



CastleMoore News

Buy, Hold... and Know When to Sell™

WASTING AWAY...



By Ken Norquay,
CMT, Partner

The financial industry normally reserves the word “crash” for a one-day occurrence. But, according to internet encyclopedia Wikipedia, the 1929 crash actually occurred over 2 days. On October 27, 1929, the Dow Jones Industrial Index [DJII] closed at 298.66. It dropped 12.8% on October 28 and another 11.73% on October 29 to close at 230.07, for a total decline of 24.5% in two days. Years later, on October 19, 1987, the DJII dropped 22.6% in one day!

What defines a stock market crash? Consider autumn 2008. From early September to late November, the DJII dropped 35%! Shell – shocked investors were reluctant to open their month-end brokerage statements. Their retirement plans were in tatters. Although it had not been as dramatic as history’s one or two-day market crashes, the autumn 2008 drop had slashed a huge chunk out of people’s savings.

But, here in autumn 2009, only one short year later, the investment community has run up the bullish flag again. Have they forgotten already? Today’s investors have regained the hope that they’ll somehow make last year’s 35% back by simply holding onto the same investments that dropped so sharply last year.

In my book, *Beyond the Bull*, I discuss human nature and investing: we are creatures who naturally seek pleasure and avoid pain. Sometimes we avoid pain by simply forgetting. We forget the pain we felt last December when we didn’t want to open our month-end investment statements. We just forget, and the pain goes away.

It reminds me of Jimmy Buffet’s song: “Wasting away again in Margaritaville,” where the jilted lover drinks tequila to forget.

Forgetting is not the solution: we have to learn from our mistakes. The 1929 crash led to the reform of securities law in the United States. The 1987 crash led to the introduction of ‘circuit breakers’ in the stock markets so as to prevent a re-occurrence of a one-day crash. Investors and authorities learned from those crashes. But today’s persistent “buy-and-hold” investors and their stubborn advisors appear to have not learned. The sharp stock market rally since March 2009 has lulled them into forgetfulness.

This is a chart of the Dow Jones industrial index for the past 10 years.



It’s lower now than it was 10 years ago. Yet somehow the myth of “buy-and-hold-for-the-long-term” persists. That mantra seems to have a similar effect to Jimmy Buffet’s margaritas: it helps them forget. But even Jimmy seems to have learned something when he sings: “Yes, some people claim that there’s a woman to blame, but I know it’s nobody’s damn fault.”

After the initial crash in October 1929, there was a 50% rally – the market regained half what it lost. Then the long term decline began in earnest – by summer 1932 the DJII had slipped under 40! As of August 31, 2009, the DJII has not quite gained back 50% of the decline. It’s not about predicting what the DJII will do – will it go back up? Will it crash back down? That’s not the point. The stock market will do whatever it does. My question is: “What will you do?” What did you learn from the 2008 losses? What will you do differently now that you wish you had done last year?

It’s obvious, isn’t it? Good investing is about buying AND selling, not just buying.

That’s why CastleMoore was started. The business plans for the mutual funds and financial planning industry all call for buying and holding stocks for the long term. But that plan no longer works. That’s why they are all in decline. There’s no need for your investments to be in decline too. That’s the lesson we all need to learn. There is no need to ‘hold’ through a 35% market decline as occurred in 2001 and 2002. There’s no need to ‘hold’ through a 50% decline as in 2007 and 2008. CastleMoore’s business plan calls for holding equities in those long periods when the stock market goes up and not holding them when the market trends down. Buy and sell – not just buy.

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MARKET RALLIES AND TIMEFRAME



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

If prices don't lie, then one must never quibble or fight the tape right? A trending security can provide profits. But depending on your timeframe, the trend may mislead, causing larger and longer term damage to capital and confidence. The 2000-2003 period is a case in point and one that echoes loudly now. In 2000 the markets started to drop, finally stopping in March 2001 with an average 27% loss. In mid 2001 economic data began improving accompanied by a strong rebound in equities. Nonetheless, stock markets did not make an eventual bottom until mid 2002 and this bottom was retested twice, the last occurring in early 2003, almost a year and a half after the initial surge in expectations and mood.

