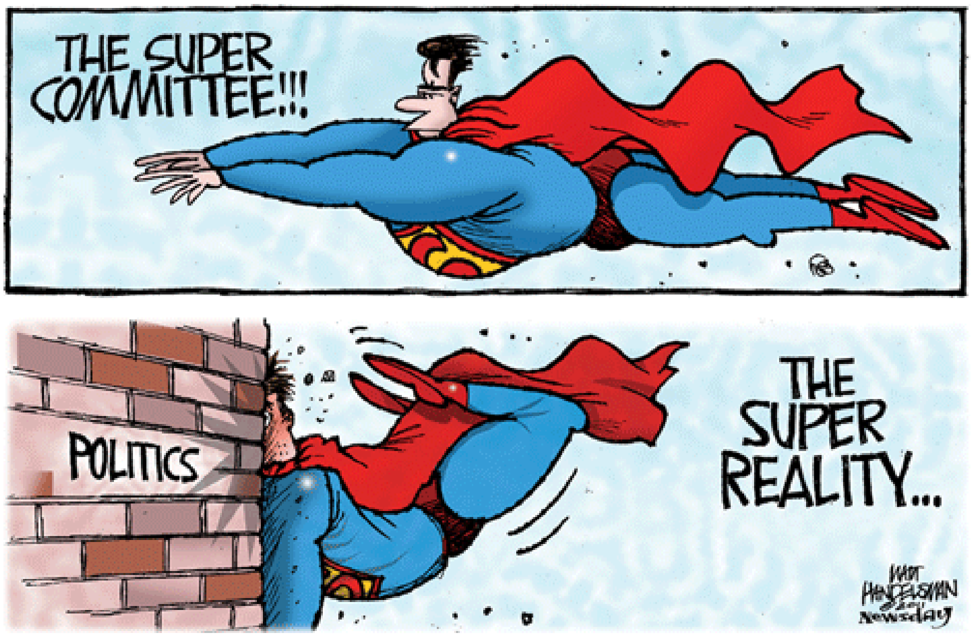
Real life needs active management

NOVEMBER 30, 2011. ISSUE 11

E.Q Trendwatch™

Heroes wanted—leaders needed



Cory Venable CIM, FCSI, CMT
Technical Market Analyst

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

Venable Park Investment Counsel Inc.

"There is a mysterious cycle in human events. To some generations much is given. Of other generations much is expected. This generation of Americans has a rendezvous with destiny." – Franklin Delano Roosevelt *(US President, 1933-1945)*

Generation waves

This month the world's human population passed 7 billion. It took 123 years for the world to add its second billion people (in 1927) but since then, we added 5 billion more in just 84 years.

Much of the people growth has happened in India and China who have been two of the world's most populous countries for centuries. But a demographic shift is now taking place as Asia faces the aftermath of low fertility rates. Today, the biggest population growth is taking place in sub-

Venable Park Investment Counsel Inc.
VIIP
www.venablepark.com

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

Saharan Africa where poverty and infant mortality rates are high and family planning low. The result is high birth rates in a population of 900 million — a number that could triple by the end of the century when the UN forecasts that world population could peak at 10.1 billion by 2100.

For those of us that are worried about the sustainability of the world's resources to support all these people there is some good news here: as developing countries mature their birth rates naturally slow and by 2100 the world population is likely to enter a phase of global decline.

E**ach country's future is exactly as strong as its young people**.

While much has been said about the rapid ascent of China's economy over recent years, the facts are that China is likely to decelerate going forward as quickly as it advanced. In 1979 China began its one-child policy to limit population growth. The result was an estimated 400 million Chinese children that have not been born on top of many more that were lost to the country through early death or adoption to foreign lands. The result is a rapidly declining labour force as China moves into the future. Ironically social safety net spending in China has historically been very limited because Chinese families could rely on the young to support the old. Now there is a significant hole in the fabric of the extended family system--there simply are not enough young people. Where the Chinese government was able to underfund the nation's social security in the past, now they face steadily increasing costs for the future.

