

E.Q Trendwatch™

Treasure in trauma



Shandie Spencer recovers her wedding dress from tornado-wrecked Joplin, Mo. Many in the town continued to search for missing relatives. (Mario Tama, Getty Images / May 26, 2011)

“In three words I can sum up everything I’ve learned about life: it goes on.”

--Robert Frost

Watching the footage of the tornado aftermath in the US Midwest this week reminds us of how fragile and vulnerable life can be. We are also reminded of the tornado that touched down in our hometown Barrie, 26 years ago on May 31, 1985. The devastation was incredible to witness. Whole neighbourhoods were wiped off streets in a matter of minutes. Children playing were sucked into the sky. Horses from the racetrack were flung like ants. Cars and trucks were placed in trees like dinky toys. Driving through the aftermath was (hopefully) a once in a lifetime experience, but the perspective was invaluable. It is trite but true—we humans often don’t appreciate what we have until it is taken away. Grateful souls strive to fight this complacency every day.



Cory Venable CIM, FCSI, CMT
Technical Market Analyst



Danielle Park LL.B., CFP, CFA
Portfolio Manager

**Venable Park Investment
Counsel Inc.**



33 Clapperton St.
Barrie ON L4M 3E6
Tel: (705) 792-3991
Toll Free: 866-792-3991
Fax: (705) 792-3992

This publication is intended to convey information only. It is not to be construed as a solicitation or offer to buy or sell and of the securities mentioned in it. The author has taken all usual and reasonable precautions to determine that the information contained in this publication d to summarize and analyze such information are based on approved practices in the industry. However, the market forces underlying investment value are subject to sudden and dramatic changes and data availability varies from one moment to the next. Consequently, the author cannot make any warranty as to the accuracy or completeness of information, analysis or views contained in this publication or their usefulness or suitability in any particular circumstance. You should not undertake any investment or portfolio assessment or other transaction on the basis of this publication, but should first consult your advisor. The author accepts no liability of whatsoever kind for any damages or losses incurred by you as a result of reliance upon or use of this publication in contravention of this notice. All performance data represent past performance and are no indication of future performance.

Amid loss and sadness it is always inspiring to watch life regroup and move forward. We were struck by many stories out of Joplin, Mo this week. One was of a young couple that were to be married on May 27. When the storm wiped out their town on May 22 they lost their home, neighbourhood and all of their belongings. As they were making their way through what used to be the streets, they were disoriented—nothing was where it used to be. Bearings were difficult to grasp. After hours of rummaging with others for bodies and survivors, the young woman recognized a fragment of a storefront. “Hey,” she said, “this is the alteration shop”. Pushing through chunks of debris, she couldn’t believe her eyes. The shop was all but gone, but there hanging on a lone clothes rack was one item—it was her wedding dress—ready for pick up. “We are taking this as a good omen”, she told CNN, “we are going to go ahead and get married this weekend anyway. The church and reception hall are both gone; but we can do it at the armoury, and we want to go ahead.”

Catastrophes like tornados, earthquakes and tsunamis offer an important reference point for the global financial crisis. Many people today worry about how we will ever find our way through the mountains of debt encumbering the world. Some feel the situation is hopeless. We do not. A debt crisis is dangerous to those who do not see it coming, but the plague is too many zeros not nuclear waste. We do know how to expunge it from the system. We just need to force the political will to do so through demands and actions from thinking people everywhere.

For thousands of years, countries, communities and families have repeatedly overcome all manner of disaster and crisis. A little thing like a debt bubble is not likely to end the world. Some banks and institutions will doubtless disappear as we work through the aftermath; bad structures must be recognized, dismantled, reconfigured and in some cases completely rebuilt. But our systems are likely to recover stronger and more resilient in the end. This crisis too shall pass. Hopefully all of us who have lived through this chapter of human history will remember its lessons and be able to offer wise guidance for several decades. This is a story for the history books. Wisdom gleaned from first- hand experience can be timeless and priceless.

A bubble in higher education?

One of the most significant inventions that allowed the human species to evolve and advance has been our ability to capture and pass on knowledge in recorded language. In this way, each generation does not have to start from scratch, but rather can stand on the shoulders of thousands of years of discovery. Our capacity for improvement and change are literally endless. Times and circumstances change, but human character and behaviour are incredibly consistent through centuries.

