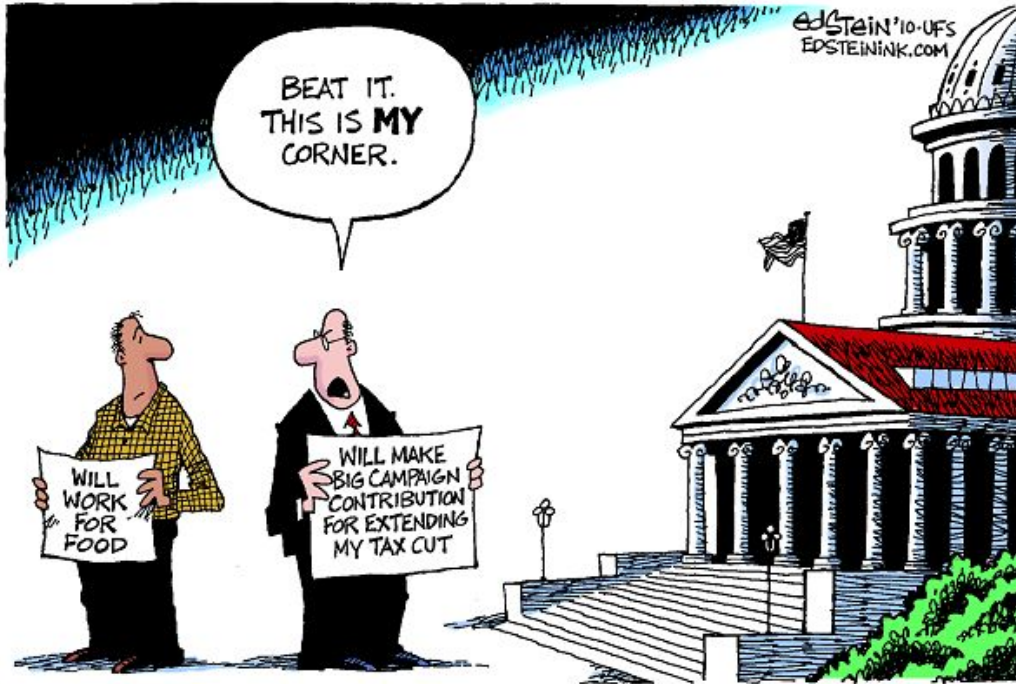


E.Q Trendwatch™

Somethin's gotta give



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This month, the US mid-term elections went largely as anticipated with the Republicans taking back control of the House of Representatives from the fledgling Democrats. The plot now thickens since Republicans campaigned to reign in the budget deficit and extend the Bush tax cuts. Accomplishing both of these goals in unison is no cake walk. Within a day of the election, the US Fed announced the details of their much telegraphed second round of quantitative easing. The stock market initially soared on the news and then weakened. Now comes the next hard part as a grid-locked government tries to strike a balance between the demands of a nation increasingly divided between those that have and those that have a lot less— less employment, less savings, less equity, less credit and increasingly less patience— than they used to have.

The latest proposal for more Quantitative Easing by the US Fed attracted almost unanimous criticism from the rest of the world at the G20 Summit this month in

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Korea. The trouble is that as the US has cut rates and flooded the banking system with capital the past couple of years, it has weakened the US dollar and caused unwanted price spikes in food, energy and basic commodities all around the world. Just as citizens and companies are already stressed from lower incomes, lower revenues and miniscule interest deposit rates, the cost of basic supplies has sky-rocketed. This means there is less money to spend in other segments of the economy. And as shown in the chart below, with interest rates at virtually zero now (left side of chart), the Fed cannot offer any further stimulus to demand through traditional monetary policy. The non-traditional measures “QE” (right side) have fed directly into looming asset bubbles again.

