Real life needs active management

SEPTEMBER 30, 2012. ISSUE 9

E.Q Trendwatch™

Charity begins at home

"Rock bottom became the solid foundation on which I rebuilt my life."

--J.K. Rowling, novelist

This month Bristol, England made news when it launched its own local currency: the 'Bristol Pound' (BP). BPs can be bought with pound sterling and are convertible back to sterling with a 3% penalty. BP's can also be used for online and cell phone transactions. 350 firms have already signed up to do commerce in the BP, and throngs of Bristol workers are signing up to receive their wages in the new local currency. The idea is to help keep more spending in local coffers by issuing money that customers can only use in Bristol shops. Customers who pay with Bristol Pounds know that local shops must then buy their stock from local suppliers using the same currency: *"If you lock the money into the area, rather than it going into the international finance system then you keep more money actually working in the city here,"* one of the founders explained. This sentiment is certainly protectionist, and Bristol is not alone.

There are more than 104 such local currencies now in circulation across Europe. In its essence, the trend reflects a growing sentiment of "reverse-globalization" as

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people and places increasingly look to focus limited resources to 'charity at home'.

We could not help but think of these trends as we read this month's lowered guidance from a list of international companies. Global bell weathers such as Caterpillar, UPS, Fedex and Intel all warned of lower sales and revenue targets over the next several quarters in a synchronized, global downturn they predict to be stubborn and persistent. Spending habits on modern earth are, after all, remarkably tethered together via international conglomerates, free trade, global finance, correlated capital markets and Goldman Sachs alumni central bankers.

Continuing this interest in local commerce, hardware mega-chain Rona Inc. announced this month that it would not be merging with competitor Lowes, but was making a philosophical shift away from 15-20 million dollar superstores toward a "satellite" chain of small (500K budget) neighborhood hardware stores designed to attract local buyers. These vastly smaller shops (leasing empty space left by defunct Blockbuster video stores) will stock about ¼ of the megastore product lines: "We are listening to what the customers want," Rona's VP of retail sales declared. The housing and credit bubble have burst and consumers (even in Canada) are now sobering up from their spending binge with a new awareness of what and where they buy. We seem to have finally hit a behavioral reset button that will help us move back to an improved era of fiscal fitness.

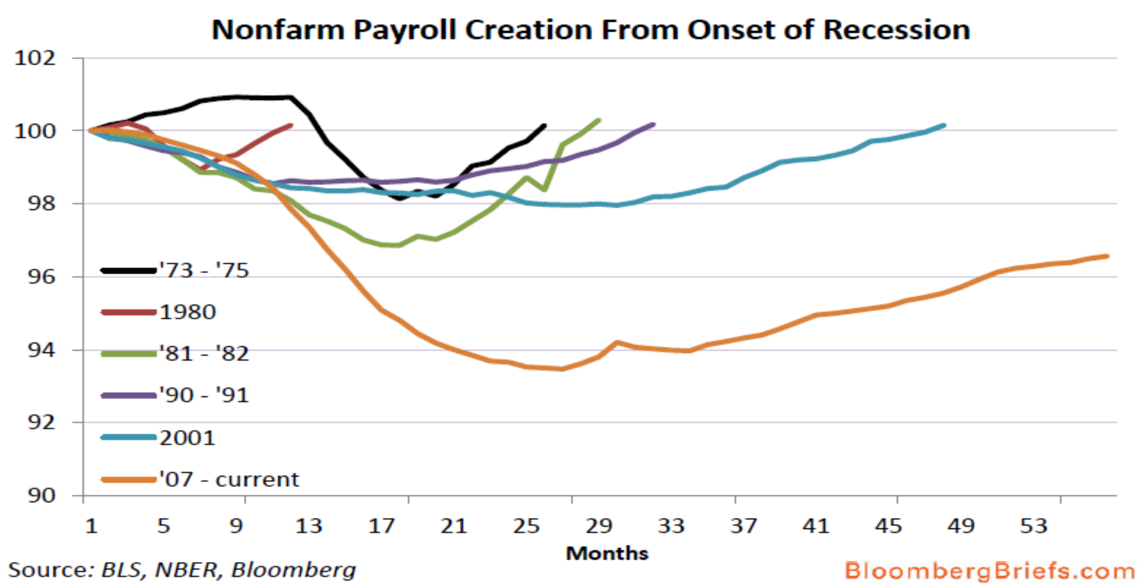
Unlike the universe, leverage and debt cannot expand ad infinitum

