

Market Timing

China adjusts US dollar peg

China's central bank dropped a bit of a bomb on global markets last Thursday by abandoning its peg against the US dollar, and announcing that it will instead implement a "managed float" against a basket of currencies. We have been expecting this to happen for some time now, and it is widely considered bearish for bonds and the US dollar over the near term and probably longer.

As we mentioned in our April newsletter, the Chinese government has been buying US treasuries in staggering quantities over the past few years, estimated in the range of 1.5 billion dollars worth per day. The effect of this demand has been to drive up the prices of US bonds and therefore drive their yield to investors down. The effects of this action are two-fold: one is that their buying lends lots of cash or liquidity to US consumers, allowing them to borrow money at very, very cheap rates. Secondly, as foreign dollars buy up US bonds, they also soak up US dollars and thereby drive up the value of the US currency against the Yuan. This makes Chinese goods cheaper and US goods more expensive to global consumers. The US has been lobbying China for years to reduce this type of monetary intervention and allow regular market forces to value the respective currencies. This recent move by China is its first response along this road. The idea is that the currencies will now be allowed to float within a prescribed band on a daily basis. It certainly means that the Chinese will need to not only downsize the extent of their present over-weight in US dollars, but they will also need to increase their weight in other global currencies which will be added to this notional basket.

The bottom line: although they have started this process in an intentionally gradual way, the implication is that the movements down in the US dollar and bond market could be quite substantial over the next many months. Having reduced our US dollar exposure and kept our bond terms short in the past year, we are defensively positioned as this un-pegging process unfolds.

Market Update:

Our buy alerts on technology and the broader market indices have so far not confirmed a break through and appear currently in a phase of rolling over once again. If this continues, they are likely to fulfill their habit of seasonally poor performance for the summer period, and we will not be in them. If this plays out, our next entry point is likely to be some time in late summer or the fall. Again, much depends on the volume of dollars being committed to world markets, and the continued drag that higher oil and gas prices are having on the world economies.



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Year to date, investors holding a portfolio weighted similar to the major indices, have been generally un-rewarded while exposing themselves to significant market volatility—risk. Half way through 2005 now, and despite the appreciation of the oil and interest sensitive sectors, we find year to date returns on the major markets are unimpressive:

-Dow 30	-1.18%
-NASDAQ	-1.47%
-S&P 500	1.07%
-TSX 60	9.28% (we were in for 6% of this to Feb 2005)

Having left these markets to the safety of cash in late February, we have received more reward with less risk by sitting out of the markets and collecting modest interest than if we had remained invested in them year to date.

Behavioural finance helps to inform conventional market theories

Recently we read a book that further develops behavioural finance concepts called “*Mean Markets and Lizard Brains.*” Its author Terry Burnham has a Harvard PhD in Business economics, a master’s in finance from MIT, as well as degrees in computer science, and biophysics. Burnham’s thesis is that our cognitive logic brain found in the pre-frontal lobe, needs to instil discipline in order to overcome the irrational impulses of our emotional or lizard brain. The lizard brain he explains is the part of the brain which houses key survival instincts and can be perfectly devastating if left to direct our investment decisions:

This book resonates with us because we developed our management approach to track market sentiment as one of the most reliable tools for earning superior risk-adjusted returns in investing. Burnham concludes:

*“Just as we must use a mirror and other tricks to see into the blind spots on our cars, we need help to spot market opportunity. **We have one tool so far and that is sentiment.** We know that in order to make money, we must make the unpopular moves and attempt to constrain the lizard brain.” (p.61)*

For any of you that have an interest in reading more in this area, Burnham’s book is very entertaining and an easy read despite its heady content. We have listed it as one of the books to read on our web site should you wish to find it.

In the end, this really just confirms our resolve that we are doing the right thing in waiting for price corrections before wading into popular assets and sectors, and for leaving popular assets when our indicators suggest that the party has gone on longer than is reasonable. Patience and an objective discipline are key to overcoming impulsive investment errors. We condition ourselves to this discipline every day.

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