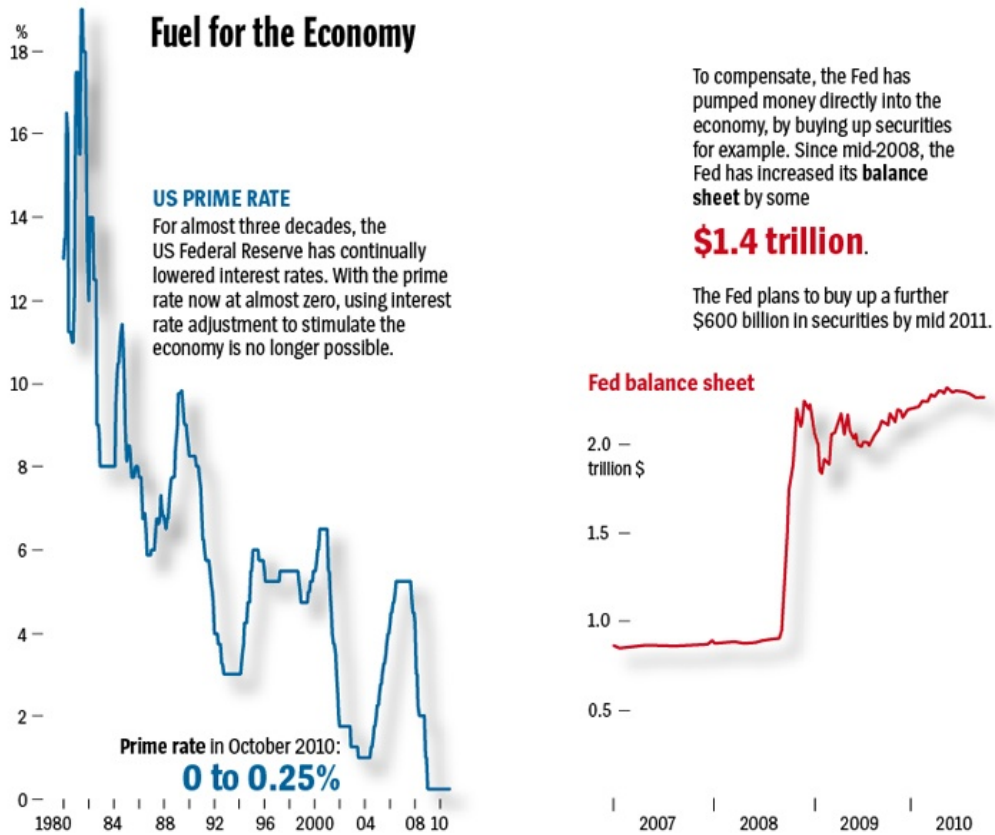


Chart source: Spiegel Online International

“With all due respect, U.S. policy is clueless.” --German Finance Minister, Wolfgang Schaeuble, Nov 2010

We can honestly say that over all the years since we have been doing this work, we have never seen capital markets behave quite as crazy as they have the past three months.

Oh we have seen crazy before alright *-have we ever!* ; but not quite *this* crazy across pretty much *all asset classes* all at once. **Our experience reminds us of something in this.** As we look back over the past 20 years, the times when we have felt the most mystified and out of sync with bullish psychology turned out, in retrospect, to be the times when prices in fact *were* crazy.

Today we are sitting with about 47% of our assets under management in cash equivalents. We are not happy to be in cash. We would dearly love to be buying excellent assets at reasonable prices and high yields. Cash interest rates today at less than 1% are **the lowest they have ever been in our life time**. No one feels excited about sitting in cash. There is nothing that we would love to do more than buy, buy, buy. And yet here we are. We have not felt such pressure in this work since the fall of 2007 when we could also find very little of value to buy.

When we finally did find growth buys in our work coming out of the market bottom in the Spring of 2009, we were relieved to think that we should have a good 3-4 years before having to confront over-valued markets again. And yet here we are, less than 20 months since the March 2009 bottom, with danger readings flashing across pretty much every reliable indicator that we follow.

Recently it occurred to us (again) that perhaps it is *us* that is nuts and so we made a concentrated effort over the past few weeks to look and to learn what other prudent managers and business owners are seeing and doing with their capital. Not the long-always-Perma-Bull managers that are the mainstay of financial channels, but the useful, real life business owners and managers that have managed to grow and steward capital through a full range of economic climates. The answers were illuminating:

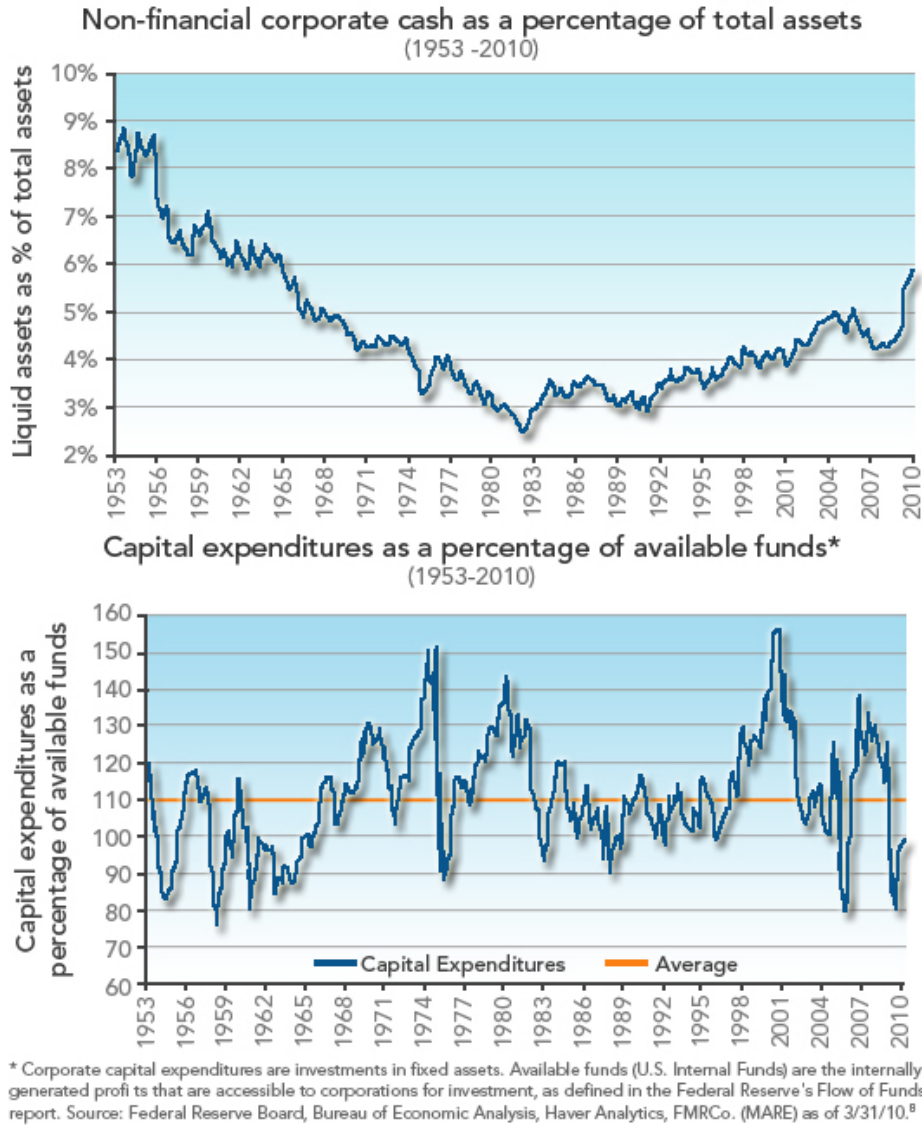
1. Business owners continue to hold mountains of cash in their bank accounts.

Cash levels at S&P 500 companies excluding financials neared \$1.1 trillion in the third quarter. US companies are sitting on a trillion dollar plus cash-mountain and they are still continuing to squirrel away hundreds of billions of dollars in perhaps the least sexy of all places: cash. A recent article on this phenomenon had this to say:

“If holding cash in the bank seems a bit...pedestrian, that’s because it kind of is. Many companies could be putting their short-term portfolio to work through a range of strategies, including agency securities, munis and asset-backed securities. But many are even passing on the king of low-risk investments— Treasury bills—as rock-bottom rates make tying up cash in short stints less attractive than the ease of having cash at hand.

...nagging economic fears, near-zero clarity on tax cuts and just plain prudence are some reasons why companies are content for now to watch their cash earn next to nothing in the bank. And with rates averaging near zero on bank deposits, money in the bank is truly returning CFO’s little more than a sounder night’s sleep.” See: [Guess what cash-flush companies are doing with their money.](#)

The following chart confirms the trend showing that publicly traded companies **today have the highest percentage of cash as a percentage of their overall assets that they have held since 1983 and this trend is growing**. In addition, the lower chart reveals that although companies are relatively cash-rich today they are so far, little inclined to reinvest this cash into expanding their businesses: they are not investing much in fixed assets or hiring new staff.



A key point often missed in this discussion about companies and their cash, is that much of the cash they are presently holding has been raised over the past couple of years by issuing bonds (borrowing) at today's rock bottom rates. It is not so much that companies today have retained net profits to build up cash on their books mostly they have taken the opportunity of low, low, rates to raise cash on hand. The fact that they have lots of cash but are still reluctant to reinvest it speaks a good deal about present business sentiment. Business managers and owners are generally nervous about the global economy looking forward. Growth prospects appear tepid in most places and most sectors. Businesses are realizing that they may already have over-capacity in their present infrastructure compared with the level of demand likely over the next few post-credit-bubble years.

