Real life needs active management

FEBRUARY 29, 2012. ISSUE 2

E.Q Trendwatch™

Decline by a thousand cuts

"Believe in history. In investing Santayana is right: history repeats and repeats, and forget it at your peril. All bubbles break, all investment frenzies pass away. You absolutely must ignore the vested interests of the industry and the inevitable cheerleaders who will assure you that this time it's a new high plateau or a permanently higher level of productivity, even if that view comes from the Federal Reserve itself. No. Make that, especially if it comes from there. The market is gloriously inefficient and wanders far from fair price but eventually, after breaking your heart and your patience (and, for professionals, those of their clients too), it will go back to fair value. ***Your task is to survive until that happens****."*

–Jeremy Grantham, GMO, Feb 24, 2012

Over the past few years, central bankers have been dogmatically fixated on forcing down global interest rates. The stated purpose has been to hold down the cost of borrowing for debtors and to force savers out of low-risk, low-interest-bearing deposits into higher risk securities. Ben Bernanke argues that this is the best way to rescue and support a weak, post-credit crash economy. We are reminded of George W. Bush to the American people after 9/11 when he urged Americans to help their country by going out to shop. The obvious response to both these ideas should be "who are we helping here?"

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Depleting already anemic consumer savings, or worse running up debt, in order to buy non-productive consumer goods is not good for the health of individuals or their families. It may well temporarily increase short-term sales for some businesses. But in the end it is worse for the shoppers and it is worse for the financial stability and health of the country.

The same holds true with respect to the perpetually asserted “advice” from central bankers and most financial types today that savers should throw caution to the wind, and reach for higher income by moving their nest eggs out of safe deposits and into over-priced publically traded markets. They talk about the relative yields of stocks being 2-3% higher than treasury bonds and ludicrously suggest this is attractive compensation for the staggering increase in commensurate risk to capital. Only fools and the desperate can believe such things.

A recent study by Credit Suisse found that 97% of the 341 companies with defined benefit pension plans in the S&P 500 are now underfunded with deficits rising by more than 200 billion in 2011 alone. Public pension plan deficits globally are in the trillions! Like individuals, in order to preserve capital and prudently meet income needs, pension plans must keep a bulk of their assets in guaranteed deposits with fixed income streams and maturity dates. The “zero rate” policies of central bankers are literally killing the ability of pension funds to meet their promises to members, unless contributions are dramatically increased going forward both by employers and employees. Neither side wants to hear this news as it means individuals must save more and spend less. It also means companies will see reduced earnings as they allocate more revenue to pension expenses. Many more companies will opt to end their pension plans rather than increase their obligations—leaving more employees to fend for themselves.

