Real life needs active management

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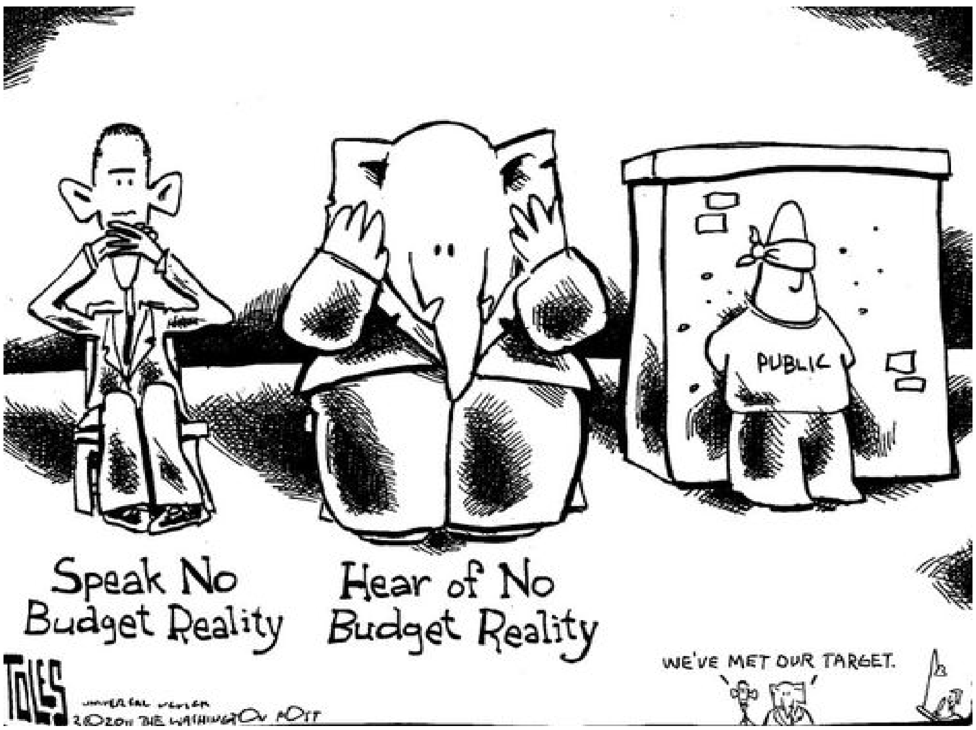
E.Q Trendwatch™

Fiscal disorder stokes social unrest



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

The words that best sum the world this month must be "social unrest."

From union protests across America, voter outrage in Ireland, referendum in Iceland, protests in Asia and riots and revolutions in South America and 15 countries (and counting) around the Middle East and North Africa, citizens of the world are expressing frustration and unhappiness with current regimes.

Pain, suffering and loss are near term costs. But there will also be positive progress and improvements made. No one witnessing the toppling of corrupt or oppressive regimes can regret the outcome.

There is irony in the timing of these events. Their common catalyst is the global credit crisis and on going aftershocks. In all the complexity of high finance, derivatives, and globalization, the trigger today is the basic need for food.

Scrambling to rescue the banking system and its many levered players the past 2 years, governments around the world made yet another deal with the devil. They flooded world markets with liquidity by issuing debt on debt. Their admitted purpose has been to prop up asset prices and paper over deficits long enough that time might heal the economic holes. They have had some apparent success: many asset markets doubled in less than 2 years. This has allowed some levered firms to recover and return to profitability. But the ugly twin to doubling stock prices at all cost has been a double in commodities and basic staples along for the ride. Coffee, wheat, corn, rice all have soared. *The world food index hit an all time high this month*.

In developing countries where people typically pay half their meagre earnings to eat, the added costs cannot be absorbed. The people have no option but to riot for attention and relief. This is causing particular risk and instability in areas key to the global oil supply. We are once again vying with $100 crude just as the world economy was starting to make *some* headway. And so the developed world too is now feeling the sting of the liquidity trap in this big circle known as our globalized economy. **A doubling in the price of oil within 2 years has happened 5 times in the past 70 years and every time it has led to a recession (4 times: 1974, 1979, 1990, 2000) or a precipitous slowdown (2005) within one month of the double.**