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2. Private companies appear to be cash-hoarding too

Information on private companies is harder to collect en masse. But we have made an effort to seek out and discover the outlook of many different clients and friends that run a host of private enterprises across a host of business types and sectors. People who have managed businesses successfully through full business cycles –booms and recessions—typically have good intuition and insight in the areas of their specialty.

We were interested to find that pretty well everyone that we spoke to was expressing some caution and concern about near-term demand prospects. Many were noting that the recent run up in commodity prices was coming at a bad time. With demand still weak in most areas today, higher input costs are not easy to push through to consumers. The boom years 2003-2007 brought a wave of new competitors and service providers into most sectors. As demand weakens, there is naturally less work and sales to go around. Businesses are trying to cut prices to compete for less work. Many have built up significant cash reserves as opportunity funds. If demand remains weak or weakens in 2011, business owners say that they will be looking to further downsize their overhead.

A common theme from several business owners is their interest in finding a new business or service to diversify their current operations. Many are hoping to use cash in reserves to buy other businesses or income streams to augment their standard cash flow.

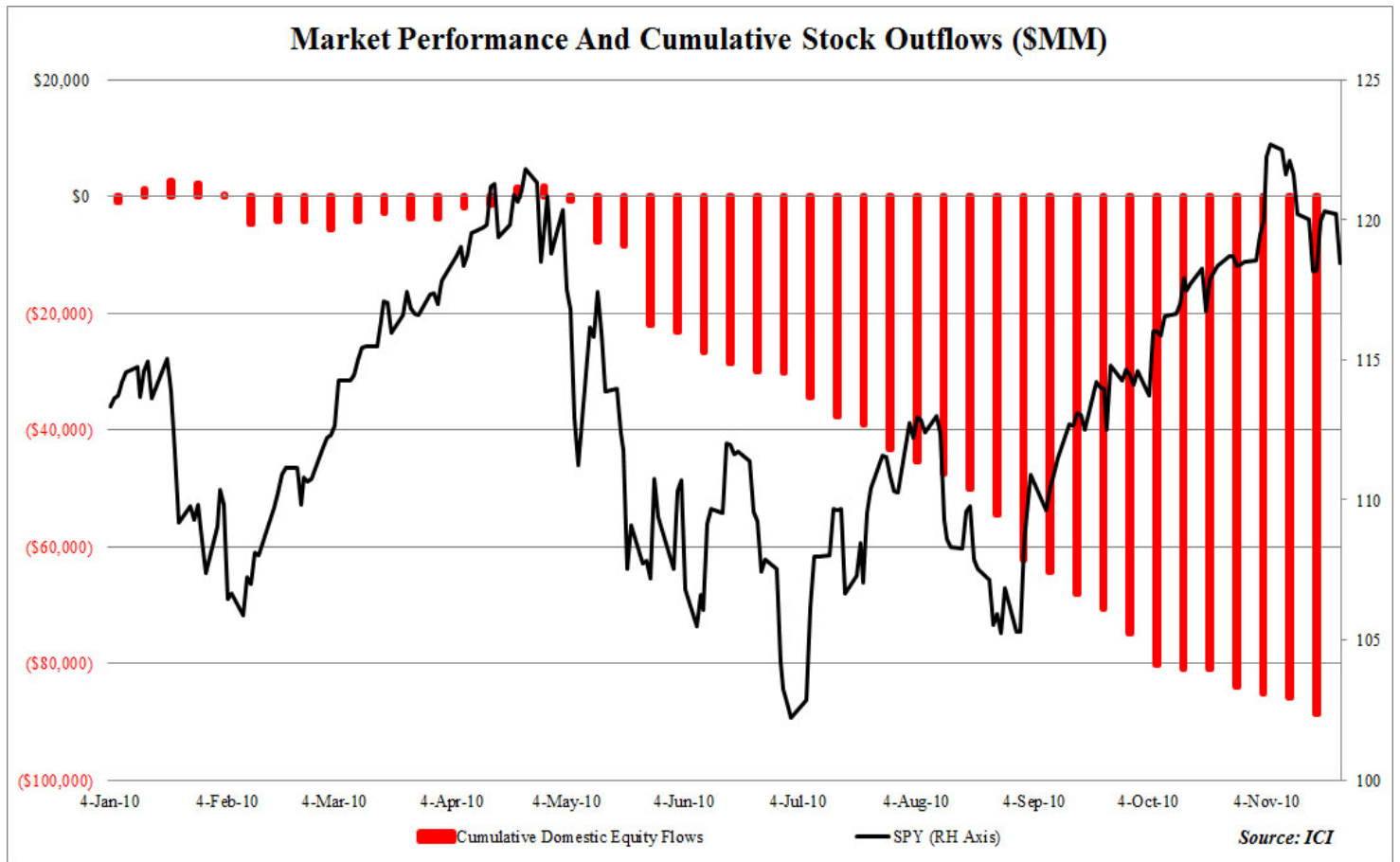
Frequently the search for extra cash flow is sending owners and investors into dangerous terrain today. Cash flow concerns make us more susceptible to pitches from those promising to get enhanced returns by funnelling our cash into stocks, mutual funds, real estate other business ventures. The trouble is that where valuations in these areas are already over-stretched buying is more likely to lead to losses than lasting gains. Losses make cash flow problems worse.

