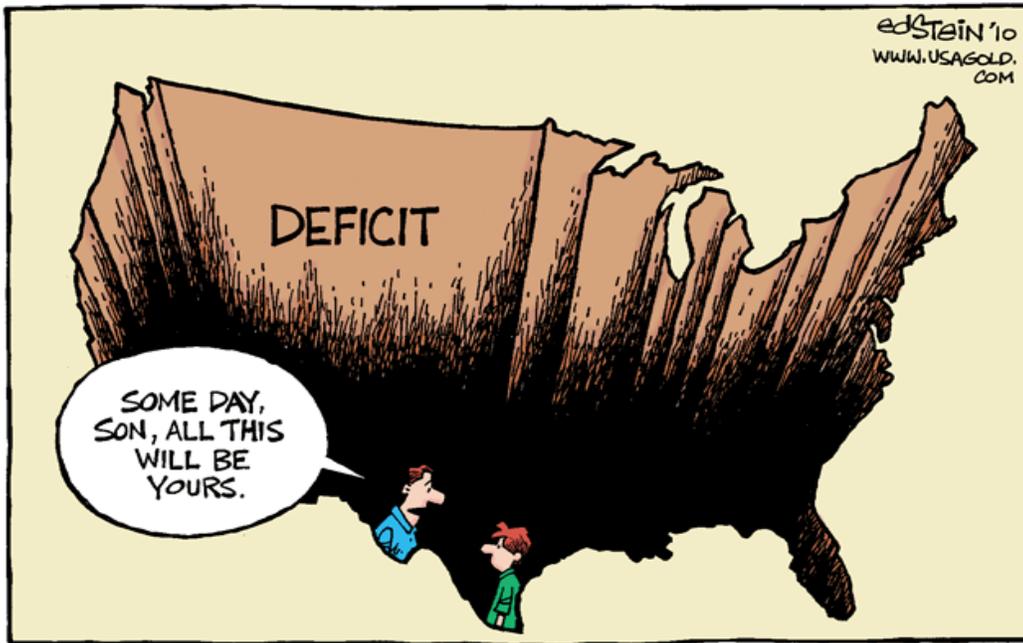


E.Q Trendwatch™

The presumption of prosperity



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It is well known that there were some 450 million people worldwide born in developed nations after the Second World War between 1946 and 1964. The “Baby Boomers,” have been at the leading edge of world demand for consumer goods, services and financial products for the past six decades.

Less understood, it seems, is what the boomers are up to now. The youngest turn 47 this year, the leading edge is 65. As usual, their progression is changing some key dynamics in the world. Life cycle studies show that for a typical western consumer, personal expenditure spending peaks at age 47 and declines steadily from there. By age 47 most people have already acquired their education, a home and personal effects. Apart from post-secondary funding for their children, most have the bulk of child-rearing expenses largely behind them.

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Between the ages of 47 and 60 the average worker comes into their peak earning and saving years. By their early 60's Boomers had expected to enter retirement with a house paid for, pension income, personal savings and an average life expectancy of 82.

