Real life needs active management

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E.Q Trendwatch™

Counting blessings

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"Plenty of people miss their share of happiness. Not because they never found it—but because they didn't stop to enjoy it."

--William Feather (1889-1981) Publisher, author

As another volatile year comes to a close, we at Venable Park find ourselves looking forward to *a few days of closed markets* and some holiday cheer. We are also feeling grateful for our health, family and friends. We are grateful for work that we are passionately committed to. We are grateful for our risk management rules and discipline that have enabled us to tip toe through imploding markets one more year in tact—*so far so good*. We are grateful for our training, study, experience and even previous mistakes, all of which help us to understand, anticipate and navigate present conditions in real time.

Above all, we are grateful for you our clients, now all over North America, who have afforded us your trust and patience and the latitude to manage your savings carefully through these cycles. Without you, we would not be able to do this job the right way—it's as simple as that.

Last year at this time, the QE2 rally was testing our commitment.

We can all recall how this time last year, in the final quarter of 2010, the QE2 risk rally (for a few months) sought to test your faith in us and our sober measurements. Although we calculated the risk to capital as too great and the potential upside too fleeting to warrant diving into stocks, it was still hard for us and our clients, no doubt, to watch from the sidelines. A handful of clients caved to the 'long-always' prophets and left us to run back into the burning building of peaking markets in the first quarter of 2011. We were sad to see them go and we are truly sad to think of their losses since. Thankfully, far more good people joined Venable Park this year. We are delighted to have you all with us.

Over the past 8 months most of the QE2 gains in stock and commodity markets have been taken back and in some cases, more. Most global markets are negative year to date. Investors across the world have suffered fresh capital losses again this year and most find themselves still well below the portfolio values they saw 5 l-o-n-g years ago in 2007. At Venable Park we are grateful to have eked out another year of positive returns.

That said, this work is never done. In this climate, returns rarely seem good enough, and we know that we never really hit the tape at the end of this race. 100-year-lows in interest rates are continuing to suppress safe income levels and make it disappointing for those who are already retired and looking to live off of their savings. **2012 promises to give many people in business, and everyone in risk management, a serious run for the money.** We will continue guarding our clients ferociously. We are also excited about the prospects of some truly valuable buying opportunities likely to present in the year ahead, perhaps even within the first 6 months.

In the end, for all our constant worry and concern, for all the disappointment we frequently feel for leaders and the propensity of humans to repeat bad choices, we know that we are fortunate to be here, living through such remarkable times. We are the lucky ones. We believe that with commitment and hard work, the world will find its way through present challenges, as it always has, and emerge stronger and wiser for the experience. And although we must acknowledge the risks and problems in order to address and resolve them, this holiday, may we all find time to reflect on our many blessings too.

2011: another record year draws to a close

As the third year of the US Presidential cycle, 2011 has bucked historical patterns and frustrated those forecasting gains. As of this writing, with one week to go to year-end, the year has brought the worst stock market performance in the third year of the US Presidential cycle since 1939.

Moreover, economic conditions look quite a bit worse for at least the first half of 2012. Corporate guidance has been almost uniformly negative across the board, from smaller companies that are planning further layoffs and to downsize expenses, to larger multi-nationals like 3M, Intel, DuPont and Apple that are lowering revenue forecasts. In the 4th quarter, 3.7 companies lowered their forward earnings estimates for each one that raised them. This is the most negative disappoint ratio for forward earnings in 10 years**. As we have pointed out many times, the trouble with overly optimistic stock markets predicting escalating trends in already peak earnings is that participants notoriously over-pay. What may have looked like a price of 15 times anticipated earnings, ends up being more than 22 times actual earnings once revisions come in.** Stock holders always react badly to this kind of "unexpected" disappointment typically triggering waves of fear and selling.

While stock and commodity prices have been continuing downside work, prices presently remain over-valued and signalling the danger of further decline. **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.**

US dollar Index 1990 to 2011: the greenback broke through 80 this month

As the global economy continues to slow, the probability of more QE from the US Federal Reserve threatens perhaps a fresh round of dollar weakness sometime in 2012. In the meantime, 88 on the dollar index remains our medium-term upside target--about 10% higher from present levels.

The Canadian dollar 1991 to 2011: where will the buck stop?