The 2000-03 downturn was initially viewed as a typical inventory based recession. This type of recession has occurred most often since the collection of data post-WWII, and means that companies produce more goods and services than is needed by customers. In order to correct the situation, companies cut back on production until demand exceeds supply. The securities markets see an eventual trough in data, and then commence to move equity prices higher in anticipation of the inventory rebuilding phase that underpin corporate profits and overall economic growth. These are predictable recessions, requiring little more than patience for monetary policy to have its effect and inventories to be worked off.

By mid 2001 and into 2002 the economic news was printing quite positive. For example, the Institute for Supply Management or ISM data release moved from 41 to almost 53 (a reading above 50 is expansionary); real sales had troughed in September 2001 aided by cheap money such as 0% financing for everything, especially autos; industrial production began ramping up in late 2001; and, GDP improved to 3.5% in early 2002. If we compare this pattern of improving economic data with today, there are many, many similarities, the latest of which had the current ISM data come in at 52.9

But it's important to remember that markets anticipate or reflect improvements in earnings and growth, not just a slowing of the decline in the data. Markets make meaningful and lasting rises – start a new business cycle – on a full recovery, not simply an end to recession. “Climbing the wall of worry” occurs when despondent participants do not believe the improving data, not like today when they cheer each tick and do so in an ever hopeful manner.



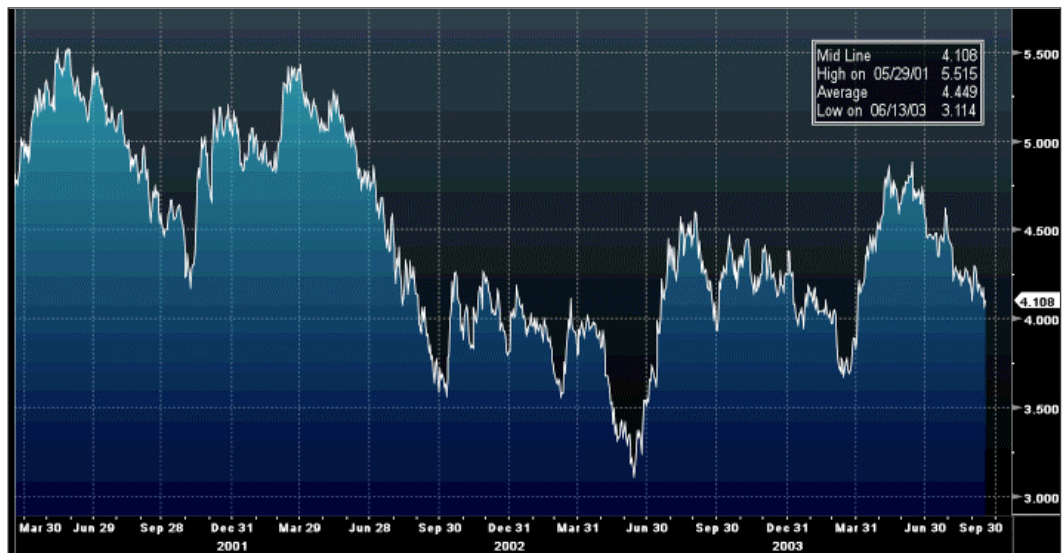
By the fall of 2001 the recession was officially deemed over. The National Bureau of Economic Research called the recession end in November 2001 and the US Federal Reserve joined the fray saying in its minutes from the time “that the incoming data and anecdotal evidence had strengthened confidence that the downturn in economic activity was ending and that growth was likely to resume in the second half of the year.” Now, if we reflect on the now seemingly daily pronouncements from the BoC, the US Fed or other global bankers today, that we have seen the bottom of things do they not sound oddly familiar? What does it mean to investors when recessions are deemed “over” but stock prices eventually fall a further 33% as they did in 2002-03? What does it mean to investors when 85% of economists have declared the recession over as is the case today?

