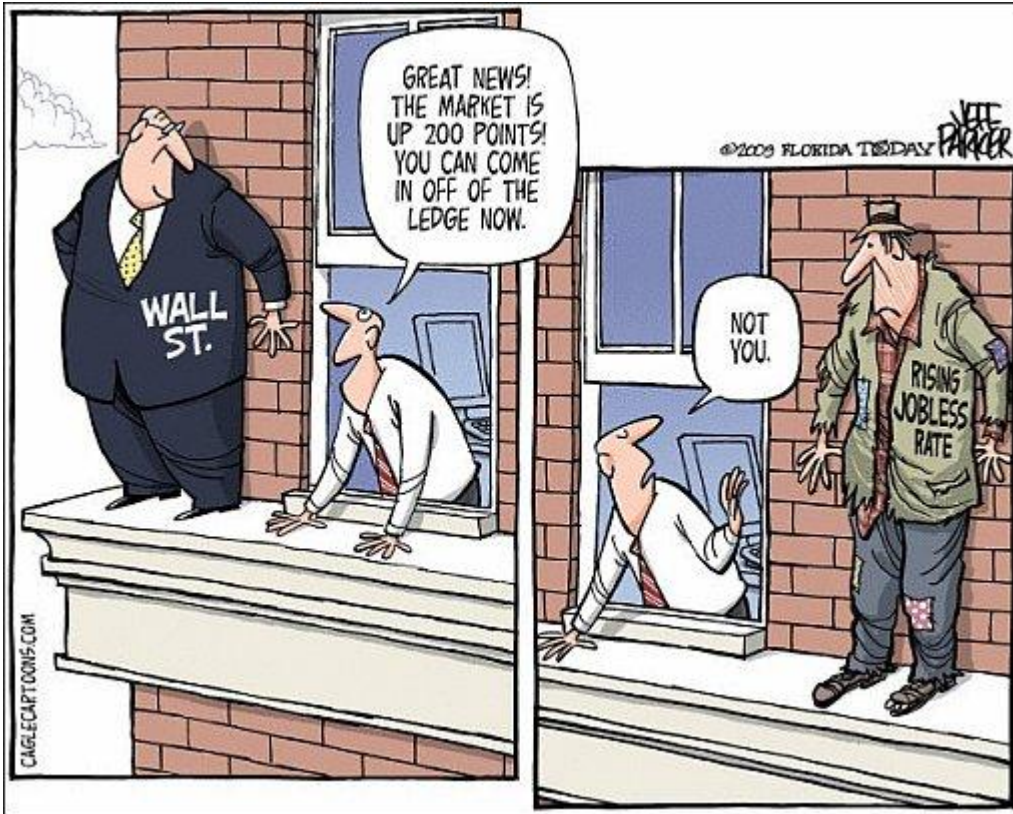


E.Q Trendwatch™

The fine art of bungee jumping



Source: Jeff Parker, Comics.com, November 11, 2009.

Throughout the 1990s, policy-makers and economists following Japan were confounded. The economy went through a decade of stagnant growth, but every so often the data would show modest signs of improvement. Desperate to declare a recovery, investors would pile into Japanese equities triggering a stock-market rally. The rally gave economists the confidence to revise up their economic forecasts for future growth. The upward revisions spurred optimism and an even bigger rally. Then came a shocking reality: the Japanese economy wasn't really