In the dark and middle ages the opportunity to spread knowledge was limited to oral traditions, face to face tutelage, and some books accessible by a limited few. Today thanks to the internet, more people have access to more information than ever before. This is an unprecedented opportunity full of great potential. But in advanced societies these developments also bring a new set of challenges.

Endless access to information can actually be stifling in its own way. How are individuals to filter it? How are we to glean the most important bits in the midst of endless clamour and noise? Moreover: how can we nurture our own creative thinking while digesting so many ideas and information from others? To this point we were struck by a new scholarship program being given out to young people who agree to turn their back on college studies for a period of two years. (Believe it or not).

The Thiel Foundation, founded by Peter Thiel, the PayPal co-founder and Facebook investor this year sorted through hundreds of applicants to select 24 people under 20 who have agreed to drop out of school in exchange for a \$100,000 grant and mentorship to start a tech company. See an [article on the story: Want success drop out of school.](#)

The winners this year include Laura Deming, 17, who is developing anti-aging therapies; Faheem Zaman, 18, who is building mobile payment systems for developing countries; and John Burnham, 18, who is working on extracting minerals from asteroids and comets. Thiel says that the fellowship addresses two of the country's most pressing problems: a bubble in higher education and a dearth of Americans developing breakthrough technologies.

There's an urgent need for innovation in areas like biomedical technology, nanotechnology, transportation and energy. Too often young people in North America blindly follow expectations to go to college or university without a clear passion or path. Meanwhile as demand has boomed, post-secondary costs have skyrocketed. This has increasingly been funded through an escalation in student loans and other debt undertaken by students and their middle-aged parents. Banks have made a fortune on the loan business. Baby boomers have been withdrawing from their already meagre retirement savings to help fund college for their kids. But when the kids are finished, there is often a mountain of debt and no decent job prospects. Thiel elaborates:

“We're not saying that everybody should drop out of college,” he said. The fellows agree to stop getting a formal education for two years but can always go back to school. The problem, he said, is that “in our society the default assumption is that everybody has to go to college.”

“I believe you have a bubble whenever you have something that's overvalued and intensely believed,” Mr. Thiel said. “In education, you have this clear price escalation without incredible improvement in the product. At the same time you have this incredible intensity of belief that this is what people have to do. In that way it seems very similar in some ways to the housing bubble and the tech bubble.”

The ‘great recession’ has opened parents’ and students’ eyes to the problems of a blind belief in higher education:

“I think a program like this would have been unthinkable in 2007, but you increasingly have people who

are graduating from college, not being able to get good jobs, moving back home with their parents,” he said. “I think there’s a surprising openness to the idea that something’s gone badly wrong and needs to be fixed.”

Which brings us to a personal peeve of status quo thinking: Modern Portfolio Theory

Acknowledging the limitations of status quo thinking brings us to an important deficit in the theories of money management. Danielle touched on this issue in her book *Juggling Dynamite* and a recent article elaborates further in a piece entitled: [Is Portfolio Theory Harming Your Portfolio](#), by Hedge fund manager Scott Vincent.

Modern Portfolio Theory (MPT) is the most prevalent thinking in the money management business today. It is the culmination of three main doctorate theories which were developed in the midst of a long secular bull market for stocks starting with Harry Markowitz’s paper on “Portfolio Selection” in 1952, William Sharpe’s ‘Capital Asset Pricing Model’ (CAPM) in 1964 and Eugene Fama’s “Efficient Market Hypothesis” (EMH) published in 1970. Markowitz and Sharpe both received the Nobel Prize for their work.

Modern Portfolio Theory (MPT) teaches that active equity managers who use judgement to make investment decisions won’t be able to match the returns (after fees and expenses) of blindly-invested, passively managed stock portfolios. Within the context of a secular bull market like we saw from 1942 to 1966 or from 1982 to 2000 passive allocations generally have a fighting chance (assuming an individual has a long enough time horizon). However during secular bear climates that existed from 1925-1942, or 1966 to 1982 or 2000 to present, MPT relies on a number of unrealistic and damaging assumptions about returns, human behaviour and the true definition of risk. MPT defines risk as the variability of returns around the mean rather than the likelihood of capital impairment or the angst, suffering and missed opportunity that follows loss.