We are reminded of a former-client a couple of years ago who realized that their business was declining rapidly and told us that as a result they needed to get more aggressive with the way they were investing their savings. We assured them that people have a lower, not higher, risk appetite when their income is lower, and the answer was to focus on efficiency and managing their business for a slower-growth climate. They did not take our advice and transferred their cash reserves to a “high-growth” stock portfolio that had been recommended to them by a sales person in April 2007. We know how stressed they were feeling about money. The bear market that happened next was the last thing they needed.

3. Retail investors have been increasing cash for the past 29 months

After 11 years of a wild and crazy equity market ride, regular people continue to cash out. As shown in this next chart, retail investors have been bailing out of equity markets month after month for the past 29 months.

As shown in the black line in the next chart, even while the S&P 500 stock index has rebounded sharply since August this year, investors have been selling stocks month after month with increasing volume (red bars above).



Throughout price gains since August, market internals have continued to weaken. On several of the triple digit gain days this month, buying volume could be attributed to just a handful of stocks. Weak broad market buying was accentuated in the aftermath of the GM new issue as pointed out recently by trading experts Joe Saluzzi and Sal Arnuk, partners at Themis Trading. Both were featured last month in a 60 minutes episode on the dangers high frequency trading brings to public markets:

“On Thursday [Nov 18], General Motors (NYSE: GM), Citigroup (NYSE:C - News) and Ford (NYSE:F - News) accounted for 15 percent of the shares traded, according to Themis. This kind of concentration does not occur in a market operating under the basic economic function of supply meeting demand, they argue. How could 15 percent of actual investors want to buy or sell these three stocks in a single day?”

...Markets that are not built on fundamental demand from long term investors are subject to cracks like we saw on May 6th...when shocks like sovereign debt problems hit the market, the lack of real demand is exposed and a market which is not structurally sound can produce violent reactions.”

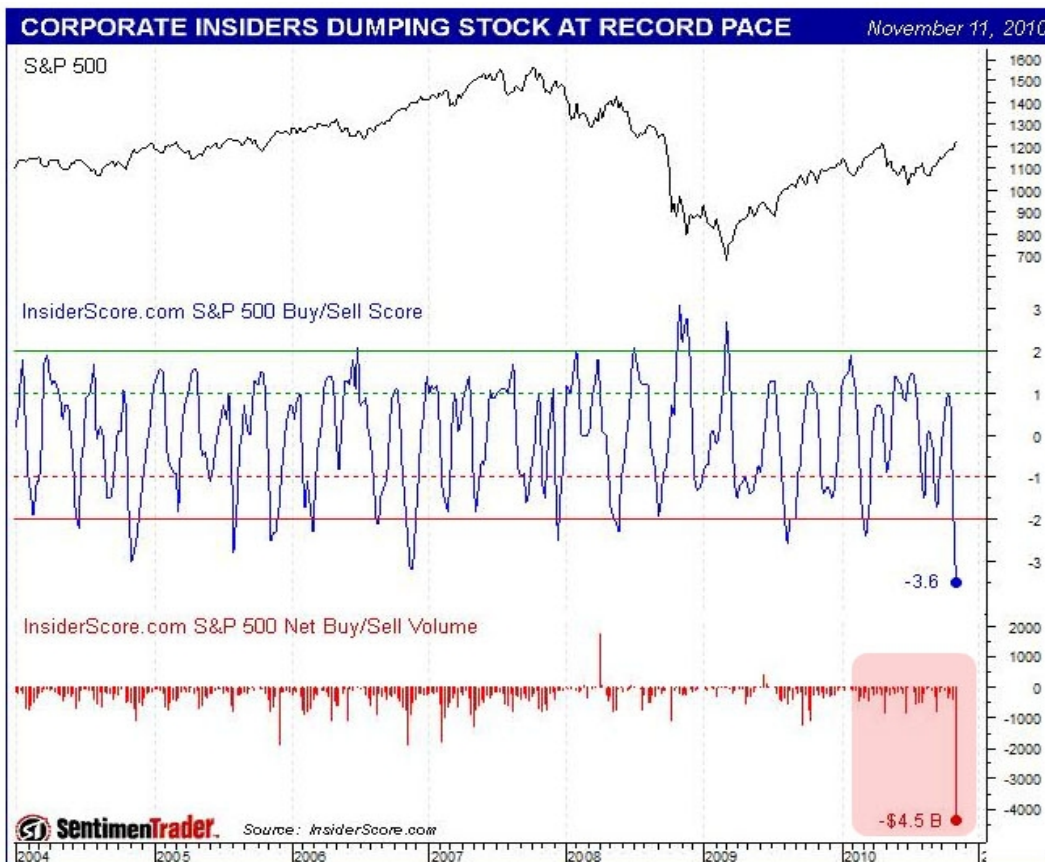
[See: Trading Expert: Market Vulnerable to another flash crash](#)