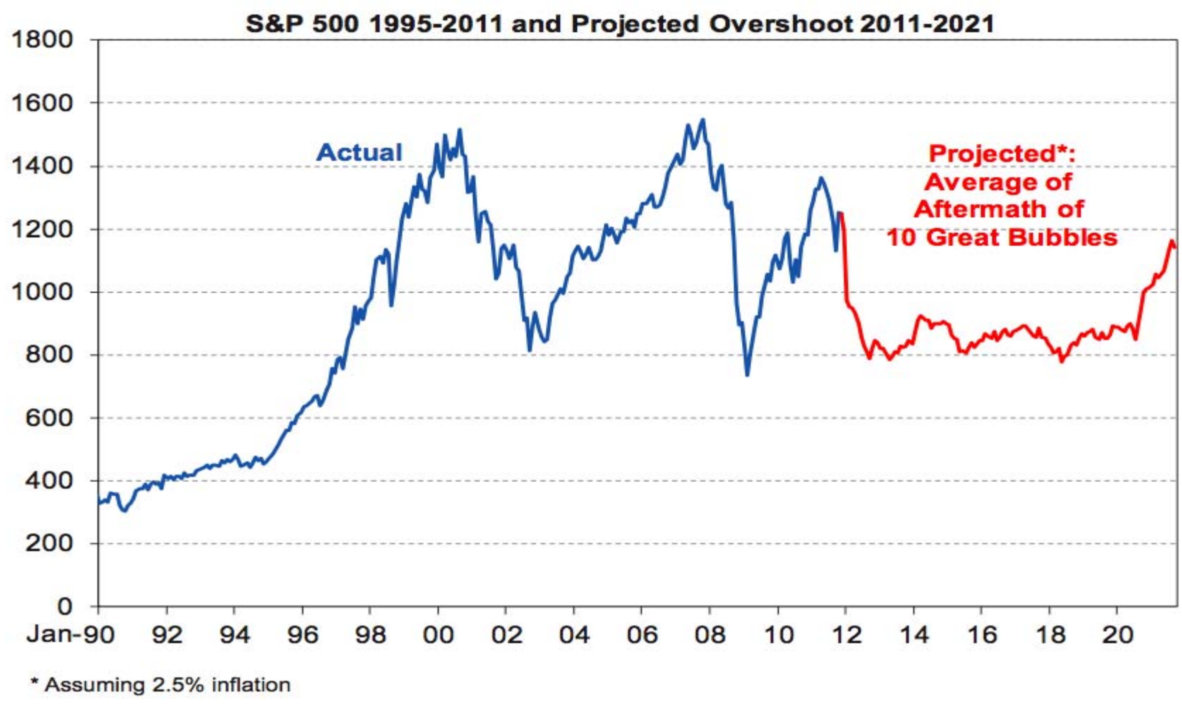
Meanwhile, commodity-centric currencies like the Aussie, Kiwi and Canadian dollar all broke lower this month along with the Euro. As shown in the above chart, the C$ Index fell below key support levels as the Bank of Canada issued a sober warning of further weakness ahead. BOC Governor Mark Carney pointed out that Canadians are now labouring under record debt to disposable income levels (above 150%!). The recession in Europe, a slowdown already underway in China, and the threat of another broad financial crisis in 2012, are all serious risks to the over-indebted Canadian economy. This will also, no doubt, present valuable opportunities for those that are prepared and liquid.

Equities: One of the key reasons that we at VPIC have erred on the side of caution and defence of capital for the past decade comes from our careful study of history and human behaviour. Coming out of record bubble valuations in the late '90's, we had to recognize that in order to correct for this period of extreme over-exuberance, stocks had a lot of downside work in order to re-couple with the reality of long term average (100 year+) valuations, yields and returns. One might hope that historical means could be re-established with a simple dip down to touch long-term averages. But this has never been sufficient before. History assures us that in order to correct for "fat" periods of years far above average trend (secular bulls), stock valuations have always needed to fall far below trend and labour there for an equally long period of "lean" years (secular bears).

