*Real life needs active management*

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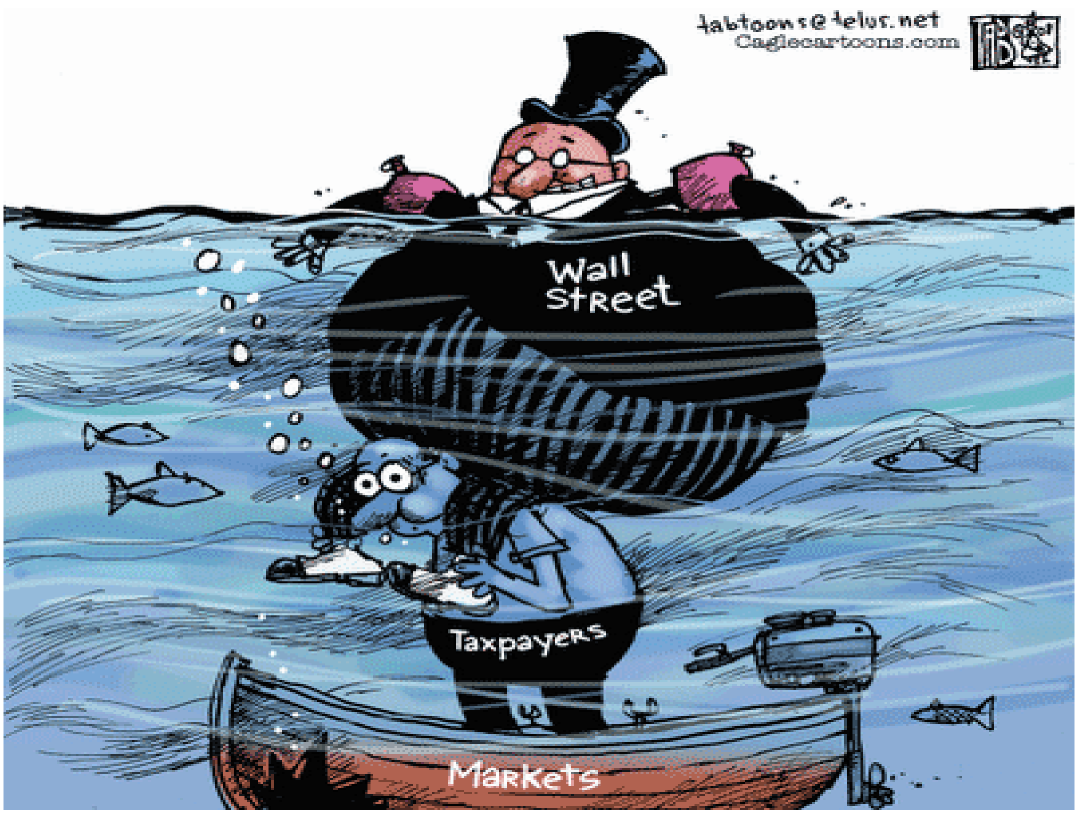
# E.Q Trendwatch™

## Hoping for the best—prepared for reality




“Illusions commend themselves to us because they save us pain and allow us to enjoy pleasure instead. We must therefore accept it without complaint when they sometimes collide with a bit of reality against which they are dashed to pieces.” -- Sigmund Freud, (1856 – 1939)

Markets staged the steepest 12 day rally since October 1974 this month with traders jumping to front run political jostling in the “European crisis”. It is worthwhile noting that manic swings are par for the bear market course and the October 1974 spike also occurred within the volatile series of an ongoing secular bear market in stocks. Unfortunately, issuing more debt cannot cure insolvency

**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.
VPP
www.venablepark.com

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

and clearly we are very far from any final fix for the debt crisis. However, we at VPIC can see two positive developments that came from the 14th Euro summit in 21 months. First, **banks finally agreed to “voluntarily” write off 50 cents on the dollar** for the junk bonds they hold from Greece. Secondly, for the first time since the financial crisis began**, governments seemed to finally exercise their upper hand over the banking lobby,** presenting the banks with a ‘take it or go bust’ offer.

