CastleMoore News

Buy, Hold... *and* Know When to Sell™

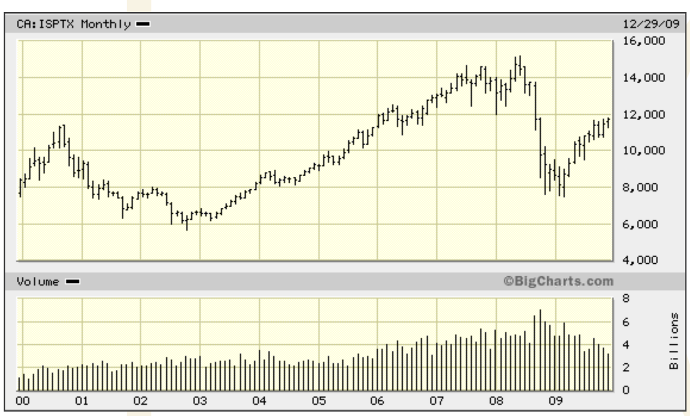
SHORT SIGHTED

By Ken Norquay, CMT, Partner

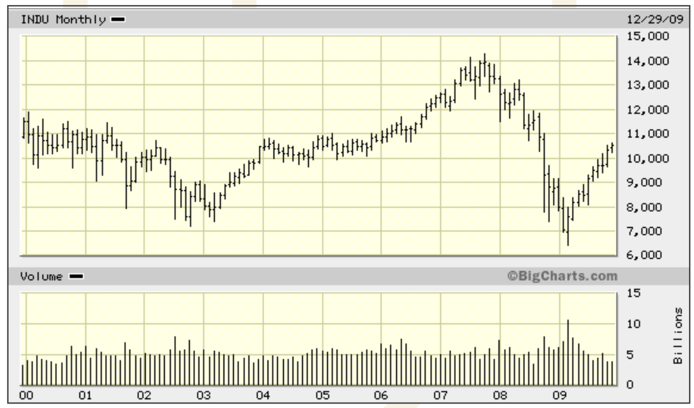
I wonder why we do it every year. Every New Year's season we like to look back at the old year: what happened in 2009 and what might be in store for us in 2010.

Let's change this familiar pattern this year. We are in the investment business. Let's look specifically at the financial trends that are in place as we enter the New Year. Maybe we can learn something from looking back at more than the old year: let's look at the old decade.

This is the Canadian stock market: the S&P TSX composite index for the past 10 years.



In January 2000 the Canadian market was around 8,000 and now it's around 12,000: a 50% gain over 10 years. But a closer look shows it was around 8,000 in January of 2009 too, only one year ago. Short term investors made as much money in the past year as long term investors made over the past 10 years.



Americans didn't do quite this well. This is the Dow Jones Industrial Index for the past 10 years.

In January 2000 it was just above 11,000 and at year end, it was just below 11,000.

As we go into 2010, what have we learned? If we only look back at last year, we might be optimistic: maybe enthusiastic. But if we look back 10 years, another story emerges. The stock market is no longer inherently a good investment. It's good for a few years, then bad for a few years. Let's take that attitude into the New Year. Will 2010 be one of the good years or one of the bad?

All of us have read the economic forecasts for 2010. The bulls believe that all the stimulus given to the world's economies last year will cause last year's up trend in the stock market to continue into the New Year. The bears talk about unresolved problems in the banking system, tapped-out consumers and the possibility of a stagnant economy and inflation. At CastleMoore, we marvel at the variety and intelligence of these conflicting arguments. Question: Who should we believe?

Answer: We don't believe any of them. By January 2011 we'll know who was right and who was wrong. In the investment business, we have to take our positions now, without knowing for sure what will happen in the future.

At CastleMoore, we try our best to follow the trend of the various financial markets. Right now the stock market is going up – and the upward momentum is slowing. Interest rates are stable. The US dollar has started to go up. We use economic models, mathematics not economic theory, to help us determine the trend of the markets. We try to participate in up trends and avoid down trends.