Cory Venable CIM, FCSI, CMT
Technical Market Analyst



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

**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

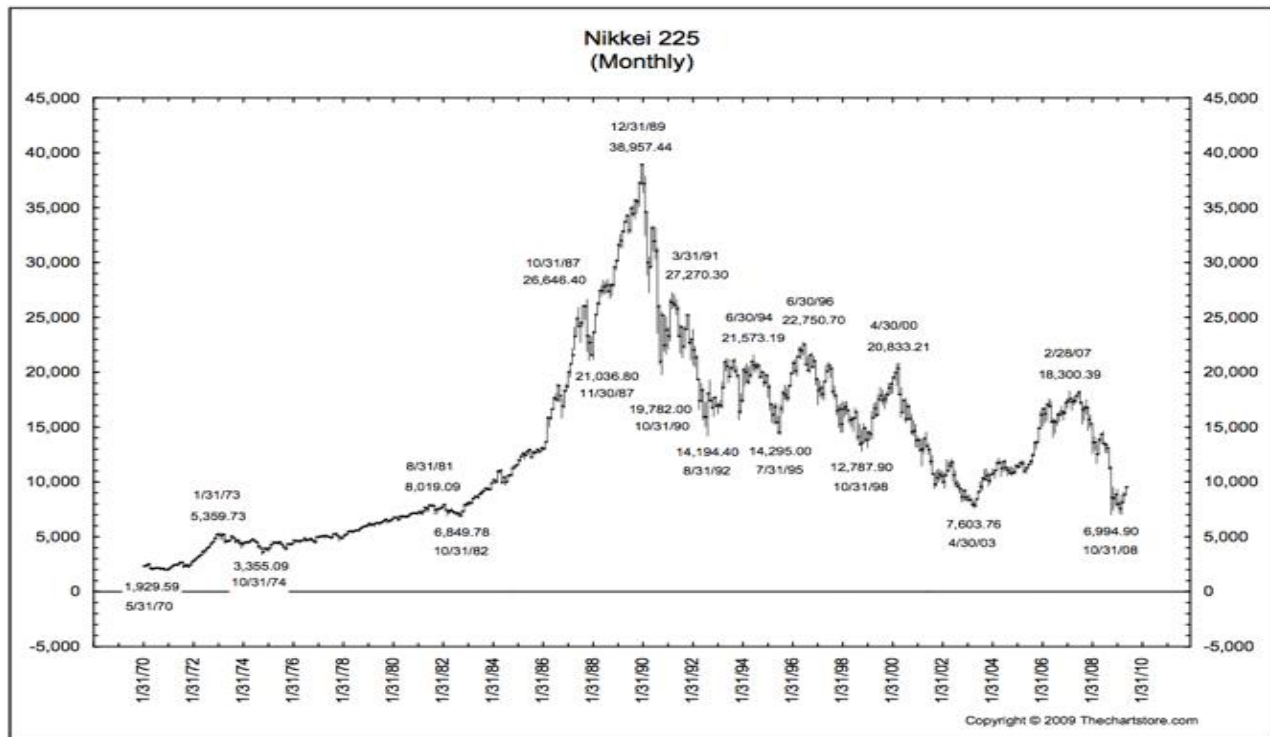
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recovering at all. It was an economy tethered to a bungee cord where occasional signs of rebound were always followed by an inevitable down-draft:

"It was a great mistake to assume that financial markets provided an accurate forecast of future economic developments. As it turned out, the best they could do was to offer an occasional bout of wishful thinking..." –Stephen King, Nov 16, 2009

Some of the key factors leading up to the lost decade in Japan are similar factors to those leading up to the global credit boom and bust of the past 7 years. In Japan, easy credit led to credit abuse in the 1980's, which led to reckless risk-taking and asset bubbles in real estate and equities. Then the bubble burst. Commercial real estate values in Japan declined 80% from the peak. The Nikkei stock index fell more than 80% in a series of rebounds and down-legs taking it from 38,000 in Dec 1989 to 6994 in Dec 2008:

Nikkei Dow 1970 - 2009



Like Japan, many countries in the present cycle are experiencing asset price deflation. Witness the remarkably reduced prices we are seeing for most consumer goods and services today. Deflation is likely to undermine real growth in the global economy for several years.

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On the plus side, when compared to Japan, North America has a relatively higher birth rate and more robust immigration policy. This should help us soak up our over-capacity faster than Japan; this should help to make our economic rehab faster—but not fast. Widespread over-indebtedness works down slowly over time. Western consumers and businesses are now focused on re-building savings and equity. Starting from virtually zero savings rates in 2005-2006, it could probably take 5 to 7 years for North Americans to build their savings back to the more robust 10-15% levels that we saw in the early 80's.

We should expect repeated bouts of government stimulus as politicians scramble to meet public demands to “do something!” Even if the government is able to keep GDP positive through fiscal stimulus, it does not mean net job creation or corporate earnings growth will automatically follow. The fact is people pay mortgage and car payments with pay cheques not small up ticks in real GDP; and so far pay cheques are still shrinking.

Massive government spending did not create inflation in Japan over the past 20 years because the on-going forces of asset and wage deflation more than offset government stimulus efforts. A difference to our present cycle is that this time most of the western world is in the throws of deflation and stimulus whereas Japan was more an island on its own over the past 20 years. In other words, today the simultaneous efforts of many countries trying to stimulate some growth may be successful in creating inflation longer term. A moderate amount of inflation would be the best-case scenario at this point. Years of stubborn deflation or hyperinflation would be worse case scenarios.

Private debt will not really disappear over the next few years, so much has to be transferred on to the public purse. Individuals will increase their net worth and governments will increase the public debt in efforts to backstop the economy long enough for consumers to recover. Unfortunately, there is no magic cure for debt it takes time and gradual repayment from income. The repayments consume money that would otherwise have been available for consumption. In this sense debt is a natural drag on future consumption. The larger the debt—the larger the drag. The world gorged on debt and consumed our economy into its fragile state. Now with patience, time and focus it will work its way out.

