



Castle Moore News

Buy, Hold... and Know When to Sell™

THE SECOND WAVE



**By Ken Norquay,
CMT, Partner**

I hope the rumours are not true. I hope there are no such things as re-sets and Option ARM and ALT-A mortgages in the USA. The sub primes were bad enough.

Remember what happened in the sub prime fiasco? A trillion dollars US was loaned to homeowners who couldn't afford their mortgages on homes that were barely worth the amount of the mortgage loan. When the people couldn't make their payments, the value of certain mortgage-backed US investments went to ZERO. And the banks all over the world who owned those now worthless investments were taken to the edge of solvency: many had to be bailed out by their various governments. And now we are all breathing a collective sigh of gratitude: the bail outs worked. The wave of sub prime re-sets and defaults has crested. The banking system of the world survived.

What's a "name your payments" mortgage? You guessed it! When the new home buyer moved in, their monthly payments were so low they produced negative amortization. Because the "name your payments" payments didn't even cover the interest, the mortgage actually got bigger over the first few years! Instead of paying it off in 30 years, now it would take 35 years! Mortgage loans were offered with "too low" monthly payments for 1, 3, 5 or 7 years. Once that period is over, the mortgage loan repayments are re-set so the loan actually does start to get smaller. Some home owners face doubling or tripling their monthly mortgage payments when the re-sets come.

Other Option ARM or ALT-A mortgages were underwritten at artificially low interest rates, same as the sub primes. The re-sets will bring these interest rates back up to normal, increasing monthly payments and increasing the risk of defaults.

How big is this problem? \$2.4 trillion. The Sub prime was \$1 trillion. But the re-sets on the sub primes were more serious a problem for the banks: the re-sets of the Option ARM and ALT-A mortgages should produce a lower percentage of defaults. If you want to look at the details, go on-line and search "Alt-a" or "Option ARM." It's big. Too big.

It appears that our American cousins are not yet out of the junk mortgage jungle. The American consumer is not bristling with money and ready to buy. Too many of them are already spent out: they blew the bank roll buying houses at the top of the cycle with mortgages they can no longer afford.

In the past, the engine of the American economy was the new housing market. Families would buy new homes and fill them with furniture. But the 2003, '04, '05, '06 years of over-mortgaging killed that pattern. Now people are struggling to pay off those mega-mortgages and continue living in their houses. The engine that powered the US economy has been sabotaged by overly aggressive mortgage lending on a massive scale. They broke the bank.

What's this got to do with you or me?

We should keep our expectations in line with the new reality: a booming US economy is a thing of the past. How will this new reality affect our retirement plans? Our financial planners' projections have not worked out: we need a new plan. How will this new reality affect those investors who still believe that we should all buy high quality stocks and hold them for the long term? American investors have negative ten-year returns on their stock market mutual funds even though the US economy was booming because of an artificially stimulated housing boom. Canadian investors made less than 3% compound returns over the past 10 years even though our economy was enjoying a resource boom. The new reality is that the world's economy has changed. American economic domination is ending and new economic forces are emerging. The American Way is no longer working.

The old ways are obsolete. Fresh thinking is required. Check our website. We offer investors a new way of thinking about investing.

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INVENTORY AND CREDIT RECESSIONS MAY APPEAR THE SAME AT FIRST, BUT THEY'RE NOT



**By Robert 'Hap' Sneddon,
FCSI, President**

In various media over the last year I have mentioned that this credit-based economic downturn was different from the typical, common vanilla recessions of the last 150 years. Usually the topic was part of another point or only briefly discussed. Well a year later and with the evidence still robust it deserves a stage all to itself.

Recessions or depressions come in two basic and fundamental varieties: one is based on the inventory cycle and the other, based on the credit environment.

Inventory-led recessions are far more common, shallow and shorter than ones stemming from credit conditions. Lasting on average 10 months they start from the over supply of goods and services and, accordingly, they are generally perceived as a healthy correction in a longer term economic growth cycle. As a kid growing up in Waterloo, Ontario in the late stages of summer it was my duty to pick clean our one and only bountiful apple tree. (The biggest challenge wasn't the picking; it was dodging all the wasps). Each spring a pleasant and quiet Mennonite man would show up at our house to prune said tree. For \$6.00 he made sure that my task was all the more difficult as his pruning efforts would make sure we got the maximum crop possible in the fall. Ergo, though pruning initially retards growth, in the end it produces more fruit because of it. It's the same in economics and investing. Pruned growth eventually increases yields and produces stable and known investment trajectories. Inventory-based downturns sop up over supply and increase long term efficiency by forcing industry to reduce production and prices to a level where eventually demand outstrips supply. Production and prices increase in response to the

higher demand. The normal recessions are really about the modest swings in supply and demand that are somewhat predictable and that present buying opportunities.