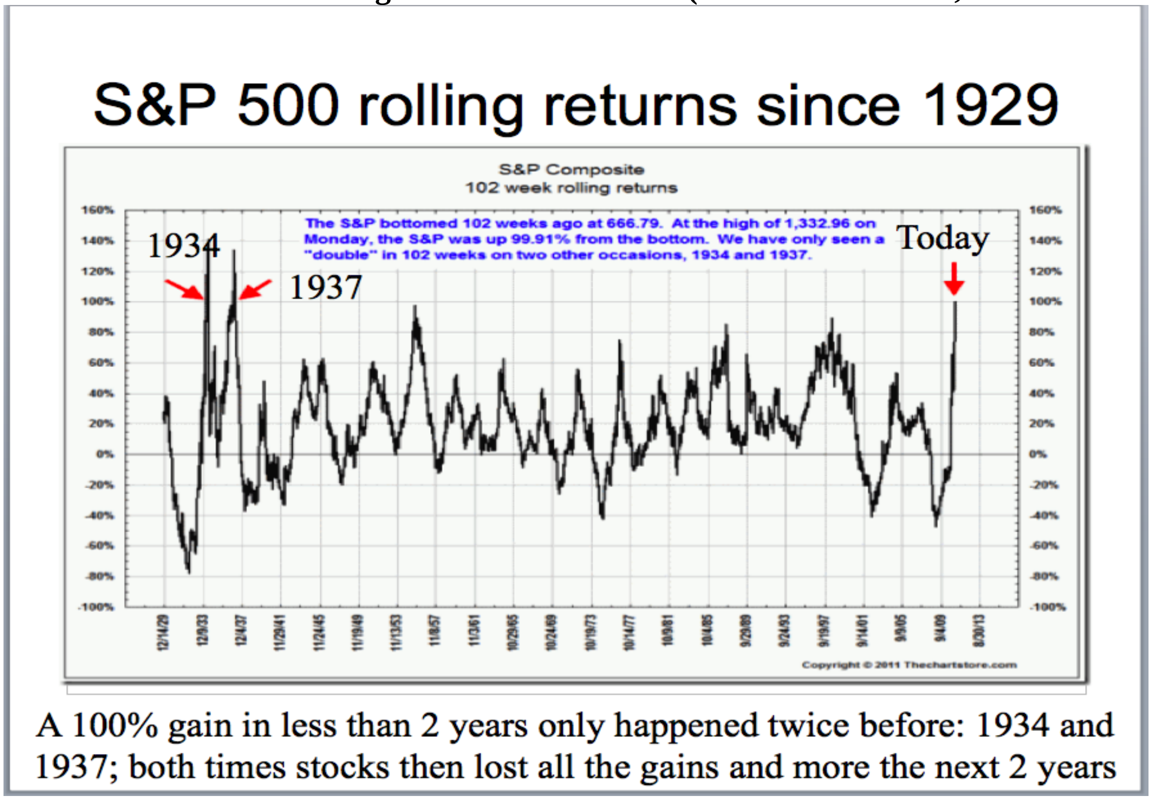
Government injections into free markets are no free lunch. We all knew that. Now we must watch with heightened concern as the domino effects play out.

Artificially inflating assets may seem helpful, but until valuations and leverage work lower, we will continue to labour with the challenges of our secular bear

For the past 23 months the stock market has enjoyed a powerful cyclical uptrend, with the S&P 500 now up 100% from the last cycle low in March 2009. There is no doubt that this has been a historic run in record time. It has prompted some people to feel a renewed sense of hope for a continued bull market. But history warns of caution. **The stock market has only ever doubled this quickly twice before in the last century: 1934 and 1937 (marked in red arrows on the chart below). In both of these previous episodes (like today) government stimulus and rescue attempts following a financial crash were the wonder drugs that reignited animal spirits and risk takers in record time.**

Following the 80% drop in stock prices from 1929 to 1932, the incredible rebounds of 1934 and '37 turned out to be not the beginning of the next big expansion, but rather two fleeting chapters in the midst of an ongoing secular bear. In both cases, the record rallies broke down again sharply giving back 100% of the rebound and then some, over the 12-24 months that followed.