These important steps comes after more than a decade where bankers have been calling the shots, ransoming governments with self-serving threats that banks could not possibly take losses on bad investments or the financial system would implode. This was the rhetoric that successfully extorted 100 cents on the dollar to banks from tax payers all over the world since the credit bubble burst in 2007. For the first time, on October 26, banks admitted a 50% capital loss on their bad investments. It’s a step in the right direction.

While a 50% “haircut” is non-trivial, the truth is this: even if Greece were forgiven of all of the debt they currently owe, **they still would not be able to pay their expenses without running further deficits**. Massive budget cuts are required to reduce the size of government and expenditures in order for budgets to ever move back to the black. Present and further cuts will force the Greek economy into a multi-year period of financial repression. No country has ever willingly accepted a recession for more than a couple of years. Longer than that has always brought great social upheaval. It is important to understand that today in the PIIGS countries about 50% of those under 25 are presently without employment. Indeed even in the US today, only 58% of the population is presently employed—the lowest since 1946. This leaves large chunks of the population unable to meaningfully participate in the economy. It also leaves large, energetic cohorts of the population with mounting frustration and lots of spare time to express it.

There is another reality check for all of us here**: the politicians and bankers who have been working on the crisis negotiations have not factored in the possibility, never mind the near certainty, of the economic recession that needed fiscal cuts will precipitate. This means that all of the econometric assumptions being used today are overly optimistic and likely to disappoint.** These erroneous assumptions are akin to agreeing to renegotiate the terms of a borrower’s loan without even considering whether or not they have income to pay.

Greek bonds are not worth 50 cents on the dollar; indeed 20 cents on the dollar may be overstating the likelihood of capital recovery. Authorities have not even begun to negotiate the necessary cuts and write offs coming on Italy, Spain, Portugal, Ireland et al. Now that the EU has blinked on Greek debt, we should see Ireland, Portugal, Italy and Spain also looking for principal reductions. Why wouldn’t they?

Three years after the bursting of the greatest consumer credit bubble in history, economies are burdened with total debt levels (public and private) at the highest ever. Here are the current estimates of the total debt levels of the world's leading economies.

| **Total Debt (public and private as a percentage of GDP)** | |
|---|---|
| Japan | 470% |
| Euro zone and UK | 450% |
| Canada | 410% |
| US | 350% |

Source: Capital Economics and Hoisington Investment Management

A realistic look at these numbers reveals a couple of important points: **massive debt will need to be paid off and written down over coming years, and the cost of carrying and retiring these debts will be a significant drag on world growth.**

For Canadians it also highlights that although our Federal debt (now 84% of GDP) is relatively lower than the others in this group, thanks to surging consumer debt over the past couple of years, the **total debt in Canada today is 410% and more than our American cousins at 350%**. We at VPIC have been pointing out the mounting debt burden for a few years now, so we are heartened that other analysts are also beginning to connect the dots between debt burdens and slower growth. Here is Lacy Hunt and Van Hoisington of Hoisington Investment Management, this month:

> *"The statistics indicate that the Euro currency countries as a group, the United Kingdom, Japan and interestingly Canada, are all more deeply indebted than the United States. This should not give the US solace, nor detract from our severe problems. However, the greater debt in these areas may serve to provide backhanded support to the dollar. More critical is that all major countries are destined to experience slower growth because of excessive indebtedness."*

**Credit, leverage and bailouts: crippling costs to the real economy**

Financial rescues with tax payer funding have a negative impact on the real world. Layering credit on credit may have looked like a free ride but today we are starting to see that credit abuse has been a costly round trip to nowhere. Society will be paying for the aftermath and clean up of recent chapters for years to come. After reckless consumption of non-productive goods, misallocation of resources and trying to cover up the mistakes by bailing out financial institutions, the real world now has less funding for the foundations of civilized society: healthcare, education, arts, investment, research, science, infrastructure…you name it.