The Baby Boom generation saw some 450 million people born in western countries between the years 1947 to 1966. Over the past 65 years this cohort has been a huge force driving demand waves for consumer goods and credit. Born into relatively "good" times, with women entering the work force in record numbers, the Boomers also did not have a lot of offspring. 78 million Boomers born in the United States had a total of just 69 million children dubbed "Generation X" and born between 1965-1985

History shows that all people in developed worlds move through a similar life cycle: they are born, schooled, get jobs, raise families, reach peak earning power between ages 40-60, then retire, need extended health care, old age homes, and die.

The Boomers are now all moving to the back side of the demand curve and because of poor planning and a preference for debt ballooning by governments, corporate leaders and individuals, the Boomers are now driving a crisis for social security, medical care and retirement income funding as they enter their older years. The funding shortfalls in our economy today are likely to continue for several years as the larger group of boomers places a large fiscal drag on the younger, smaller group of workers behind them.

The good news for North America is that the kids of the Boomers have had strong birth rates.

Dubbed "Generation Y" the grandkids of the Boomers born 1985 to 2005 are a huge 100 million in the US. These grandkids are now age 7 to 26 with the leading edge coming into a very weak economy looking for jobs and summer work, which are scarce and often just not there. (Those

Kids “Occupying” everywhere the past couple of months are predominantly Gen X and Y’ers).

The Boomers and Generation X need Generation Y to find productive jobs in society—they are the tax base of the future. In the short run this will be a source of escalating societal unrest as Boomers seek to direct government policy to support their own interest in maintaining inflated prices in real estate and investment securities as well as increased spending on social security and medical services.

The Boomers will eventually see, however, that they will have to give to get.

The generation following them cannot buy assets off the Boomers at current prices. With the credit bubble now deflating, Gen X and Y simply do not have sufficient savings and incomes to do so. The Boomers cannot keep all their cake and have others buy it too. Asset prices will likely adjust down to more affordable levels as sellers looking to raise cash increasingly dominate markets. The socio-economic transition over the next 5-10 years is likely to be bumpy and challenging as the competing interests in our society find a manageable and affordable equilibrium.

Necessary, large, systemic global adjustments are underway and will take a few unsettling years to complete—but understanding and accepting this, we can thrive by governing our decisions and expectations accordingly.

In his newsletter this month, long-time Pimco manager, Bill Gross explained the current market upheaval this way:

> *“…investors should recognize that Euroland’s problems are global and secular in nature, reflecting worldwide de-levering and growth dynamics that began in 2008. It will be years before Euroland, the United States, Japan and developed nations in total can constructively escape from their straitjacket of high debt and low growth. If so, then global growth will remain stunted, interest rates artificially low and the investor class continually disenchanted with returns that fail to match expectations. ”*

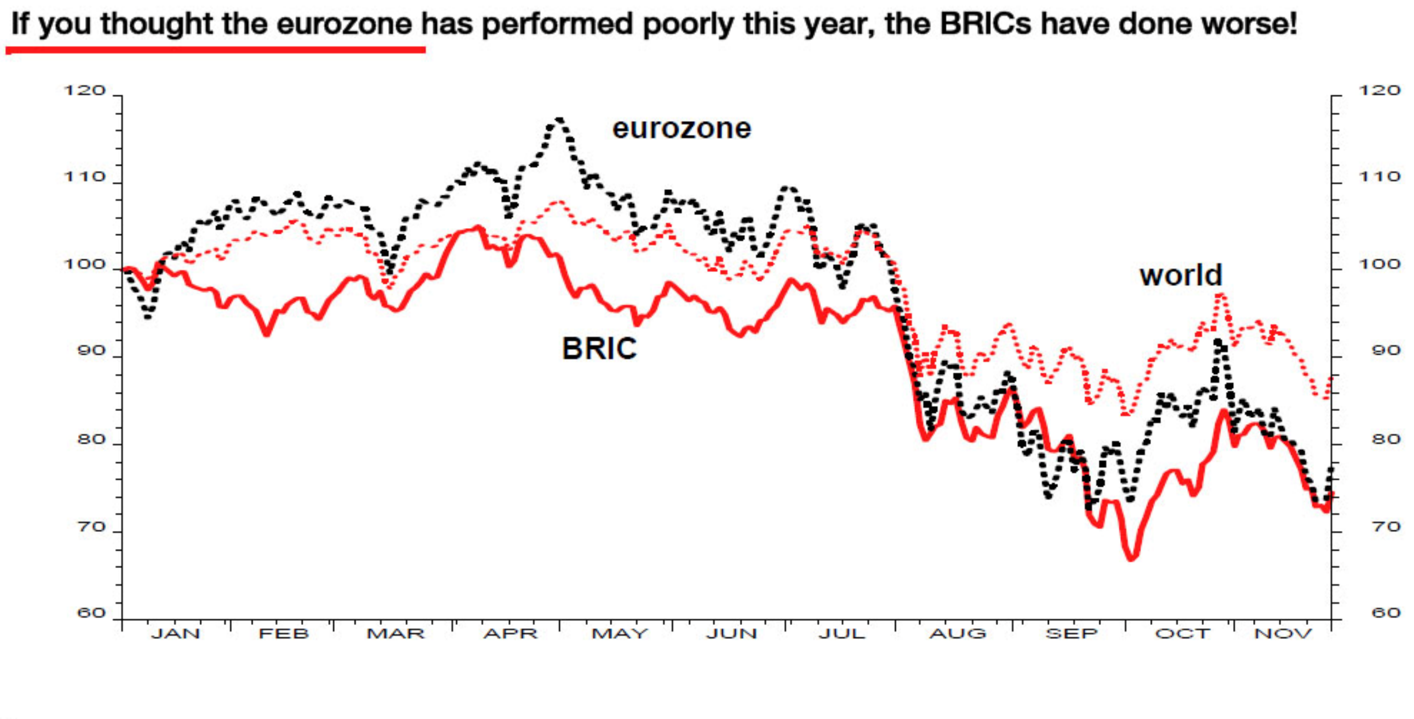
Those who understand this big picture and can navigate businesses, governments, clients and households carefully through the next few years, will prove the valuable leaders and even heroes of this era.