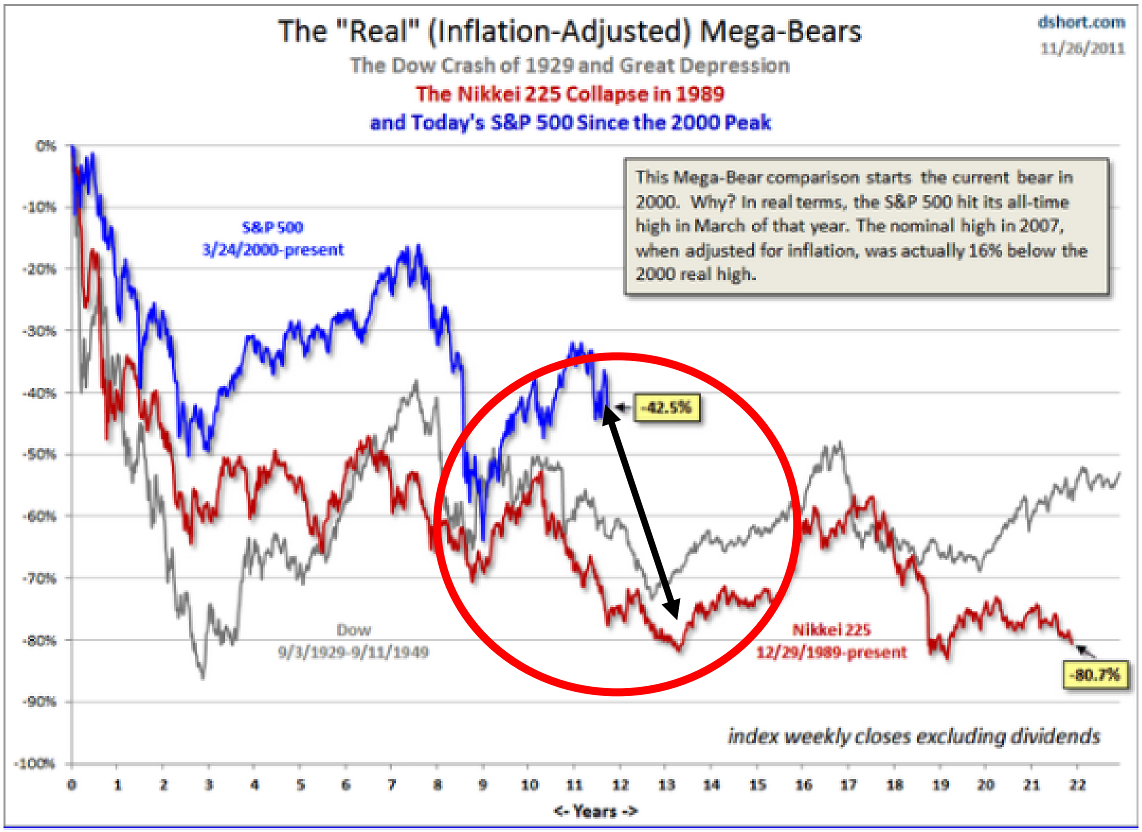
In his recent third quarter investment letter, GMO manager Jeremy Grantham, explains it like this:

> "Historians would notice that all major equity bubbles (like those in the U.S. in 1929 and 1965 and in Japan in 1989) broke way below trend line values and stayed there for years. Greenspan, neurotic about slight economic declines while at the same time coasting on Volcker's good work, introduced an era of effective overstimulation of markets that resulted in 20 years of overpriced markets and abnormally high profit margins. In this, Greenspan has been aided by Bernanke, his acolyte, who has continued his dangerous policy. The first of the two great bubbles that broke on their watch did not reach trend at all in 2002, and the second, in 2009 – known by us as the first truly global bubble – took only three months to recover to trend. This pattern is unique. Now, with wounded balance sheets, perhaps the arsenal is empty and the next bust may well be like the old days. GMO has looked at the 10 biggest bubbles of the pre-2000 era and has calculated that it typically takes 14 years to recover to the old trend. An important point here is that almost no current investors have experienced this more typical 1970's-type market setback. When one of these old fashioned but typical declines occurs, professional investors, conditioned by our more recent ephemeral bear markets, will have a permanent built-in expectation of an imminent recovery that will not come. For the record, Exhibit 1 [chart below] shows what the S&P 500 might look like from today if it followed the average flight path of the 10 burst bubbles described above. Not very pretty."

Our thought: the below picture is only "not pretty" if you are holding and losing now, but for those now safely on the sidelines for this present wave of correction, the next year could offer an excellent re-entry point to pick up dividend paying equities near the bottom of the red line below that will pay us good income, through flat markets, to the end of the secular bear.



This thinking and Grantham's chart corresponds with the below chart that we have shown you before (here updated) of our current secular bear (top blue line) versus two others: Japan's Nikkei (1989 to present in red) and the Dow (1929 to 1949 in grey).