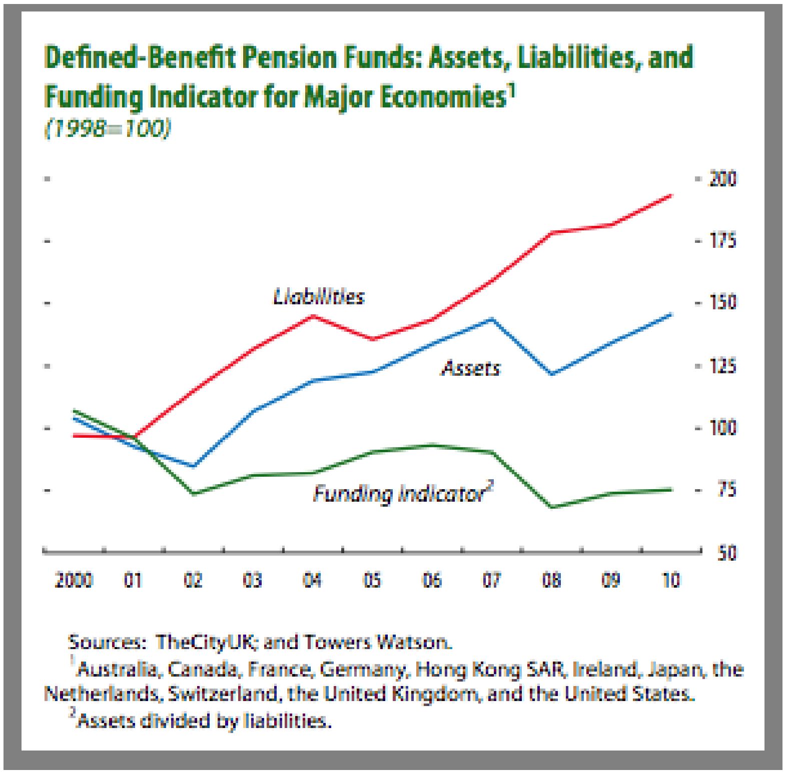
As our poor planning would have it, all of this is coming just at a time when the world is approaching 7 billion people and more innovative, efficient technologies and systems are desperately needed. The US is the largest economy and relatively wealthiest country in the world, yet years of neglect and imprudent policies have left it hobbling along with sub-par infrastructure in most key areas (shown below). The challenge for both the private and public sector going forward is how to implement the necessary upgrades while capital is scarce, growth is slow and tax receipts are still declining. **Tough choices are ours but there is also enormous opportunity here for an efficient focus on restoring and rebuilding the infrastructure for the next 100 years. Captive capital wants a valuable focus—infrastructure is a no brainer.**

## Failing U.S. infrastructure

The grades from the American Society of Civil Engineers:

| | |
|---|---|
| Aviation | D |
| Bridges | C |
| Dams | D |
| Drinking water | D- |
| Energy | D+ |
| Harzardous waste | D |
| Inland waterways | D- |
| Levees | D- |
| Public Parks and Recreation | C- |
| Rail | C- |
| Roads | D- |
| Schools | D |
| Solid Waste | C+ |
| Transit | D |
| Wastewater | D- |

At the same time, the indebted west faces the burden of the aging baby boomers and their promised entitlements in healthcare and old age security. All of this comes as world pension plans from Australia to Canada, Europe to Japan, UK to the US, are all facing massive underfunding (graphed below).

