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CastleMoore Investment News

Uniquely Superior Portfolio Management

Economic Tsunami:The Crest of the Wave

By

Ken Norquay
CMT, Partner

The ripple began 2 or 3 years ago. Then the US sub-prime mortgage wave hit the headlines 14 months ago. And the crest of the wave is hitting now. September 2008 is the month when the maximum number of US homeowners will have their mortgage rates adjusted upwards. By the end of this month millions more Americans will no longer be able to afford to live in their homes. The last quarter of 2008 will be the time of the maximum number of mortgage payment arrears. Spring of 2009 will be the maximum number of foreclosures. By this time next year, the US banks will own the maximum number of homes. I wonder how long banks hold real estate before they lose patience and just sell.

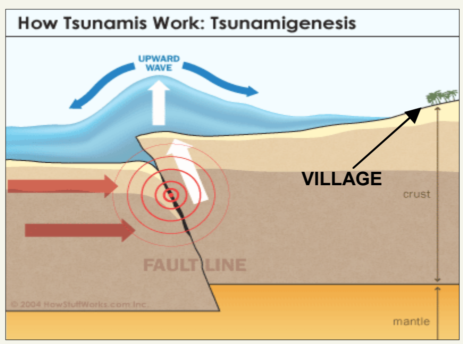
Test Question: when do you think will be the best time to buy American residential real estate? [Clue: you buy it from a bank… probably at an auction.]

Of course, we Canadians are immune from that virus. Our realtors fondly tell us it'll never happen here. Our banks were not so irresponsible as the American banks.

I wonder what the British are saying. Their mortgage lenders were not so "irresponsible" as the Americans, but their real estate prices are in a downward spiral too. The Financial Times reports that there have been 10 consecutive monthly declines in the average price of a home in the UK. Prices are off 10.9% this past year. The Brits measure buying activity by keeping track of the number of buyers who are approved for a mortgage. June 2008 was down 65% from June 2007. 65% fewer approved buyers!

Of course, we Canadians are immune to that virus ...

Exactly what IS wrong? What is causing house prices to fall? The most common theory we've heard is that consumers and homeowners are too much in debt. And when they can't afford to pay, they lose their collateral. But maybe that's only the cover story. Maybe it's simpler than that.



Those palm trees look really small.

Is it possible that house prices are just like the stock market? Prices go down simply because they went up too far. Is it useful for homeowners to act like stock market investors? Is it useful, or even possible for homeowners, when faced with a decline in the price of their most valuable asset, to sell and wait it out?

Remember Canada's last real estate decline? The peak in prices was 1989. The bottom was 1996. Would you have made money by selling in the late 80's and buying back in the mid 90's? I did. I made a little over $100,000. During the time my family was renting, I used my capital to start a stock brokerage firm. It worked for me. Could it work for you?

Selling a home and renting for a few years is so much more complicated than selling your investments. It's easy to sell your stocks and switch to some other investment that is going up instead of down. Most investors can reposition their whole portfolios within a week or two. Not so easy with a house.

The whole idea of a housing crisis makes me wonder who is in charge of our lives. Is it me or is it my banker? Or is it some other guy and his banker? I didn't stretch myself out in debt to buy a house way bigger than I could ever use. I didn't buy two or three houses, renovate them and flip them out for a fast profit. Yet, because of the aggressive actions of others [and their bankers], my house will go down in price too.

That's why I manage my financial affairs the CastleMoore way: rather than ponder the why's and wherefores of the economic mind, we just sell out of investments in downtrends and buy investments in up trends. Helps keep our lives simpler.

- Ken

ken@castlemoore.com
1.905.847.8511 or toll free 1.877.289.5673

TIME AND VOLATILITY: HOW HAS IT CHANGED THINGS?

By
Robert "Hap" Sneddon
FCSI, President

Making investment decisions in the last year seemed like a mugs game. Investors, whether professional or individuals, may have done their homework, hopefully dotting all the "i's" and crossing all the "t's", yet still feel like they've been played for a fool, watching decision after decision turn out opposite of expectations. Enough of this and one have eventually lost confidence, patience and assets.

