

E.Q. Trendwatch™

Slowing growth: a natural, normal part of every business cycle

“Asset allocators have begun to reduce their underweight stance on bonds for the first time in three years.”

Merrill Lynch Global Fund Managers Survey, August 15, 2006

After 17 consecutive rate hikes since June 2004, it is now likely that the Federal Reserve in the United States is done or close to done in its rate hiking duties this business cycle.

Q3 GDP is projected to slow significantly to an annualized growth rate of about 2% from a Q1 annualized growth rate of 5.6%. Given the lag time between rate hikes and their slowing effects on the economy, the full extent of the slowing brought on by the last 8 hikes is still several months away. It is quite possible that as the rate increases continue to be felt over the coming months, Q4 2006 GDP may contract to an annualized growth rate of 0%. This is what happened at the peak of the last cycle in 2000, when Q4 growth slammed shut surprising the majority with a sudden contraction to 0. It is this scenario that prompts many bond traders to now surmise that the Federal Reserve will be cutting rates again in Q1 of 2007 in an effort to apply the cardio paddles and jump start the life back into the US economy.

We believe that the extent of the slowing over the coming months will be dramatic and that interest cuts are a likely response in early 2007, but we also know that rate cuts have the same lagged impact as rate hikes. Even if the Feds do start to cut again early in 2007, the desired re-inflated growth is not likely to reappear in the economy before the fall of 2007. This would be really a best-case scenario. A worse case scenario would be that the slumping housing market would make the economic hang-over longer this time around. In any event, with world economies now almost universally slowing, it is becoming widely presumed that the need for rate hiking is coming to a close. At the same time, it is normal to expect that inflation will continue to ramp up in the next quarter since rate hikes are a blunt tool with a lagged effect in curtailing inflation.

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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

For this reason, bond allocations can start to move to longer terms than we have felt comfortable buying over the past three years.

As a “smart money” indicator, the Merrill Lynch monthly Global Fund Manager Survey provides some insight on market sentiment. In August, we thought the following statistics were worthy of note:

- Money managers indicated the worst outlook for corporate earnings in 8 years
- They indicated the least confidence in global economic expansion in the past 10 years, with 70% saying they saw slowing global economic growth in the upcoming year. This was the highest consensus on this point since the survey began asking this question in 1986. More were pessimistic about stocks than at any time in the past 2 years.
- In a separate survey in August, US homebuilder confidence fell to the lowest level in 15 years. (That is the lowest level of confidence, since the housing led recession of 1990)

Bottom line: the economy is slowing, and this is a natural, normal part of every business cycle.

“The state of the housing market correction remains a key focal point for the US growth outlook and Fed policy.” Sheldon Dong, TD Institutional Fixed Income Strategist Aug 16, 2006.

US housing facts update

Recently many articles are sounding alarm at the seemingly sudden shift in the momentum of the US housing market. For those of us who have been watching the mania unfold over the past couple of years, current trends are not surprising. Really our amazement has been at how long the housing party raged without interruption. According to the federal housing index, average US home prices jumped 58% over the 5 years ended Dec 31, 2005. This annual pace of increase of almost 12% per year is more than twice the longer-term average. Since the start of 2006 the trend has been reversing. As at the end of June, the median sale price of used homes had increased a mere .9% since June 2005. Over the next several months, it is likely that the median prices will register a decline from year-earlier periods. Negative year over year growth in housing prices has not happened in the US since February 1993, so this “new” trend is taking some by surprise.

A Wall Street Journal article on August 23, *“Housing Slump Proves Painful for Some Owners and Builders”* noted that over the past year, the inventory of previously occupied homes for sale nationwide had risen 40% on average, and in some metropolitan areas, supply had quadrupled. Meanwhile, Homebuilders like Toll Brothers Inc. continued to issue dramatic profit warnings based on reduced demand for new homes with orders down

about 50% from a year earlier. CEO Robert Toll told company analysts that in his 40 years as a homebuilder, he has never seen a slump unfold like the current one: “It would be difficult to characterize the position of the homebuilders as other than in a hard landing.”

In July, the nation’s largest homebuilder D.R. Horton Inc. reported a 21% decline in its third quarter earnings, being the first quarter they did not report year over year profit growth in over 28 years. CEO Donald Tomnitz, acknowledged that price gains in the past few years have now priced many people out of the market. “Every time we’ve gone into a downturn in the home-building industry, they’ve always been longer and deeper than we’ve all imagined. So we’re preparing for the worst, and we think this one will be longer and deeper than just the last six months.”

Once again, we need to recall that the only way prices can revert to their long-term average is to either have a time of negative returns going forward, or a period of no gains for several years. Reversion to the mean must happen, or few of us would be able to afford to live anywhere in the future. The invisible hand of supply and demand will eventually find a healthy balance again. This will mean lower stock prices and heightened opportunity for our clients.

Enron: The Smartest Guys in the Room

We recently had the opportunity to watch the Enron documentary on Rogers On Demand, and for any of our clients that has not yet seen this film, we would like to recommend it to you as good entertainment and a worthy use of a couple of hours. In highlighting the foibles of large numbers and hubris, this real life story has much to teach us about human nature and money. It also explains a lot about why individual company stories can be alluring and dangerous for outside investors. The fact that a company can attain the acclaim of President’s and nations as the “World’s Best” before being unveiled as the world’s biggest fraud, is a useful lesson to study and retain. It also reminds us again that book learning and intelligence are not enough in themselves to produce wise thoughts. It turns out that those who called themselves “the smartest guys in the room” deluded themselves and others, and in the end were everything but wise. The Emperor had no clothes once again.

REPORT ON BUSINESS TELEVISION (ROBTV- Channel 64 on Cable)

For those that are interested, **Cory** will be the **guest Technical Analyst with Pat Bolland on The Chart Room, Friday September 15, at 3:30** and **Danielle** will be the **guest Portfolio Manager on AM Business at 9:20am on Wednesday, September 20**. The clips can also be viewed for the week following the appearances on the ROB website at http://www.robtv.com/shows/past_archive under past video archive for the date and time in question as well as through a link on our web home page at www.venablepark.com.