But a strange thing happened on the way to retirement: Boomers took the wheel



Born 1946

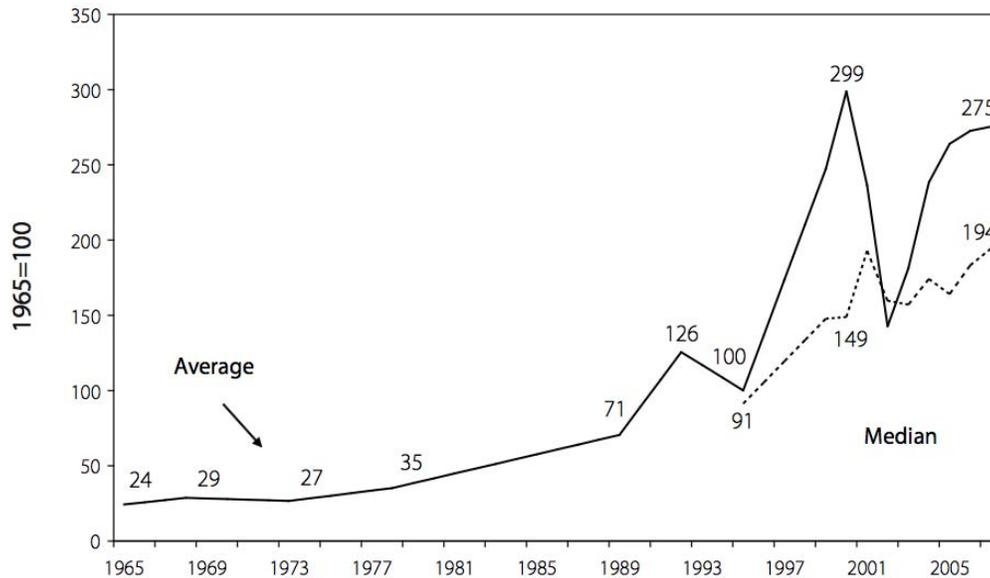
Born 1946

Born 1953

As a generation, it must be said, Boomers lacked wisdom. Theirs was the classic error of optimism: they took prosperity as a given. With the leading edge entering their 40's in the early 1990's, Boomers began moving into influential positions across all levels of government, business, policy and finance. They had higher education. Most meant well. What they lacked was real life experience with hard times. Unlike their parents who had lived through four rough-scrabble decades from the turn of the century, the Boomers were born into an era of relative ease and for the bulk of their adult years experienced easing conditions: falling inflation, falling interest rates, falling taxation, technological innovation and increasing productivity.

Their parents learned lessons the hard way in the 1920's, '30's and '40's. The older generation had penned rules of restraint and control on finance and banking born of their first-hand-experience in two world wars, pandemics, financial panics and a worldwide depression. The rules they enacted helped to contain animal spirits for almost 60 years. But the Boomers saw old rules as old fashioned. They did not see the need for antiquated regulations in modern times. Throughout the 1990's, the Boomers systematically repealed and reduced rules controlling leverage, accounting, banking, conflicts of interest, lobbyists and special interest groups.

At the helm of public companies, Boomers (dubbed the "ME" generation) paid themselves remarkably well. CEO compensation that had averaged about 30 times the average worker's pay from the 60's through the 80's soared to nearly 300 times the average worker's pay by the year 2000. (See next chart)

FIGURE 3AE Ratio of average and median CEO total direct compensation to average worker pay, 1965-2007

Source: Authors' analysis of *Wall Street Journal*/Mercer, Hay Group (2008).