The good news about bungee bouncing is that with proper precautions it does not have to be harmful to our personal health. We can survive and prosper through these times through self-discipline and careful management. History will undoubtedly record this time as a challenging era. We can all look forward to telling future generations all about the lessons to be learned from our experiences. The youth of the future may not listen to us; but at least we will be able to offer some wisdom.

Real estate defaults: the next wave is building

We have been writing in recent letters that the housing downturn is likely not yet over. In the past few months government tax credits and aggressive intervention in the mortgage market has helped to prop up demand on lower end properties. As a result, the pace of descent in home prices has slowed of late. As we discussed last month however, we know from default data that there are still some 3-5 million homes in the US that will be coming on to the market over the coming months through foreclosure. In some of the hardest hit areas of Florida, Arizona and California, this next wave of foreclosures will swamp the market with 3 to 5 times the number of houses that are already listed for sale. Just think about that for a moment- 3 to 5 times.

At the same time we are now seeing commercial realty defaults beginning to mount. Historically during downturns, commercial loan defaults have lagged residential loan defaults by a few quarters. Given that residential defaults have been surging for a couple of years now it seems that commercial real estate defaults have some catching up to do. Quite simply, most areas in North America have over-built commercial real estate over the past 10 years.

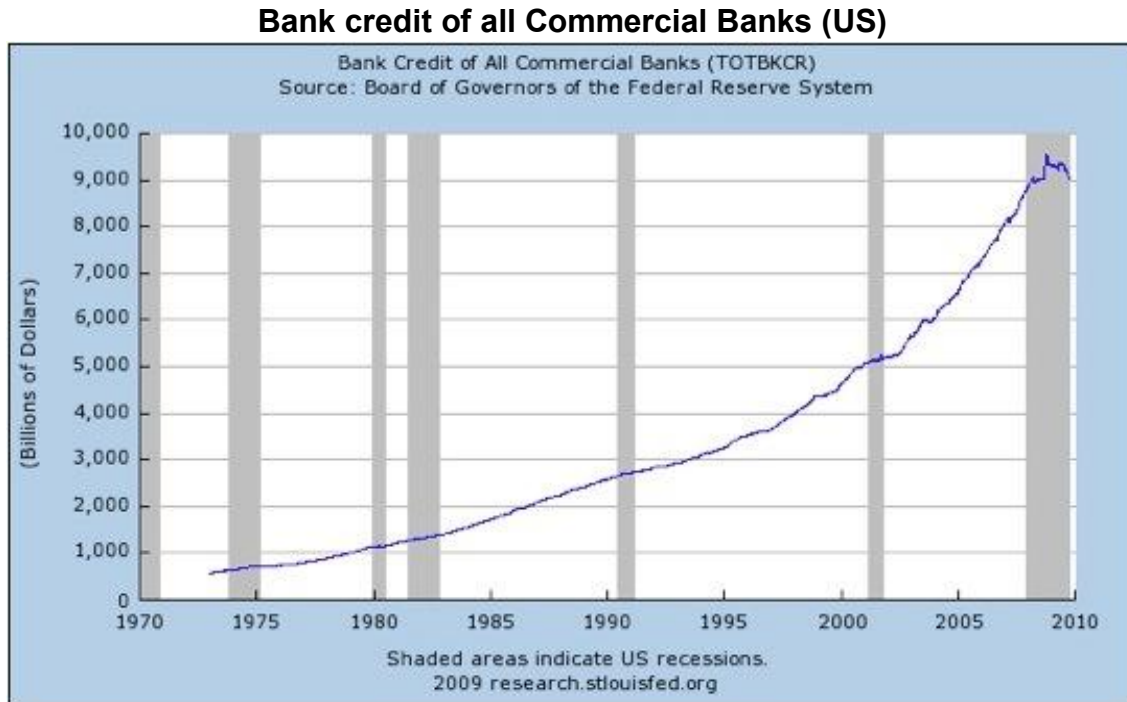
As businesses fail, and landlords lose rent, more properties sit empty and are listed for sale pushing market prices down. So far, commercial real estate prices in the US have corrected about 30% from their peak in February 2008 as shown in this chart:



The structural forces of over-supply, deleveraging, contracting credit and weakened consumption

suggest that commercial real estate prices in the US (and some other countries) are likely to continue down at least another 10-15% over the next couple of years. (Knowing that Japanese commercial real estate fell 80% after its credit bubble burst- a total decline of 45% in the US would be relative out-performance!)