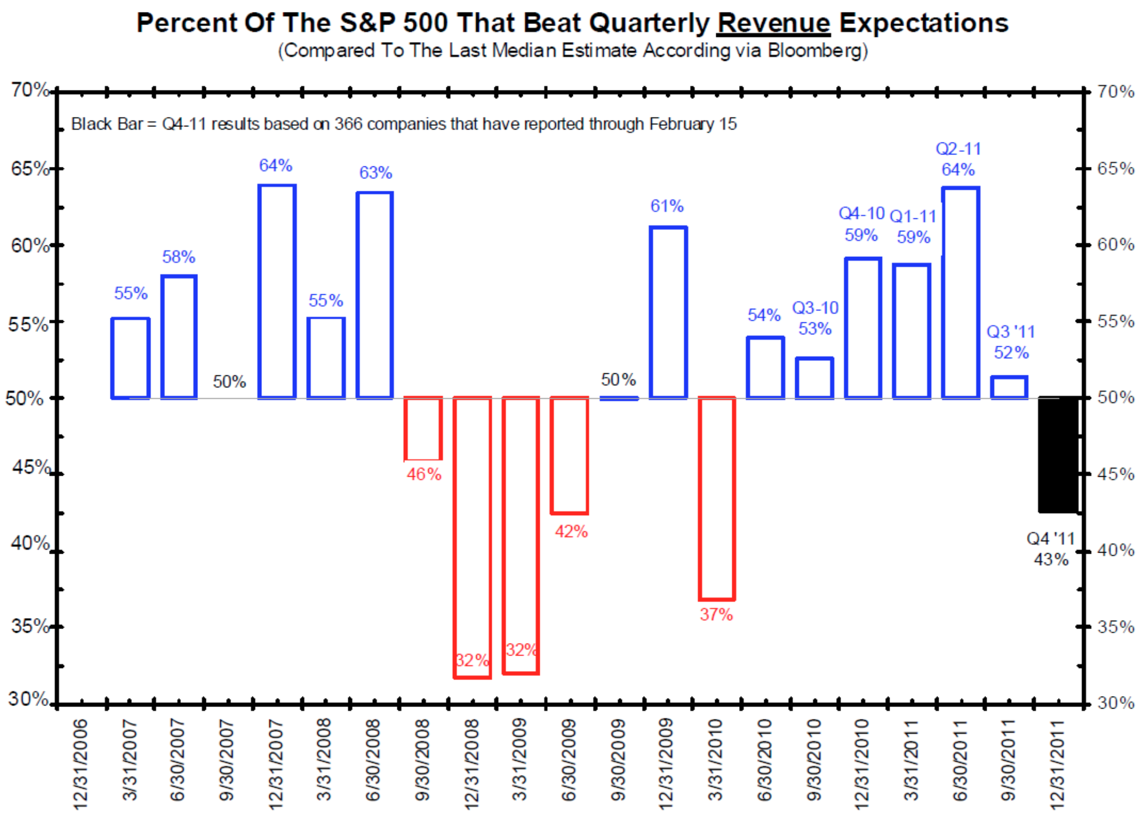
Adamant that they will have their way, recently the US Federal Reserve said that they would continue to suppress interest rates to “at least 2014”. Their message to risk-averse savers: “we will smoke you out of safe-keeping into over-valued stocks—and you will starve for yield unless you come in”. Thankfully many are still refusing to take this cruel bait. Month after month retail money has flowed out of equity markets leaving mutual funds and hedge funds with decreasing capital. At the same time, institutional cash on the sidelines stubbornly mounts waiting, however impatiently, for the promise of capital risks that will be worth taking at lower prices ahead.

The dark truth is that while politicians and central bankers may well continue ‘rescuing’ big banks, multi-nationals and a few other key cronies, they offer no such assurance or safety to individual investors or small business owners. In the real world, we individuals are all very much on our own to manage capital risks however we might. For an aging population these are particularly dangerous times. Those of us in the later stages of our working lives, or who have already amassed a bulk of life savings, have everything to lose in these artificially contrived conditions. We at Venable Park never forget this.

Meanwhile amid all the talk of "rescues" the next cyclical slow down has arrived.

> *"Hope still beats in the breast of equity investors. The market will rip out that hope and consume it in front of investors' eyes."* –Albert Edwards, global strategist, Societe Generale, Feb 24, 2012

Corporate earnings estimates for S&P 500 companies as a group are dropping for the first time since late 2007, when the U.S. economy was last sliding into a recession. The S&P 500 earnings growth rate has dropped from 8.0% on September 30 to 3.0% on December 30 to 0.0% this month. More importantly, revenues--harder than earnings for management to "game"--are also plummeting. This next chart captures the plunge in the percent of companies beating revenue expectations in the final quarter of 2011. Forward looking, earnings and revenue expectations for the first quarter of 2012 continue to decline.