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It's what we do every year. Sometimes we get it exactly right [we sold out of the stock market in May and June of 2008 before the crash]. Sometimes we don't [we did not buy into the stock market in spring of 2009 during the strong 2009 rally]. Contrast this to all the "buy and hold" investment managers: they lost their shirts in 2008 and made back part of the losses in 2009. Check the ten year charts of the Canadian and US stock markets above. Check back to 2001 and 2002: the same thing happened to the buy and hold crowd then. They lost their shirts and then slowly made back the losses. It's a familiar pattern by now. They do it every year.

CHANGING OUR PATTERN: A REVIEW OF 2009

The sharp plunge in world stock markets ended in March 2009. There was a swift three-month rally followed by a gentle zigzagged up trend through the rest of the year. In hindsight, it appears that the strong rally was caused by the strong government stimulus package. Because of our concern about a resumption of the down trend, CastleMoore elected to not participate in the stock markets. We were over cautious.

The sheer size of the stock market collapse in '08 and early '09 has made most long term investors much more short term oriented. And the sheer size of the 2009 rally has made CastleMoore more short term oriented too. We saved our clients from the 2008-9 losses, but our over caution resulted in missing out on the 2009 gains. To prevent this "missing out" from happening again, we have modified our methodologies: we are more sensitive to shorter term market swings. Rest assured, however, that we have not lost sight of our two founding principles: 1. Safety first: it is more important to not lose money than it is to make money. 2. We manage risk by selling, not by diversifying. There will be times when we have very high levels of cash in our clients' accounts. And, as a result of our new sensitivity to the short and intermediate term, there will be more transactions in 2010 than in 2009.

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A FEW VIGNETTES

By Robert 'Hap' Sneddon, FCSI, President

Perception is often reality – for a while anyway. In the investment industry it can be profitable or reflect good risk management to understand where disconnects may be occurring between price and "reality". Prices don't lie, but sentiment can cloud eventual truths. The last year has led many market players to fixate on some apparent certainties, if not solely to tether onto something and run with it, its human nature. In three small pieces, one on China, the US dollar and fixed income, consensus or sentiment is strong in one direction on each of these, yet the opposite, or something less than meets the eye today, anyway, maybe in the cards.

China

In the last year the local Chinese market, the Shanghai, is up 80% and the Xinhua China 25 Index, foreigner's market access, is up 45%. To the end of November, the housing market was up 100% year over year (YoY) and housing starts up a 194%.

China (and to a lesser degree the other BRIC partners India, Russia and Brazil) has been seen as somewhat of a global market saviour, back-stopping global demand for everything, especially assets related to commodities. It's as if China will be the tonic until the West gets back on its feet. But has the China fixation runs its course? Was it ever as big as was thought?

Over the last few months the Chinese authorities have been trying to jawbone down both the real estate and stock markets. More recently, they have taken to actually raising, at the fringes, domestic interest rates. This week, Liu Mingkang, chairman of the China Banking Regulatory Commission allegedly told banks to stop lending entirely through the end of January. This was later denied by the government. Like the rest of the world, except it's much more juiced up here, the low rates have fuelled possible speculation in real estate and stocks.

It's odd then that the regulators there are now opening up the market to foreigners for such things as REITs, ETF's, and index futures. In addition they are allowing IPO's to be released for companies in military production, culture, railways, and grid and nuclear power. You need to open up to become a financial centre as China wants but the timing is suspect as the actions appear to help place a bid under things.

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Though it's been repeated here before here is some perspective on Chinese influence:

	GDP	Consumption
CHINA	$3 trillion	$1 trillion
USA	$15 trillion	$10 trillion

China does matter to global growth. It will eventually become a true economic engine (based on trajectory it will surpass the US GDP by 2025), but maybe not before some house cleaning and the long term development of domestic demand and a middle class. Sure the world needs China, but let's not forget that the Chinese story is based on exports today. Today, over production of all "things" is rising while Westerners are in the midst of secular consumption changes (see Fixed Income for more on the changes) and China doesn't have a middle class to take up the demand for all those "things" they make or copy.