The credit bubble of 2000 to 2010 created a grand delusion. Many people and countries mistook levered asset values and cash flow as an endless growth model. Businesses raced to build capacity and inventory. Financial and political leaders slashed interest rates and opened monetary spigots in order to ramp consumer spending and discourage savings. They achieved their goal and then some. Personal savings rates in the G7 countries fell from above 10% in the 80's to a financially suicidal zero by 2005, as global growth surged to a record peak *above 5%* in 2007. As a point of reference: global GDP growth over the next few years is presently *hoped to be 3%.*

"How did you go bankrupt?" "Two ways. Gradually, then suddenly." (Hemingway, *The Sun Also Rises 1926)*

As people often learn the hard way, buying on credit always has limits. There is a qualitative difference between having financed cash flow and having savings. Even where real interest rates are virtually nil, there are only so many debt payments that a person can make, before they have no cash flow left to live on. The same goes for countries.

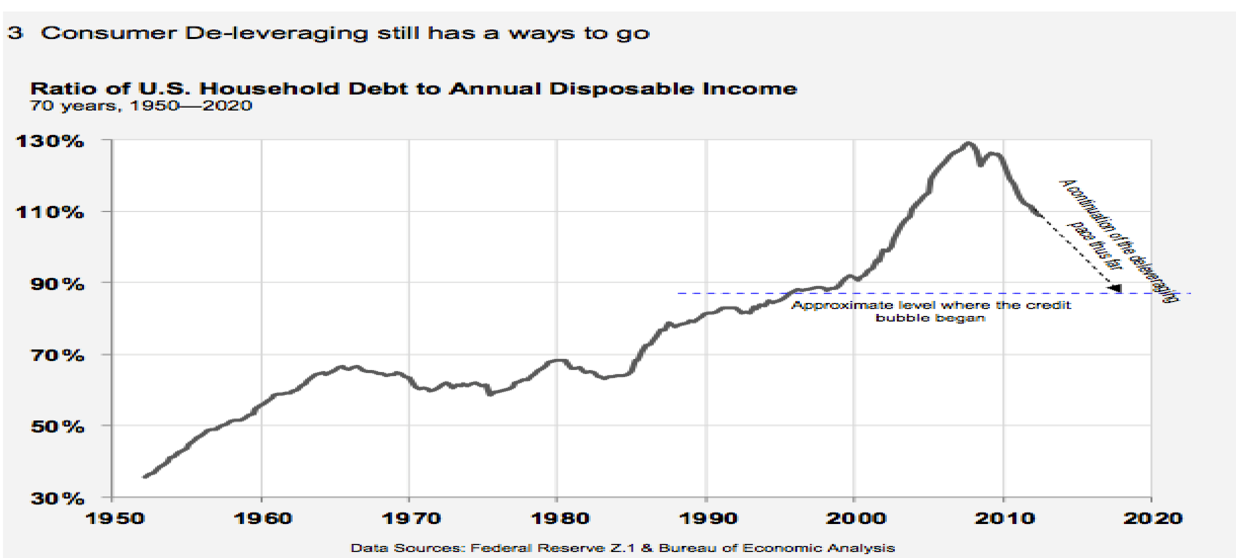
Most people have now lost paper wealth in declining stocks, commodities and housing since 2000. Even more importantly, millions have also lost the sustaining income of normal interest rates and employment. As shown in the chart below, 54 months after the start of the last recession, the US (and most of the developed world) has seen the lowest jobs recovery in more than 40 years. Now heading into the third recession in 13 years, the employment numbers are on course to weaken further.