S&P 500 Index 102 week rolling returns 1929 to 2010 (red arrows at 1934, 1937 and 2011)



__Probable Outcomes__

Financial market historian and principle of Crestmont Research, Ed Easterling recently sent us a copy of his new book *"Probable Outcomes, Secular Stock Market Insights."* This latest update from Easterling follows his 2004 classic "Unexpected Returns: Understanding Secular Stock Market Cycles." His conclusion today is that more than a decade into our present secular bear, we are <u>not nearly</u> through it. **We recommend that everyone with capital at stake today will benefit from reading this book.** We wanted to reproduce the entire thing for our clients to read this month it is so perfectly on point to present experience! As an alternative we thought the following excerpts gave a good taste of key ideas:

> *"The outlook for the current secular bear market is uncertain. It could last a decade longer with mediocre returns, or end in a blaze of fury within 5 years or so…For people who have many years to go, the keyword is patience. This decade will be a slog of accumulation. It is a period for careful and consistent additions to savings, and it's a very good time to be contributing. If you are in this group, then you will want lots of savings in the future when returns on savings (investment income) are positioned to be above average. Do not accept the conventional wisdom that you can afford to take more risk because you have more time."*
>
> *…There is no reason to play a game of chance with your life savings when the odds are weighted*

against success. When armed with a reasonable expectation of return based upon market conditions, investors do not need to take long-shot risks that are weighted against them.

Importantly, this does not mean that investors should avoid the stock market—rather it highlights the need to alter their approach away from passive buy and hold investing to more actively managed and diversified investment strategies. The stock market provides solid opportunities for returns during the secular bear markets, but during those periods, portfolios require an enhanced level of risk management to complement return generation." (p. 193-194)

He acknowledges the mental torture that daily gyrations in stock quotes can cause if we let them under our skin. But success in this environment requires us to stay extremely focused on our own rule set and risk management:

"…Market movements are choppy, volatile, and often without regard for the immediate economic or financial conditions. Overtime however, markets see the completeness of the forest, not the interim distraction of individual trees. Nonetheless, the experience of investors is quite the opposite—constant distraction from individual trees that often distorts the forest.

Though the shorter-term cyclical periods at times may last one or a few years, with dramatic surges and falls, these periods tend to feel like an eternity for long-term investors. There are 500 market days across just two years, representing several thousand hourly data points for those people who watch more closely. Though the overall trend may have direction, like a good story that takes time to develop, there will be many subplots that will create distraction if one does not remain focused on the overall script.

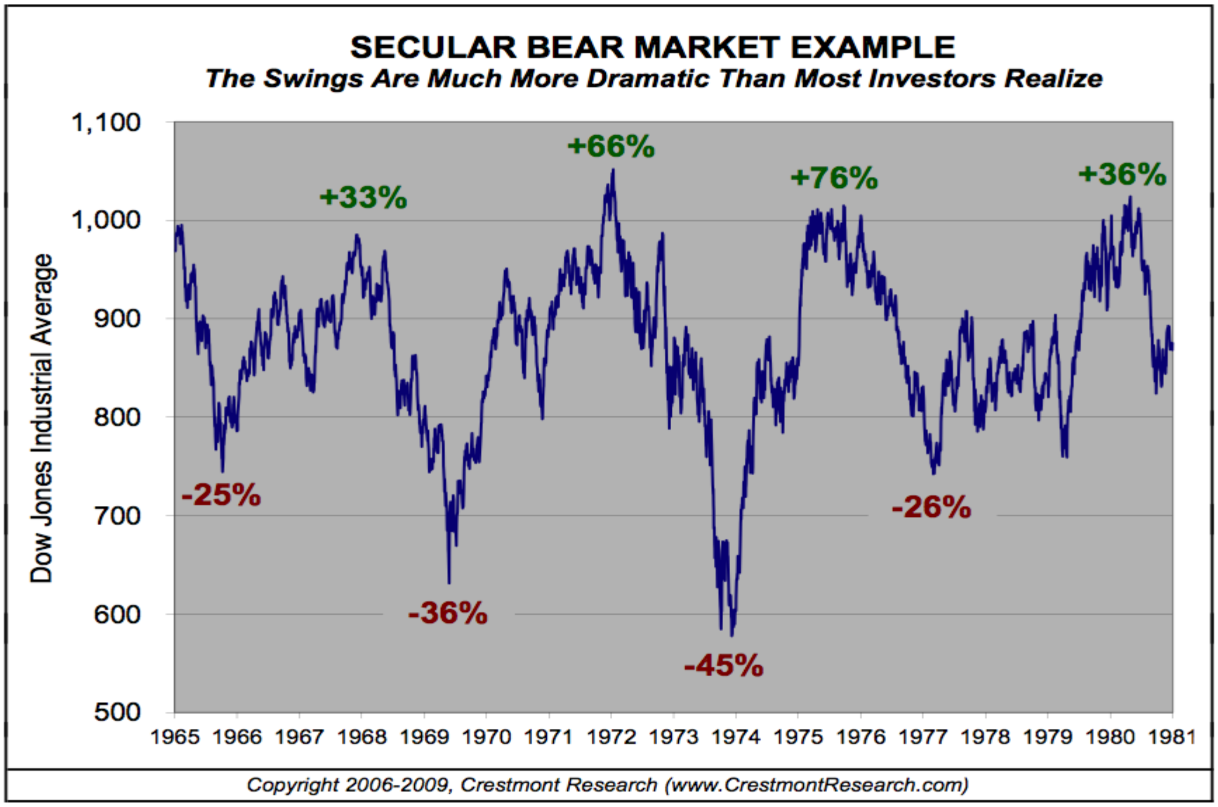
In the course of the market's script, there will be many instances when the fundamentals will be in charge, and there will be other times that may appear to be confusing exceptions. Another goal for investment success is to learn to avoid false lessons and misinformation as markets naturally take their course through the short-term cyclical periods across the long-term secular cycles. A portfolio that is appropriately structured helps to protect investors against the uncertainties of market action and to position investors with patience for performance." (p. 182-183)