According to James Chanos, a reputable Wall Street hedge fund manager, noted for calling the collapse of Enron, the scandals at Tyco, the homebuilders crash and the banking crisis well ahead of the herd, "bubbles are best identified by credit excesses, and there's no bigger credit excess than in China".

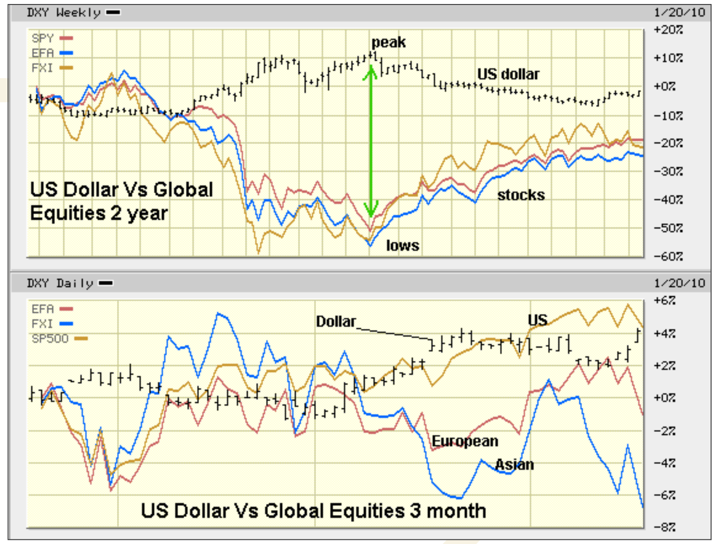
Credit excess was the culprit in the West. It started the whole mess and it's why I do not see a return to a secular bull market for another 5-6 years. Most analysts/economists are just now realizing, if at all, that this was not a typical inventory-led recession that sops up excess in short order, but one of debt payment and deleveraging, hardly the things of a growth period.

China bottomed last year in November, 4 months before the lows in the Western stock markets. Since the beginning of the New Year North American markets are up 1.68%, Europe up 2.8%, South America up 4.2% and Shanghai? Down 4.00%.

US Dollar

Since the market lows March 9/09 the US dollar has moved inversely to the global equity markets. That is to say, the US dollar, as measured against a basket of international currencies, made a multi year peak in early March last year as stocks made a multi year low, and today stands closer to having flirted with historical lows while stocks are near a yearly high (upper chart). Much like what happened to the yen throughout the 90's and, continuing through to today, the US dollar in March became a proxy for risk assumption elsewhere, in other asset classes, namely stock or currency markets.

The Japanese experience revealed that investors there would naturally borrow money at inordinately low interest rates compared to the rest of the world and send it out to markets abroad, thereby earning a higher return. Since the peak of the Nikkei in 1990 the stock market is off over 70% while 10 year yields for Japanese Government bonds are hovering around 1.30%. During every major financial crisis since the early 1990's the Yen would strengthen as locals would repatriate their assets from abroad seeking the safety of domestic cash. The US dollar peak last March marks a like event.



At present, it seems still to early – 10 months – to make similar comparisons with the greenback. The lower chart shows the machinations and grinding of the stock-USD relationship from October through to mid January. As you can see it appears that in November the relationship – weak dollar, strong stocks – has been temporarily broken as the dollar and the US market have moved in the same direction.

The point here is to observe going-forward whether the strengthening dollar portends deep underlying weakness in global stock markets or simply that the relationship that has existed since last March has evaporated. It still stands to reason that any global market weakness or potential crisis would be met by a flight to the US dollar.

Government Fixed Income

Government bonds have become the black swan of the markets. No one loves them, and the reasons are piled high and deep by the fervent. But a look at the drivers of bond prices reveals that there maybe too much common sense (it can make an idiot out of many otherwise bright people) and blinders at work.

One of the biggest arguments against bonds, particularly longer dated ones, is that inflation will erode purchasing power. Inflation is no where to be seen. The most recent report by the Bank of Canada (BoC) showed that December inflation dropped another 0.3%. US data is similar. In addition in its recently released Monetary Policy Report, the BoC stated "that the global recovery could be even more protracted than projected" and that it was clearly "tilted toward the downside" (possible contraction). These are words not highlighted by the major investment houses or media.

