Real life needs active management MARCH 31 , 2009. ISSUE 3

E.Q Trendwatch™

Markets hit a 12-year low and bounce

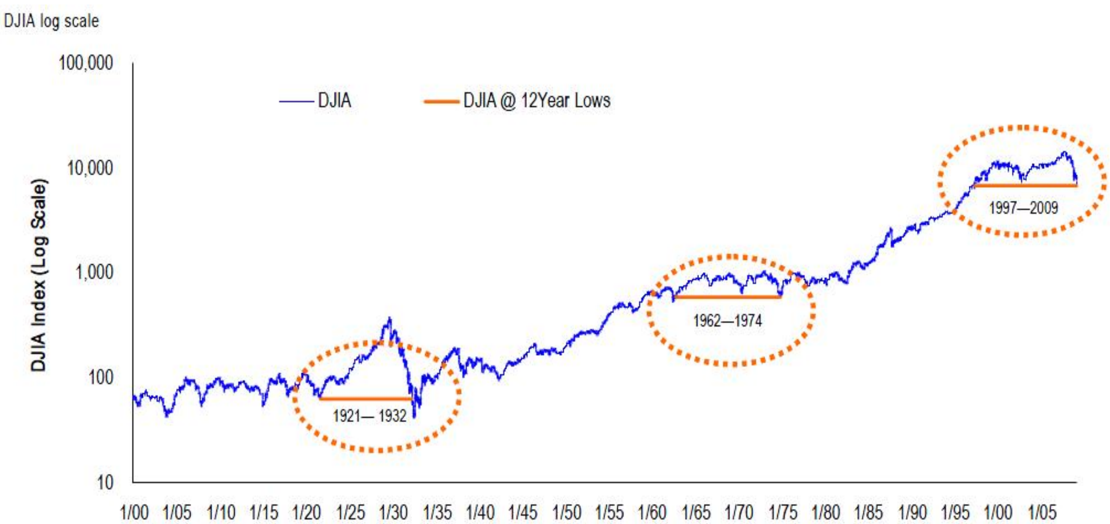
Cory Venable CIM, FCSI, CMT
Technical Market Analyst

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

Venable Park Investment Counsel Inc.

This month many world stock markets including the US Dow and the S&P 500 hit fresh lows on March 9. The new lows brought prices back to levels last seen in 1997, some 12 years ago. When we look at market data over the past 109 years, we can see that price retracement to 12-year lows has only happened twice before: 1932 and 1974, and both previous occasions marked the start of a lengthy market recovery.

12 year price lows in the stock market have been rare



Source: JP Morgan

Whether 2009 will follow historical precedent in this sense is yet to be seen, but to month end indices managed a significant rally of more than 13% for both the S&P and the TSX. Year to date the TSX is now down just over 3% and the S&P is down just over 11%. Off the bottom on March 9, this month's rally was the biggest we have seen since this bear market began in November 2007.

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

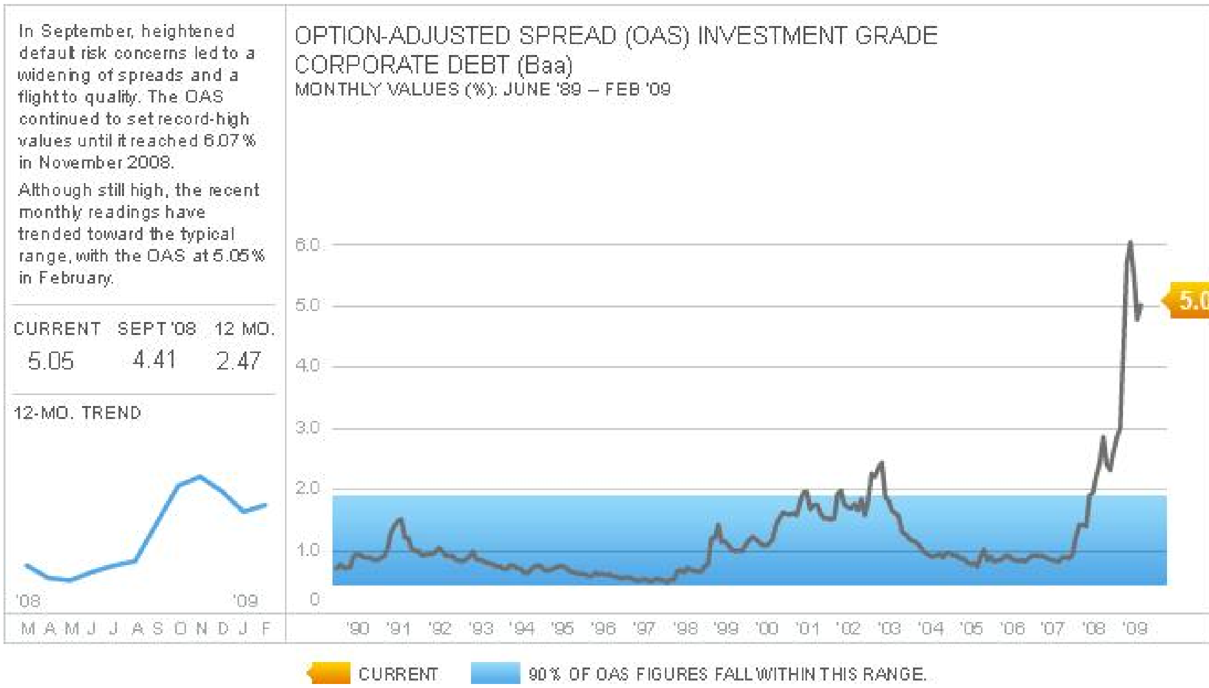
Perhaps magnitude is enough but not time?