4. Corporate insiders have been selling hand over fist

Corporate insiders of publicly traded companies are privy to intimate information about the growth and profit prospects for their company and sector. Over the last six months, corporate insiders sold over 120 million shares, while they bought just 38,000 (per CNBC). They entered 3,177 times more sells than buys.

Last week, insider sales hit a fresh high when they sold 8,279 x as much stock as they bought. The chart below tells the story from a long-term perspective.

The top section of the chart shows the price of the S&P 500 index. The middle graph shows a "score" representing the ratio of insiders buying to selling; a high score indicates insider buying, and a low score means insiders are selling. The bottom graph shows net volume (\$ value of transactions, buys minus sales). From this chart one can see strong insider selling volume from late 2005 to late 2007 as the stock market peaked, as well as strong buying volume in late 2008 to early 2009 as the stock market bottomed.



The recent flight to cash by corporate insiders is a bearish indicator for the stock market and lines up with the preference for liquidity that we are seeing across other businesses and investors.

Politicians spent their political capital on banks the past 2 years--now they are spent

“So badly have banks played their hand in showing absolutely no contrition for their mistakes, nor displaying any willingness to share the pain they have inflicted on the rest of the economy, that they have made it impossible for politicians to cut them any slack.”

--Anthony Hilton, London Evening Standard

When the European debt crisis came to the world’s attention early in 2010, the offending nations reassured world markets with proposals of large budget cuts. “European austerity measures” became the phrase du jour. The Euro which had been falling in value for more than a year staged an abrupt about-face in September and began to recover. As shown in the chart below, we confirmed a buy on the Euro in early October as it broke out.



Although EU debt levels are alarming, it seemed that countries like Greece, Portugal and Ireland actually understood the gravity of their situation and unlike the US were prepared to make hard cuts to reign in runaway budgets. The trouble is that the new cuts were aimed at the real economy where unemployment was already at 30-year highs. As citizens face more hard times and less benefits, they grow increasingly inflamed by government-funded bail-outs of the banking system. Citizens suffer cuts, while banks declare garish record bonuses to their executives? The ‘proletariat’ are taking to the streets.