Another concern is that governments, especially the US, have thrown out too much supply. US bond auctions have usually been oversubscribed by an average factor of 2.5 times throughout the equity run up. Who's buying them then? Moreover, rates for Japanese government 10 years bonds (JGBs) stand at 1.30% while its debt to GDP stands at 200%. The Japanese government, since it entered the lost decade (it's now going on 20 years

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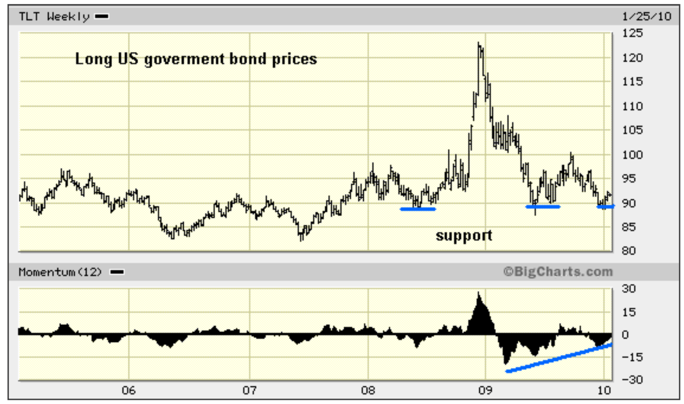
so they may have to change the name) in the early 1990's has thrown more money at problems than any developed country and the rates have moved from 6.5% to 1.3% - nice profits if you were a bondholder.

Something being discounted today is that we are in fact out of recession. Bond yields backed up (prices fell) during the initial "green shoot" recovery period in 2001 as investors worried about inflation and better prospects for returns in equities. The markets and economy were apparently humming along until the two quarters of positive economic data, assisted to a great deal by government stimulus, faltered. Yields went from 5.5% to 3.00% in a year and stock markets eventually made the final low in 2002, 20% lower than the initial, first bottom. Nice profits again. Today, "assisted" it is purported might mean that governments in the west account for as much as 80% of growth. If the growth occurring is sustainable and can become organic 10 year yields should be closer to 6% not 3.6%.

Longer dated bonds have come under pressure during the stock run up because of conventional wisdom and common sense but so far have held.



Secular changes are also occurring on the individual consumer and investor level. Besides adjustments in consumption habits – smaller homes, less "things", a focus on happiness and family – individuals are paying off debt at a rapid rate. Last month, for example, US data showed that $17.5 billion in debt was paid down against expectations for repayment of only $5 billion. This trend has been firmly entrenched for sometime now and does not bode well for secular equity growth right now. Lord Keynes called it the Paradox of Thrift. Investors' getting their houses in order hurts the economy until they reallocate more funds again to consumption.

And finally, the average advisor is woefully under invested in fixed income and over invested in equities. The average investor has just 7% in fixed income. Imagine the push in prices if that were to even double to 14% of the average portfolio. A quote that I find fascinating and that has been repeated here before reveals how lopsided portfolios become, mostly at market turning points.

"Professional managers, who by 1969 had pushed client portfolios as high as 70% in common stocks, felt like fools. Their clients took an even harsher view. In the fall of 1974, the maiden issue of The Journal of Portfolio Management carried a lead article by a senior officer of Wells Fargo Bank who admitted the bitter truth:

Professional investment management and its practitioners are inconsistent, unpredictable and in trouble… Clients are afraid of us and what our methods might produce in the way of further loss as much or more than they are afraid of stocks…The business badly needs to replace it cottage industry operating methods.[2]

True, bonds have some head winds but as the famous investor Nassim Taleb (please read the story Blowing Up, by Malcolm Gladwell online or in his new book for more on the unpredictable and investing) knows it's those black swans days, or those exogenous events, that realign everything, and quickly.