Debt and low savings rates make individuals financially vulnerable. And the masses see this now. They can feel it in their bones. It is one thing to talk about drawing on high savings in lean times in order to prop up spending. But it is a different situation where one's savings were already consumed in the boom.

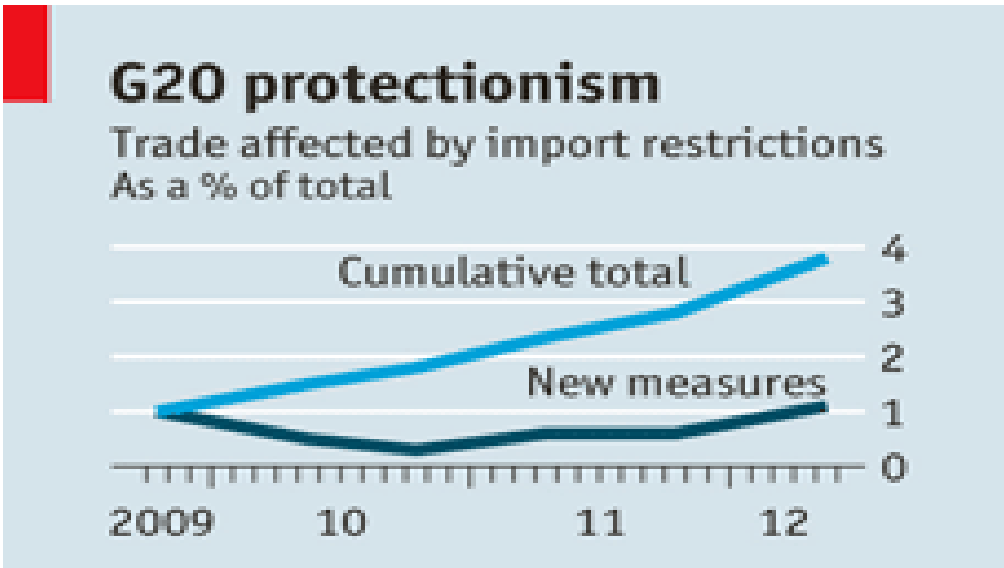
First we kill the debt and then we build the savings

There is some good news here. As shown in the chart below, US households have made some progress on debt reduction over the past 6 years. They are spending about 20% less of their disposable income today on debt payments than they were in 2006.



This is a trend in the right direction. At the current pace it will take another 3 to 5 years to get back to the debt to income ratios of 1995 before all the leverage bubbles began. At that point workers will have greater net cash flow to focus toward rebuilding their savings.

Financial peril has a powerful way of focusing the mind. On a larger scale, until debts can be paid down or written off, slower growth means that countries and regions are collecting less tax of all kinds. This prompts necessary cut backs but also, an inclination toward "beggar thy neighbor" policies that seek to buy less from foreigners and keep more cash flow within one's own coffers. The next chart captures the cumulative total of G20 trade restrictions and import tariffs introduced since 2009.