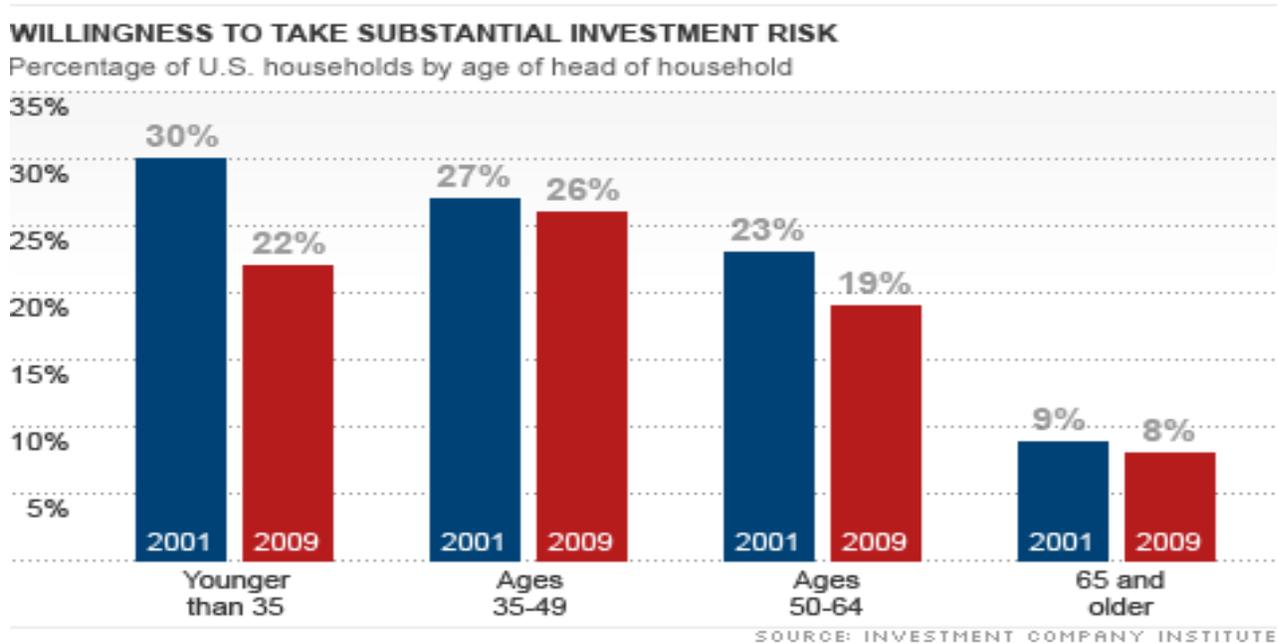
Baby Boomers didn't worry so much about what could go wrong. Their focus was more on the upside. As interest rates began falling they spent more and took on debt. They embraced leverage like a magic potion, because it could magnify shrinking capital into larger profits. They stopped saving much for rainy days. They lowered tax rates and slowed reinvestment in infrastructure, education, competitiveness and people. They started betting on stocks and real estate rather than careful deposits to build nest eggs. They shopped 'til they dropped and led their children to do the same. They stopped funding pension plans at prudent levels. They assumed unrealistic, aggressive return expectations of 8%+ in their retirement accounts (almost twice the historic average) so that they could save less for the future and spend more today.

It has been wisely said that people go mad in herds, but recover their senses slowly, one by one.

We seem to be in the early stages of this process now. Boomers are growing older, and are having wisdom thrust upon them. Although some politicians and central bankers appear still in denial, many regular men and women appear to be catching on. Retail investors have been pulling their savings out of the stock market for the past two years. Even with a whippy stock rally in the latter part of 2009, cash redemptions from stock funds have continued month after month throughout. People are working to pay down their debt and build up their savings the old fashioned way by increasing deposits and playing it safe.

The most popular refinancing in 2010 have been “money-in” mortgages, where people pay down the principle with cash rather than the “money-out” refinancing so prevalent the decade before.