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THE CHART PAGES

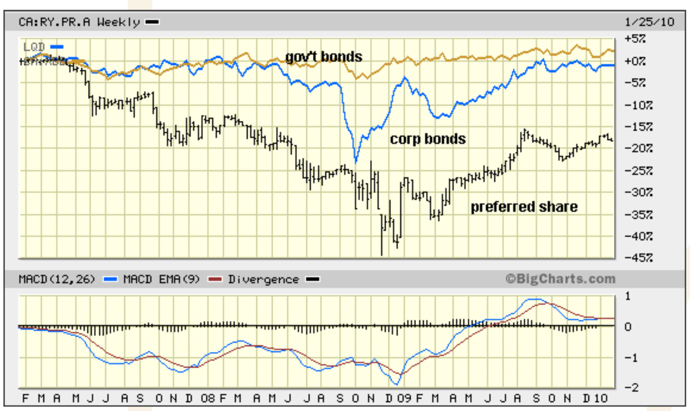
GOLD BULLION

Gold bullion topped out around $1200oz/USD in the beginning of December and the momentum bottomed in mid December. It did not take long for bullish sentiment to drop and get slightly bearish. As indicated in our last issue we were awaiting these conditions to manifest before stepping in again. We have since taken a new portfolio position across all our portfolio types.

COPPER

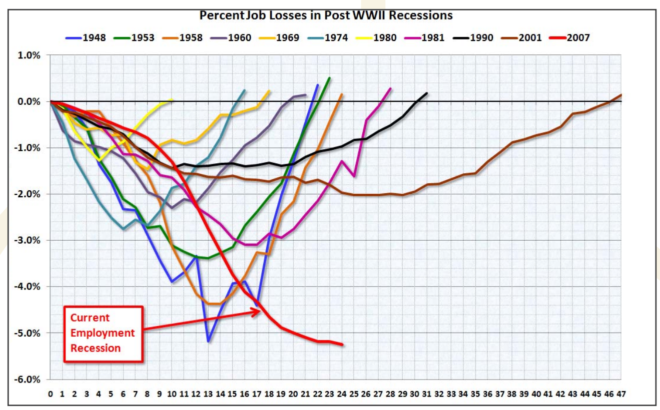
The base metal has done quite well since its own lows (alongside those made by the NASDAQ, Asian & Emerging markets) in December. It has clearly tracked global equities. Along with major indices we expect copper to test support before resuming a strong trend into the summer. Support is in the $3.00.$3.10/lbUS range.

PREFFERED SHARES VS BONDS



The preferred share (represented by a large bank issue) vs. government bond relationship has not changed much since we last published – preferreds picked up 4% more of their dramatic loss. Corporate bonds have been added to the picture for a broader look at investor sentiment towards seeking out income beyond the safety of government bonds. Both preferred shares and corporates are running into a bit of overhead resistance here, and will likely track stock markets for the foreseeable future. This chart reveals investor inclination toward risk in attaining more income.

US EMPLOYMENT



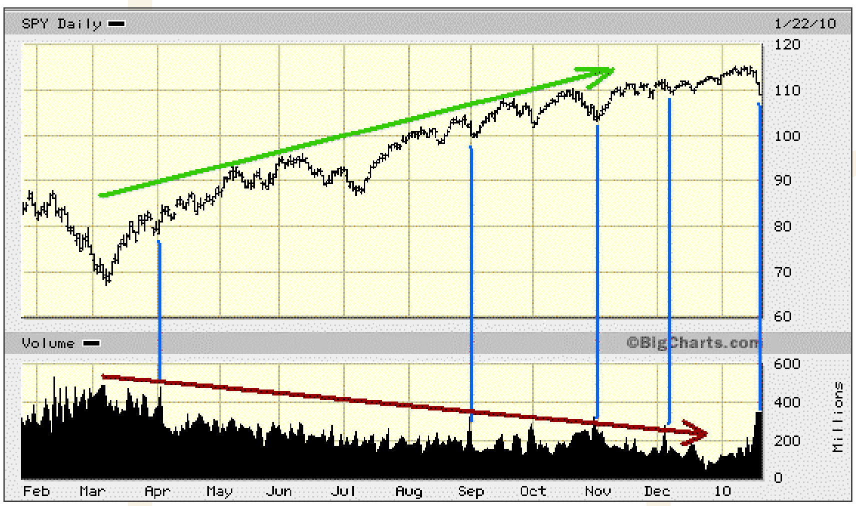
Because we are Canadians and seemingly come through the financial crisis (an odd term in my opinion) okay compared to our American friends why does US data matter to us? Well they are still our largest trading partner by far, and long term they always will be – sort of like two pees, one on steroids and one the runt, in a pod. This graph shows the US job loss in percentage terms not the actual number of jobs lost. It certainly appears that markets have not discounted this like the overlook of any unpleasant economic data that occurred in 2001-2002 before the market made a final much lower bottom in 2003.