As the chart of the Volatility Index (VIX) indicates markets have been very extreme in their movements over the last year after having been reasonably well behaved for quite a long period. Without getting into too much detail, some of the accompanying indicators in the upper and lower most charts suggest we are in a persistent trend; that is to say, volatility may be here for a while. Occasional pauses may provide periods of calmness. Making decisions against a backdrop of extreme price swings may too be the norm for some time to come.

Volatility is a significant part of investor experience now.

Why does volatility rise and fall? The two of the simplest answers lie in how markets *correct* and how markets *rotate*.

Corrections occur after the halt to a sustained upward move. Bounces occur amidst bear moves. Just like a gardener pruning his rose bush or apple tree, these "adjustments" allow for markets to flourish again in the direction of the prevailing trend . The magnitude of adjustments vary, depending on the underlying fundamentals and the extent to which froth or pessimism developed.

For example, the run up in commodities and precious metals has been very robust. Of course, the momentum or rate of change is unsustainable. Parabolic price movements in these cases invoke the fundamental axiom of "demand destruction". This occurs when high prices are cooled by lack of demand because of …ah...high prices.

Corrective volatility does not always account for large price movements. For example, if you look back at the North American banking sector data between December 2006 and February 2007, or the tech sector data from mid 1999 to 2000 you can see that these were not corrective moves—more was going on. In these instances, the sectors were finally falling out of favour, most notably with investors who, until these moments of crisis, had long term buy and hold views.

What then was actually going on was sector *rotation*. The volatility in such cases was a result of a changing of the guard. You can look at it like a large manufacturer changing over and retooling for another product line.

The challenge for investors is to recognise when this is occurring and thereby avoiding making purchases. In February 2007 leadership of the financial sector was waning and that of commodities and precious metals rising.

About a year ago it seemed to traditional and pure fundamentalist managers that the financials represented real value, however static and rear-view looking the quarterly reports. What was not known to them at the time, but was apparent in *price*, was continuing weakness in US housing and tightening of commercial credit. In short, a *correction* may in fact be sector *rotation* as large players change their portfolios to reflect conditions.

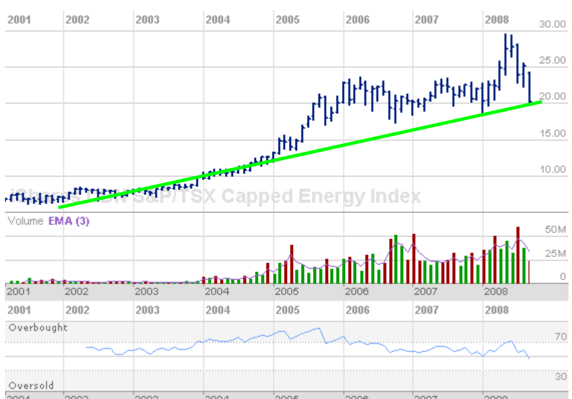
If we are to extrapolate this to the energy sector today, we would not still know whether its day in the sun has come and gone for now (rotation) or whether it is

Continued next page

Volatility continued

merely taking a pause to consolidate (correction) longer term gains.

How can we mitigate the harmful effects of buying too late, just before a correction, or against buying a waning sector? Part of the solution lies in good old modern portfolio theory: asset allocation. If investors limit sector concentration it is still acceptable to be wrong. But combining large "bets" with poor timing is not prudent. Adherence to asset allocation principles easily removes avoidable risks.



Long term energy: Is this a correction or done?

Another part of the solution is found in understanding ahead of time what loss one will allow to accrue before selling. Knowing in advance some percentage loss helps to keep emotions in check and decisions made. If a 10% loss threshold established then investors may not suffer the steeper losses that can occur in the case of a deep correction or sector rotation. Again, being wrong is acceptable; its whether the price of doing so impacts capital and confidence.