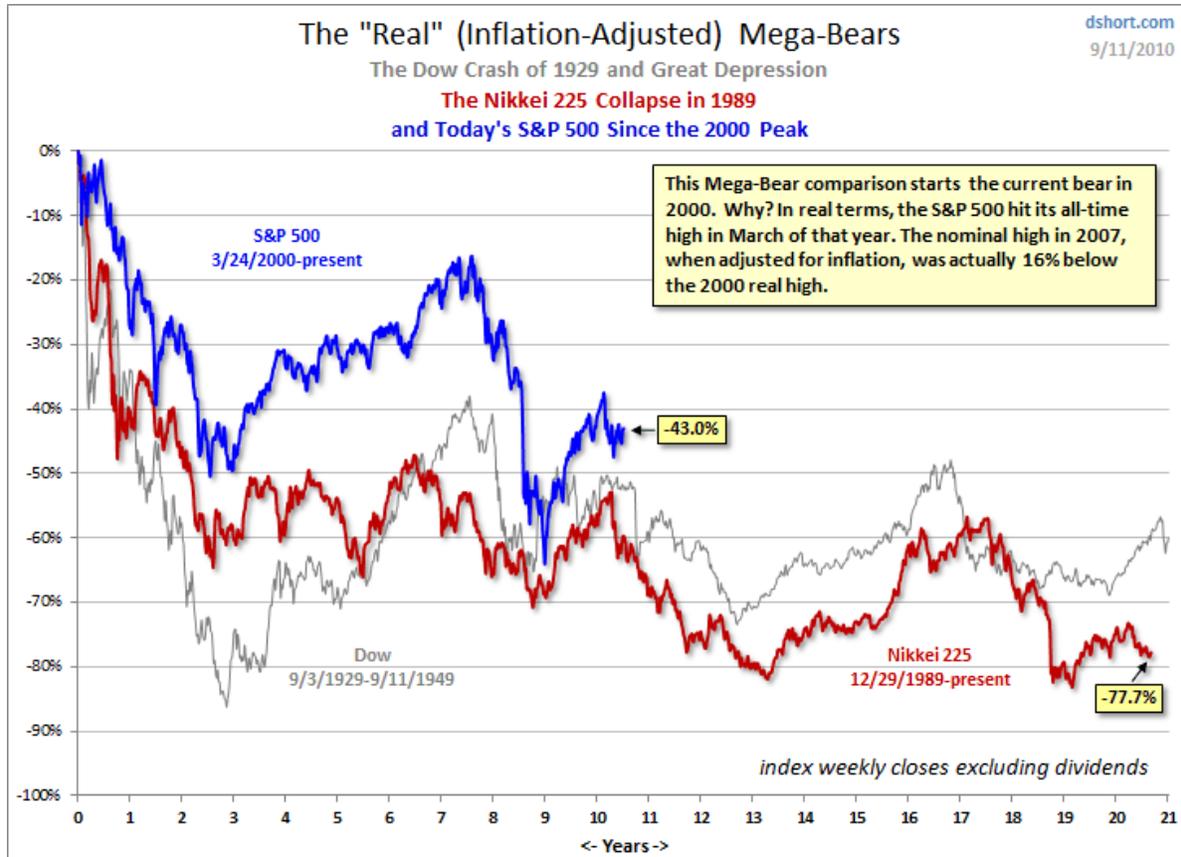
It’s not just that people are realizing they are poorer than they thought. The population is getting older. Feeling less risk tolerant is a rational response to less time ahead. As shown in this next chart, willingness to take “investment risk” with one’s capital naturally diminishes with age. This is especially the case today in an era where stock markets have been brutal for 11 years.



History suggests that as in the last decade, over the next few years, taking only carefully measured market risk is likely to be rewarding. Asset markets typically take a period of 15-20 years to move from times of grave over-valuation to times of eventual under-valuation. Almost 11 years into this secular bear, and after losing more than 50% of their value twice, stocks today are still historically over-valued.

The next chart plots the price path of the S&P 500 Index (blue) since the year 2000 and compares it with the price behaviour of two other secular bears: the Dow 1929-1949 (grey) and the Japanese Nikki market from 1989 to present (red):