As time moves along and the Boomers retire out of the highest paying jobs, and interest rates and dividend yields normalize and move up, North America is likely to enter a renewed boom of economic growth and demand as the Gen X and Y kids get out of debt, build up savings and move strongly (at last) into the next secular demand boom. The future at that point looks bright indeed. All policy from here should be devised to support—not arrest—this necessary transition.

2011: another wild "bear" year for the Trader's Almanac

As we move into the final month of 2011, history will attest that it has been a year of extreme volatility in society, global politics and asset markets. Fortunately the accounts managed at Venable Park have been protected from the declines and wild gyrations experienced by most managers. But for big picture perspective, we thought it was instructive to reference this picture of the year to date experience of the 'buy and hold' masses in global stock markets.

So much for the higher growth economies: Brazil, Russia, India and Chinese markets have lost the most this year. Most global benchmarks are down, some by 20 and 30% so far.



Source: Datastream

We hear so many investment types talking about hopes that developing countries will continue to grow in 2012 even if much of the developed nations enter into recession. This is the "decoupling" theory we heard so much about heading into the 2008 downturn. It didn't work then.

As clearly shown in the graph above, it is not working this time either. While economies like China and India may well grow faster than the Eurozone or North American in 2012, recession risks and global liquidity crunches pull capital out of all risk markets as money moves back to the liquidity of cash, Treasury bonds and relative safe-haven currencies. For this reason, the higher growth developing economies are actually more dangerous to capital during bear markets than developed markets.

Strategy update: The next phase of the financial crisis is here: batten down the hatches.

> ***"The situation in Europe and the world has significantly worsened over the past few weeks. Market stress has intensified, we are now looking at a true financial crisis -- that is a broad-based disruption in financial markets."***
>
> -ECB governing council member Christian Noyer, speaking at a conference in Singapore Wednesday November 30, 2011.

In November, Europe's worsening sovereign crisis devolved to the next phase, forcing a credit squeeze for all kinds of companies around the globe as European banks pulled back lending in an effort to hoard capital and shore up their balance sheets.

The deteriorating situation prompted the Organization for Economic Cooperation and Development to lower its projection that the United States economy would grow at a 2 percent rate next year, down from a forecast of 3.1 percent growth in May. It also lowered its outlook for Europe and the rest of the world, noting that the credit contraction would exacerbate the slowdown already underway.

The historic bear market stock rally of October was largely given back in November. Then overnight on November 29 there were rumours that another major European bank was on the verge of collapse. The next day, the final day of the month, Central banks of the world's major economies announced concerted efforts to assist the Euro banks in their liquidity crisis. The fact that they announced concerted action (last done in the meltdown of 2008) should serve as a warning for just how severe this next phase of the financial crisis threatens to be.

