REAL LIFE NEEDS ACTIVE MANAGEMENT

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Market Timing

“Don’t do that! Someone could lose an eye…”

Recall those immortal words from our parents as we were growing up? Lately we have not only been saying them to our kids, but also thinking them when someone mentions the idea of trying to jump back into current markets just in case we miss something. At this point, we believe we are likely to miss something alright- that something to miss would be a negative return in stock markets and long bonds from present levels.

Now that we are into the third week of August we are officially entering that worst time of the year for equities, now until mid-October. That is ok; we are on the sidelines while this unfolds. The only things that have been going up over the past year now is oil and short-term interest rates. We participated in the initial leg of the oil upturn via our time in the markets until February 2005, but since then the speculative flavour of the sector has taken on legendary proportions once again, and our risk management rules have kept us on the sidelines.

The thing we must all recall is that rising oil prices are bad for the rest of the economy.

Oil plays arguably the most influential role in our economic prospects. John Murphy, a world-renowned expert on intermarket analysis has this to say on the role of oil in his recent book, *Intermarket Analysis, Profiting from Global Market Relationships*, (2004) New York: Wiley & Sons, p. xv:

> *In 1999, rising oil prices set in motion a series of events that led to the start of a bear market in stocks in the spring of 2000 and the onset of a recession a year later in the spring of 2001. Rising oil prices have contributed to virtually every U.S. recession in the last forty years. 1999 was no exception. The surge in oil prices led the Federal Reserve to tighten interest rates, which helped end the longest economic expansion since the 1960’s. This action by the Fed led to an inverted yield curve as 2000 started; this is a classic warning sign of stock market weakness and impending recession. All of these trends were clearly visible on the price charts at the time…. Unfortunately, the economic community—together with most Wall Street analysts—either did not see the classic warning signs of trouble or simply chose to ignore them…in 1999, oil stocks were the market’s strongest sector. This is usually a bad sign for the economy and the stock market.”*

Since we do not want anyone losing an eye, we, and other money managers worth their weight, must continue to be cautious during this period.

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Fixed Income markets

The yield curve is a graphic representation of the rates of return available on government issued bonds in a given country at a given time. For our purposes in Canada, the US yield curve has the biggest impact on what goes on with interest rates in our own country. So we must analyse the US yield curve for insight. For the past many months, as the Federal Reserve has raised its overnight lending rate 10 consecutive times, the 10 year bond yield has dropped resulting in a yield curve which is now flattening-to-flat.

Presently there is a mere 0.21% difference between 2yr. bond yields and 10 yr. bond yields. In real-life terms this means you can invest in a 2yr. US govt. bond at 4.11% or invest for 10 yrs. and get a meagre .21% more yield while taking on 8 more years of risk. Needless to say this is not attractive to us as a risk-reward trade-off.

What bond market participants are signalling with this, is that they see slow-to-negative economic growth ahead and are choosing to ignore Greenspan's projections of solid growth and the need for on-going rate hikes. We shall see which camp proves right as the next few months unfold.

As soon as the federal reserve does come to the end of its rate tightening time, we will be happy to add some longer term bonds and more income instruments to our portfolios, having good prospects for higher yields and capital gains from there.

Final thoughts:

> *"Try not to become a man of success but rather a man of value."* --Albert Einstein
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> *"Nine-tenths of wisdom consists of being wise in time."* --Theodore Roosevelt
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> *"One of the greatest pieces of economic wisdom is to know what you do not know."*
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> --*John Kenneth Galbraith*

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