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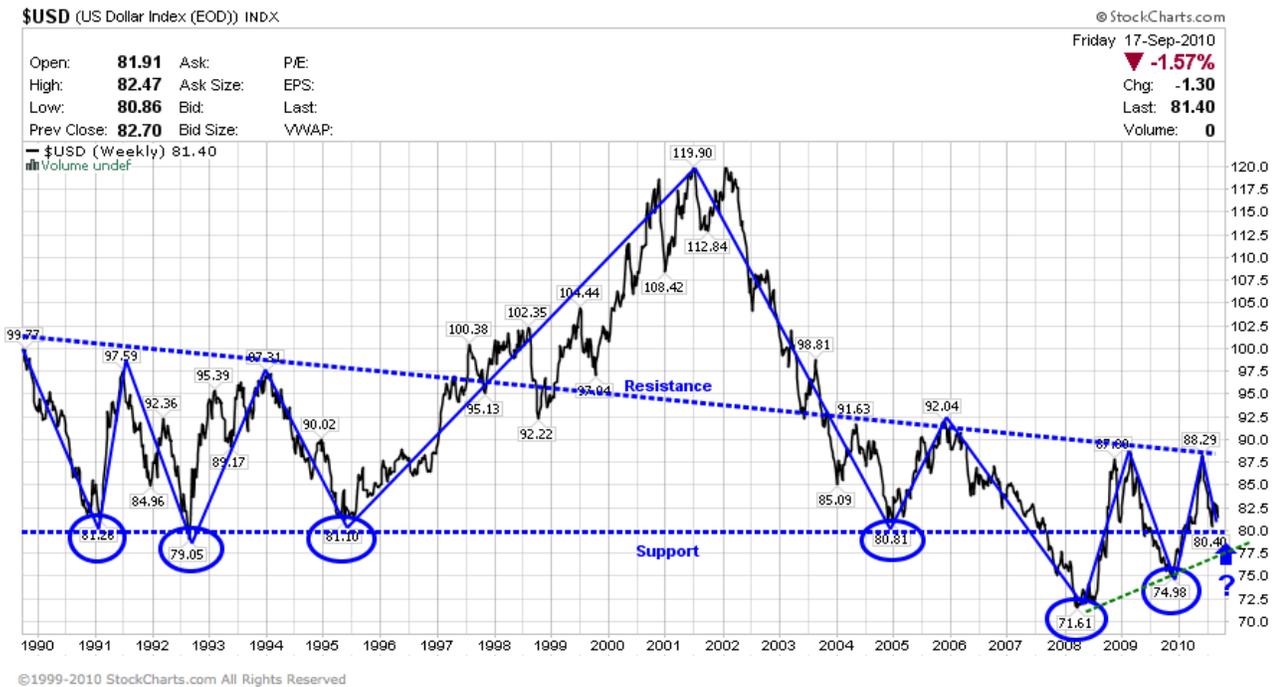


If history is a guide, we may be half way through the price declines needed before we will enjoy the start of the next secular bull for stocks. The next bull will come to us in its own time. Not when investors or politicians would like to dictate.

None of this is to suggest that there are not still some good opportunities today.

We just have to look for them with greater care, skill and thought. We need to use our own expertise and personal experience to find worthwhile options. We cannot afford to buy the ideas of others. This is no time to be blindly following the deluded. The focus today must be on rebuilding buffers. We will rebuild equity and wealth in our companies, families and countries through diligent work, innovation, savings and investment in things and people that are worthy.

The US dollar Index is back testing support again



The US dollar lost some ground against a basket of world currencies this month as risk appetite rebounded and capital moved to seek out higher yielding currencies. The Canadian dollar however did not strengthen against the US\$, as data showed our economy noticeably weakening alongside our biggest trading partner to the south. The question now is whether the US\$ index will rebound again here at long-term support around 79 where it has bounced many times in the past 20 years. (lower dotted line in the chart above.) We suspect that this will depend largely on whether the next inning of the credit crisis resurfaces first in the deficits of US banks and State governments or the Sovereign debts and banks of Europe, Japan and the UK. All of these issues are on our radar heading into 2011.

Stock prices gave a low volume cheer when NBER (National Bureau of Economic Research) declared the last US recession ended in July 2009. However serious money remained uncommitted. Some 70% of stock market volumes during the month of September could be attributed to high-frequency day trading rather than institutions investing. Even at that, trading volumes over the past few months have been so low that many financial institutions are now reporting revenue declines estimated to prompt some 80,000 staff cuts in the US alone by year end.

North American central bankers have been signalling the idea of more QE (“Quantitative easing”) ahead to inject more government-funded liquidity into the banking system. The trouble is that they did this already with trillions of dollars in 2009/10 and still the global economy remains anaemic facing uncomfortably high odds of a renewed recession in the months ahead. Banks have been stockpiling cash on their own balance sheets. But the cash has not made its way into real investment in the economy. Until businesses see a pick up in real demand, and better valuations in investment assets, they are likely to continue sitting on their cash.

Over coming months as the economy slows, governments are likely to announce more emergency measures. This would mean more deficit spending from money they do not have. This means growing national debt and more currency weakness for most countries. Government liquidity may also pool into more feeble rallies in stock and commodity markets. But the next quick fix is likely to prove as short and fleeting as the last. The question is not whether governments can jump start more low volume speculation in asset markets, the question is how long it will take to get the global engine running on its own fuel again and away from its dependence on credit abuse and government injections. That verdict on this still lies ahead.