This wave of deflation in commercial property prices will be painful to the financial system because banks remain heavily exposed to commercial credit having dramatically increased their lending in this area over the past several years as shown in this next chart:



Loan data suggests that there are about 1 trillion dollars in commercial loans coming up for renewal in the US over the next several months. Just as in the residential market, where property values have dropped precipitously, many of these loans will be difficult to renew without significant write-offs and restructuring. The Obama administration is presently trying to find ways to prod banks to re-work failing loans - so far with little avail.

While banks sold off a large portion of their residential loans to investors over the past few years, they still hold a large 45% of commercial loans (compared to 21% of residential loans). As a result, banks remain heavily exposed to losses in this sector.

Its not just consumers who are building up cash

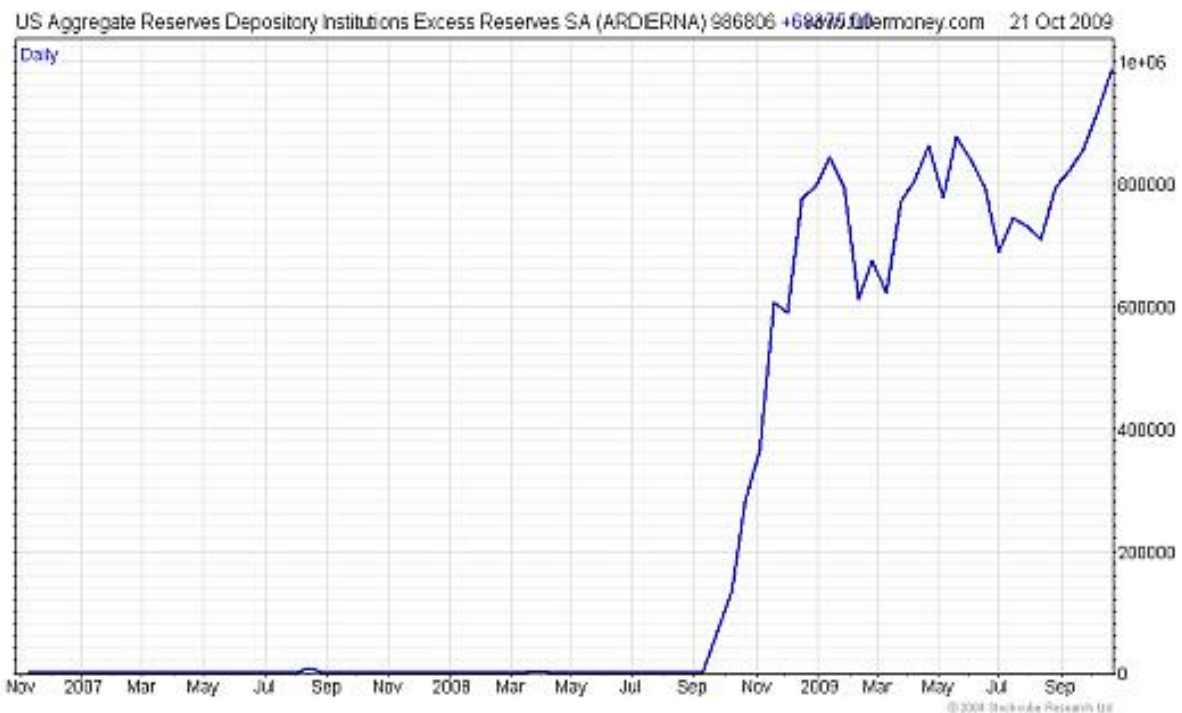
An amazing thing about human behaviour is how synchronous it tends to be. Today we are seeing a preference for frugality and liquidity move across virtually all segments of society.

Having previously encouraged consumers to borrow and overspend, today banks are responding to increased regulation and compressed earnings with their own propensity to hoard cash on the balance sheet:

If cash is trash why are so many hoarding it?

With interest rates at record-lows today, some commentators have labelled cash “trash” reflecting its currently low level of yield. But this is missing the point. Today the world is focused on building up security, liquidity—rebuilding a financial buffer. With so many assets at risk of further price deflation, there is a systemic preference now for return of capital more than return on capital. And so like individuals, as shown below, banks are hoarding cash-like deposits on their balance sheets.

Excess reserve deposits in US banks over the past 2 years



History suggests that this too is a natural part of this cycle. After the bust of the late 20's, banks built their cash reserves back gradually until cash was a massive 80% of the balance sheet by the 1940's. As prosperity returned and bad memories began to fade, conservative habits again receded. By the 1970's cash on bank balance sheets had fallen to 40%, by 2005 it was less than 20% and then leading up to 2007, cash balances dropped below 20%. We know what happened next.