In real life, whether we develop a rule set about when to buy and sell individual stocks or when to accept or reject market exposure using ETF’s or indices, good “active” managers undoubtedly add value—greater lasting returns with much less risk over full market cycles. This is doubly true during secular bear periods. Meaningful risk management requires some creative independent thinking, wisdom, experience and a practical discipline that requires constant monitoring. Yikes, sounds like work!

Nonetheless in a powerful financial industry focused on ever increasing scale and asset collection, marketing and circular arguments blindly trumpet MPT and its auto-pilot assumptions (PhD’s developed it, don’t you know!) over meaningful risk management. Bear markets and their crippling effects to capital are an inconvenience to be ignored in the long always machine of financial sales.

As author Scott Vincent puts it:

“Regardless of MPT’s shortcomings on both a theoretical and empirical level, its dominating influence will not easily be dislodged. MPT is deeply woven into the fabric of our financial system, its mathematical grounding and precise answers inspire confidence. Further, its application is crucial in bringing increased scale and profitability to the financial services industry. Few want to see change. As such, common sense and judgment will continue to diminish in importance as top-down, quantitative strategies and blind diversification gain investment dollars.”

The investment world has built itself upon the faulty founding principles of Modern Portfolio Theory. Adopting the erroneous assumption of an endless secular bull in stocks, it is virtually impossible to get most financial commentators, managers and advisors to question their beliefs and approach. Trying to convince them otherwise is akin to arguing against another’s firmly adopted religious beliefs. There really is no point.

In many key areas today—energy, health, sustainable growth and finance—the status quo approach does not serve the needs of our modern world. Einstein said imagination (and perspiration!) is more important than knowledge. Actually we need all three. The future lies in new ideas, inventions and thinking outside of the box. Critical, creative thinking and humble hard work are the keys to our continued evolution and success.

Strategy update: for clients who like detailed strategy we offer the following month end summary.

May continued to bring gains in our bond holdings with the US dollar bouncing off support amid weakness in stock and commodity markets. Our current defensive investment stance seems to be gaining support. Risk measurements for stocks and commodities are at extremes matching if not exceeding levels measured before their last price crash in 2008. **In fact we see the near term risk of contagion and shock to the global financial system as broader and potentially more dangerous today than at the start of the sub-prime debt crisis in 2007.**

Remembering our analogy of the global teeter totter with the bench mark currency— the US dollar—on one side and the rest of global asset markets—stocks, commodities, other currencies—on the other, the mounting crisis in the Eurozone has the potential to trigger a massive rally in the US dollar and an equally large and opposing decline in other risk markets.

Financial author John Maudlin [articulated the reality this week](#):

“Our credit institutions are so intertwined that a repeat of the 2008 credit crisis is entirely possible. Who plays the role of Lehman? Let me count the candidates. Greece. Ireland. Portugal. Spain. The ECB. Any number of large European banks with massive Irish exposure. Greece alone could be dealt with. That is why ECB leaders are right to talk passionately about contagion risks. But ignoring the political realities is not the way to deal with it.”

US dollar Index 1990 to 2011: the benchmark currency still calling the shots



As shown in the above chart, the US dollar index bounced off of long-term support around .73 against the basket of world currencies this month. From there it continued to rally to a high of .76 before closing the month above .74. So long as the US dollar continues to hold above support we expect the sell off in the rest of the markets to continue.

The Canadian dollar 2007 to 2011: this month the C\$ sold off and broke below 102.50



This publication is intended to convey information only. It is not to be construed as a solicitation or offer to buy or sell and of the securities mentioned in it. The author has taken all usual and reasonable precautions to determine that the information contained in this publication and to summarize and analyze such information are based on approved practices in the industry. However, the market forces underlying investment value are subject to sudden and dramatic changes and data availability varies from one moment to the next. Consequently, the author cannot make any warranty as to the accuracy or completeness of information, analysis or views contained in this publication or their usefulness or suitability in any particular circumstance. You should not undertake any investment or portfolio assessment or other transaction on the basis of this publication, but should first consult your advisor. The author accepts no liability of whatsoever kind for any damages or losses incurred by you as a result of reliance upon or use of this publication in contravention of this notice. All performance data represent past performance and are no indication of future performance.