Credit-based downturns on the other hand are far more systemic and deeply structural in nature. They take longer to develop, have a greater duration, and are larger, peak to trough. Most importantly, recoveries are often anticipated or front ran to the detriment of investors who simply expect that an inventory rebuild and increase in final demand are at hand and sustainable – at first they appear like your normal recession, and with a run up like we've had whose to blame them? After all, stock markets reflect economic conditions 6 months to a year out. During the downswing companies and investors start to make some crucial consumption decisions based on rising debt levels. Instead of re-ratcheting up debt loads to pre-recession levels they choose to pay down debt after reviewing their net worth. Since June 2009 the levels (US data in particular) of debt paid off have been staggering with the largest decrease in history. And we know from Keynes' Paradox of Thrift thesis that increased savings actually hurt markets in the end as assets are sold, not bought and debt is paid down, not increased.

From the San Francisco Federal Reserve: "US household leverage, as measured by the ratio of debt to personal disposable income, increased modestly from 55% in 1960 to 65% by mid-1980. Then over the next two decades, leverage proceeded to more than double, reaching an all-time high of 133% in 2007". Today, even after the unprecedented move since June we still stand at 131%. We are at the beginning of a secular shift in credit and consumption. Despite the individual's misstep in 2001-2002 where governments extolled people to shop and spend as almost a part of their patriotic duty and the private sector came out with 0% financing and jumbo, no down payment loans, citizens are not getting fooled again. With US home values off some 30% from their peak (the Canadian market is still hot right now but we always lag the US) and the average portfolio, even with the run of the last year, still down dramatically, individuals have lost two sources of further leverage. They are tapped out and feeling not too consumptive.

The "stimulus", when all is said and done, found its way into stock markets not into main street. Markets were the recipient because markets would

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be a source of liquidity. The recession of 2001-2002 was also credit-led, but the governments of the day managed to kick the can down the road once again. Consumers played their part too – change is tough sometimes. Like much medicine, who wants to be the one to be associated with it when it's easier to have to land on someone else's watch? Though they have a greater impact on societies, credit-based recessions clean the slate too for the next growth phase. Ludwig von Mises (early 20th century figure who specialised in the differences between government controlled economies and free markets) said of them: "There is no means of avoiding the final collapse of a boom brought on by credit expansion."

Today, leaders are hoping that the passage of time will help to heal these economic wounds; that consumption which represents 70% of GDP will return to normal levels. Baby boomers have passed their peak consumption years; India and China together still only represent about one quarter of US consumption; bank lending is still anaemic; and employment has headwinds.

Part of the problem for conventional money management – for Bay Street or Wall Street – is that they too depend on the can getting kicked down the road. They depend on bull markets in stocks to keep the world going round. At CastleMoore we care not a wit which way the wind blows, for it will fill our sails nonetheless. During protracted credit deleveraging as we have just embarked upon there are great opportunities in fixed income, gold, income producing equities and stocks at certain times. We just won't drink the cool aide.



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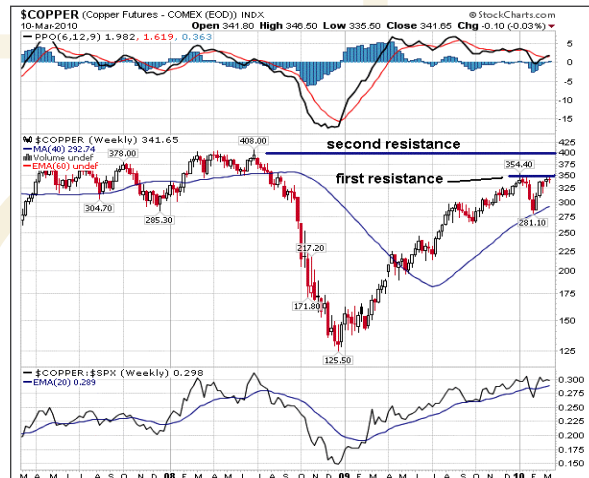
THE CHART PAGES

GOLD BULLION



Gold bullion topped out recently around \$1200oz/USD in the beginning of December. It has a good long term uptrend in place. Over the course of the last few years a quick glance at the chart shows that gold has never truly become "oversold", that is its stochastic measurement (a momentum indicator) has not touched the traditional bottom of 20. This reflects a strong bid underneath the market.

COPPER



Like the equity markets, copper bottomed in late January and too like stocks has hit resistance. Point and figure upside targets suggest that copper could fly through the second resistance level at \$4.00US/lb which bodes well for stocks, if it comes to pass. Volume peaked in late August and has declined in tandem with the upside move in price making a bullish move possible but with a weakening risk-to-reward ratio – too much risk for too little reward.