Easterling points out that people at or within a decade of their retirement must not lose sight of the overall climate if we are to successfully protect and gradually grow our capital through the next few years and be well set up to benefit from the next secular bull that is coming:

"Rather than view the past and current decades as fallen periods, think of them as pauses resulting from the stellar surge of the prior two decades…one that requires wealth preservation rather than wealth accumulation...focus on additional savings rather than near-term returns on savings." (p196)

We hear from people each week who lament that prices keep powering up despite mounting hurdles. Over the past 6 months in particular the rally has been so fast and relentless it feels like it may never end. *We feel that way some days ourselves!* But logic assures us otherwise. As shown in the next chart of the last secular bear from 1966-1982, these periods are filled with a series of short-term bull market surges and bear market falls.

The only rational course is to sell after large rebounds and wait for contractions to buy back in.



It is widely known that reckless, levered investors went bust in the market crash of 1929; but **less understood is that many conservative investors later went bust not anticipating the subsequent retests that followed**.

This gruelling cycle of hope and crisis has always ended in a period of either rapid inflation or deflation which finally breaks the culture of speculation and compresses stock valuations to single digit multiples of earnings.

Sticking with our discipline is the best possible shot at success.

One last excerpt from Easterling:

> *"The key to successful investing in the environment of uncertainty presented by secular bear markets is the businesslike discipline of consistency based upon fundamentals...Consistency however, does not imply perfection. Consistency of principles and discipline sometimes meets the unexpected…as a result not all good investment decisions have good results, but consistently good decisions generally yield good results over time. In the end, rational discipline leads to investment success.*
>
> *Success is dependent not only upon the gains that are achieved but also upon the risks that are controlled and the investment process that is employed."* (p. 181)

Keeping focused on the progress of the secular trend, while maintaining a discipline aimed at controlling our risk so as to participate in a piece of each up cycle while avoiding the bulk of each contraction is the best course one can take in this environment.

Remember those roller coaster warnings: "For your own safety: remain seated, with your seatbelts securely fastened until the ride has come to a full stop"

Being long aware of the extreme volatility inherent in these cyclical swings, admittedly we at VPIC have erred on the side of being extremely defensive of capital the past 8 years. We have participated in each up leg (although yes, we tend to leave early) and we have bypassed the capital losses in the down legs. This has enabled us to accumulate positive gains with very low volatility over the years. **But in doing so, we have also had to stay out of the stock market about half of the time when it moved to dramatic over-valuations.** During these periods, the stock market has typically powered up without us for a while, making some clients feel unhappy that we are missing out on gains.

It is critical to understand that these "missing out" periods are our version of a bear market. The time out of favour can feel like an eternity for some. Some cannot sit tight and wait for the re-entry. They are driven mad by green stock quotes in the business news. They jump ship before they are able to see their patience rewarded. We know that we cannot help those who cannot stick the discipline. But these periods out of favour are undoubtedly the hardest part of our job. To add value, we have to be prepared to move against the herd; we have to look wrong before we can come to look right again. To benefit from this process, clients have to be prepared to stay with us through not just one or two years, but rather the full market cycle.