The 2000-03 period, as in our current time, was, in fact, about asset deflation from bulging credit levels and not about inventories. This is what led to the second or “double dip”. Today, deflation pressures are much more acute than they were back then. The personal consumption expenditure or PCE is currently running at -1.9% vs. +1.0% back then, and we have the consumer who represents over 70% of GDP paying off debt at a record pace. June's credit data expectations had individuals paying off around \$4.5 billion in debt. Instead, it came in at \$21.6 billion! Greenspan and Busch helped companies and individuals kick the can down the road in 2001. But now, it looks like the individual has said uncle, which doesn't bode well for GDP to print positive any more than Q3 or maybe Q4. This is what Keynes called the “paradox of thrift”, that people's saving hurts economic recoveries. And we haven't even talked about a key component to a recovery, job creation, which is a long way off as we

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are still shedding them with a market up 55%!

This recession, much more than the last one, is centred on credit contraction, not inventories. Just ask the Japanese what this means. The Japanese stock market is still off 70% from its 1990 peak and 20 year bond yields moved from over 6% to 2% today. An infrastructure build out was going to replace flagging consumer and corporate spending - not sure this mattered to investors though.



US gov't bonds yields during the 2000-2002 bear market fell (prices rose) and good profits were made, but not without rising first as investors succumbed to the "green shoot" and inflation talk of the day.

Now, if you think China is going to underpin things this time, we may have to wait a few years as its GDP is \$3 trillion vs. \$15 trillion for the US, and its consumption is \$1 trillion vs. \$10 trillion for the US.

Some additional deflating data trends:

- The average investor has only 7% fixed income in their portfolio
- Corporate insiders sold 31 times more stock than they bought (a record)
- Last year, before stock market selloffs 12% of US homeowners were upside down on their mortgage; today its 35%
- Commercial rents fell for the first time in 16 years
- Commercial real estate problems because they are long cycle haven't hit the tape yet
- 95 failed US banks so far YTD, more than last 16 years combined

Sometimes the topics I focus on are too large to cover in such short space. I can only hope I do them justice. They are, at least, intended to provide unique and valuable viewpoint from which macro investment themes can be advanced, or disproven, as the case may be. It should be clear that growth and further equity expansion will be difficult to come by, and in fact, could be well over priced today, and that income orientated investments, and especially bonds, are the best place to invest. The comparisons a few months from now or sooner will be overwhelming and you may be sick of the phrase "double dip".

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THE CHART PAGES

GOLD BULLION



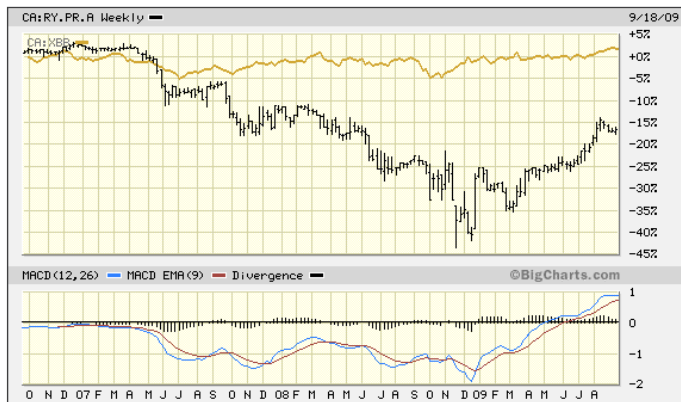
Gold bullion appears to have broken out to the upside, despite being in a crowded space. When too many participants are of like mind it leaves little room for further buying – investors have their positions. Gold is conventionally thought of as an inflation hedge, but it is more important as a separate reserves currency and moves higher in deflationary times. A push up from these levels would make \$1000 US/oz support and not still quasi resistance as it seems to still be today.