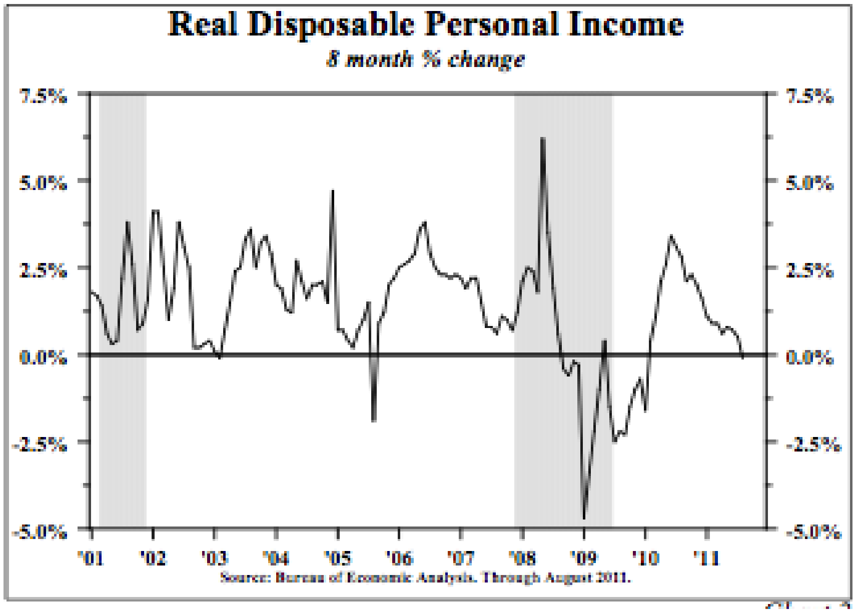



*"That global fiscal policy is forced into austere spending cuts for research, education, and social services as a result of financial recklessness, but we've become conditioned not to blink, much less wince, at gargantuan bailout figures to defend the bloated financial institutions that made bad investments at 20- 30- and 40-to 1 leverage, is Timothy Geithner's triumph and humanity's collective loss."* – John Hussman, October 24, 2011

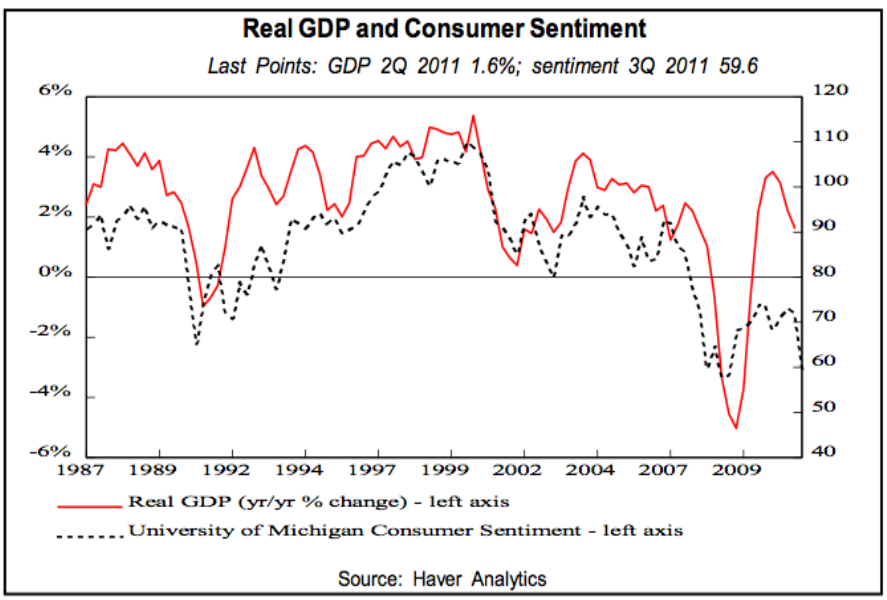
**The 'Occupy' movement is part of our history of social upheaval to force change.**

What started as the Arab spring became the European summer, the Wall Street fall, and has now spread to the 'Occupy world' movement. Civil unrest is a typical hallmark of change periods in history and is a catalyst for rebalancing world order.

**The real economy tells the story: families are struggling**

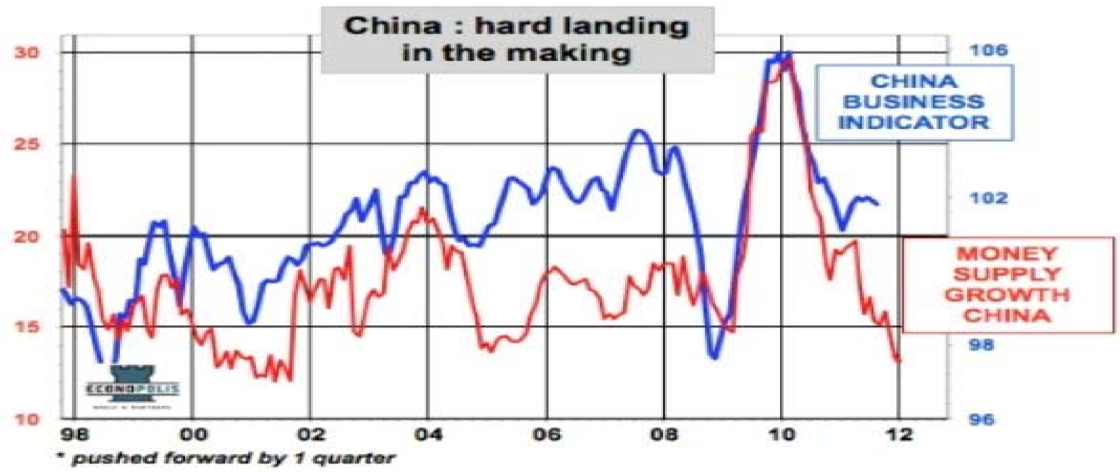



The US is still relatively better off than most countries, but the average disposable personal income (shown to the left) is today back at the lows it breached in the midst of the great recession of 2007-2009. With consumer credit also contracting and hard to get, it is not surprising that domestic consumption has been faltering since early 2010.