A couple of basic rules applied today and during all extreme volatility provide a better bearing to be guided by. The over-reaching principle against being wrong and suffering loss is that there are always plenty of opportunities, but capital is limited. By establishing rules and sticking to them investors can be very well served, knowing it's the totality of their decision-making process that ultimately matters. Investment success for the lay and professional investor should never be judged on any one decision, but as a group.

Volatility today challenges buy and sell processes unlike at any time in the last few years and more. Without volatility there is no opportunity. If the level or rate of change of volatility was reduced to a comfortable level it would limit opportunity .

- Hap

robert@castlemoore.com
1.905.847.1125 or
toll free 1.877.289.5673

Guest Columnist

U.S. Equity Markets and the U.S. Presidential Election Cycle

By
Don Vialoux, CMT

U.S. equity markets historically have moved higher during U.S. presidential election years. Data for U.S. election years starting in 1888 shows that the S&P 500 Index advanced in 23 of the past 30 periods. Average gain per period was 8.4%. Equity markets respond to hopeful comments and promises made by politicians during the election period. After the election is over, equity markets continue to move higher in anticipation of action on a new mandate.

However, when digging down deeper into the data another picture is revealed—a picture within a picture. When the incumbent party won, the S&P 500 Index averaged a gain of 13.9% per period. However, when the incumbent party lost, the S&P 500 averaged a gain of only 1.6%

What about this year? Political agendas by both major parties may have an influence on equity markets. John McCain, the Republican candidate is advocating continuation of existing personal tax rates and a lower corporate tax rate. Barack Obama, the Democrat candidate, is advocating a higher tax rate for persons earning more than $250,000, a higher tax rate on capital gains and dividend income and no change in the corporate tax rate.

Standard & Poor's recently released an interesting report showing that performance by the S&P 500 from the end of July to the end of October during a U.S. presidential year is a good predictor of re-election or replacement of the president or his party. Gains by the S&P 500 Index during these periods predicted that the existing president's party will be re-elected while losses predicted a replacement. Data for 20 periods starting in 1928 recorded a 79% accuracy record when predicting re-election of the party in power and an 83% accuracy record when calling for a change in party.

Election year	End of August	End of December	Percent Change	President
1968	896.01	943.75	5.33	Nixon
1972	963.73	1,020.02	5.84	Nixon
1976	973.74	1,004.65	3.17	Carter
1980	932.59	963.99	3.37	Reagan
1984	1,225.38	1,211.57	-1.05	Reagan
1988	2,031.65	2,168.57	6.74	Bush Sr.
1992	3,257.35	3,301.00	1.34	Clinton
1996	5,616.21	6,448.27	14.82	Clinton
2000	11,215.10	10,787.99	-3.38	Bush Jr.
2004	10,173.92	10,717.50	5.34	Bush Jr.

Market action in an election year is usually positive AND predictive of how incumbents and newcomers fair.

Data from the end of August to the end of December during a U.S. Presidential election year since 1968 also shows positive returns. Average (median) gain per period for the Dow Jones Industrial Average during the past 10 periods was 4.35%. Following is the data:

Average (median) gain per period: 4.35%

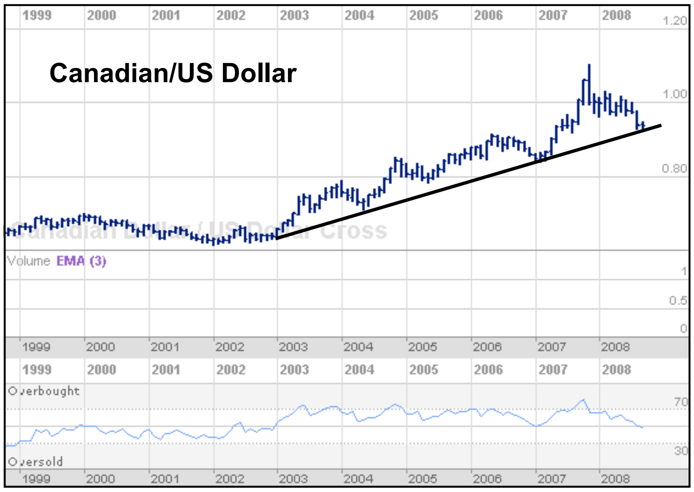
Number of profitable traded out of 10: 8

What is the S&P 500 Index telling us about the current period? The S&P 500 Index closed at 1267 at the end of July.