At the same time, as shown in the next chart, non-financial companies are also building up their cash reserves, now at the highest levels in 40 years. In the shorter term, this means less investment and job growth. In the longer term it means better financial health for future capital expenditures.

Non-financial S&P 500 companies building cash too



What about all the “cash on the sidelines” that the financial sales types keep promising will be coming back into the market?

There is not a week goes by that we do not hear or read of someone talking about ‘cash on the sidelines’ as money that will soon be flooding back into risk assets. This is the popular “greater fool” argument so pervasive in speculative psyche. Basically the infamous argument goes that no matter how high and crazy prices may go there are always large pools of cash sitting on the sidelines that will swoop in and buy at any moment.

History would suggest that this argument is deeply flawed. First of all as we have said, deleveraging cycles are lengthy periods lasting several years. They follow multi-year periods where leverage was

increasing to a peak of reckless excess. In the recovery after the bust, human behaviour typically takes a generational shift to more conservative spending and investing habits. An aversion to risk and credit builds an attraction to cash and equity. As shown in the previous charts, the cash-building phase is now upon us.

It is of course ironic that investment sales firms and other corporations are trying to convince consumers to part with cash and buy products, while the companies themselves are hoarding cash and insiders are selling their shares at record levels to raise cash. This is textbook behaviour in post-bubble cycles.

As shown in the chart below, cash on the sidelines is not a new phenomenon. It has been building steadily in money market funds for the past few decades and that is not likely to change any time soon. The other point is that money market levels build with market advances; they are not negatively correlated the way that market perma-bulls would have us believe.