US LONG BONDS



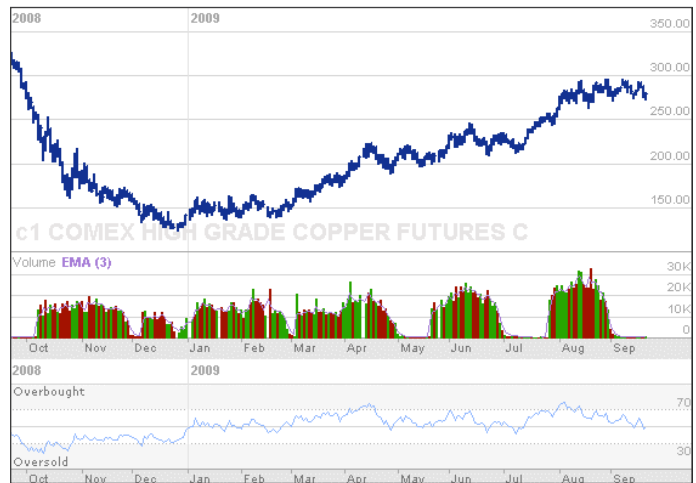
Despite the talk of inflation and the US (and other governments) supporting stimulus through debt issuance, bonds have held in well and if we are at such a sweet spot economically, as the markets suggest, bonds yields should be much higher and prices lower, reflecting the coming growth that requires rates to be reigned in. In June US individuals paid off a record \$22 billion in debt when the market was looking for \$4-5 billion. If this is the tip of the iceberg, coupled with other data, such as the shrinking money supply, credit availability, and underachievement with growth forecasts, there may be a bid under bonds, including high quality corporates, for many years to come.

PREFERRED SHARES VS BONDS



The relationship between preferred shares (a bank-issued one is shown to represent the group) and the bond basket, has narrowed alongside the stock market. Preferreds, since last publication, have regained 10% more of their total loss. The relationship between the two reveals investor confidence in corporate dividends vs. income from debt securities. Will the preferred share market hold and provide a positive return from here, despite what equities or bonds do? What are the cash flow needs of the largest holders, pension funds and institutions?

COPPER



Since early July, copper has been on a good run up over 27%. During August and September, the base metal has done little but move sideways – basing or rolling over? It's worth noting that copper made a bottom in December 2008 well ahead of global markets (ex China) lows in March 2009. The London Metal Exchange recently announced copper stockpiles were at four month highs.

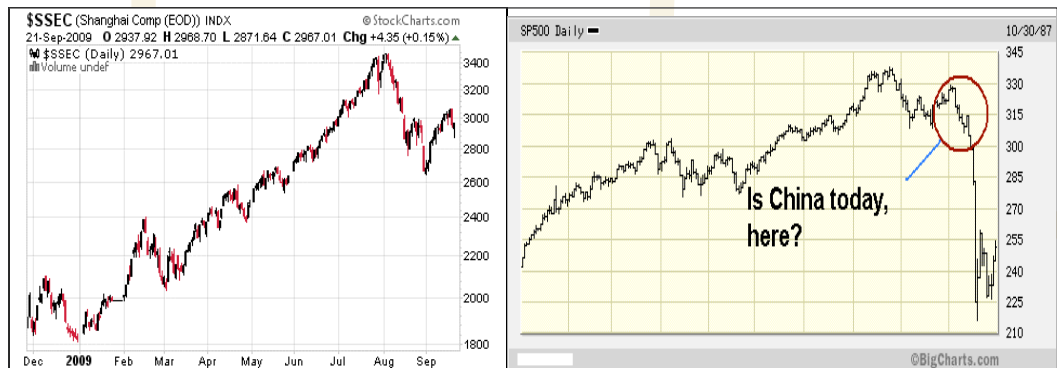
THE CHART PAGES

BALTIC DRY INDEX



The Baltic Dry Index, which tracks global shipping rates of bulk dry cargo, is off 45% since mid June against a global market up. Like a component of the Dow Theory, the argument goes that rates should accompany moves in the equity market, thereby confirming the equity market move.

CHINA TODAY VS WESTERN MARKETS IN 1987



Idle Observation? The chart on the left is of the Shanghai stock market up to the present. The chart on the right is the S&P from January 1 to November 30 1987. The chart patterns look exceptionally similar.



LIQUIDITY



**By Sheldon Liberman,
Portfolio Manager**

The other day I was speaking with a financial reporter from the National Post. He was interested in my take on how the market could be expected to perform down the road as all the cash currently held by institutional portfolios gradually gets invested. We in the biz call this “adding liquidity to the market” and this is considered bullish.

Of course, just part of my commentary made it to print, so you’ll have to speak to me directly to hear the rest of it. But it started me thinking how important the concept of liquidity is for portfolio managers, traders, and virtually anyone else for whom price is a critical concern.