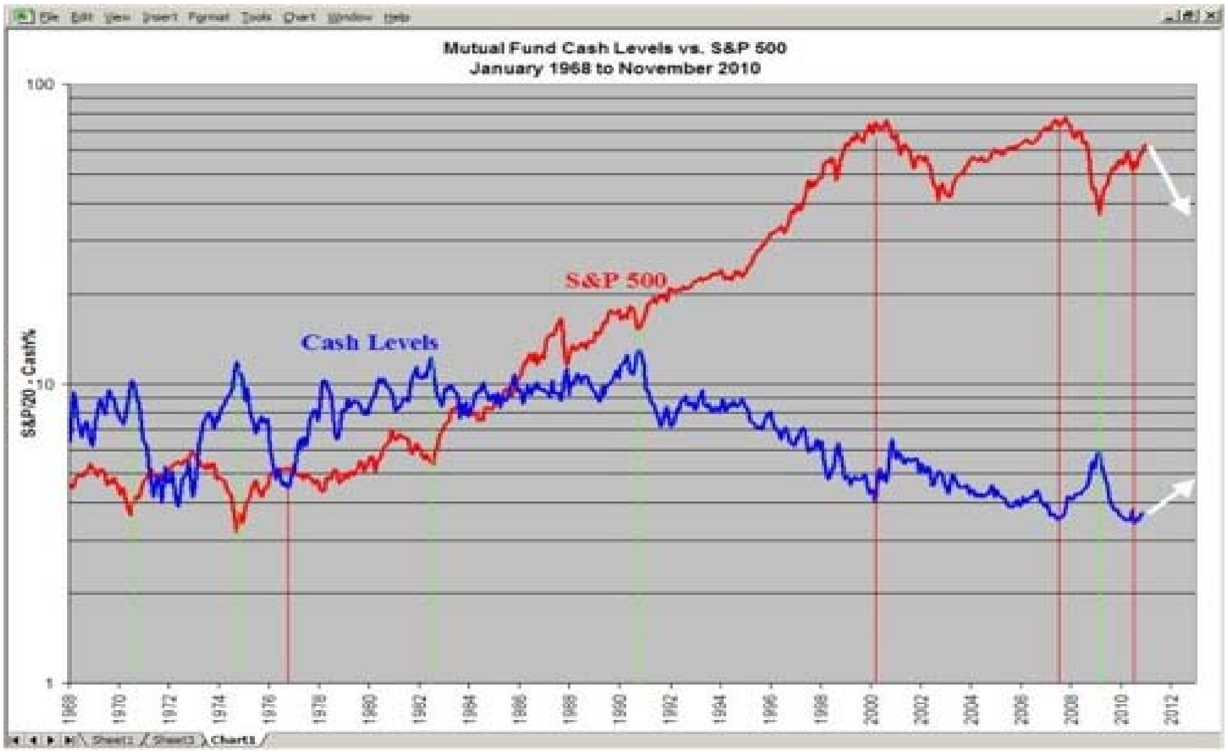
Many of our clients came to us after reading Danielle's book "Juggling Dynamite." **For those that are feeling bothered today by being out of market gains the past 6 months, we suggest that you might be well served to leaf through the book again now.** The wisdom and lessons therein are as applicable today as they were in 2007 when stocks and commodities spent another year surging up to their precarious peak. We all know what happened next.

History and the plethora of unaddressed financial challenges in our present time, assure us that bear market rallies are temporary and that lower more stable re-entry points lie somewhere within the next several months. We look forward to the opportunities this will bring all of us who through patience and discipline will have earned the reward.

Retail investors capitulating late once again

Sadly over the past couple of months, retail investors that had cashed out of the stock market with losses in 2003 and 2009 have just recently been moving back in. This emotional reaction is likely to end in tears for them again. At the same time, as shown in this next chart, mutual fund cash levels are now fully invested in stocks, with virtually no cash set aside for the high probability of lower prices coming.