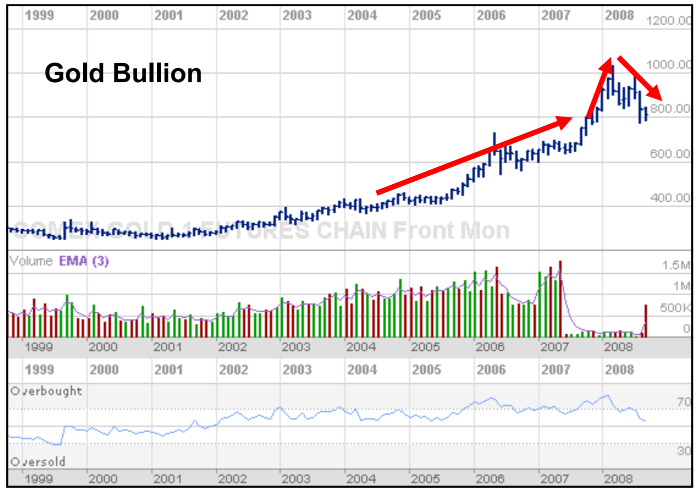
-Don

Don Vialoux is a Chartered Market Technician and analyst for www.dvtechtalk.com. He is a frequent guest of *Business News Network* and a business columnist for *The National Post.*

The Chart Page

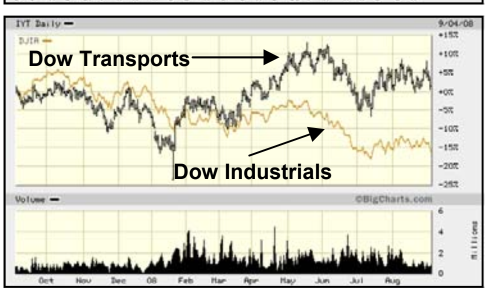


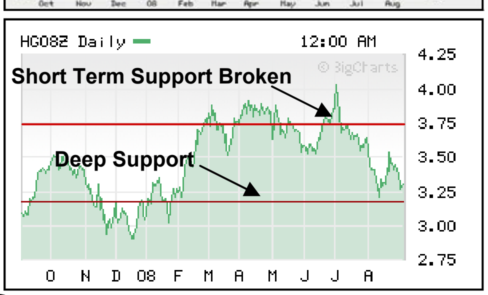
The CDN/US dollar relationship has cooled of late with no signs that it will dramatically run up or breakdown from here. The anomaly we saw this past year allowed Canadians to puff out their collective chests a bit when we hit $1.10 but that's it. The US dollar was oversold, and today it is restored to its reserve currency status.



Gold has been a drama queen whose sun may have set for a little while. An invigorated US dollar combined with a seeming global slowdown in growth has changed its meteoric pace. With much doom and gloom about gold does not rise. Something that cannot rise in the face of supportive fundamentals is often telling the opposite.

Canaries in the Coal Mine — Life In the Markets





Because of continued market volatility and speculation this section, initially introduced as a "one-off", will carry on indefinitely in our attempts to monitor key signals about the nature of security prices and the economy they reflect. These little birdies and others to come let us see what's going on in the deep.

<u>**BONDS/PREFERRED SHARES:**</u> This "indicator" tells us investor perception of issuers' abilities to pay dividends. Price is especially effected by whether a preferred share is a cumulative or not, that is to say the issuer must pay any dividend in arrears before paying common stock shareholders. Since we reported last this metric has deteriorated further, giving up another 5%. We still do not own any preferreds and are in no rush just yet to step in.