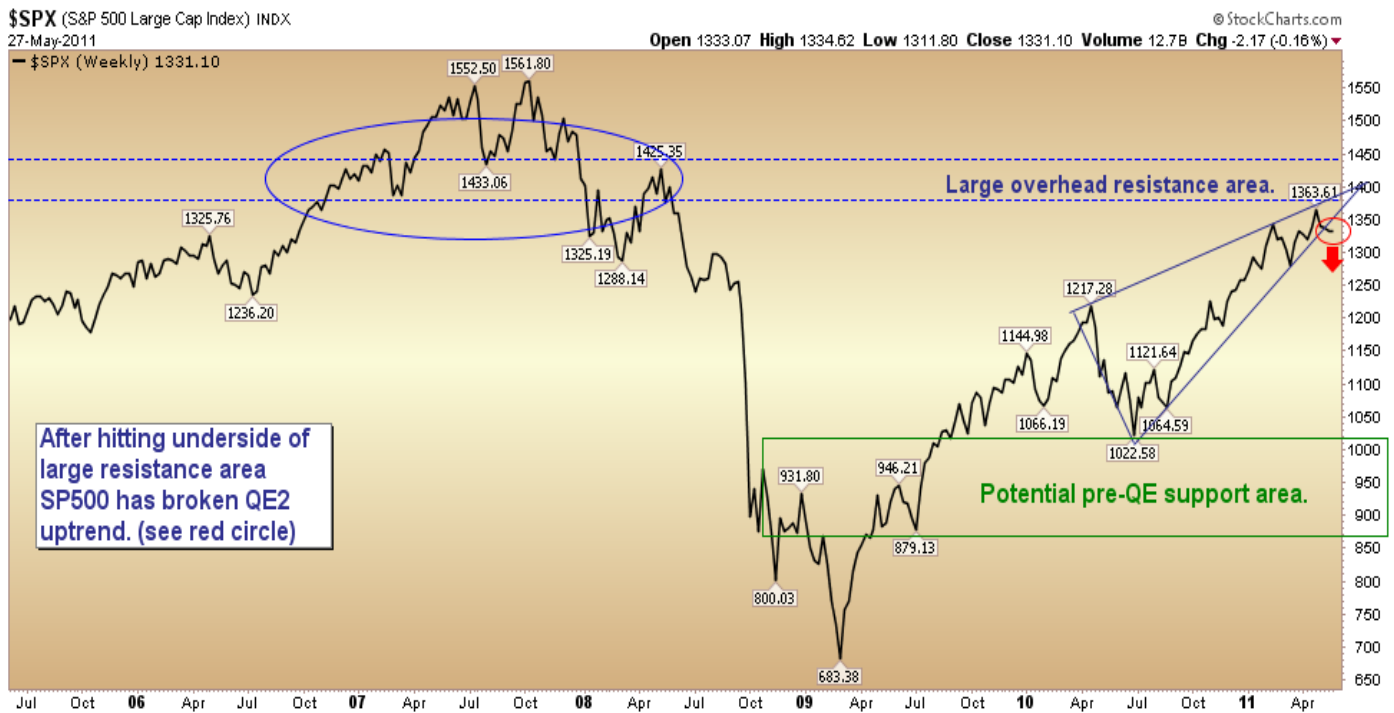
As shown in the above chart as the C\$ Index broke below key support of 102.50 at the start of this month, we removed our hedge and reinstated exposure to US dollar T-bills in our client accounts.

We are watching this trade extremely closely as a leading indicator for the risk cycle. It is interesting to note that the Canadian dollar peaked with the US stock market in October 2007 and bottomed with the world stock markets in March of 2009.

Equities: on ANY reasonable and historically reliable valuation model, equities are overvalued. The Fed's efforts to re-plate risk assets have come at a large price. Valuations across the board have become overblown on high margin, low volume trading. This short term side-effect should dissipate as the QE ends this June and markets are left to find their own equilibrium.