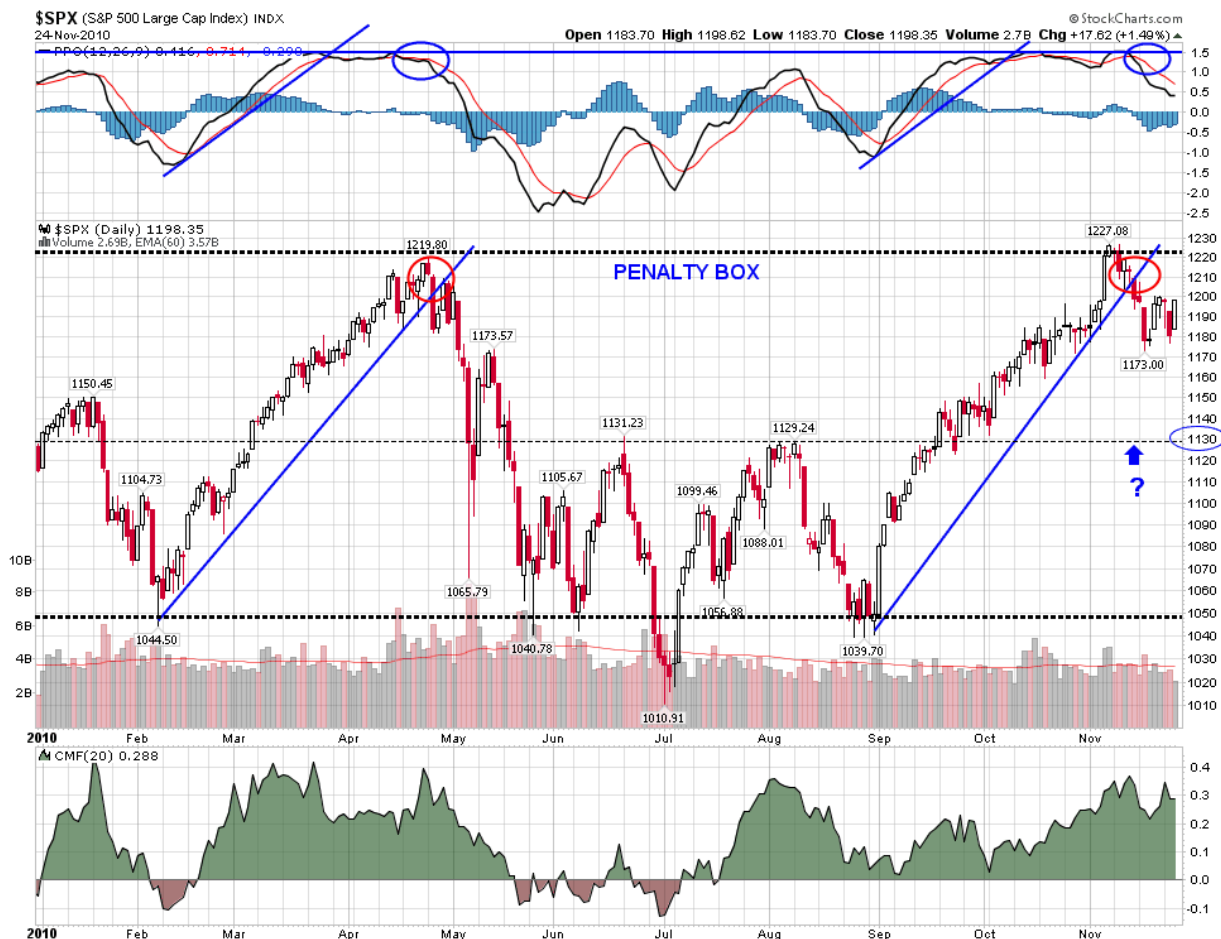
This month the Irish austerity plan is being cited by angry throngs as the cause of their current crisis (rather than its treatment) and the new government is likely to step down amid a call for new elections in 2011. The Euro is weakening on the news as what seemed like a painful but necessary course back to solvency a few months ago, is now once again in question. Our sell rules were triggered in November and we exited the Euro.

While the past 2 years have been all about governments rescuing banks, it is now governments who are in need of rescue. People around the globe are under pressure and increasingly mad as hell. No one likes tough times, but more than that, voters expect fiscal pain be more evenly distributed in a democracy. Bankers and bond holders should not be uniquely spared at the public expense. Governments are receiving votes of non-confidence as the debt crisis enters this next phase. Politicians are seeing that their capital—monetary and political—is increasingly limited.

As Winston Churchill once said, “America can always be counted on to do the right thing, after it has exhausted all other possibilities.” We suspect that this quote can be applied to politicians all over the western world as the next phase of global deleveraging enters 2011. Restoring financial health to families and countries is a multi-year project. The shock and awe of the early government bail-out efforts for a ‘fast fix’ to these issues are fading into a realization that there is more hard work ahead.

For now, perceived safe-havens--US dollar and bonds--are strengthening once more and we are holding both.

S&P 500 Index 2010: Has QE2 forged a double top for stocks?



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The above chart formation in the US S&P 500 stock index has been mirrored in a wide range of global stock and commodity markets this year. Global diversification has again been a non-starter, as risk asset correlations have virtually moved in concert. As the US dollar sold off January to April risk markets rallied. They repeated a similar move August to November as the US dollar weakened afresh on the promise of QE2.