Market bottoms are a process. They take time to form. In the last market cycle, the bottoming phase from June 2002 to April 2003 took 9 months to complete. This cycle markets have so far been seeking a bottom for about half that long or just over 5 months. This is one of the reasons we think that more time may be needed yet before the next cyclical bull is here to stay.

That said, it is also possible that March 9 level will prove the ultimate low this cycle even if it is retested again in the next few months. We note that the New York Stock Exchange registered its November 20 low with the incredible participation of more than 1300 stocks at 52 week lows. While March 9 saw prices at lower levels than November, the number of NYSE stocks making new lows in March was just over 400. If the level of new lows continues to decline this would be constructive. If the level of new lows begins to balloon again on a future re-test, we would take this as a sign of further downside risk.

Corporate bonds

We recently registered a buy on corporate bonds and began adding this sector as a portion of the Canadian fixed income holdings in our accounts. Over the past year, credit default fears have pummelled corporate bond prices to historically low prices. The typical yield on corporate bonds over government grade bonds since 1990 has been less than 2.5%. By November 2008, this spread had gapped out to an incredible 6.07% as shown in the chart below.



Over the past couple of months, corporate bond prices had stabilized and the yield spread has begun to come down again. As risk appetite resumes in the world, this spread will normalize further as corporate bond prices begin to rise. Eventually this will afford recent corporate bond buyers capital gains on top of attractive income yields.

US Dollar update

Over the past couple of months, as the Obama administration unveils historic stimulus spending, there has been renewed concern about a resumption of weakness in the US dollar. So far however, the US dollar up trend remains in tact (see $USD chart next page). We suspect this is in recognition of the fact that most other countries in the world are presently in worse economic condition than the United States. It seems that fear has gone global. Currency assessments are relative and so far at least, risk aversion has kept global deposits stored in the green back. As global fear dissipates (eventually), it is likely that US T-bill deposits will work their way back toward equities.

How now gold?

If this trend continues to support the green back it will make it very difficult for gold to break a new high through $1,000 an ounce. Futures are currently pricing gold at $918 an ounce one year from now, about the same price as it is today. As shown in the chart below, if gold fails to gain price momentum from here, the downside test remains the $650-700 an ounce range.

"Making back losses" and other desperate thinking.

Psychological damage from the economic downturn has been epidemic among professionals and laypeople alike. Demand for anxiety medication is up. Many now suffer post-traumatic-stress-like symptoms and rather than objectively hunting for attractive investment opportunities, a large number of financial professionals are now engrossed daily in fending off lawsuits, rethinking their careers, re-visiting an interest in God, religion and the meaning of life. This is typical of what happens to investor sentiment after lengthy bear markets. The consistency of our behaviour and thinking is what makes it a useful contrarian indicator.

None of this is new. It is classically human. Recently we have noticed that those who lost heavily in this bear market are uttering a common refrain: "How can I get my losses back?"

A desire to make back one's losses is understandable. But investing with this motivation is inherently dangerous; more likely to compound rather than recoup losses going forward. There is desperation in this thinking. Desperation is the arch enemy of reasoned and objective investment policy. Investment strategy must be designed with a responsible risk exposure for a given person, account, and market environment. We cannot force markets to give us what we demand. The first step is to acknowledge past mistakes; the behaviour and strategies that took one down the wrong path.

Next we must understand that once financial bubbles burst, it is typical that price peaks in effected areas do not return for years, decades, or sometimes longer.

Today we are cleaning up the after-mess of coincident financial bubbles which ballooned and burst across the world from real estate to credit, corporate bonds to equities, commodities to currencies, antiques to collectors' art.

Few things in the world escaped over-inflation caused by the 2004-2007 spending spree. Those who are now hoping for a quick re-inflation of consumer spending and prices to bubble-levels are sorely missing the lessons of history. A study of the semi-conductor sector over the past 10 years is instructive.

Did the world stop using semi-conductors in 2000?