Our estimate is that at a minimum, pre-QE2 price levels could easily re-appear (about 1000 on the S&P, 11,000 on the TSX). It is also entirely plausible that most if not all of the speculative gains made since the QE's first began in the spring of 2009 will ultimately be given back.

S&P 500 2007 to 2011: QE2 uptrend broken



©1999-2011 StockCharts.com All Rights Reserved

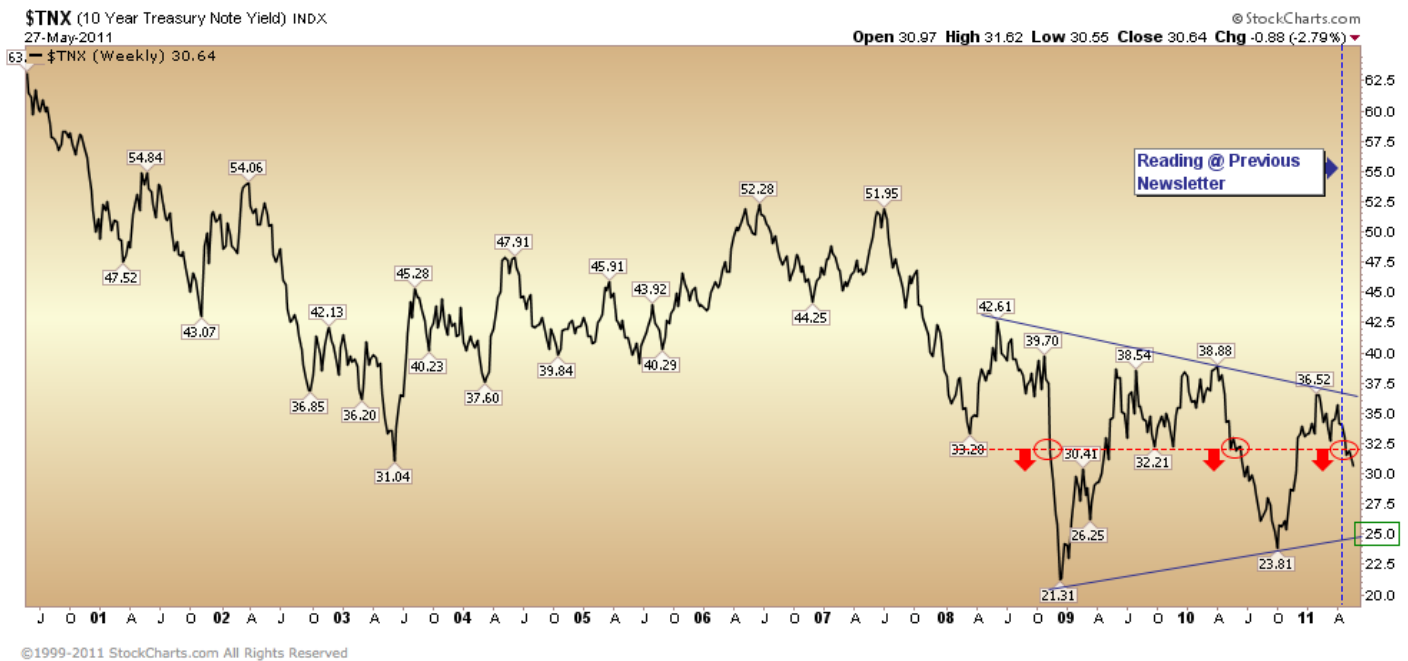
This publication is intended to convey information only. It is not to be construed as a solicitation or offer to buy or sell and of the securities mentioned in it. The author has taken all usual and reasonable precautions to determine that the information contained in this publication is based on approved practices in the industry. However, the market forces underlying investment value are subject to sudden and dramatic changes and data availability varies from one moment to the next. Consequently, the author cannot make any warranty as to the accuracy or completeness of information, analysis or views contained in this publication or their usefulness or suitability in any particular circumstance. You should not undertake any investment or portfolio assessment or other transaction on the basis of this publication, but should first consult your advisor. The author accepts no liability of whatsoever kind for any damages or losses incurred by you as a result of reliance upon or use of this publication in contravention of this notice. All performance data represent past performance and are no indication of future performance.

