REAL LIFE NEEDS ACTIVE MANAGEMENT SEPTEMBER 29, 2005, • ISSUE 8

Market Timing

Discipline— easier discussed than exercised!

Good News First: Income Trusts and the 10-year bond prices are dropping at last!

The Finance Minister's sucker-punch to the belly of the trust market over the last week has illustrated the government's growing discontent with the proliferation of larger and larger tax paying corporations opting to snub the CCRA and convert to the income trust model.

Mr. Goodale's postponement and recent verbal shell game has been the catalyst for the 10 - 25% drubbing to income trusts over the last week. Of course in the interest of self-preservation and the realization of his tremendous gaff, Goodale quickly deferred making or clarifying the government's position until after the election in the spring of 2006. Boy we can hear the corporate coffers opening up with campaign funds for this one.

However purposefully unclear the Minister's comments were, what is clear, is that the government is now second guessing the long-term tax revenue drain posed by trusts and is looking for a way to dull the tax appeal of the income trust tax structure. Of course one way to turn something special into ordinary is to make everything special so that nothing is. (ie.lower the tax rate on dividend income)

The secondary and equally potent pressure on trusts recently, is the price of the 10-year treasury. Rates on the long end of the curve have been slow to move but are finally starting to rise. It suggests that we are a few steps closer to higher mortgage rates and the opportunity for the purchase of reasonably priced income producing assets.

The drop in the 10-year bond price is largely in response to a realization that the Federal Reserve in the US and central bankers in Canada will continue to raise interest rates for the foreseeable future. There had been some speculation that the fall-out from the hurricanes may have caused the Feds to pause in their assault to puncture bubbles in real estate and the credit orgy that has been underway.

Greenspan has set his sites on the housing bubble and rate hikes are the weapons of choice.

Here is a lesson in economics 101 and how the market is a discounting mechanism.

The relationship between the economy and the stock market is consistently repeated over time. The stock market cycle leads the economic cycle by about 6 to 9 months, which means that the stock market will go into decline 6 to 9 months before the economy.

Four of the primary leading indicators of economic health are consumer expectations, industrial production, direction of interest rates, and the slope of the yield curve. The following is a summary of what these four factors are typically doing as the economy

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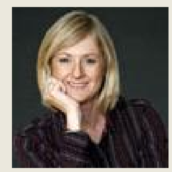

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goes through expansion and contraction then back to expansion:

The stock market is a leading indicator of the economy. Listed below are four primary indicators and what they show at differing stages of the economic cycle.

When we look at the following cycle indicators and evaluate the current status of those indicators we see the ones we have noted of late (marked with a **+**) suggest that at this point of the economic cycle we are moving out of late recovery towards early recession.

Cycle Stage:	**Recession**	**Early Recovery**	**Late Recovery**	**Early Recession**
Consumer Expectations	Reviving	Rising	Declining **+**	Falling Sharply **+**
Industrial Production	Bottoming	Rising	Flat **+**	Falling **+**
Interest Rates	Falling	Bottoming	Rising **+**	Peaking
Yield Curve	Normal	Steep	Flattening **+**	Inverted

Source: Intermarket Analysis, John Murphy

As confirmation, it is often the case that the peak of a stock market cycle has the energy sector as the top performing asset class. Five of the last six recessions were led by an oil price shock.

The latest part of this puzzle signalling the end of the recovery is a wave of pessimism to dampen consumer expectations. This morning's consumer confidence report came out at the lowest levels in 15 years! People are having trouble now making their many payments on time and are falling behind.

It is this last part of the picture, the debt-laden consumer, that makes the pain from high oil prices and still higher interest rates, particularly dangerous this time. Borrowing or leverage has the effect of magnifying financial risk. And much of the world is more levered today than ever before. We won't even talk about hedge funds, but in terms of dollars and people affected, this "credit-bubble" presents a more magnified risk to the economy than the tech-market bubble did at the end of the 90's. The following table of percentage ratio of savings to personal disposal income highlights the issue further:

Canada and the United States % Ratio of Savings to Personal Disposable Income

	Canada	**United States**
1980	14.3	5.7
1985	14.0	6.9
1990	11.1	5.1
1995	7.3	3.4
2000	3.9	1.0
2001	3.4	2.3
2002	3.7	2.3
2003	2.3	2.0
2004	0.4	1.0

Sources: Statistics Canada, U.S Bureau of Economic Analysis, Economic Indicators

Canadians used to be much better savers than Americans. By 2004, Canadians actually saved 60% less than their American counter-parts, and both countries were at all-time lows in savings rates. Governments on both sides of the border have warned that savings rates in 2005 have now deteriorated even further and are now negative. Meanwhile, the consumer has consumed everything possible and the economy has benefited. But the effects of this trend have now run their course. Consumers with a negative savings rate and big consumption can only borrow so much until their ability to gain fresh credit, even in today's conditions, comes to an end. Or they lose their jobs, due to layoffs. When there are practically no financial incentives to leave your money in savings- ie, with interest rates on cash at 2%, people do not consider saving an attractive option. Highly indebted consumers as with highly indebted countries are much less able to weather financial shocks when they come. A good example of this is the extra burden Katrina places on the US right now as they must spend billions to re-build infrastructure while running very high deficits due to the on-going war and the increasing demands of their aging population.

Bottom line: If the masses have bought their new 5000 Sq ft homes, re-furnished them with don't pay till 2010 deals from The Brick and happen to pick up a new GM, Ford or Chrysler because you spent over $30 at Wal-Mart during the isle 3 blue light special that offered the employee deal and free gas for the rest of your life and you happen to pick up some new duds with the 5 credit cards received gratis from every conceivable lending institution, including Wells Fargo. WHAT'S LEFT? Answer: consumers will take a breather. When they do, consumption slows and so do corporate profits. And when that happens, stock prices fall. When they fall enough, WE BUY!!! The game is a foot…

Words of Wisdom from 1940

> "When there is a boom and everyone is scrambling for common stocks, take all your stocks and sell them. Put the proceeds in the bank [T-bills]. No doubt, the stocks you sold will go higher. Pay no attention to this—just wait for the recession, which will come sooner or later. When it gets bad enough to arouse the politicians to make speeches, take your money out of the bank [T-bills] and buy back the stocks. No doubt the stocks will go still lower. Again pay no attention. Wait for the next boom. Continue to repeat this operation as long as you live, and you'll have the pleasure of dying rich."
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> *--Fred Schwed, Jr., (1940) Where are all the Customer's Yachts?*

Fred Schwed Jr., was professional trader who worked on Wall Street during the 1920's. Although his quote makes market timing sound simple, it is of course, hard to do without a clearly established set of buy and sell rules. The good news is the set of objective rules are precisely the basis for our method and approach. All we have to develop is the patience to live through the waiting times in between. As you know, discipline is often easier discussed than exercised.

Best wishes for a happy autumn!!!

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