Gold seems to be voting against central bankers

This month gold, in US dollars, broke out to a fresh high in its parabolic run since the sell off in 2008. At present levels bullion is looking very, very over-bought. At \$1300 bullion could correct down to the \$700 range without even violating its long term up trend. Indeed this is precisely what it did do in the global sell off in 2008. (Gold is a hedge we are told, but with a hedge like that who needs risk?) Gold bulls tend to be perma-bulls and tell us not worry about “pull-backs” as gold is going to the moon. But the risk of big, fast drops do worry us, indeed they do. This is especially true when price is trading at astronomical multiples of any actual demand for the commodity. It pays no income, it has no business model. It has no heart - just tons of price risk and lots of hope. More the opposite of hope really: as we have said before, hoping that gold goes to the moon is the same as hoping that the real economy goes into a depression. We are admittedly not keen to place significant bets there.

That said, unlike bullion, major gold companies do have a business model, and they do pay some dividends. Presently their shares are testing the overhead resistance they have been consolidating under for almost three years. As shown in the following chart of the gold company sector (XGD), if price can finally get through the \$25.25 level on a weekly close, with sufficient volume, we would be willing to add a sector weighting to our accounts. We have made money on this holding a couple of times over the years and perhaps we will soon have an opportunity to do so again.

Can gold companies finally break out on a new cyclical run at last?



Overall, lots of risk and little progress

After a quick bounce this month, equity and commodity markets close September looking very stretched and tired. It is worth remembering that this September bounce followed the worst August performance for stocks since 1934. All things considered, 9 months through 2010, stock markets have produced lots of noise, lots of volatility, no real gains and no clear trend. Next we enter October a month that is infamous for volatile moves. Stay tuned.

Bonds are so far still supported by in flows

We are always watching for a change in this trend, but so far global capital inflows are still choosing the relative stability and income of bonds over stocks. As stock markets rebounded in September, bond prices actually held firm with yields maintaining their plodding downward trend.

Bond prices still holding



As the chart above of the US 10-year Treasury Yield shows, we are still some .40% above the bond yield bottom seen in the financial panic of 2008 of 2.04%. It seems that we may well head there again in the weeks ahead as disappointing economic news continues to mount. Hopes for a “V” shaped recovery in the economy have now been officially quashed. Analyst attention must now move to a re-assessment of their over-zealous growth estimates for 2011.

World wealth in perspective

Lastly in a world where there can appear to be endless amounts of money moving around the planet, we think it is always interesting to look at the annual big picture data. According to the Capgemini World Wealth Report 2010, in a global population of just over 6.8 billion there were:

- 1010 people with more than 1 billion US dollars
- 10 million people with more than 1million in equity outside their home (56% live in America)
- 90,000 people with more than 30 million in equity outside their home

In terms of spending power (shown in the chart below), it is also interesting to note that the median household income is comparatively very modest: \$33,000-\$45,000 in the western world and less than \$10,000 a year in developing nations like Brazil, China and India. It is little wonder emerging economies look to the West to buy the bulk of their goods.

Median household income (\$) per capita in PPP terms

US	45,600	
Canada	35,800	<u>SPENDERS</u>
UK	35,100	
Japan	33,600	vs.
Brazil	9,570	<u>SAVERS</u>
China	5,380	
India	2,750	

Source: United Nations Development Programme, 2009 Human Development Reports

Such comparisons make us realize how much we take for granted in our part of the world.

Best wishes for a happy autumn!

Quotes of the Month:

“Of all parts of wisdom, the practice is the best.”

--John Tillotson, 1630-1694, Archbishop of Canterbury

"Setting an example is not the main means of influencing another, it is the only means."

--Albert Einstein, 1879-1955, Physicist

"Even a mistake may turn out to be the one thing necessary to a worthwhile achievement."

--Henry Ford (1863-1947), Industrialist

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