Money market cash has been moving higher for many years

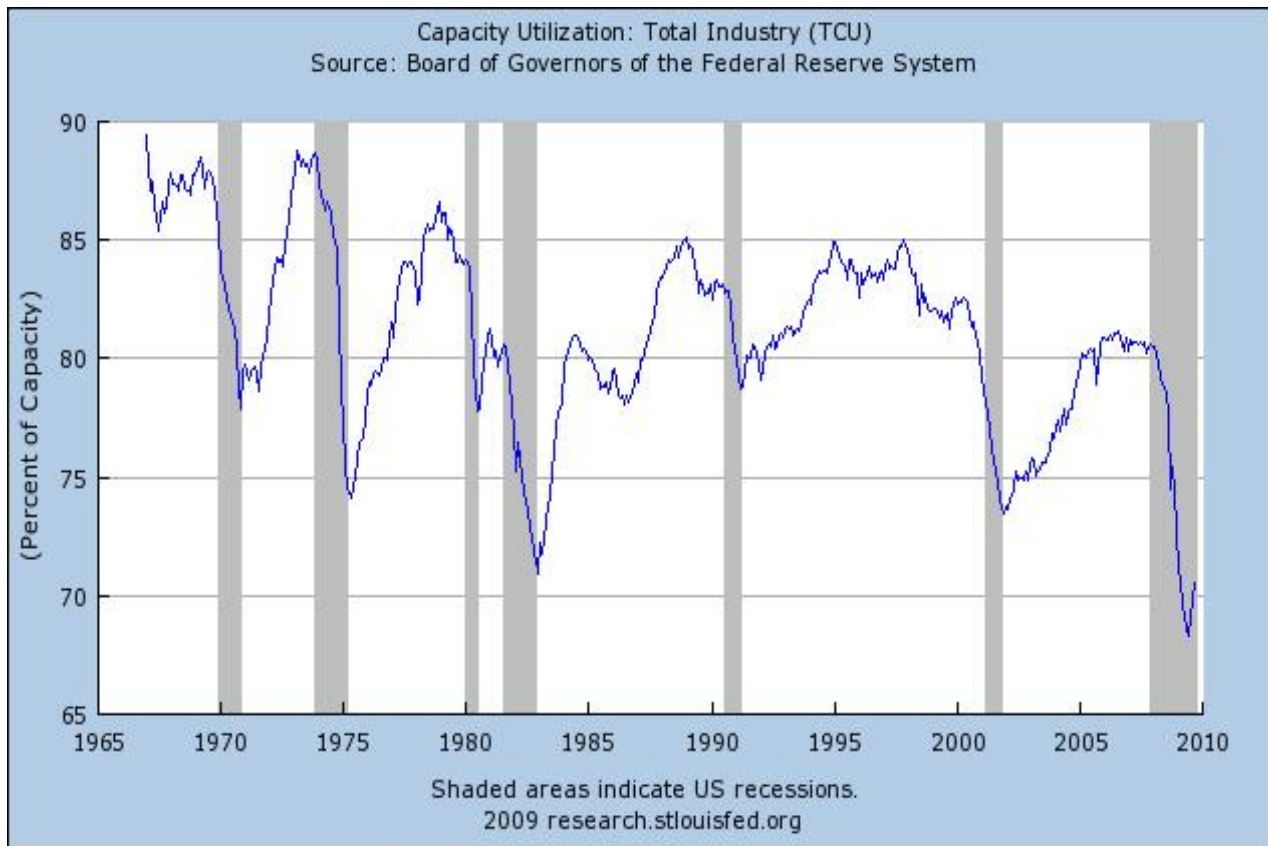


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Part of the preference for cash and more liquidity is also a natural product of an aging population. The older we get the less “risk” and “long-term” our investment horizon can be and the more we need to draw on liquid savings to live. This trend is playing out in developed countries around the world as the bulge of the baby boomers move into retirement. And after 10 years of a secular bear market that has seen the stock market lose half its value twice, mature investors today are exhibiting an understandable preference for principle protection.

The truth is we are in a “new normal” world

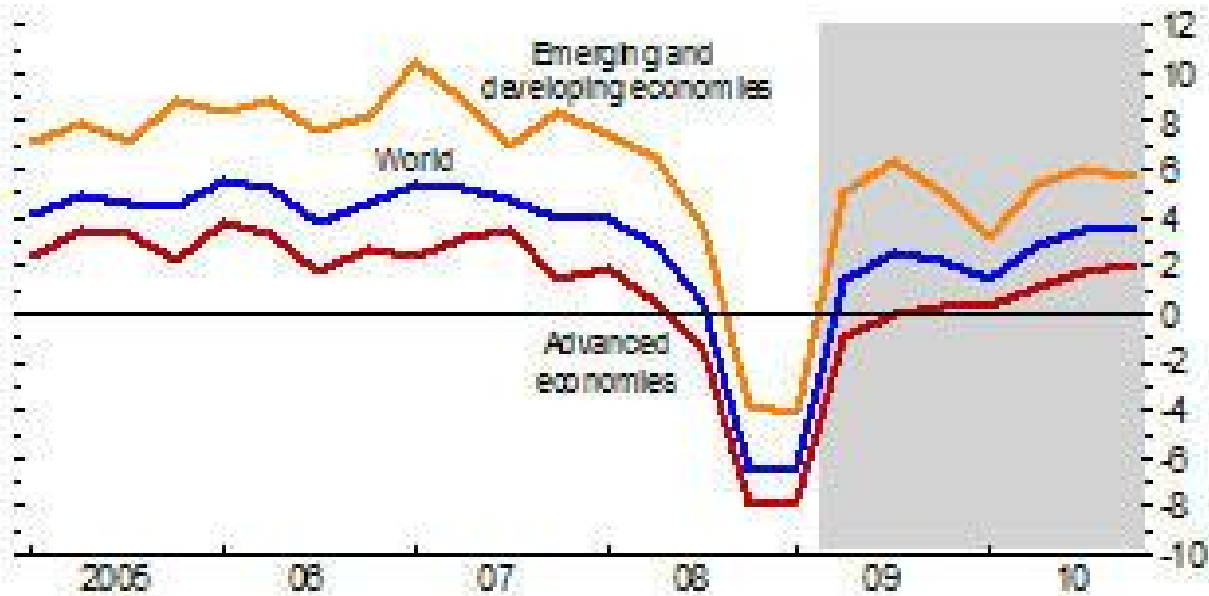
Now that the debt-bubble has burst, about 30% of the world’s present production capacity is not needed to meet the lowered demand. As shown in this next chart capacity utilization is now at its lowest levels in more than 40 years.



With bubble demand not likely to return any time soon, the world will have to rationalize down to the new level of demand. This is not the end of the world; but it does mean that we presently have too much of most products: buildings, equipment, workers —you name it. Not only will unemployment and under-employment continue to rise for some time, pricing power will be weak for a while.

The credit-hyped-growth of 2005-2007 is not likely to be back soon

Figure 1. Global GDP Growth
(Percent; quarter-over-quarter, annualized)



Source: IMF staff estimates.

None of this is doom and gloom. The future will undoubtedly bring some economic growth. But we can see that realistically global growth of 2-3% a year seems a more likely “norm” for the next few years than the hyper-growth of 5-6% we saw over the 2005-2007 phase.

Canada doesn't have a "get out of jail free card"

The number one catalyst behind soaring risk assets over the past 9 months has been a falling US dollar. As the benchmark currency with near-zero interest rates, the US dollar has become the carry-trade currency de jour. This means that speculators have been borrowing US dollars at virtually nil rates and then selling the dollars to buy up anything else: other currencies, commodities, stocks, bonds and real estate. This is a dominant reason for why risk markets have rebounded so sharply without evident economic justification to support the massive price rebounds.