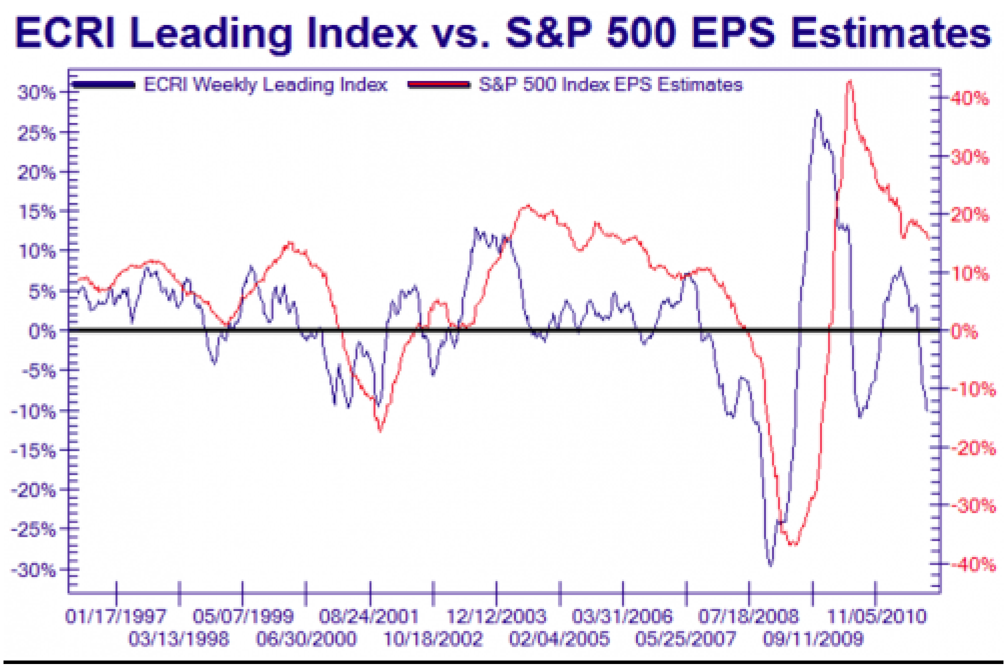



Consumer sentiment correlates with economic growth and today US consumer sentiment (dotted line left) is lower than in the aftermath of 9/11 or the recent Great recession. One can only imagine how main-street will cope with further lay-offs and home price declines as we head into this next recession. History tells us that the gap at the far right of this chart will close with Real GDP (solid line) moving down to follow consumer sentiment (dotted line).

**Indicators suggest the next cycle downturn in China is also underway.** After herculean government intervention to stem the downturn in 2008, Chinese money supply has been normalizing lower and business growth (blue line) has been contracting along with the money supply (red) since 2010. An ominous gap has now opened up between the two (bottom right of chart). Traditionally this gap closes with business growth falling to meet money supply. After two years of making loans to anyone and everything, the Chinese banking system is now awash in non-performing loans some 60% of which are unlikely to be collectable.




A similar gap is apparent in the below chart of the Economic Cycle Research Institute leading index (red) and the consensus earnings forecasts for the S&P 500 companies (blue) looking into 2012. This gap in the past has always eventually closed with earnings estimates moving down to match the leading indicators. Once earnings are revised lower, stocks are revealed as having been over-optimistically priced heading into the downturn.