<u>**DOW THEORY:**</u> This theory foretells the health of the overall economy. If goods are being produced (as a result of demand) then they have to be transported to the consumer. If the Transports fall below the Industrials it usually predicts poor economic conditions lie just ahead. So far, it is appears to only be forecasting a slowing economy with both not doing much of anything.

<u>**COPPER PRICES:**</u> On the other hand, copper prices seem to predicting that we have already entered a slow down in the global economy. Near term support was broken crossing $3.75 US/lb. At the time of publication prices fell through deeper support around $3.25 and lie somewhere near $3.11. Now support (or resistance) levels are certainly a matter of interpretation and we could not quibble with other suggested levels. Certainly, any way you cut it they have softened. If you take a five year view one could make the case that global *growth* is intact. With respect to Yeats, the centre must hold; waiting for a five year chart to tell you something could be costly.

-Hap

Hurting Days Hath September

By
Sheldon Liberman
Portfolio Manager

I've always loved the month of September. The weather was usually agreeable, the pennant races were in the home stretch, hockey was becoming more the buzz (go Habs!) and the NFL season was kicking off.

It was also a month of new beginnings, as the school year got underway with a chance to improve upon the sorry performance of the previous year. This goal was usually doomed from the start, since September is also the month all the new TV shows came out, as well as new seasons of the old favorites.

As I matured (don't say it!), sports became less important to me and spirituality took over at the top of my priorities list. For members of the Jewish faith, September, or the month of Elul, is generally a time of reflection and spiritual opportunity, just ahead or coincident with the holiest days of the Jewish year, Rosh Hashanah.

Lots of things change in Fall

For investors, September is significant—some would say infamous—for another reason: it has historically been the worst month in terms of performance, period. For instance, dating back to 1928, the average return on the Dow Jones Industrial Average for the month of September has been -1.40%, far worst than the average return for May, the second worst month. May is the only other month with a negative return (-0.16%) But at least May gives a positive return most of the time (52.5% of the time). September has been profitable only 39.2% of the time, the only month batting less than .500. October seems to grab the headlines with the big, dramatic days, including 1929 and 1987.

In case you're wondering December is the best month in which to be invested, with an average gain of 1.44% and a 72.5% "success" rate.

This point hit struck a chord with me as I sat here deciding what to write about this month. The Dow is off about 4.1% so far this month, although most Canadian investors would gladly change positions with their US counterparts these days. As we wrote in a weekly commentary (www.timingthemarket.ca, see guest column by the site's market master Don Vialoux in this newsletter), we hope Canadian investors had a restful Labour Day, because the rest of the week saw nothing to write home about: down 11.2% as of this writing.

At our shop, we do consider seasonal tendencies, as well as the fundamentals of markets, sectors and individual securities, but these factors are considered adjuncts to our most valuable investment tool: KNOW THY TREND. Only by doing so can an investor master the most difficult task he or she will ever have: selling. After all, it's market declines that separate the contenders from the pretenders in *this* business. Selling, not only preserves confidence, but also capital, two dear resources which allow investors to carry on.

Throughout my career as a Portfolio Manager, I've always considered risk reduction and capital preservation to be my Prime Directive. Hence, I've never to my knowledge, had a problem selling any security, save for one:

After having sold Microsoft, I quickly found that my Excel didn't, my Outlook became cloudy, my Power Point became pointless, and suddenly my Word wasn't good enough. Moreover, after using Microsoft's Flight Simulator, my luggage went missing.

Just kidding of course. I can truly say that Microsoft has added value to my life just as it has added value to thousands of portfolios over the years.

As for the month of September, I am happy to report that it only has 30 days, and we've held the line for client portfolios so far, edging them up slightly to date.

To all our Jewish friends, may the New Year bring Peace, Health, and, of course, Prosperity.

-Shel

sheldon@castlemoore.com
1.416.306.5770 or toll free 1.877.289.5673