As the neighbouring cousin to the US and with a reputation for relative stability in our banks and government, Canada –our currency, commodities and other asset markets have been a major recipient of US carry-trade in-flows over the past 9 months. The negative correlation between the falling US dollar and our rising stock market is captured dramatically in this next chart.

US dollar down, Canadian stocks up since March: but the "trade" cuts both ways 'eh?'



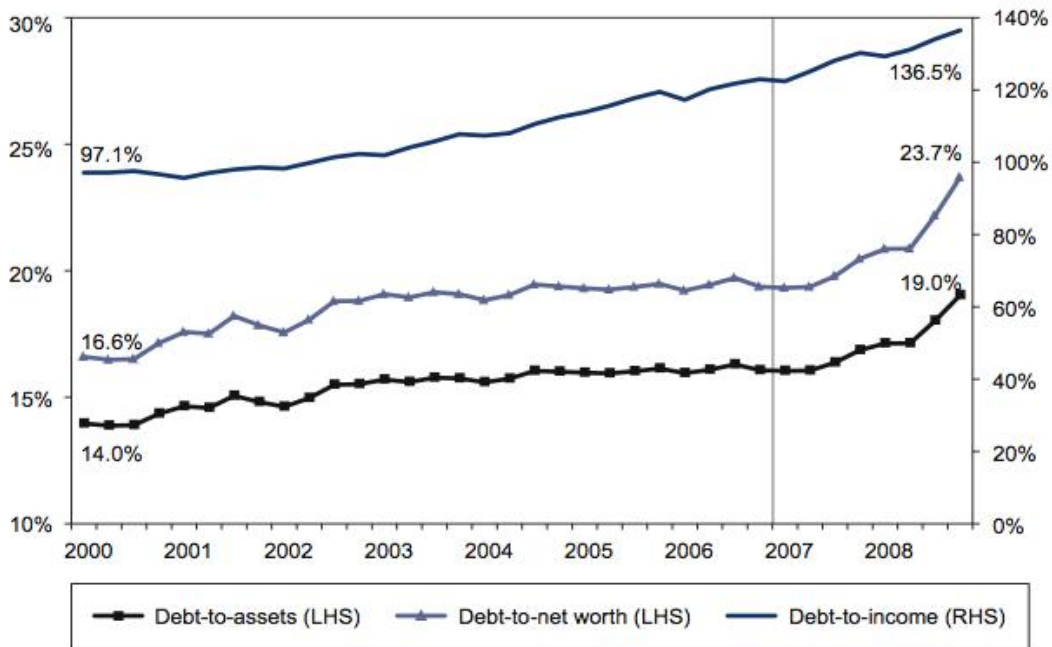
This speculative euphoria has spilled into our real estate markets as well, spurring a new frenzy of bidding wars and large price spikes again over the past few months in several areas.

The downside of our inverse relationship to the falling US dollar is few-fold. First of course, it means a soaring C\$ which is a damper on our export-based economy. This is especially the case since in all the world, our largest trading partner is the US. Their dollar's loss of purchasing power is an ongoing loss for our economy. This would be the case even if the US weren't in the midst of a massive consumption contraction; so it is especially the case now.

Secondly, the rapid rebound in our asset prices has given some a false sense of economic independence in Canada. There have been glowing reports about how Canada is bouncing back quickly, despite the on-going weakness in the States. Our real estate markets are roaring, interest rates are at 50-year lows, and some people (those still employed at least) are still piling on debt. Unlike the US and most of Europe and the UK, Canadians today are so far still saving little and increasing debt loads.

Canadian household debt has continued to grow through 2009

Figure 5 – Measures of Household Debt



Source: CANSIM Tables 176-0032, 380-0004 and 378-0009. CGA-Canada computation.

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Excessive credit poses the same risks for Canadians as it does for the rest of the world.

It means less financial resilience to get through challenging adjustments in the economy. It means greater vulnerability to rising unemployment. It also means greater reliance on asset bubbles rather than cash savings to pump up balance sheets. Over-confidence can be a curse at times like this. Canadians may need to learn this the hard way as we did in 1980-1982, and 1990.

Ironically while a stronger US dollar will eventually be positive for our exports, thanks to the carry trade, a rebounding US dollar also poses a near-term and significant risk to Canadian stock and commodity markets. The 'hot money' that has flowed into Canada over the past 9 months is not here to stay— it is here for a trade. When the US dollar rebounds it will leave our markets even faster than it came. This potentially rapid reversion is likely to be a shock to the many that are not expecting it.