THE CHART PAGES

US DOLLAR

More on the greenback – it matters that much. A plot of the US dollar index alone shows that it appears to have broken the downtrend against a global basket of currencies in late November. As the short piece on the dollar suggested it's still too early to make a correlation with a "broken" global equities move, but it must be paid attention to until it can be determined that is what is occurring or that another relationship – strong US markets/strong dollar – is starting.

VOLUME



Volume has been moving down since the lows of last spring as the price of markets has been rising. On the significant down days or periods, volume has risen significantly. Last week saw some of the biggest volume in almost a year. What does it mean? It appears that conviction in this bull run is tepid as investors are ready to abandon positions quickly. This overall behaviour has, in part, reduced our conviction that we are in a new market in stocks and bolsters the case that some testing of the March 9th lows is in the cards. Bull markets begin with a breakout in prices and volume.

WHAT NOT TO LEARN FROM A COYOTE

By Sheldon Liberman, Portfolio Manager

Good judgement in the result of experience.
Experience comes from bad judgement.

--Unknown

Experience is the toughest teacher.
First you get the test, then you get the lesson.

--Vernon Law

Newsflash: Wiley Coyote dies at 83. Acme shares drop 20%. Roadrunner unavailable for comment.

Fortunately, Mr. Coyote is a cartoon character; otherwise it might actually bother me that he must have spent all kinds of money on

paraphernalia from Acme instead of on dinner. Apparently, he had more dollars than sense.

Of course, when it comes to money management, there is no shortage of real life examples I could site that leave me perplexed (some of you reading this article will have no idea that I'm referring to you).

One might be tempted to hold a grudging admiration for what Mr. Coyote represents: persistence personified (coyotified?). No amount of being shot, blown up, falling from a cliff or conks on the head from an anvil would ever deter him from his objective. But I live in the world of investments; things are different here. Such commitment to an ideal is not only inadvisable, but can be downright foolhardy, not to mention costly. Wiley's persistence came not from nobility character but from the stubborn unwillingness to admit defeat. Experience taught him nothing.

And so it often goes with investors. To actually sell a stock, particularly one that has lost money for the one who bought it, is often considered to be an admission of defeat. Or being wrong.

The proper way to manage money is to sell an investment even before it's been bought.

Whaaa…..?

Not literally of course. But our practice in every investment decision is to decide on a plan of action for cases where a stock doesn't perform as expected. When do we sell if it moves against us, and how much of a move is required to trigger that sale? And what if we're wrong about being wrong, i.e. when do we get back in? It's much easier to conquer the psychological barriers to exit when we realize that it is possible to make a good decision and still have a bad result. At that point, the sell decision is not viewed as an admission of failure but rather as an instance where a sound investment decision simply didn't pay off – this time.

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The worse two times to sell are 1) when everyone else is selling (bad), and 2) after everyone else has sold (worse). Selling under these circumstances can cause an investor to conclude that his or her initial judgement was bad, meaning he or she is now more experienced as an investor, which should mean his or her judgement is now improved. But what good is good judgment if one now lacks the confidence to put it to good use?

Investment management is about more than skill. It's about mental toughness, and experience.

MORE EXPERIENCE QUOTES:

Experience is not what happens to a man. It is what a man does with what happens to him.

-Aldous Leonard Huxley

Experience is what you got by not having it when you need it.

-Author Unknown

There is only one thing more painful than learning from experience, and that is not learning from experience.