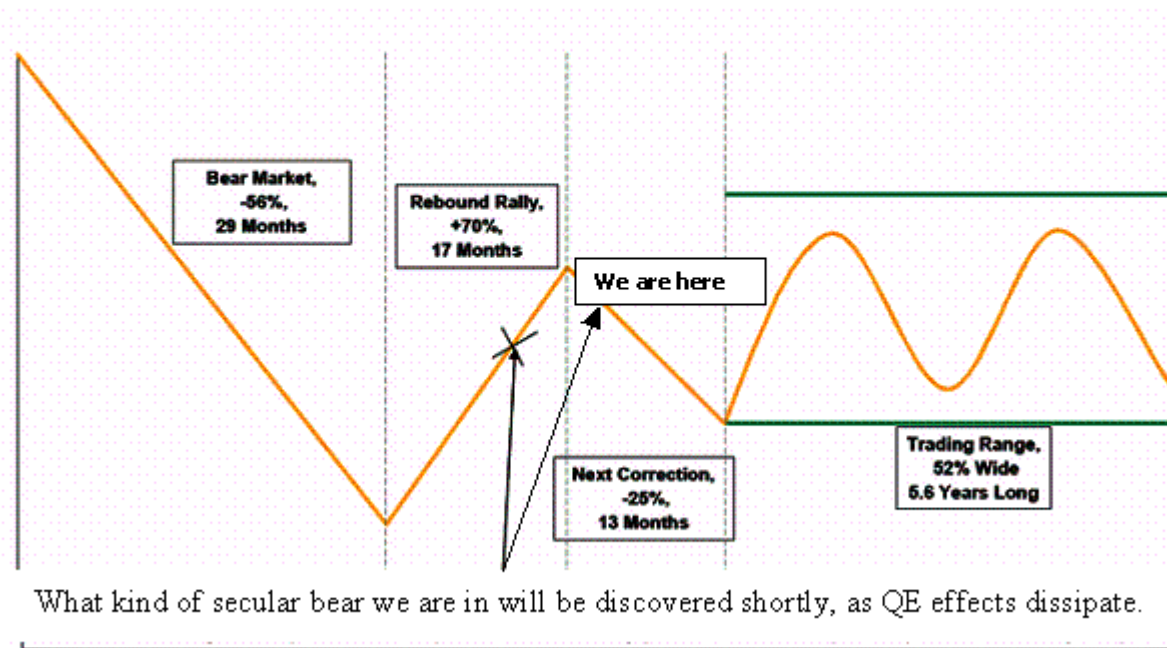
Over the past couple of weeks, the usual suspects are at it again: US dollar has rebounded on the re-emergence of global risk and world markets have rolled over with the US stocks (above). Having failed now twice at the April and then November resistance, if the market cannot rally from present levels it is on its way to another downside test. The question is: will the stock market be able to hold at the next downside test (1050 on the S&P) or will the next correction prove more severe? The downside risks of - 20%+ are significant from here. So, we are not crazy to have some cash set strategically aside here and especially since we have a plan for exactly when and where to use it.

The plan —yes we have a plan!

Our readers will know by now, that we suspect we have perhaps another 7 years to go before world markets complete this secular bear that began in 2000. That does not mean however, that we expect to sit with 47% cash for the next 7 years. The strategy is to buy high quality assets at a reasonable price and collect good income while the over-levered world pays down its debt and builds up its savings. From our perspective, **the trouble today is not that the economy continues in a slow growth phase for the next few years; the trouble is that government rescue efforts have forced most asset prices above reasonable valuations.** Equity investments are presently priced 20 to 30% above fair value. If we buy or hold them here, even if they are excellent companies, we face a high probability of capital loss. As we have said many times, being paid a 5-6% dividend is little consolation if our capital drops 20%+ while collecting the income.

The other key point in a deflationary environment is that when asset prices do finally correct, those with cash will be ideally positioned to buy more for less. This is the golden lining to asset deflation: assets we own drop in value, but so do the assets we are waiting to buy. Having cash at the ready is the only way to take advantage of the opportunities this presents. The next chart (we have shown before) captures the market behaviour typical in previous secular bear periods and aligns so far with what we have seen in this cycle to date since the stock market topped in October 2007. After a roughly 56% drop to March 2009 and a 70% rally into 2010, we now wait on alert from the next interim correction likely in the weeks or months ahead.

Typical Secular Bear Market and Its Aftermath



We may in fact be in the midst of the “next correction” phase as we write. Once this phase completes, we will be able to deploy our cash with a reasonable margin of capital safety, adding quality, income-bearing, growth assets at a reasonable price that will pay us to row successfully through the next few years.

Best wishes for December, where did this year go??

Quotes of the Month:

"Either you deal with what is the reality, or you can be sure that the reality is going to deal with you."

-Alex Haley (1921-1992), author of *Roots: The Saga of an American Family* and the co-author of *The Autobiography of Malcolm X*

“To lead a symphony, one must sometimes turn his back on the crowd.”

-Dr. Earl Reum, educator, writer, speaker

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