Source: The Economist

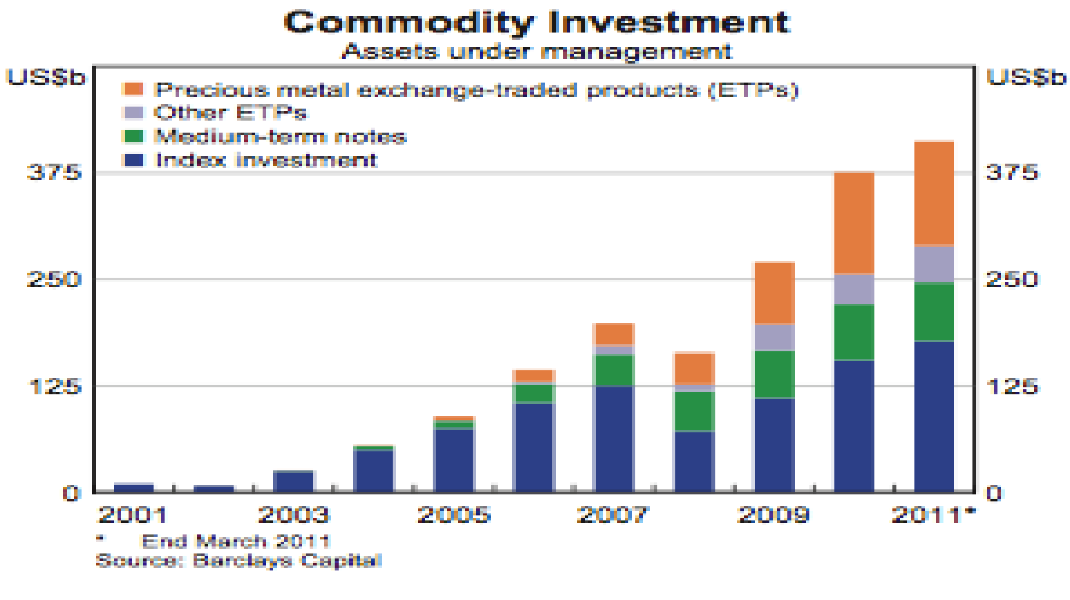
Conventional economic theory suggests that protectionist policies have a dampening effect on growth in that what is thrifty for individuals will be negative for overall demand. In economic theory, this has been dubbed 'the paradox of thrift'. But charity must begin at home and the impetus toward protectionism is pretty clearly here to stay over the next few years.

The countries and communities likely to fare the best in "reverse-globalization" are those with relatively more domestic wealth to recycle.

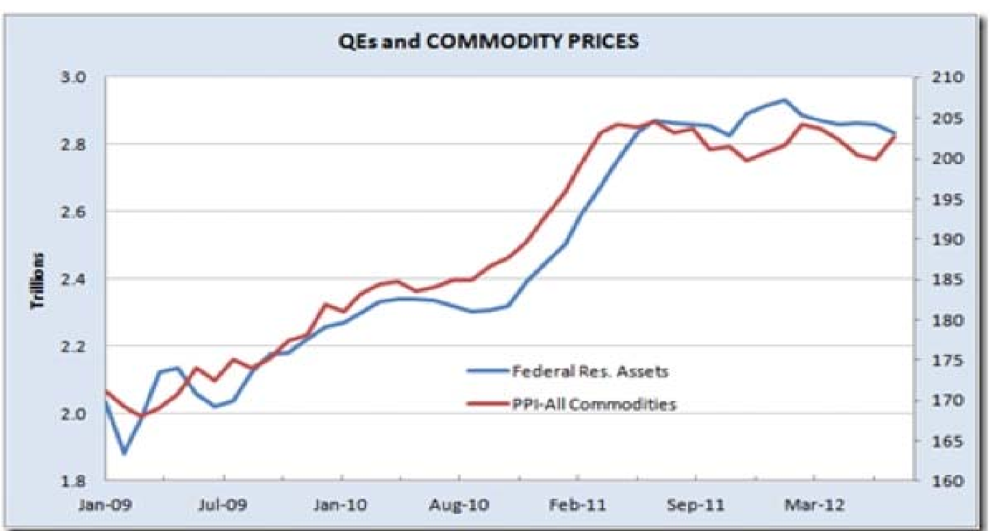
The US still has some of the highest per capita income, birth and immigration rates in the world. And whoever wins the upcoming US election—government spending cuts are inevitable. This suggests a need for greater efficiency and lower current account deficits. Domestic energy is an obvious focus for "Buy America".

Gifts from the bubble: a world now awash in commodities

Like excess inventory left from the tech bubble of the 1990's and the housing bubble of the 2000's, epic investment flows into commodities over the past 10 years have left a world now awash in innovative techniques, producers, record capacity and supply. This chart of investment flows into commodity focused investment products over the past decade offers some perspective, where assets under management have grown about 108% a year.



