

Market Timing

Economics 101: “Re-visiting to the Business Cycle”

Business Cycle Economic Impact

	(1) Trough (last in 2002)	(2) Recovery/ Expansion (2002 to 2006)	(3) Peak (2005)	(4) Recession (2006- 2007) (?)
Savings	High	Begins to decrease	Decreasing ✓	Increasing
Spending	Low	Begins to increase	Increasing ✓	Decreasing
Output/ GDP Production	Reaches lowest point	Increasing and moving toward full capacity	Increasing or steady as economy reaches full output capacity ✓	Decreasing
Employment	Unemployment reaches highest level	Increasing and moving toward full employment	Steady or increasing as economy reaches full employment ✓	Decreasing
Yield Curve	Inverted start to flatten again and turn modestly positive.	Normal, upward sloping	Flattening and inverting ✓	Inverted. ✓ Short term rates higher than long.
Best performing sectors	-financials -consumer cyclicals	transportation -technology -services -capital goods	- <u>Energy</u> ✓ - <u>Basic materials</u> ✓	-Consumer staples -utilities



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As you can see from the ✓ marks indicated in the chart above, it looks as though we could be at the economic peak for this business cycle. The next stage in the cycle is the contraction stage that may lead us to recession starting in Q2 2006.

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With all of the world news bombarding us every day, it can be helpful to review basic concepts that matter most to investors-- like the economic business cycle.

In this light, we have taken some time lately to review where we likely are in the current business cycle, and compare that to previous cycles and in particular the last 4-year cycle from 1998 to 2002. During the past cycle, the recovery began in 1998, peaked in 2000, contracted into a recession in 2001 and hit a trough in 2002. This then started the recovery again expanding our economy from 2002 to present.

This well-documented pattern of economic peak, contraction/recession, trough, and expansion to economic peak, is highly reliable throughout history. It is also quite common that Canada's economic cycle lags that of the United States by about 3-6 months, as we feed off of the US GDP cycle. The chart above shows these phases, what the economic indicators reflect in each, as well as which sectors of the economy generally prosper at each of the various phases of the cycle.

Because we are realists, and follow what is actually happening rather than wishful thinking, we are well positioned to both protect your hard-saved capital during this period, as well as profit from the sector rotation that is currently underway out of energy and into more defensive sectors over the coming months.

The reality is that once the stock market sees a coming contraction/recession six months out, prices begin to drop in anticipation of reduced corporate profits. Just an average price drop for equities during this phase is -26%, and it is not uncommon for prices to drop much further than -26%. The losses averaged -50% in the broad markets during the contraction phase in 2000-2002. (remember how painful that was?)

Some interesting fundamental indicators that highlight concern with the upcoming contraction and the broad markets at this point are as follows:

-Price to Earnings (P/E) ratios currently average 24 (S&P 500 trailing) versus a long-term average of 18, and the single digit PE's that typically present at the trough of an economic cycle—*stock prices are currently relatively very high.*

-dividend yields at an average of 2% presently, are the second lowest they have ever been on the S&P 500 since 1900! The long-term average is 4.4%-- *stock prices are currently, relatively very high.*

-out of 700 largest publicly listed companies in Canada, only 38 have a **debt to equity ratio** of less than 1 and a **price to book value** of less than 1.2X. In more average market times, there would be roughly 200 of these 700 stocks that would present as reasonably priced on these metrics. During an economic trough or valuation bottom, one could typically find more than 400 of the 700 companies that would be considered reasonably priced by these value measures--*the Canadian market is incredibly over-priced at current levels.* --source: **Vito Maida- Patient Capital Mgmt Inc. Newsletter Feb/06.**

-while crude oil and gold commodity prices have been up in the past couple of weeks, oil company and gold company shares have been lower in value. Why? Both groups of companies have been warning that their profitability will be lower over the foreseeable future because their operation costs are up due to high energy costs! *High energy costs are bad for all businesses at some point, even the companies that produce the oil.*

-many manufacturing companies are now reporting what they call **hyper Inflation in their material and energy costs** since the peak of the last business cycle in 2000, some increased cost examples given by a large equipment manufacturer in the US are as follows:

- all grades of steel bar price increase 186%
- the truck lines have implemented as high as 40% fuel surcharges on the total freight bill
- wood spacer boards for packaging have gone up 98%
- cutting fluid coolant oil up 47%
- cleaning supplies up 25-40%
- utility bills up 30%

The 3rd generation owner/operator who quoted the above increases, goes on to explain the impact of these much higher costs to the profitability of real companies as follows:

“Where does this end? Many cases it is very hard to pass it on. However, and this is the key, when we quote new work the costs are much higher and the piece comes out much higher. (My competitors are all doing the same thing.) All this leads to being less competitive in the Global market place. China will take even more of the work. When the big slowdown comes everyone will be searching for work but with all of their price increases they will have priced themselves out of the market. Then they start buying the work to keep cash flow going and many end up out of business. I have seen this too many times over the years. It is going on now.”

-Matt Kemp, Owner large equipment manufacturing co (as quoted in Probabilities of Recession, John Maudlin Feb 24, 2006)

Bottom Line:

It now appears that the Federal Reserve in the US will have to continue hiking its over-night lending rates past the previously predicted peak of 4.75 in March. The market is now predicting there will be at least another hike needed to 5% in May, and possibly more after that in order to contain the inflation which is now wide spread in North America. This will further invert the already inverted yield curve in the US. The further the inversion goes, the more likely, and the more extreme the economic recession that follows is likely to be.

On the fixed income side, thanks to recent rate increases, we are pleased to report that Gov't bonds in the 2 to 3 year range are now yielding over 4% again, which is a large increase from the 2.4% yields they were offering in the summer of 2005, this will help support returns on the bond side of accounts going forward.

We believe that the correction in the over-inflated values on the TSX has begun, with considerably more down side to follow in the coming months. The benefits of our objective discipline will show it's metal. We do not need to rush to get equity money invested at these levels, better prices are on their way.