**Strategy update:**

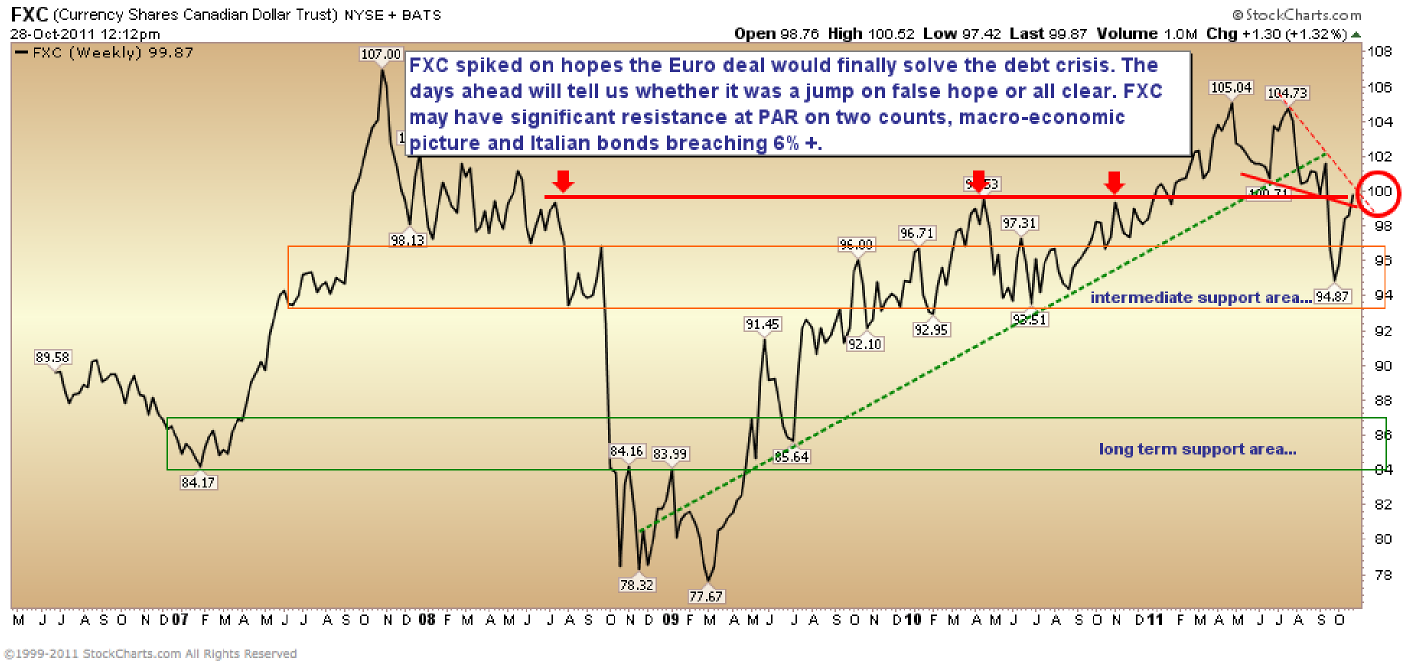
October staged a massive counter-trend rally in risk assets. In a matter of 12 trading days stocks and commodities moved from being heavily liquidated at the start of October to massively over-bought by the end of the month. Since these assets remain over-priced, risk measurements for stocks and commodities are signalling danger of significant price declines. **We continue to 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, some of the other currencies—on the other:

**US dollar Index 1990 to 2011: the greenback held long-term support this month amid great volatility**


At the start of October, the US dollar index rebounded above 78 against the basket of world currencies. In the final couple of weeks euphoria on hopes for a painless Euro rescue, saw the U$ weaken somewhat. The tug and pull continues: the likelihood of further disappointment in Europe and the November 23 deadline to announce 1.2 trillion in US budget cuts are U$ bullish. While the possibility of more QE from the Federal Reserve as the economy moves into recession presents a downside risk for the greenback. In the meantime, 88 on this index remains the medium-term upside target.