Central bank liquidity injections have also directly inflated commodity prices since 2009.



High prices are the cure for high prices, because they attract more and more production at the same time as they incent consumers to conserve and substitute. Eventually supply is destined to swamp demand—and we are there.

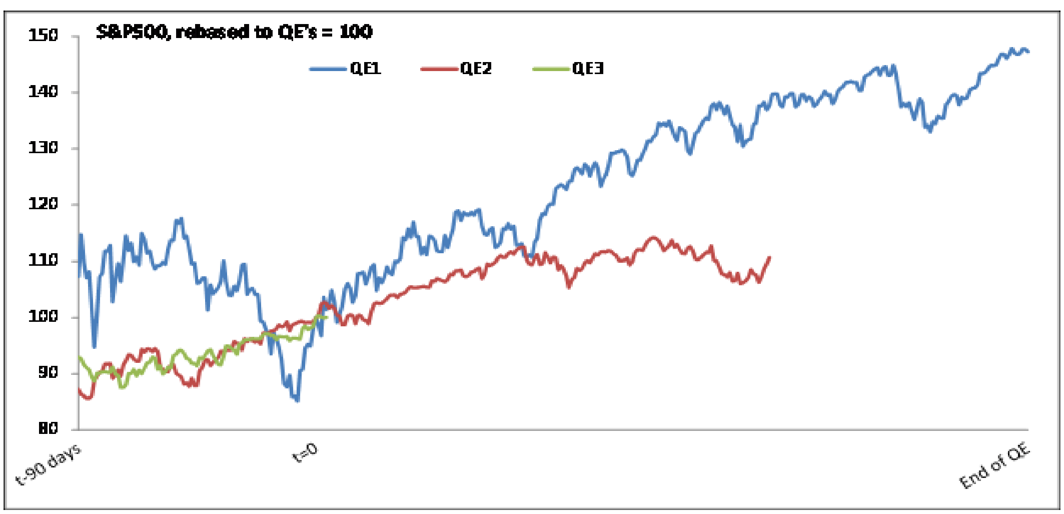
In this midst of a fiscal crisis, record energy supplies are coming at a particularly good time. The US in particular stands to benefit greatly from its now massive domestic inventories of natural gas and coal and 5 x more oil wells today as it had in 2009. It now appears that the US can be 95% energy self-sufficient within 10 years. This will be a huge shift resulting in approx. $365 billion per year in savings for America —cash flow that can be recycled into the US economy, infrastructure and domestic jobs. This can go a long way in reversing fiscal deficits that presently appear hopeless.

In the near term, as a close trading partner, Canada is likely to continue as a favored vendor of energy imports needed in America. But as the US moves increasingly toward self-sufficiency, Canada is likely to see declining US sales over the next 10 years. Our ability to re-sculpt our business model to a focus on domestic demand, manufacturing and more diverse export markets, will dictate how well we fare in the new "after the debt-rush" world.

QE'finity and beyond!