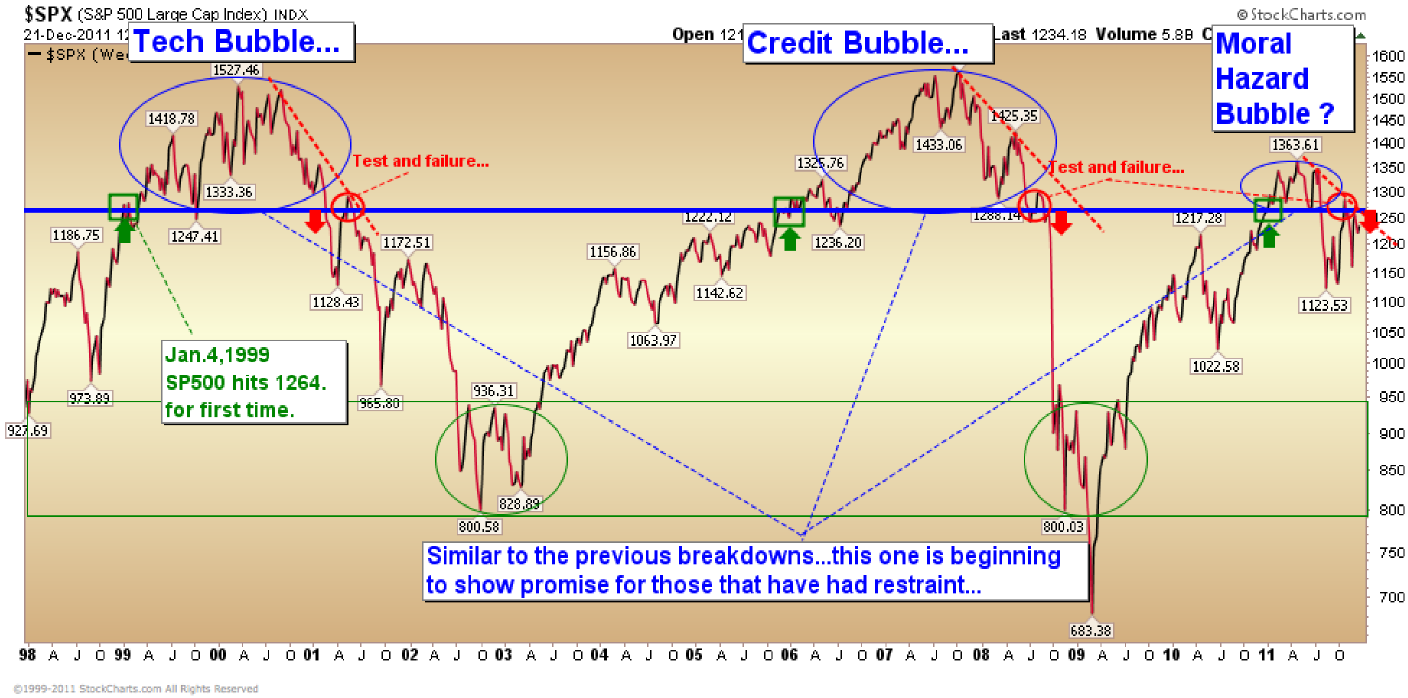


The red circle and black arrow above highlight the downside gap between where we are 12 years into our current bear market in stocks and where other secular bears have gone thereafter. These facts and figures must always be in the back of our mind as we try to move our capital very carefully forward.