World demand for semi-conductors did not end in 2000. It has been growing ever since. A recent KPMG report estimates that global semi-conductor sales will reach $260 billion in 2009 up from $213 billion in 2004. Although very cyclical, the 20-year average annual growth rate for this sector has been 13%. Yet the aftermath of the 2000 tech bubble was not kind to semi-conductor investors. After a bubble peak of $105 a share in 2000, the semi-conductor index (SMH) deflated more than 80% into late 2002. It recovered 130% from 2002-2004 (see box in SMH chart above) and then dropped 57% to $15 a share in the bear market of 2008.

From present levels it is probable that this index could climb back to the $35 area again in the next cyclical expansion. Returns of 130% are excellent over a 4-5 year market cycle--but only if we buy low and then sell again to capture the gains. For those who held and did not sell near the peaks of 2000 and 2007, reclaiming $35 a few years from now, will amount to negative real returns for years of heart-thumping holding in this “growth” sector. Charts of copper and oil suggest similar stories about the recovery prospects for many commodity prices from here.

"Dr" Copper—bubble peak was $4.00

Starting from .67 cents a pound in 2002, copper rocketed to an incredible $4.00 a pound in the speculative bubble of 2006-2008 before collapsing 69% to $1.25 in 2008. Even in a muted economic recovery, on-going demand for copper is likely to see some growth. A price gain of 100% to $2.50 a pound would be within reason over the coming expansion, and yet will be of little comfort to those hoping for a move back to bubble prices.

Pegging our hopes to past bubble peaks is most likely to cause further frustration and financial pain. It will also make us more susceptible to over-holding risk assets again in the next expansion. Even if asset prices succeed in making very respectable gains over the next few years (and we think its likely) those trying to reclaim bubble levels are likely to be impatient, desperately aggressive and emotionally geared to suffer heavily again in the next cyclical bear.

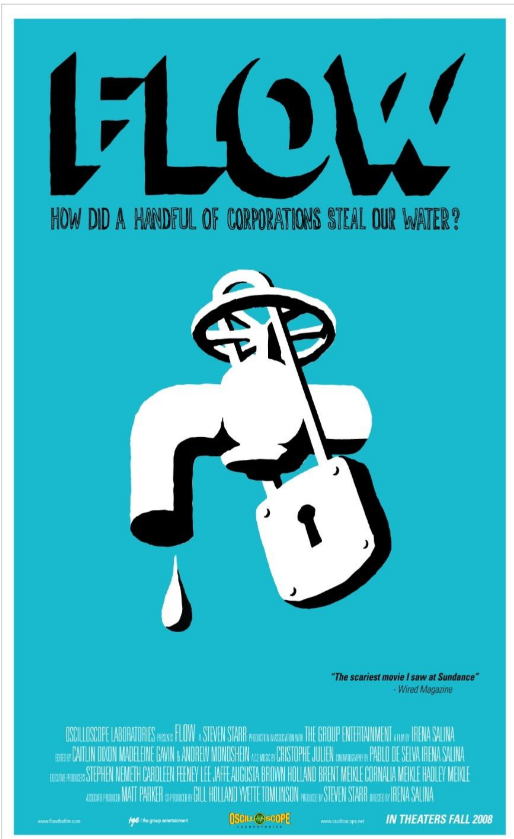
Oil—bubble peak was $147

Oil demand has softened significantly over the past year, but at this point at least, the world is still reliant on oil. From the bubble peak of $147 a barrel WTIC contracted to $35 a barrel or 76%. It is possible that the next cyclical expansion could take oil prices back to the $60-$80 a barrel range. This would be a strong appreciation from present levels. Those hoping for the bubble peak to return however, may be waiting a long time.

The passion for domestic, greener power is gaining momentum. The alternative energy genie is not likely to slip back into the bottle any time soon. Finding alternatives to foreign oil has become the first stated goal of the Obama administration. While some find time for endless debate about theories of climate change, we find this to be the pastime of navel-gazers and tire-kickers. Whatever one's beliefs on global warming, there can be no credible argument for continuing to send billions of Western dollars into the coffers of foreign oil producers when there are countless more efficient domestic technologies (and jobs) available for development at home. Couple this with the recent urge to keep US spending in the US and we believe we have a seismic shift in American energy policy.

While oil has been the dominant global theme of the past 100 years, it seems obvious that cleaner energy and clean water management will increasingly become the dominant themes of our century and beyond. There are many substitutes we can develop for oil. There are none for water. Anyone who disagrees that water is more valuable than oil should be invited to take the age old taste test and drink a nice big glass of each!

So far our Canadian government seems hopelessly myopic on this key issue, stubbornly promoting excavation projects like the tar sands that consume three barrels of water for each barrel of oil produced. Eventually the madness of such propositions will be proclaimed in the main.



For those that have not yet seen the new water documentary "Flow," we recommend a look. (Blockbusters has it)

The film is sweeping cinematic awards around the world and helping to mobilize world attention on the issue of stainable water management.

Annual Reviews

Anyone that would like an annual review appointment in person or over the phone, please contact us to arrange a time.

Quote of the month: ***"There is never a better measure of what a person is than what he does when he is absolutely free to chose."***

—William M. Bulger, American educator and Senator

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