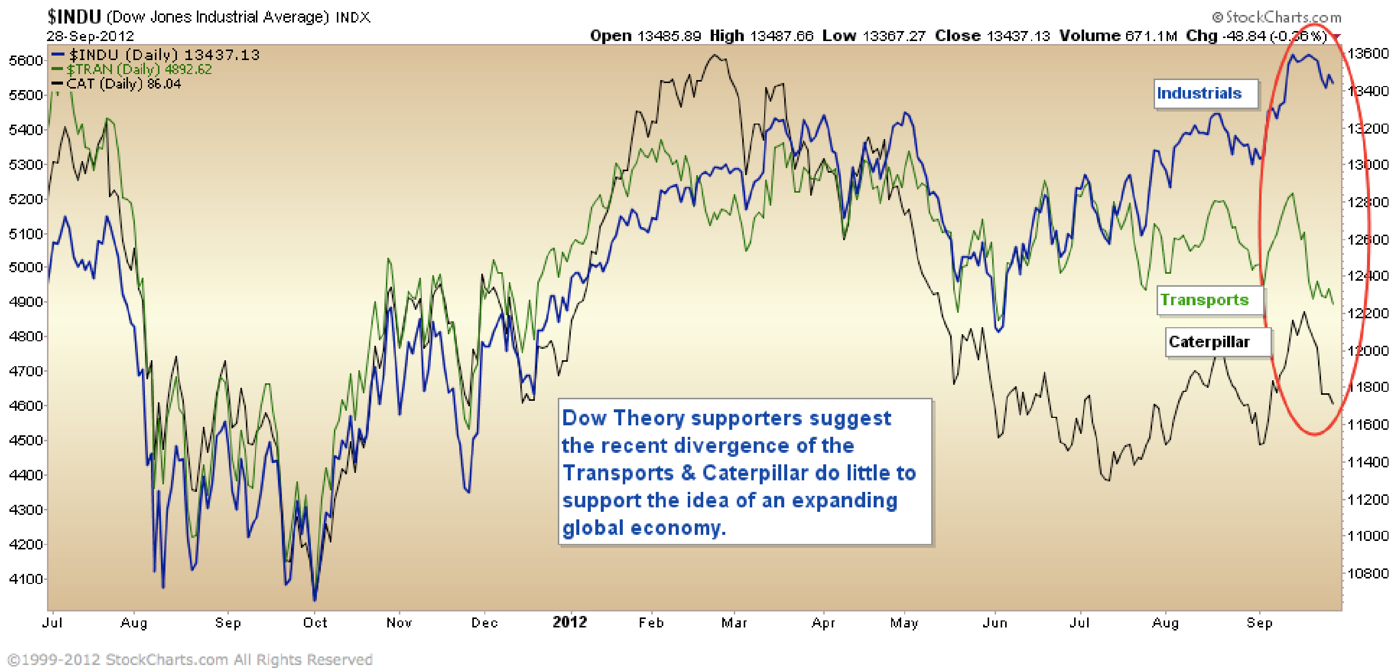
This month the US Federal Reserve followed a page from the European strategy book and promised to continue pumping liquidity into US debt markets indefinitely. As the third installment in the now infamous Bernanke 'QE' experiment, markets had widely anticipated this move in the wake of increasingly sour economic data over the past 6 months. But a funny thing happened. As shown in the chart below, risk markets initially rallied in anticipation of QE3 and then sold off over the last 2 weeks. It seems market traders have finally lost faith in the force of the Fed?

Diminishing gains on the S&P 500 of Fed's QE1 (blue) and QE2 (red) and QE3 to date (green)



Indeed by month end, stock markets had given back all of the initial pop they saw following the Fed's latest announcement. Bond yields and commodity prices dropped even more. If faith in the Fed is now finally faltering, this could present a tipping point for lofty market prices to recouple with the reality of contracting global growth. As shown below, typical cycle leaders such as the Dow transportation index and heavy equipment maker Caterpillar remain uninspired by the global demand picture, ignoring central bank infusions to garner negative returns year to date and are registering a now ominous performance gap beneath the Dow 30 Index (red circle).

Significant divergence: Dow 30 Index (blue), Transport Index (green) and Caterpillar shares (black)