Moreover our thesis that the US dollar would remain the currency of choice during troubled times has been affirmed as global capital scrambles to move away from other currencies into the "less ugly" greenback. Normally, central banks only make loans in their domestic currencies. But in times of global stress like 2008 they set up swap lines that allow them to borrow from each other, helping them to make loans in what ever currency their customers are demanding. As solvency concerns mount in the Euro zone the past few months, swap lending rates have widened, making it expensive for European banks to borrow and lend the US dollars being demanded by their customers. This has lead to another cash crunch throughout the global financial system.

The US Federal Reserve announced that it was allowing the ECB to swap Euros for the US dollar in an effort to provide the banking system with the dollar liquidity needed. While the US dollar index had traded as high as 80 this month, the November 30 announcement caused the index to weaken somewhat closing the day at 78.38. The trouble is that currency interventions are always desperate efforts that typically buy short windows of reversal before market forces reassert their natural bias. In this case the dominant bias is for a weaker Euro and a stronger US dollar.

US dollar Index 1990 to 2011: the greenback continued to advance this month

Our upside target remains 88 as marked above. Ironically, as the US Super-committee failed to agree on strategies for deficit reduction by this month's deadline, the automatic 1.2 trillion cuts are now up for implementation in 2013. In the shorter-term the dysfunctional US government may lead to lower deficits, as many of the expiring tax cuts (shown below) have been unfunded contributors to huge deficits. Again this could be another reason for U$ strength to continue for some time here.

<u>Expiring in 2011</u>

• 2% Social Security payroll-tax cut for employees
• Alternative minimum tax patch
• IRA charitable contribution for people older than 70½.

<u>Expiring in 2012</u>

• Bush tax cuts of 2001 and 2003.
• Top tax rate on wages reset to 39.6% from 35%
• Top rate on long-term capital gains to 20% from 15%
• Special 15% rate on dividends
• Estate-tax provisions.
• 10 million lower-income families and individuals restored to the tax rolls

We continue to measure 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. The below chart of the 20+ US Treasury bond price as a ratio over the Canadian dollar is one of the more useful risk gauges we have monitored over the years. Today it continues to flash risk conditions similar to those experienced three years ago in the fall of 2008.