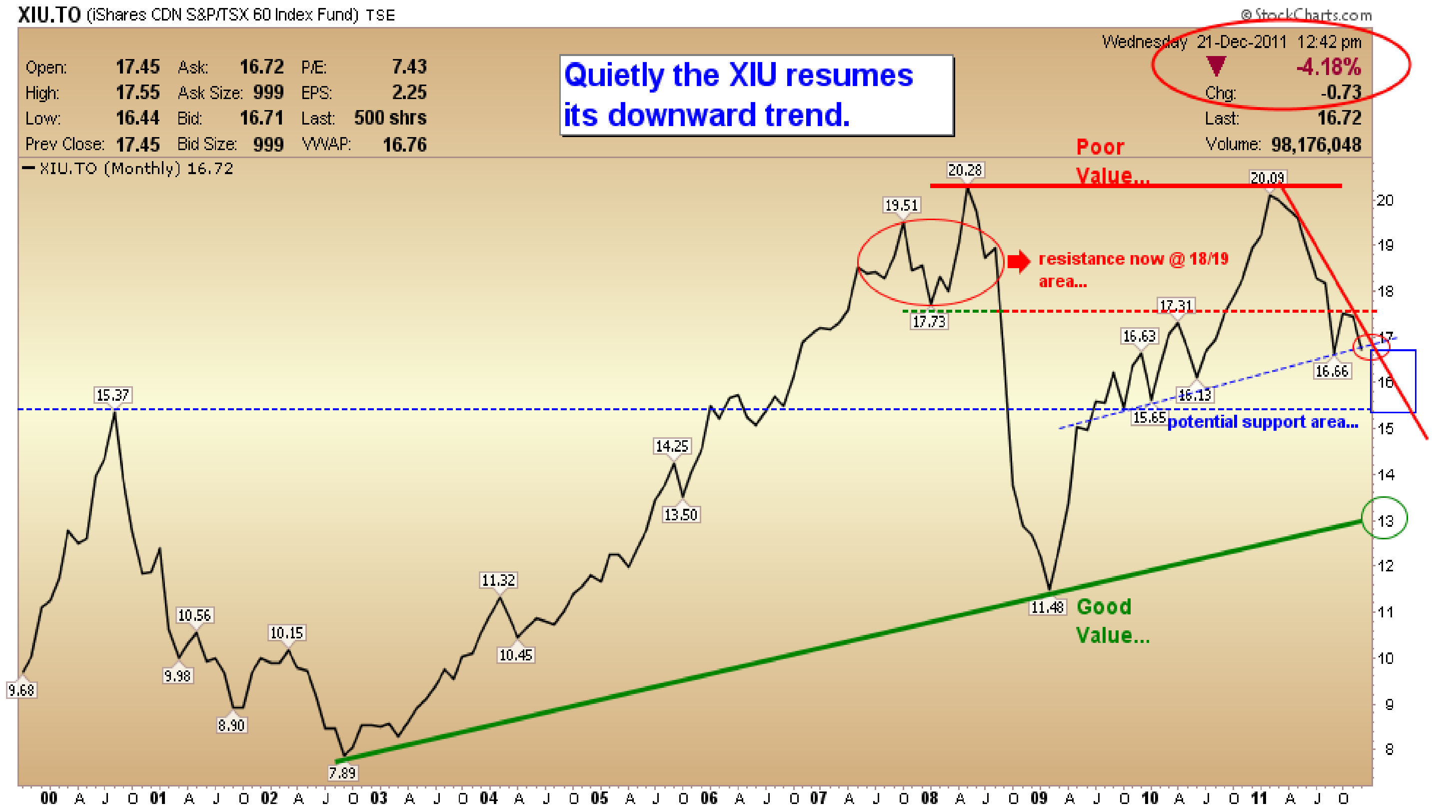
Meanwhile the Chinese stock market, a leading indicator for demand in the global economy, is so far continuing to beckon stock markets lower. We note that in the last cyclical downturn, the Chinese market finally bottomed in November 2008 after losing 70%, and turned up some 4 months before the final bottom in global stocks in March 2009. We are watching the Shanghai for a possible early turn signal this cycle as well. As shown in the next chart, there is no sign yet of a cyclical bottom. But having fallen already 30% over the past year, and still more than 60% below the cycle peak in 2007, we are watching this leading indicator very carefully for signs of the next bull cycle turn.

Chinese Shanghai stock index still leading global markets lower: 2008-09 low next test?

S&P 500 1998 to 2011: Third asset bubble since late '90's now popping?