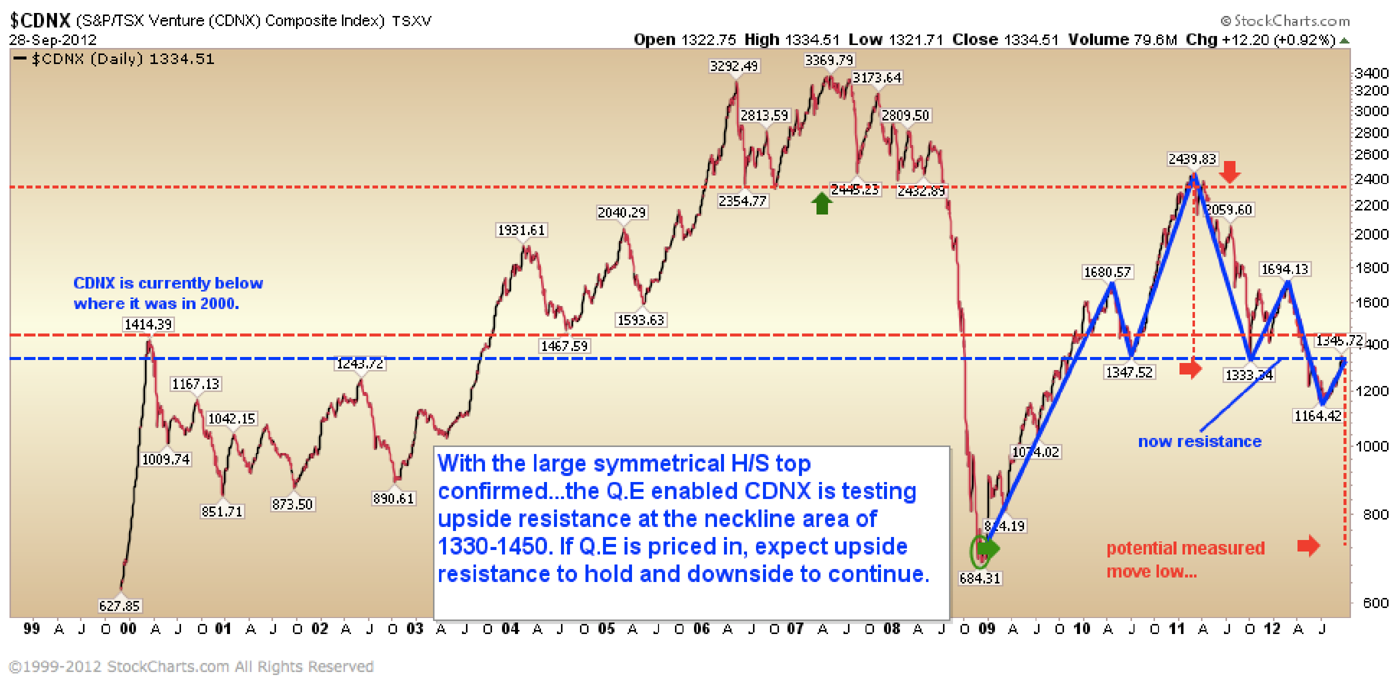


In a similar incidence of non-confirmation, the Shanghai stock market fathomed a fresh cycle low this month at the 2000 level. This is the same level it was at before China joined the WTO in 2001, and 65% beneath the credit bubble cycle high in 2007.