Mutual fund cash levels vs. the price level of the S&P 500 from 1968 to 2011. Market peaks of 2000 and 2007 compared with levels today



An ominous gap: elevated stock values (red) and depleted mutual fund cash levels (blue)

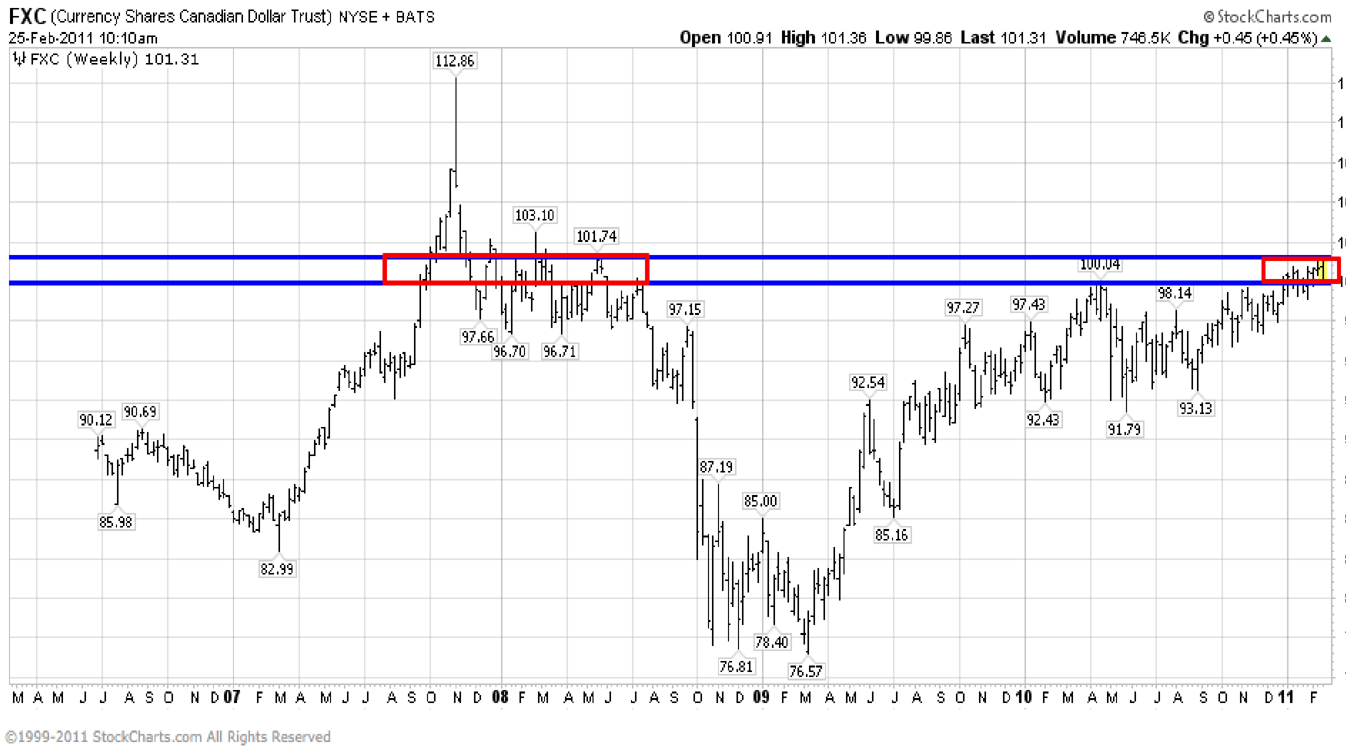
As always, once all the cash allocated for stocks has bought in, there are no further "fools" to buy and prices will begin to mean revert. Typically the declines appear with stunning speed, which catches the masses by surprise and unarmed. We are determined this shall not be the fate of our clients.

<u>Some price firming in our bonds this month</u>

After selling off the past three months on QE euphoria, this month bond prices bounced and strengthened a bit.

Strengthening bond prices, suggest that bond markets see more risk of deflation than inflation in the medium term. This corresponds with our own assessment, where we think recent commodity inflation will erode profits and demand but will not spread into the broader economy and labour markets thanks to enormous over-capacity in our post-credit bubble world. As a result, North American governments are unlikely to want to raise interest rates in a significant fashion any time soon, and this should be supportive of bond prices for at least the next year or so.