Canadian stock market now playing: 3rd cyclical decline since late 90's

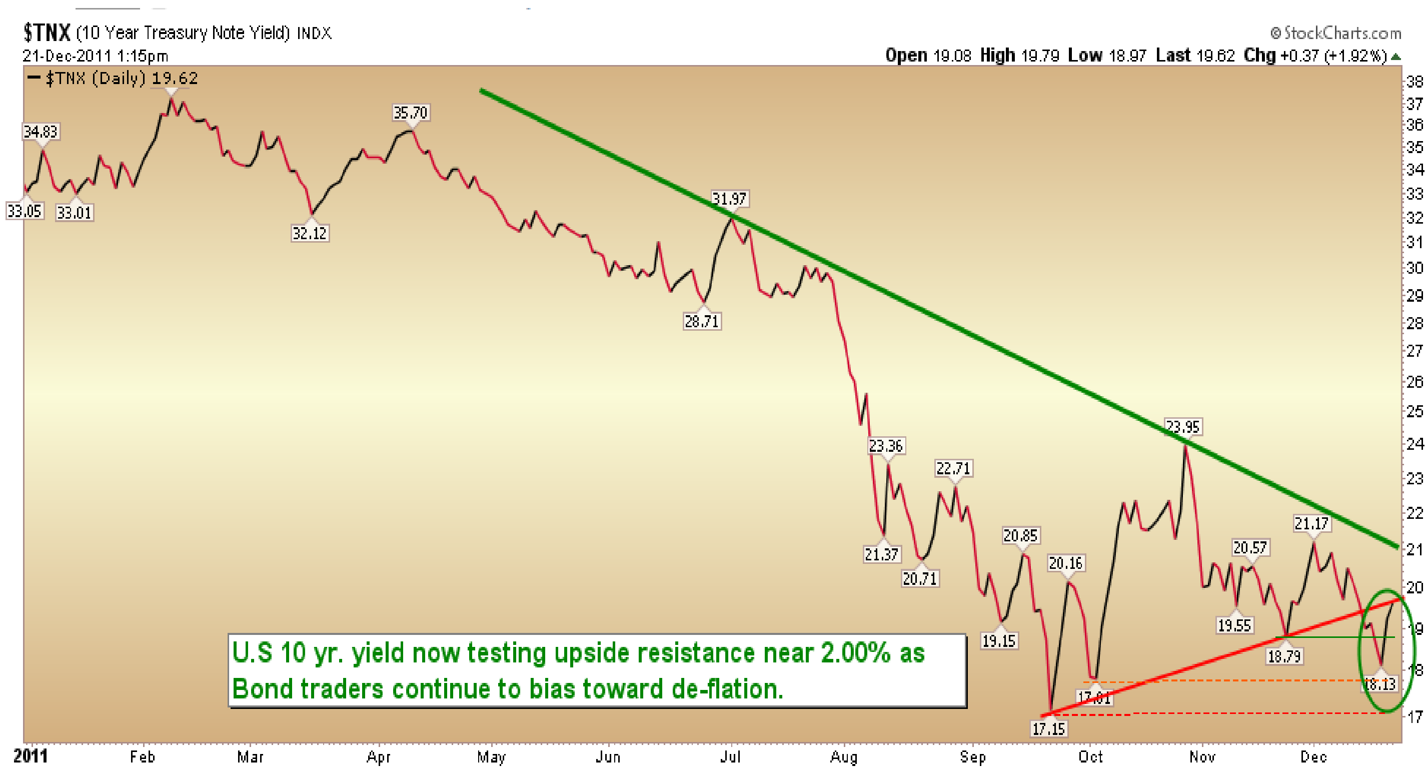


As shown in the big picture view of the TSX 60 ("XIU" above) continued erosion of value has been the main theme throughout December with the ETF moving down 4% in the month. The next key support level is the August 2010 lows (blue line above). The potential for contagion from the Euro zone, slowing China and continued stale-mate between U.S politicians, may stifle inflows until investors see some reasonable stability in some of these large questions. Ultimately, a test of the baseline uptrend on the "XIU" at $13 appears a plausible outcome—22% below present levels. The reciprocal levels on the S&P 500 (chart previous page) remain 1000 for the next support test, and then 800-900 after that. We stand ready.

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



North American bond yields moved lower this month, as investors fled other international markets in favour of US bonds. 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 top green line above.

We will continue to watch the medium-term trend carefully. So far, the bond market is still signalling “risk-off”. 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.

All of these issues are economic headwinds moving into 2012. At the same time, we still think it plausible that the stock market may well give us a valuable cyclical bottom some time in the first ½ of the year. This will afford us the opportunity to shorten up our fixed income duration, while adding dividend paying equities to increase portfolio yields as we row our way through the next cyclical recovery phase—whatever duration that turns out to be.

Warm holiday wishes from all of us at Venable Park. Have every bit of fun you can!!

Quotes of the month:

"The value of a person resides in what s/he gives and not in what s/he is capable of receiving."

-Albert Einstein, Physicist (1879-1955)

"The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance."

–Marcus Cicero, Roman philosopher, lawyer, constitutionalist (106 BC – 43 BC)

"During times of universal deceit, telling the truth becomes a revolutionary act."

-George Orwell, author (1903 – 1950)

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