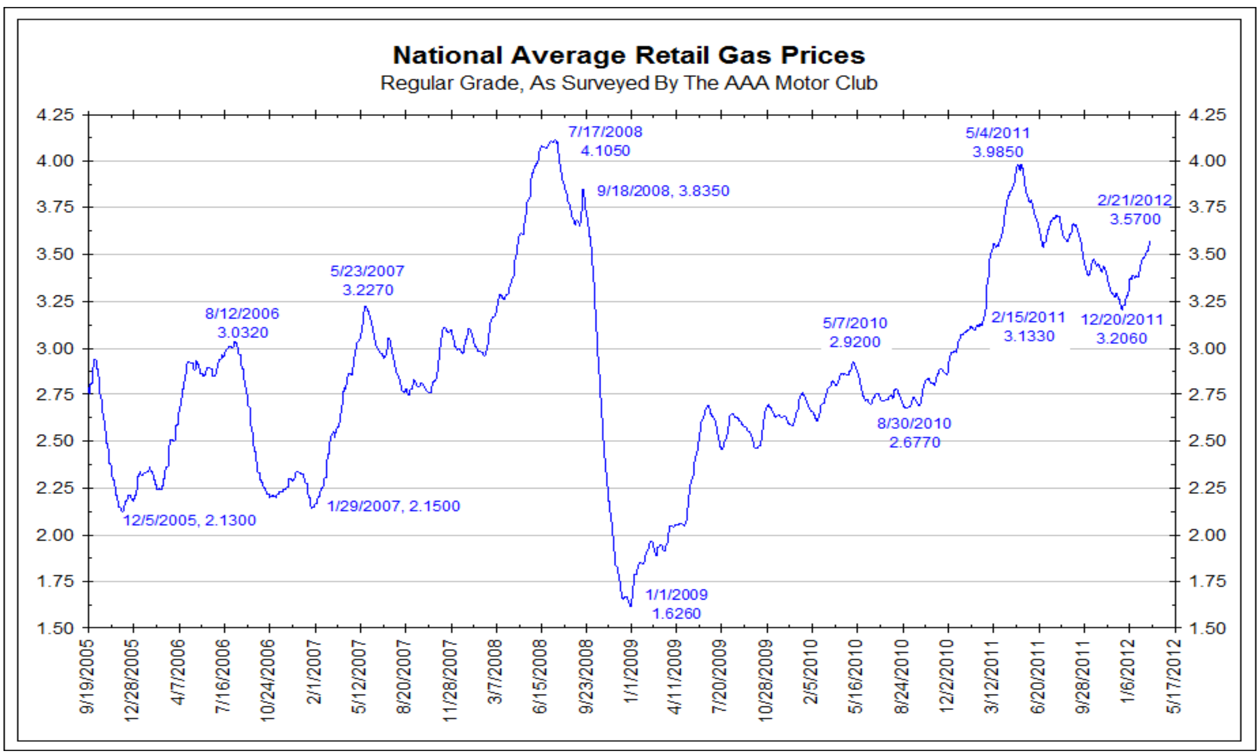
Source: Bianco Research

Stocks meanwhile, as shown in the next chart below, have surged in yet another seemingly death-defying rally over the past three months in remarkable symmetry to what we saw in the fleeting QE2 rally from October 2010.

Chart Source: Bloomberg

This latest rally (blue line above) risks topping out and following a similar path down as we saw in the last two years (purple line), where early year hopes of growth were dashed in the later half and stocks gave back their gains and, in many cases, more.

As if shades of 2008 and 2011 weren't ominous enough: gas prices have spiked again



Fuelled by the usual suspects of geo-political risks in the Middle East and levered financial speculation, Brent crude prices have hit record highs in the U.K. in sterling terms and back to 2008 levels in euro terms for the already recession-gripped euro area. In the US gas prices are averaging above 3.50 a gallon and in some states, like California, Hawaii and Alaska are already over $4.00. Every penny increase per gallon in the US siphons away about $1.5 billion from consumer wallets into the gas tank.

Consumers have responded by cutting back on energy usage at a pace not seen in 15 years. Gasoline and petroleum demand is now back to 1997 levels and has plunged more of late than at any time in the last 2 recessions. Unlike the 2005-2007 cycle peak consumers today are no longer able to use endless amounts of revolving credit to absorb the increase in gas prices. They are simply finding ways to not use fuel.

Both the ECRI and OECD warn global recession likely in 2012

Economic growth in developed economies almost ground to a halt in the last three months of 2011, with the U.S. driving what little growth there was. According to the Organisation for Economic Co-operation and Development (OECD), gross domestic product (GDP) in the 34 major economies including the U.S., Germany, Japan and the UK, grew by just 0.1 percent in the last quarter from the previous one and rose just 1.3 percent from the same time a year earlier – the slowest rate of growth in two years.

This slowdown comes despite the concerted liquidity efforts of global central bankers including the European Central Bank, the Bank of Japan and the Federal Reserve. A thousand necessary austerity cuts in the Eurozone as well as state and local governments in the US will accentuate already slumping growth. Here are the latest GDP data for 8 major economies, Euro and Asia zones, as well as the OECD as a whole.