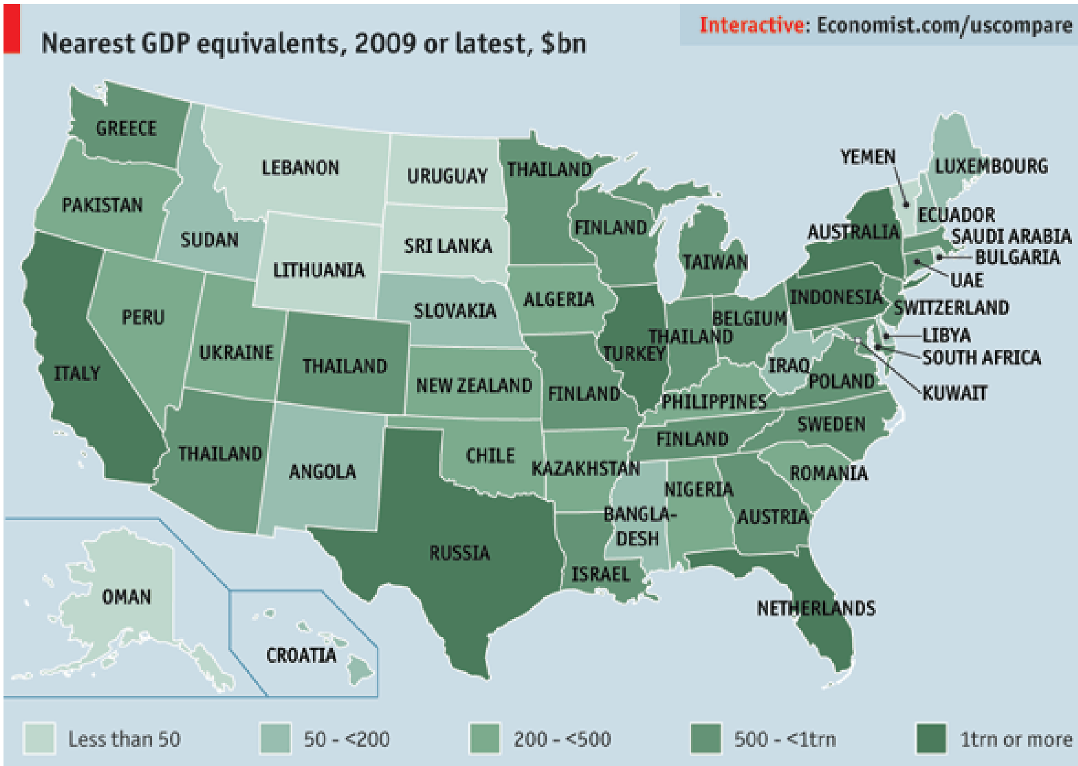
Oil spikes however are running up the Canadian dollar of late



As temporary as we suspect this may be, recently the Canadian dollar (FXC shown above) has moved through parity with the greenback once more. If it closes the week through the above marked long standing resistance (red box above) we may opt to cover our US dollar exposure in Canadian accounts for a period, by buying the FXC. However as the global economy is expected to slow in the months ahead, Canada is certain to feel that trend as well.

This time around we have a further vulnerability in that Canada's domestic housing market is over-valued and now starting to weaken just as Canadian consumers are even more over-indebted than in 2007 and with lower savings rates than Americans today. If the US can get any of its needed austerity measures in order over the coming months, we believe we are likely to see another interim rally in the value of the greenback as against Canada and the Euro. In addition as inflated commodity values put a damper on demand, Canada will export less to the world. As their co-dependent supplier, Canada definitely looks forward to a time when America is able to come into a period of organic growth again, free from its current dependency on government support. This next chart shows just how relatively big and important America still is to global growth.

The US Economy in relative size to other global economies



The above graphic of the US economy (courtesy of Dennis Gartman) and the relative size of the state economies which comprise it, is a helpful reminder of why America continues to be such a key and needed player in the world today. We should all hope for wise policies, leadership and meaningful fiscal rehab there as soon as possible. Come on America!! Your Canadian cousins are counting on you to get back to health.

And now we shall have March, spring is just around the corner!

Quotes of the month:

"It is the mark of an educated mind to be able to entertain a thought without accepting it."

—Aristotle (384 BC - 322 BC)

"As a profession we have failed miserably at our primary function – the efficient and productive allocation of capital…Today's rock-bottom yields, however, have less to do with disinflation and more to do with providing fuel for an asset-based economy that promotes unsustainable wealth creation and a false confidence in perpetual capital gains."

-- Bill Gross, principle of PIMCO, world's largest bond fund.

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