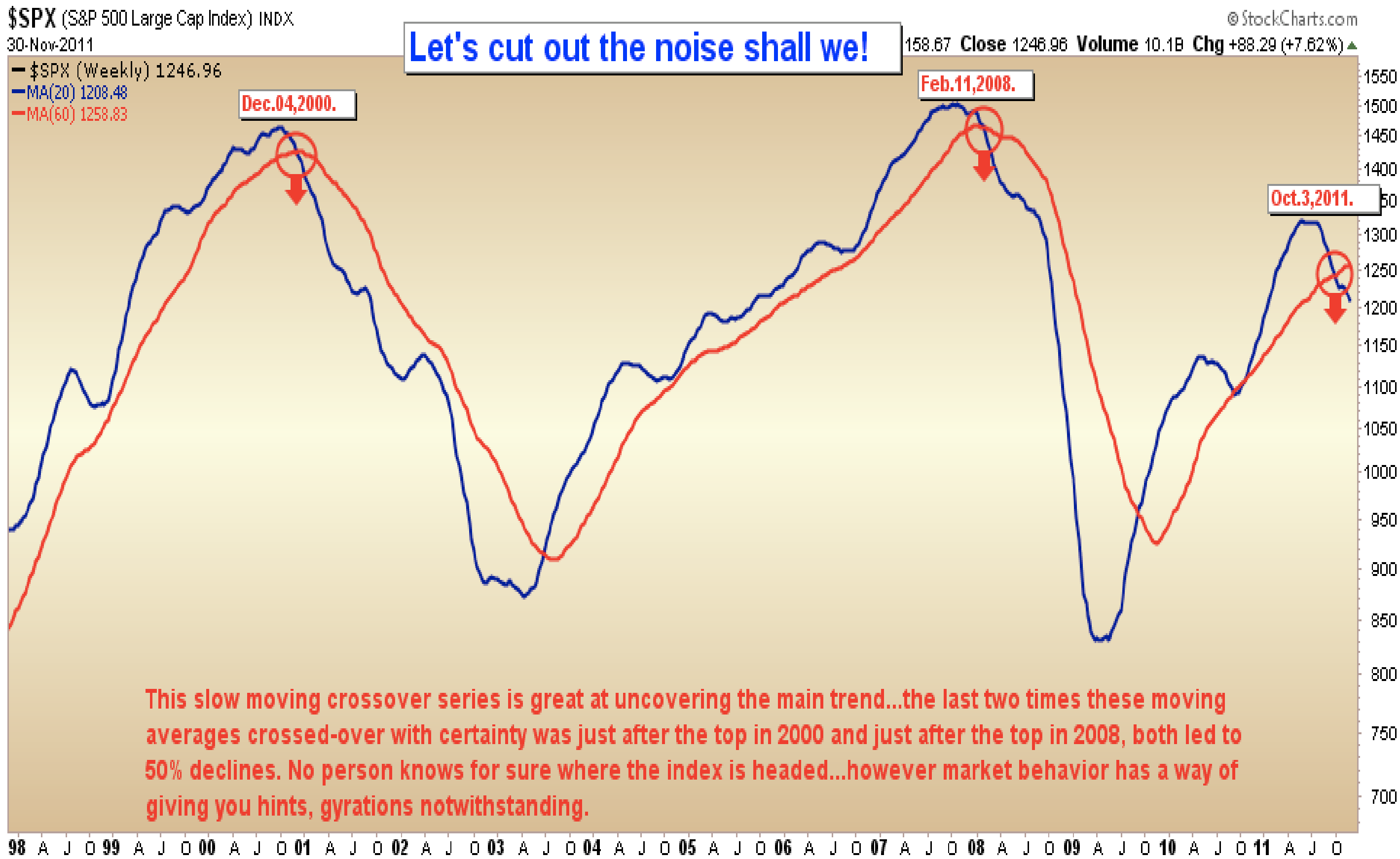
Fear trade still in play: risk gauge suggests further downside to go in this contraction

Indeed, apart from a rebound on the final day, the C$ Index continued to fall steadily against the US dollar this month finishing lower by 2.3% overall. We still see the probability of further weakness from here as the global 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-inflate risk assets have come at a large price. Valuations across the board are overblown on high leverage, low volume trading. Apart from intermittent sessions of wild bear market euphoria on government rescue announcements, we think the downtrend may well quicken as we enter the New Year and economic data continues to affirm the downturn.

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 20% and 8% 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 1998 to 2011: recent break down formation looks similar to 2000 and 2008 peaks



After the market close on November 30 the world learned that the Chinese Purchasing Managers Index—a key indicator of economic health of the manufacturing sector in the world's hottest economy—had contracted below the all-important 50 level for the first time since February 2009 in the midst of the last recession. This chart below of the Chinese PMI since 2005 reminded us of the S&P chart we have just shown above. The next few months have an important story to tell…

November Chinese PMI signals a contraction for the first time since the last recession

Bonds: Our strategy continues to focus on high quality North American issues in the short to medium part of the yield curve. Our rationale is that in times of global crisis, investors 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 big picture barometer on this battle, we continue to monitor the US 10-year treasury yield shown next below. After all the government injections of liquidity in world markets this month, North American bonds still gained and yields fell.

10 year Treasury Yield 2001 to present- yield downtrend still supportive of bond prices

Our thesis of short-term deflation remains intact. There is significant resistance to higher North American bond yields as noted above. Meanwhile the opposite is happening in the Euro zone where yields on Spanish, Italian, Portuguese, French and the European Stability Fund bonds all moved higher this month signalling the growing recognition of insolvency risks there.

Best wishes for December, where did this year go??

Quotes of the month:

"Experience is a dear teacher, but fools will learn at no other."

–Benjamin Franklin (1706-1790), author, printer, political theorist, politician, postmaster, scientist, musician, inventor, satirist, civic activist, statesman, and diplomat.

"Your time is limited, so don't waste it living someone else's life. Don't be trapped by dogma - which is living with the results of other people's thinking. Don't let the noise of other's opinions drown out your own inner voice. And most important, have the courage to follow your heart and intuition. They somehow already know what you truly want to become. Everything else is secondary." –Steve Jobs (1955-2011), Co-Founder of Apple Computer

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