	Dec	Nov	Oct	YOY Growth
OECD	0.2	0.1	−0.1	−2.0
Euro Area	−0.1	−0.3	−0.5	−5.7
Major 5 Asia	−0.1	−0.3	−0.2	−2.6
France	−0.1	−0.3	−0.4	−5.3
Japan	0.2	0.1	0.0	−0.2
Germany	−0.3	−0.6	−0.9	−7.5
Italy	−0.4	−0.6	−0.9	−8.6
USA	0.7	0.5	0.2	0.6
Brazil	−0.1	−0.5	−0.8	−9.0
China	−0.5	−0.3	−0.3	−2.4
India	0.6	0.4	0.1	−5.8

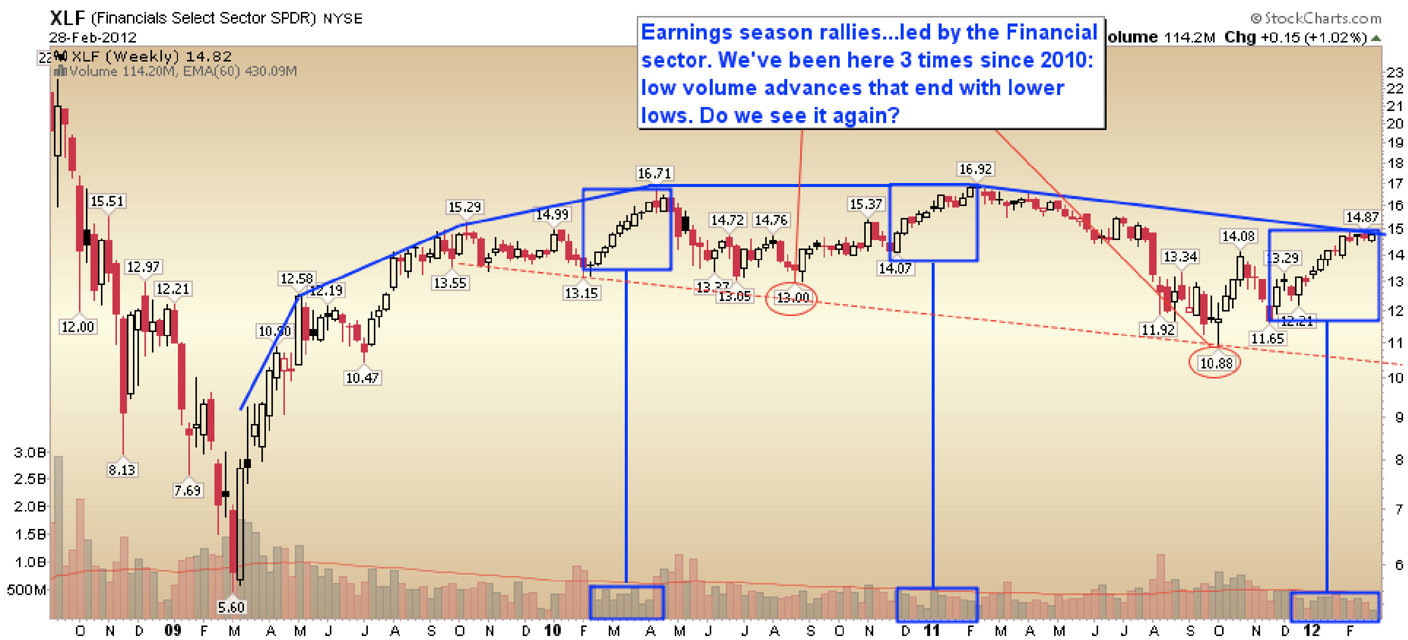
Chart source: Simon Hunt Strategic Services

Meanwhile the Economic Cycle Research Institute (ECRI) last week confirmed its call that a global recession is underway and is likely to be recognized in US economic data by this summer. "No one can get away from these facts, no matter what you do", ECRI's President, Lakshman Achuthan, told Bloomberg.

It is critical to remember that by the time recessions are officially declared, stocks have typically already lost 25% of their ultimate decline, and during secular bears, they lose an average of 45% of their value before the downturn ends. Since few commentators ever look for recessions never mind see them coming, it is critical that we err on the side of capital protection until the downturn becomes acknowledged (and then feared) by the consensus.

In the charts: strategy update

Financials: more low volume (see rectangles at chart bottom), price advances, leading us lower?



As we have highlighted many times over the past 3 years, the low volume of participants in equity markets has suggested that serious investment capital has opted out of what they (and we) perceive as undue risk with little likelihood of lasting rewards. The next chart below compares the volume of capital that participated in the US stock rally during the cyclical bull from 2003 to 2007, as compared to the more recent rally from 2009 to present.