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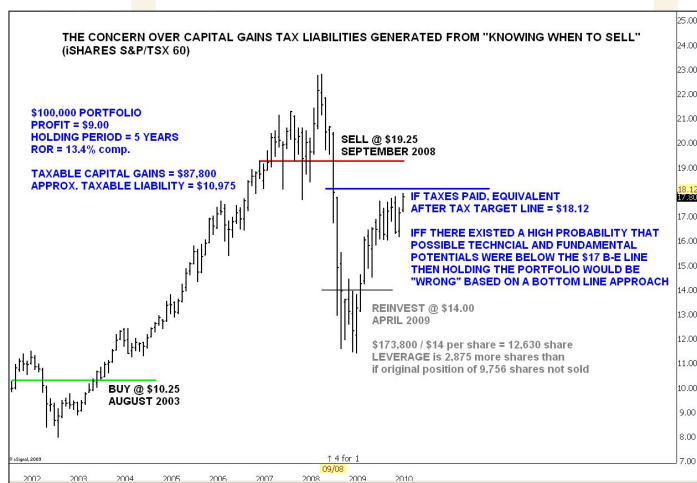
A COMMON-SENSE APPROACH TO RISK AND REWARD – PART THREE, To Sell or Not To Sell



By Thomas Kleinschmidt

In Part 1 (May-June 2009 Newsletter) I said: The most important point is that in order to turn paper profits into real capital you must sell and sell higher than you purchased. In Part 2 (July-August 2009 Newsletter) I said: Only investors who sell to protect profits/rates of return/capital are rewarded for risk. Profit can only be recognized after the sale. Choosing to not sell at a loss is a tax issue, not investing. In Part 3 I talk about tax implications realized by selling to protect capital.

In Canada, Capital Gain Tax is calculated as (Selling Price – Purchase Price) x 50%) x Investor's Marginal Tax Rate: assumptions are (a) capital gains are treated as such and not as income as with some professional traders and corporations and, for easy arithmetic, (b) the investor's marginal rate is 25% (approx. for \$100,000 taxable income).



The chart below is a \$100,000 investment in XIU at \$10.25 buying 9,756 shares with a selling decision point at \$19.25:

1. If you sold, you would crystallize a tax liability of $((\$19.25 - \$10.25) \times 9,756 \text{ shares} \times 50\%) \times 25\% = \$10,975$
2. The tax liability results in a \$1.13/share setback ($\$10,975 / 9,756 \text{ shares}$) resulting in an 'after tax target line' of \$18.12 ($\$19.25 - \1.13) to use as a sell-don't sell decision line**
3. If you indeed sold you would have, after tax, $(\$19.25/\text{share} \times 9,756 \text{ shares}) - \$10,975 = \$173,800$ to reinvest.

So, if you believe a corrective move in XIU would bring the share price to BELOW the \$18.12 'after tax target' equivalent level, selling and paying the taxes would be best. Calculating a bottom ABOVE \$18.12 you would decide to hold the shares. However, the salient point in all of this is to actually be 100% confident of 'the bottom' before it actually forms is far beyond the reach of the average investor. PROTECTING CAPITAL is always going to be the prudent and safest action.

Without a selling methodology all of investing becomes folly. Remember the thousands of investors who did not want to sell their Nortel shares at the top for tax reasons and how, during the collapse, those same investors did not want to sell their Nortel shares for other reasons?

The bottom line: if you did sell and repurchase the shares at a level below the after tax target line of \$18.12/share with the after tax funds remaining (\$173,800) you would experience leverage. In the example above, if you repurchased at \$14/share you would have about 2,875 more shares than before!

At CastleMoore, we aim to give our clients tax problems! It means that we are doing our jobs and achieving capital gains for clients! In the end, taxes are inevitable but major losses are not. Recovering from not participating in an advance is far easier than recovering from capital loss, so we use selling to manage risk. A bit of extra work for us – and perhaps some tax issues for you – but in the end usually proven as the right thing to do.

p.s. For new clients we are happy to work with your accountant to address specific tax issues.

** If your marginal rate is higher than 25% and the more taxable gains you have, the lower the 'after tax line'; if your marginal rate is lower than 25% and the less taxable gains you have, the higher the 'after tax line'.

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GUEST COLUMNIST

AN OUTLOOK FOR THE CANADIAN DOLLAR



By Don Vialoux,
CMT

The Canadian Dollar has a history of moving higher from mid March to the end of May. Will history repeat this year?