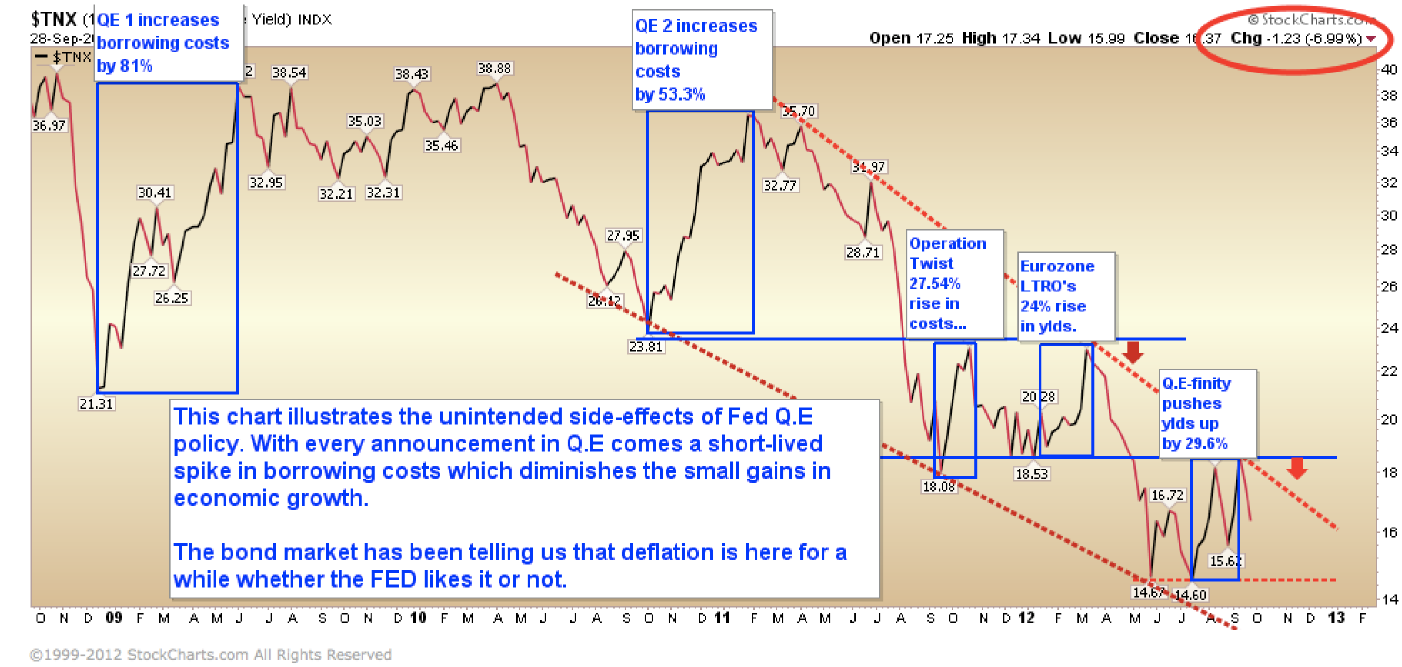
We are watching to see where Chinese stocks will bottom because they typically have served as a leading barometer for cyclical turning points in commodities and other global stock markets. As shown in the chart below, so far the trend is profoundly down, and the 2008 low is now just 300 points down from here. The TSX venture exchange also remains in consolidation mode, with its 2009 low also a potential downside test. **As prices languish over the next year or two, the resource sector is likely to see significant consolidation, with some 70%+ of present companies in the sector failing similar to dot.com companies 2001-2003.**

Shanghai Composite Index 1999 to Sept 2012: flirting with the 2008 cycle low

The Canadian venture exchange (mining and energy juniors) is suggesting similar downside risk



10-year US Treasury bond yields rallied on the QE3 announcement and then fell back to signal deflation



US dollar index also weakened into QE3 and then rallied again—so far $88 still upside target

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The world is in the midst of a huge wave of rationalization and consolidation today. While some of the adjustments are undoubtedly painful in the short run, in the longer run they are necessary and have been a long time coming. Systems and structures that cannot remain the same necessarily evolve and change to meet the future. This is how we humans have managed to survive and evolve over the past 100,000+ years. We say bring it on.

In the end, fleeting central bank injections aside, incoming data has continued to corroborate our long-term thesis that we are in a post-credit bubble, declining growth world with a preponderance of unattractive reward dynamics for presently elevated stock and commodity prices. Getting to the end of 'belief in central bank magic' is a necessary development toward realistic price discovery, and this month we seem to have made some important progress in this direction.

Happy autumn…here's to crisp, sunny days and cozy fires. **Quotes of the month:**

"So often we dwell on the things that seem impossible rather than on the things that are possible. So often we are depressed by what remains to be done and forget to be thankful for all that has been done."

—Marian Wright Edelman, Activist for the rights of children (b. 1939)

"A leader takes people where they want to go. A great leader takes people where they don't want to go but ought to be." —Rosalynn Carter, Former First Lady of the United States of America (1977-1981)

"You will find that the mere resolve not to be useless, and the honest desire to help other people, will, in the quickest and most delicate ways, improve yourself."—John Ruskin, writer, philanthropist (1819-1900)

Germany grows weary of the EU weight

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