Why do we think that the US dollar is likely to rebound?

Because the economic consensus is now almost universally predicting its demise-- bearish sentiment against the US dollar is at epic proportions. Meanwhile the US is still the world's largest military power, the world's largest free-market economy, and the wealthiest most innovative nation on the planet. And as we saw last week with the Dubai debt shock, tough talkers aside, geo-political risks still drive capital back to the US dollar as safe-haven. We expect there will be more shocks in 2010.

We at Venable Park were just kids in the 70's but we know from our studies of history that the US has been down and counted out before. [This week John Mauldin](#) (now 60) gave his first-hand account of the 70's like this:

"[In] 1975 we were coming off a recession...facing another eight years of high unemployment, a tumultuous stock market, rising commodity prices, high inflation, and rising interest rates. Japan was just beginning to be a real force in the world. People were still buying bomb shelters as Russia was a feared and powerful enemy. As the price of gold rose, there were those who told us that the dollar would soon be worthless (the Fed was a problem, and the deficit was out of control), and so we needed to buy yet more gold and also a year's worth of dried food."

Sound familiar? The good old days *indeed!*

Once the US dollar does stop dropping, US assets are likely to present the most compelling investment opportunities that we foreigners have seen in several decades. As Canadians we will be able to buy some of the best real estate and best corporations in the world, at the cheapest prices in more than a decade. In addition, as the US dollar begins to recover strengthens, foreign investors will be rewarded with currency appreciation on top of investment income and price gains. *We are very excited about the prospects of coming opportunities in the US.*

Recently we have noted strong demand from foreign investors for US Treasury bills. Some commentators have expressed surprise that foreign investors are so willing to buy US Treasury bills at virtually zero yields. But here is the thing - if the US dollar is oversold and due for a bounce back soon, then US T-Bills will be the perfect asset class to hold in these challenging times—low market risk, with large upside gains to be made on the US currency as it strengthens. Even if US equities and real estate prices take further to bottom this cycle, currency tends to be a leading indicator of economic strength and the US dollar is likely to turn up before the economy. Getting the opportunity to buy the currency first and the assets a little later would be very powerful.

But what if the US \$ bears are right and the US \$ does not bounce but weakens forever?

If the US dollar does not bounce then the world will be in for a rough ride indeed. A majority of the world's largest economies remain dependent on US exports to keep them growing. If the US dollar continues to fall without reprieve, foreign governments will begin a mad race to debase their own currencies. They really will have no choice. A collapsing US dollar will cause ancillary inflation and major destabilization in world trade, aggravating already weak demand. We may well get a buy on gold in such an environment (as it would finally have broken out of the February 2009 high gold/C\$ ratio) but that would not be a good sign. It would be a sign of enormous risk in the world economy and other asset markets. As a result we will watch this situation very carefully. And given the possible outcomes, we will continue to hope that the US finds its way back to recovery sooner rather than later. Meanwhile US dollar perma-bears and gold-bugs should be careful what they wish for.

So we will hold on to our hats—happy that we have hats to hold

The price rally in risk assets over the past 9 months has been awesome- there is no doubt. Bullish sentiment among market commentators is now back to levels last seen at the market peaks of 2000 and 2007 (now infamous). Meanwhile low volume and other weak and deteriorating technical indicators continue to suggest the risk of significant air pockets beneath present prices.

At the same time, many macro trends suggest a high likelihood of a fresh leg down in the economy during 2010. Too far, too fast off the March lows has left a stock market that is presently pricing a dramatic rebound to record profits and growth in 2010. If this does not materialize then stocks are now about 40% over-valued on fundamental metrics. Gold and commodity markets have gone simply delirious.

We had hoped that investors would have learned more lasting lessons after two 50% losses in the past 10 years. Apparently desperate folks are driven to desperate measures trying to re-coup losses.

At current valuations the stock market is priced to deliver the lowest 10-year total return period since the mid 1990's. Lasting gains from these levels are a low probability shot full of risk. Our portfolios have gained nicely year to date and with a fraction of the volatility of the overall market. We continue to have some market exposure here but we are very defensive and are content to let euphoria run its course without more of our capital at this point. History and our own experience tell us that more promising opportunities will lie ahead.

And now we enter the last month of 2009; what a year this has been. Happy Holidays!

Quotes of the Month:

“Always forgive your enemies; nothing annoys them so much.” --Oscar Wilde

“A person who dares waste one hour of time has not discovered the value of life”
--Charles Darwin

“In the end we will conserve only what we love. We will love only what we understand. We will understand only what we are taught.” --Baba Dioum

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