**The Canadian dollar 2007 to 2011: the C$ laboured below par for most of October**



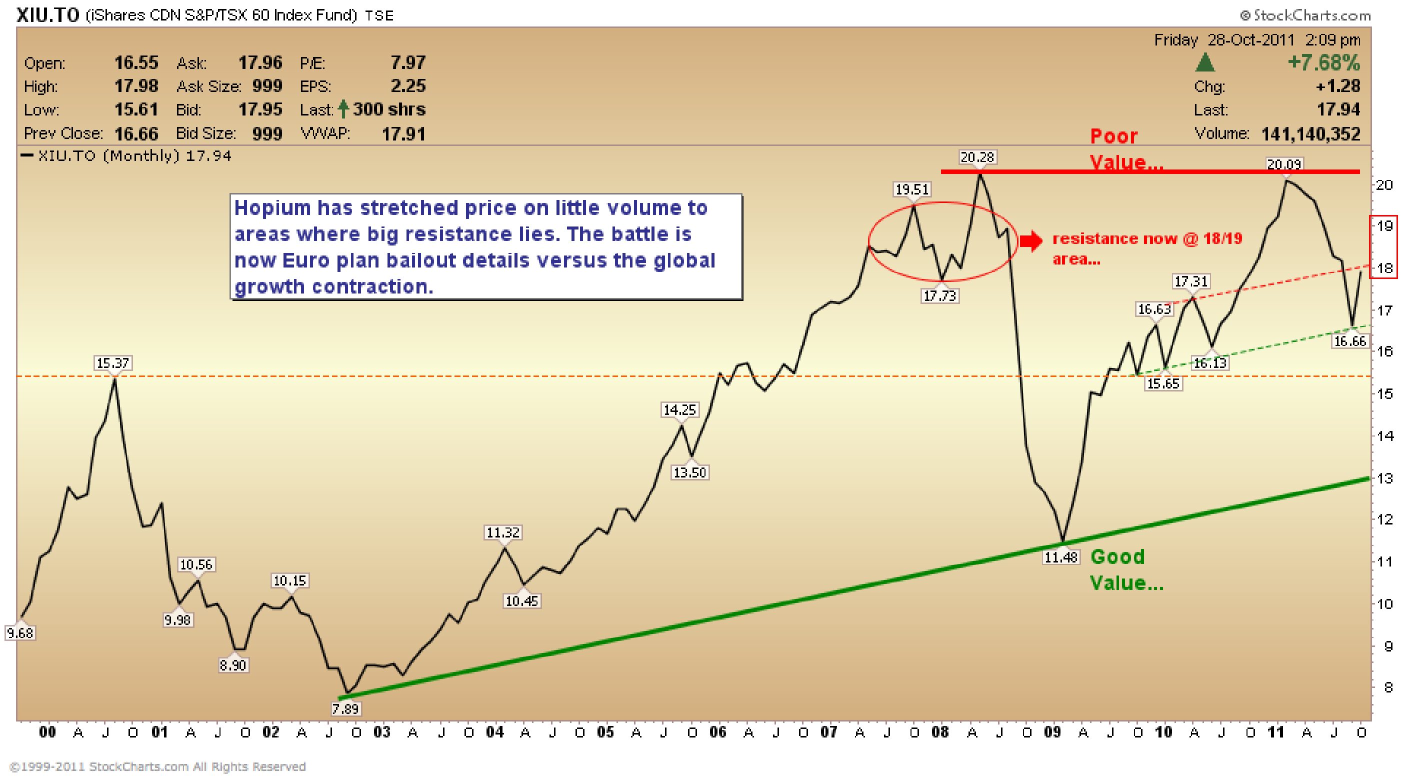

As shown in the above chart the C$ Index broke below key support of par at the start of this month against the US dollar. As Euro optimism in stocks soared in the final week of October, the loonie staged a rally back to par. The days ahead will tell the story of whether the recent strength was misplaced optimism on the global economy. We still see the probability of further weakness from here as the recession story takes its toll on world risk markets and the demand for commodities.

***Equities:*** Although downside progress has been made since the start of the year on every reasonable and historically reliable valuation model, equities remain overvalued. Government efforts to re-flate risk assets have come at a large price. Valuations across the board are overblown on high margin, low volume trading. This short-term side effect should dissipate as appetite for government intervention wanes and markets work to find their own equilibrium.

**Our estimate continues to be that pre-QE2 price levels could easily re-appear (about 1000 on the S&P, 11,000 on the TSX). At month end we are now 22% and 12% above this test. 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 before the next cyclical bull begins (this support is at 700 on the S&P and about 8500 on the TSX).**

## S&P 500 2007 to 2011: a low volume bounce off support; now testing upside resistance


## Canadian stock market: quick sharp bounce on weak volume. Where to next?



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As stock prices staged a sharp recovery this month, the lack of buyers was alarming. The S&P 500 daily turn over volume fell 20% from September, where the sell off days saw big volume spikes. On Asian markets, participation this month was 20 to 45% less across the board. The growing evidence of global recession including a major slowdown or hard landing in Asia continues to threaten a wide sell-off of over-priced asset markets.