Less central bank asset purchases following the end of QE2 in June is likely to encourage a continued re-pricing (lower) on many of the commodity and interest sensitive stocks that we seek to purchase. Dramatic drops in some commodities such as oil and silver this month forced further liquidation selling prompted by margin calls on highly levered participants. Still elevated commodity costs in many areas following a period of “peak” earnings continue to be a drag on corporate earnings going into the second quarter of 2011. This month the second confirmation on US GDP for the first quarter affirmed the anemic 1.8% annualized growth rate for 2011. Estimates for the second quarter are now being downgraded by the many analysts who were characteristically too optimistic on economic growth over the past 6 months.

Bonds: In bond selection our strategy continues to look through the current fog of uncertainty to focus on our target quality and duration (avg. term to maturity under 5 years). Holding good quality bonds in the short to medium part of the yield curve has meant looking past short-term price swings while inflation and deflation forces do battle.

For a good big picture barometer on this battle, we continue to monitor the US 10-year treasury yield.

10 year Treasury Yield 2001 to present- still moving down- supportive of bond prices

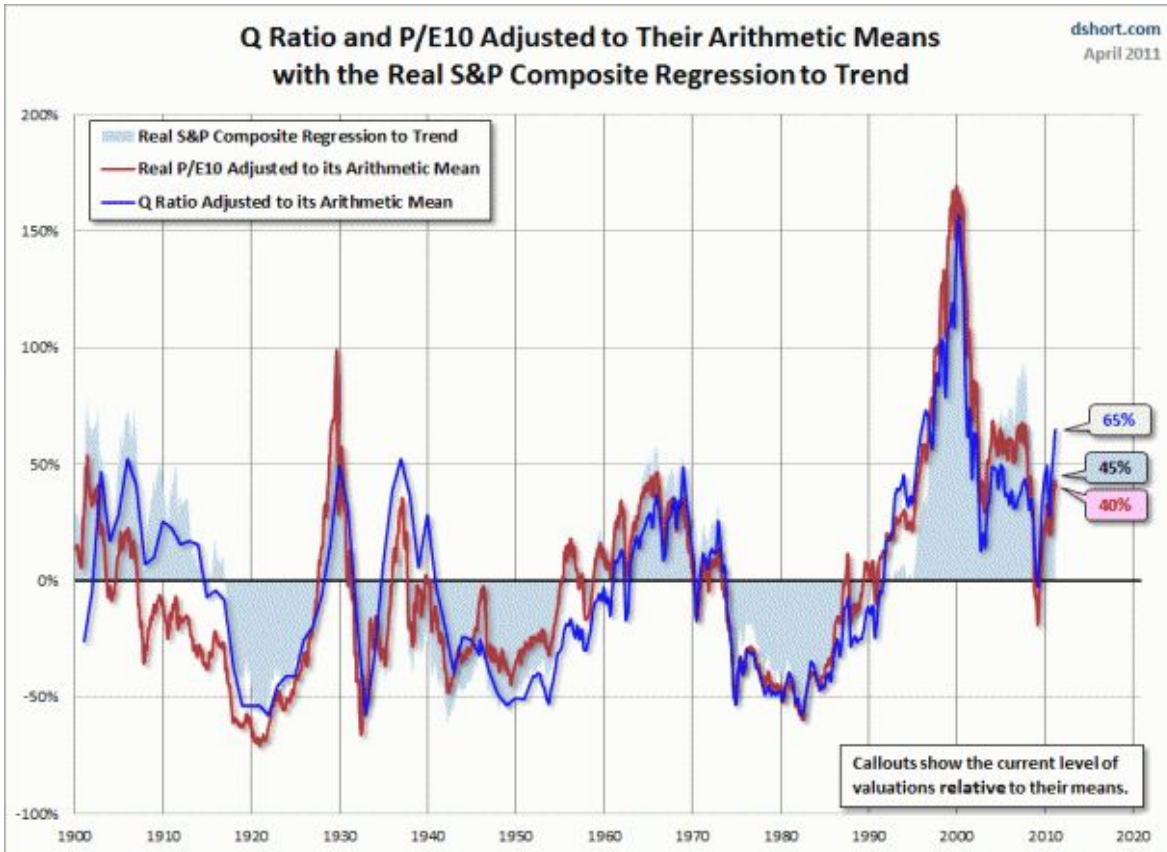


So far the bond market is signalling that since QE2 brought higher yields (lower bond prices)— the opposite of what the Fed said would happen— the end of QE2 in the next few weeks warrants lower yields and higher bond prices. This trend has been supportive of our current bond holdings. The 10-year note broke below key support at 3.20 and 3.09 this month to close at a yield below 3.07%. This is relevant as previous breaks below 3.2 % (red circles above) signalled the start of both the 2008 and 2010 stock market sell-offs.

This publication is intended to convey information only. It is not to be construed as a solicitation or offer to buy or sell and of the securities mentioned in it. The author has taken all usual and reasonable precautions to determine that the information contained in this publication is to summarize and analyze such information are based on approved practices in the industry. However, the market forces underlying investment value are subject to sudden and dramatic changes and data availability varies from one moment to the next. Consequently, the author cannot make any warranty as to the accuracy or completeness of information, analysis or views contained in this publication or their usefulness or suitability in any particular circumstance. You should not undertake any investment or portfolio assessment or other transaction on the basis of this publication, but should first consult your advisor. The author accepts no liability of whatsoever kind for any damages or losses incurred by you as a result of reliance upon or use of this publication in contravention of this notice. All performance data represent past performance and are no indication of future performance.