-Laurence J. Peter

If we could sell our experiences for what they cost us, we'd all be millionaires.

-Abigail Van Buren (Dear Abby)

A man begins cutting his wisdom teeth the first time he bites off more than he can chew.

-Herb Caen

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GUEST COLUMNIST

AN OUTLOOK FOR NORTH AMERICAN EQUITY MARKETS FOR 2010

By Don Vialoux, CMT

Volatility is expected to highlight North American equity markets in 2010. Equity markets are expected to follow their traditional four year Presidential Cycle implying strong equity markets in the first half of the year followed by a sharp decline into the third quarter followed by an important recovery beginning in November.

First Half Prospects

Economic stimulus programs in Canada and the U.S. will have a significant influence on equity markets in the first half of 2010. Most of the funds for economic stimulus programs in both countries already have been allocated. However, only about 30% of the $783 billion U.S. economic stimulus package has been spent to date and most of the spent funds were transfers to state and local governments to reduce layoffs of existing employees. Major infrastructure spending will start in spring 2010 in Canada and

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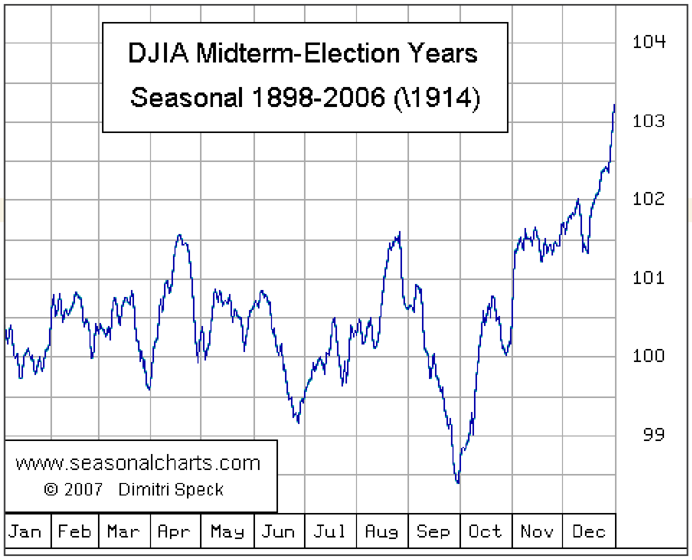

Chart courtesy of SeasonalCharts.com www.seasonalcharts.com

the U.S. after winter weather conditions dissipate. Look for lots of politicians to appear at ribbon cutting ceremonies this spring when the shovels finally begin to dig into the ground. Net result will be a strong increase in employment, increased demand for materials such as steel, base metals, a strong recovery in corporate earnings and a continuing recovery in real Gross Domestic Product.

Second Half Prospects

Prospects for equity markets beyond the first half are less attractive. Historically, the third quarter in the second year after a President is elected has been the weakest quarter for North American equity markets in the four year cycle. Political rhetoric escalates in the third quarter prior to the mid-term election. Equity markets respond to disappointment about the ability of the President and Congress to pass promised legislation successfully. Uncertainty about control over Congress following the election creates concerns about future government and economic policy. This year political rhetoric will ramp up in the U.S. when higher costs of health care, financial service regulation and climate change legislation become apparent. In addition, the Federal Reserve and Bank of Canada will respond to stronger first half economic growth and higher inflation rates by increasing administered interest rates. Also, U.S. investors will anticipate higher tax rates on January 1st 2011 on capital gains, dividends and income by taking profits in equities before the end of 2010.

And now the good news! The low point reached in the second year after a President has been elected historically has proven to be the bottom of the four year cycle. Largest gains in the four year cycle have been recorded during the six month period after the bottom of the four year cycle has been reached.

Best seasonal sector play in 2010 likely will be in the energy sector. Colder than average weather this winter will prompt energy prices and energy equity prices to move higher during their seasonally strong period between February and May.

PREDICTIONS

Upside potential for the S&P 500 Index to be realized in the first half of 2010 is 1,250. Downside risk is to 1,000.
Upside potential for the TSX Composite Index in 2010 is 12,500. Downside risk is to 10,000.

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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