***Bonds:*** Our strategy continues to focus on high quality North American issues in the short to medium part of the yield curve. Our rationale was that in times of global crisis, investors would move out of many troubled regions abroad and migrate back to North American bond markets. This has proven correct and has been supportive of our bond holdings year to date.

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- yield downtrend still supportive of bond prices**


In the final 2 weeks of Euro hopes, we saw some sell off in North American investment grade bonds as yields rallied from 100 year lows in September. Our thesis of short-term deflation and growth slowed by government debt and austerity remains in tact. There is significant upside resistance for higher bond yields noted at the dotted line above.

At the same time, the bond markets in Europe did not confirm the stock markets hopes on Euro debt negotiations. Yields on Spanish, Italian, Portuguese, French and the European Stability Fund bonds all moved up signalling recognition of growing (not declining) risk.

We will continue to watch the medium trend carefully. So far, the bond market is still signalling tough times ahead. The trend of falling inflation is supported by a lack of wage pressure, continued weakness in housing, contracting GDP expectations and slack in economic capacity.

**A final note on managing risk in this climate**

We are seeing an incredible storm in world asset markets. By the end of September, our balanced accounts were positive year to date while comparable benchmarks were several points negative. Our holdings gave back some of their gains this month as the risk trade rebounded in the last 3 weeks. Our accounts have been largely insulated from the manic swings endured by the fully invested public, but slow progress can still seem frustrating. It is for us, so we can imagine it can be frustrating for our clients too.

Most investment strategies from day traders to long-short funds, hedge funds, portfolios of “conservative, diversified” and dividend paying stocks have all experienced losses year to date. 80% of hedge funds have now lost money in 2011 some are negative by as much as 50%. **We have received many calls and emails over the past few months from customers at all these other firms who are unhappy with another year of capital losses and especially coming before they were able to recover their capital lost in the 2008-2009 downturn. Most people at other firms are now facing compound losses over the past 5 years and more**. Understandably, most say that they are frustrated and unhappy with their investment manager and approach.

**At VPIC our compound returns have been positive but modest, now averaging just over 4% net annually since 2003, (with 1/3 of the market volatility). We would love to make more. We want you to know that we are doing everything we can to protect your capital and look for opportunities**. Our dilemma remains that while we measure price risk as shockingly high today, it is possible that government interventions from more QE in the US, UK, Japan and bail out funds in the Euro zone and Asia could spark another rally leg in risk markets—perhaps lasting days or weeks, maybe even a few months. We will take our signals as they come, but we are not prepared to jump in with the madness of crowds where it exposes our clients to unreasonable risks no matter how impatient we, or they, may become. **We have to insist on our principles and rules, or we can fall for anything today along with the masses**. The art of now is not to drive capital hard but to go gently into the future with our savings in tact and our investment buy lists at the ready.

**Best wishes for October, the winter is coming… the story of the grasshopper and the ant comes to mind this fall more than ever…**

**Quotes of the month:**

***"The average pension in Slovakia is less than 400 Euros. The average pension in Greece is 1,400 Euros—three, four times higher. It's impossible to explain to a Slovak pensioner that he or she has to contribute—in the form of a higher VAT, for example—toward Greek pensions, or toward Italian MP's salaries, the highest in Europe."*** –Richard Sulik, leader of Slovakia's neo-liberal Freedom and Solidarity Party.

***"Hard work spotlights the character of people: some turn up their sleeves, some turn up their noses, and some don't turn up at all."*** -- Sam Ewing, Former Major League Baseball Player

***"…overconfident professionals sincerely believe they have expertise, act as experts and look like experts. You will have to struggle to remind yourself that they may be in the grip of an illusion."***

–*Daniel Kahneman, Princeton University, winner of 2002 Nobel Prize in Economics.*

***"None of us can be free of conflict and woe. Even the greatest men have had to accept disappointments as their daily bread."*** –Bernard Baruch 1870-1965, Financier and Political Consultant

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