So far the bond market does not seem to be buying the idea that the economy is strong enough to produce inflation. To the contrary, so far it is suggesting a stagflation environment where input costs are rising while economic growth is slowing. The trend of falling inflation is supported by a lack of wage pressure, continued weakness in housing, contracting GDP expectations and continued slack in economic capacity.

An instructive big picture view of where we are at in our secular bear journey is captured in this next chart, showing the S&P 500, Tobin Q and Shiller PE values today relative to their long term average. The S&P 500 today remains 45% above its historical price trend while the other two valuation ratios suggest stocks are 40-65% overvalued relative to the long-term average reading on these metrics since 1900.



History assures us that the next secular bull period will not begin until the above values all plot 30-50% below the mean (solid black line drawn). And when they do it will present us with the buying opportunity of our lifetimes. (Won't that be fun?) In the meantime we continue to watch for the next phase of cyclical rally where we may capture good yield assets and a chunk of interim gain without unreasonable levels of risk to capital.

For more historical reference we liked the following chart showing the Historical Timeline of Dominant Currencies throughout time. From the beginning of money, the dominant military power has been the dominant

This publication is intended to convey information only. It is not to be construed as a solicitation or offer to buy or sell and of the securities mentioned in it. The author has taken all usual and reasonable precautions to determine that the information contained in this publication and to summarize and analyze such information are based on approved practices in the industry. However, the market forces underlying investment value are subject to sudden and dramatic changes and data availability varies from one moment to the next. Consequently, the author cannot make any warranty as to the accuracy or completeness of information, analysis or views contained in this publication or their usefulness or suitability in any particular circumstance. You should not undertake any investment or portfolio assessment or other transaction on the basis of this publication, but should first consult your advisor. The author accepts no liability of whatsoever kind for any damages or losses incurred by you as a result of reliance upon or use of this publication in contravention of this notice. All performance data represent past performance and are no indication of future performance.

currency. Looking forward, this history tells us two things that are likely: the US dollar will indeed one day lose its dominant status, and secondly, it may well take years or decades before that happens.



Best wishes for June. May we savour a part of every day.

Quotes of the month:

"If your actions create a legacy that inspires others to dream more, learn more, do more and become more, then you are an excellent leader." --Dolly Parton, Singer/Songwriter

"It isn't what you have, or who you are, or where you are, or what you are doing that makes you happy or unhappy. It is what you think about." --Dale Carnegie, 1888-1955

"You can preach a better sermon with your life than with your lips."—Oliver Goldsmith 1730-1774

Don't forget to visit our market blog www.jugglingdynamite.com for weekly commentary, articles and media clips.