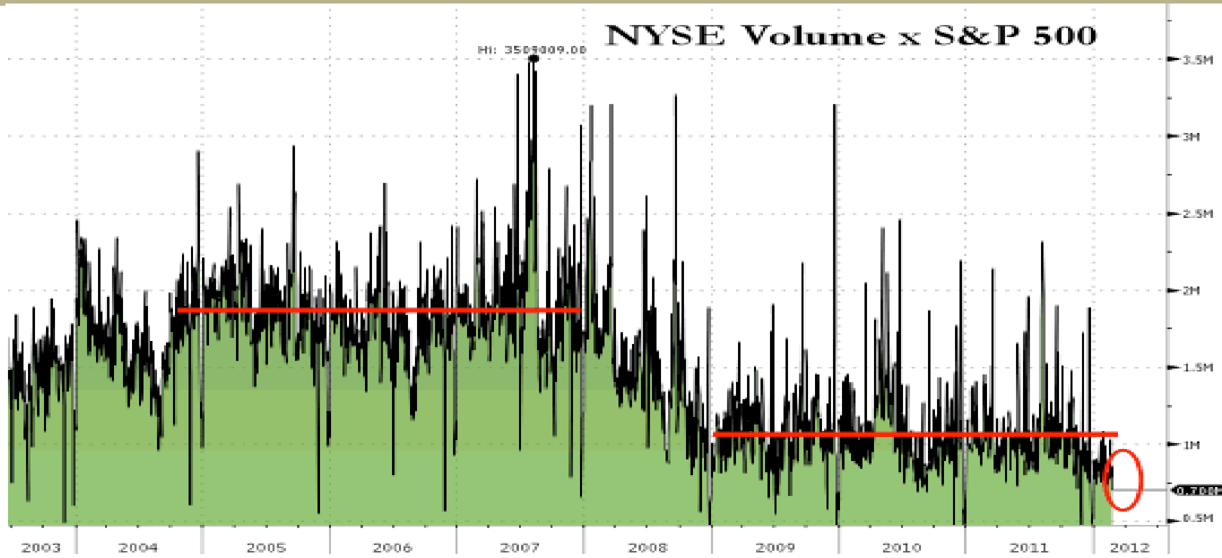


Chart source: Bloomberg

Note the volume level (red line far right above) versus that of the 2003-2007 rally (left above). While many market bulls choose to ignore this important metric, market history assures us that volume always matters. The fewer the participants, the more volatile and dangerous price swings are (as we have seen the past couple of years in particular where stocks have gained and lost 10-20% in a matter of weeks and months several times). It also warns us that once the next recession is finally acknowledged, over-priced markets, thinly supported with few buyers, can fall with shocking speed to the surprise of participants who typically run for the exits at once.

US dollar Index 1990 to 2011: 78 now support, 88 still upside target

Despite another bumpy ride this month on Greek 'bailout' euphoria, the US dollar continued to receive safe haven inflows for the month. $88 remains our upside target.

At the same time, financial speculation on liquidity injections (LTRO in Europe) and mid-east tensions around oil led to higher commodity prices and some rebound in the Canadian dollar. We believe this will be short-lived, with the C$ vulnerable as global growth and the risk trade retreats over the next 6-12 months.

Canadian dollar 2001-2012: Par proves resistance

Canadian stock market currently range bound, with overall trend bias still down

Bonds: North American bond yields moved lower this month, as investors continue to flee other international markets in favour of US and Canadian 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 dotted line below shown on a chart of the bellwether US 10 year Treasury yield.

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

We will continue to watch the medium trend carefully. So far, the bond market is still signalling "risk-off". The trend of falling inflation is supported by a continuing lack of wage pressure, weakness in housing, contracting GDP expectations and historic slack in economic capacity.

All of these issues are economic headwinds moving into 2012. At the same time, the data continues to suggest that the stock market may well offer a valuable cyclical bottom some time this year. This may also afford us the catalyst 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 length it turns out to be.

Spring is just around the corner!!

Quotes of the month:

"An error does not become truth by reason of multiplied propagation, nor does truth become error because nobody sees it." –Mahatma Gandhi, Indian political and ideological leader (1869-1948)

"I don't want to be a Cassandra, but the idea that it's over is an illusion. I am amazed by the short-term psychology in the market. I don't think we're anywhere near the endgame."

--Feb 24, 2012, Harvard economist Kenneth Rogoff, author of

"This time is different: 8 centuries of financial folly."

"The individual investor should act consistently as an investor and not as a speculator. This means that he should be able to justify every purchase he makes and each price he pays by impersonal, objective reasoning that satisfies him that he is getting more than his money's worth for his purchase."

--Benjamin Graham, father of value investing, (1894 –1976)

"Every artist was first an amateur".

– Ralph Waldo Emerson, an American essayist and poet (1803-1882)

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