Seasonal Influences

A recent seasonality study by EquityClock.com based on data for the past 20 years shows that the Canadian Dollar has a seasonal sweet spot between mid March and the end of May. On average, the Canadian Dollar has gained 2.0 percent per period against the U.S. Dollar. The sweet spot corresponds to a period when seasonal demand for commodities such as lumber, copper, zinc and nickel as well as manufactured goods such as autos reaches a high.

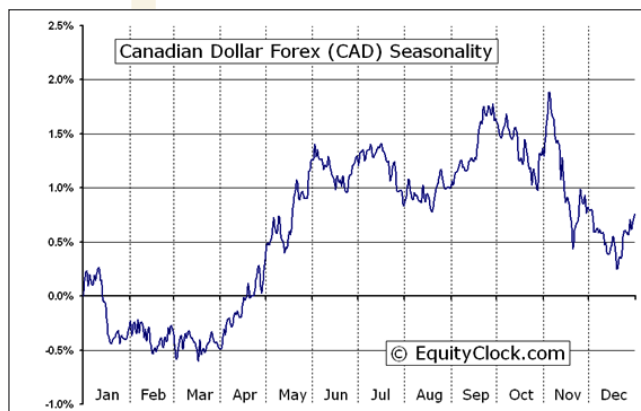
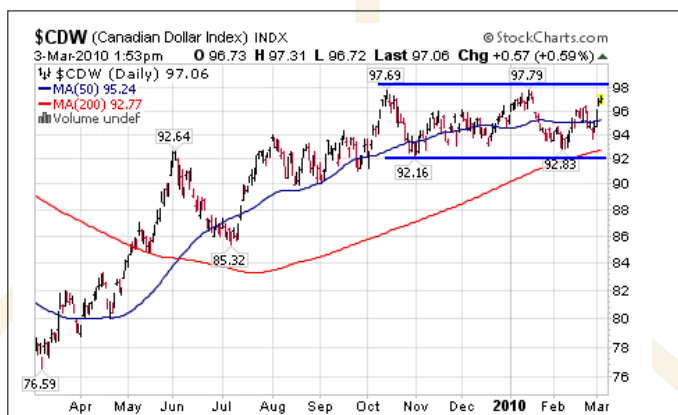


Chart courtesy of www.equityclock.com

Technical influences

The Canadian Dollar appears poised to move above a tight five month trading range between 92.16 cents and 97.79 cents U.S. Intermediate trend is up. The Canuck Buck recently bounced from its 200 day moving average currently at 92.71 cents U.S. The Canadian Dollar held its trading range despite a 9.6 percent gain by the U.S. Dollar Index since December. Historically, the Canadian Dollar has traded lower when the U.S. Dollar traded higher. A break above resistance at 97.79 cents U.S. implies intermediate upside potential to 103.75 cents U.S.



Fundamental influences

A series of events are coming together to trigger a breakout by the Canadian Dollar during its next seasonal sweet spot between mid March and the end of May.

- The Canadian economy is recovering strongly. News last week, that fourth quarter real annualized Gross Domestic Product rose by a faster than expected 5.0% rate, confirmed the trend. Growth is coming from greater federal government spending related to an economic stimulus program and from rising demand and prices for commodities including copper, zinc, nickel, crude oil, potash and lumber.

- Strength in the Canadian economy and its currency relative to other G8 countries is attracting speculative attention by international investors. The Russian central bank recently noted its intentions to diversify its currency reserves by purchasing Canadian Dollars.
- Early technical signs of an intermediate peak in the U.S. Dollar Index have appeared during the past two weeks. Recent strength in the U.S. Dollar Index was triggered partially by weakness in the Euro that, in turn, was triggered by concerns about a possible default by Greece's debt. At least a temporary resolution of Greece's financial crisis is likely to be reached this week. The U.S. Dollar Index has a history of peaking each year near the end of March. Technical confirmation of an intermediate peak in the U.S. Dollar likely will be the trigger for a breakout by the Canadian Dollar above the 97.79 cents U.S. level.
- The Bank of Canada confirmed last week that monetary policy is expected to remain accommodative until at least the end of June, but hinted that an easy money policy was approaching an end. Anticipation of a tightening monetary policy in the second half of 2010 will prompt strength in the Canadian Dollar.

What to do

The preferred strategy is to continue to own investments that trade in Canadian Dollars. Investments in securities trading in other currencies also are possible if they are fully hedged against currency risk. Investments in U.S. Dollars are particularly vulnerable if not hedged.

Don Vialoux, Chartered Market Technician is the author of a free daily report on equity markets, sectors, commodities, equities and Exchange Traded Funds. Reports are available at www.timingthemarket.ca

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- Effective Portfolio Management – Plain & Simple
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- Managed Asset Classes – cash, maturities, ETFs/stocks, precious metals

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