Firstly, it must be pointed out that money on the sidelines, or in “cash”, doesn’t necessarily make its way into equity markets, and what does might be less than the market might anticipate. In other words, to assume that the market will rise simply because there is a lot of cash waiting to be invested is to make an egregious assumption about the efficiency of the market. While I personally embrace the notion that the markets lack efficiency under certain circumstances, it is quite another thing to suggest that an investor can beat the market simply by knowing, for instance, how much assets are contained in money market funds relative to historical norms.

Moreover, as our colleague, respected economist and strategist David Rosenberg pointed out at a recent UJA fund-raiser, the assets currently (September 10, 2009) held by U.S. money market funds is no higher or lower than they were while the markets were tanking in 2008.

This doesn’t mean that an understanding of liquidity and their levels at any given point is without value.

Every economist is aware of the “quantity theory of money,” which simply states that the number of dollars in the economy multiplied by the average number of times each dollar is spent is equal to the number of goods bought times the average price per unit bought. In other words, all other things held constant, the price level is a function of the money supply.

As money comes into the market from cash or the sale of other financial assets, and the number of shares outstanding remains relatively stable, prices must go up. This also works in the case of sector allocation. If investors sell oil stocks to buy technology stocks, we know what happens to the prices of each.

But the analysis of liquidity has another, perhaps more important, application: determining the value of a particular asset. The number of shares traded in a typical day for a given security is its volume, and the higher the volume (relative to the number of shares outstanding) the more liquid the security, and the more liquid the security the more valuable, all other things equal, the asset. This is because investors would rather hold assets that can be more easily sold, particularly in a declining market, than ones that can’t (without large price concession).

When a security trades on thin volume relative to its size, then small additions are its liquidity – money going into it or out of it – can have a significant impact on its price movement. This is a great advantage small investors (or investment managers) have over their larger brethren: we can give up liquidity for enhanced opportunity because we aren’t large enough to move share prices in any meaningful way. Larger investors, on the other hand, need to worry about just who they are going to sell their position to when they find another attractive investment opportunity they need to raise cash for.

To discuss this, and how loss of liquidity under certain market conditions can reduce your fiscal fitness more than you might realize, please call.

And to all our Jewish friends, kesiveh v’chasima tovah, and may the New Year bring peace, good health, and of course, prosperity.

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GUEST COLUMNIST

SEASONAL INFLUENCES ON EQUITY MARKETS IN THE MONTH OF SEPTEMBER



**By Don Vialoux,
CMT**

History shows that September is the cruelest month of the year for equity markets.

Will equity markets weaken again this September?

Seasonal Influences

September historically has been the weakest month of the year for North American equity markets.

During the past 10 Septembers, the S&P 500 Index dropped an average of 2.76% per period, the Dow Jones Industrial Average fell an average of 3.02% and the NASDAQ Composite Index plunged an average of 5.35%. Worst performing sector was the Semiconductor sector with an average drop of 12.35% per period. In Canada, the TSX Composite Index dropped and average of 3.28% per period.

Weakness in equity markets in September is universal:

The Nikkei Average dropped 2.21% per period, the London FT Index gave up 3.38%, the Frankfurt DAX Index lost 4.72%, the Frankfurt DAX plunged 4.72% and the Paris CAC fell 3.91%.

Fundamental influences

A series of annual recurring events tend to influence equity markets negatively in September:

- Institutional investors have a history of adjusting their equity portfolios after returning from holidays. In particular, many U.S. investment funds are looking for ways to improve tax efficiency of their portfolio prior to their fiscal year ending in October. They do so by liquidating underperforming securities prior before the end of October.
- Fundamental analysts tend to reduce earnings estimates for the current year prior to release of third quarter results. Analysts have a history of over-estimating annual results in the first half of the year following positive guidance offered in annual reports and annual meetings. By the third quarter, they realize that all of their projections are unlikely to be achieved by yearend and they respond accordingly. Also, September frequently is the time when analysts either reveal or refine their earnings estimates for the following year. Initially, analysts tend to be conservative.

What about this year?

The 50% gain by the S&P 500 Index and TSX Composite Index since March 9th has been partially in anticipation of at least a mild recovery in third quarter earnings on a year-over-year basis followed by a strong recovery in the fourth quarter. In fact, consensus earnings estimates for major companies on both sides of the border already are suggesting a much slower recovery. Consensus estimates for the 30 Dow Jones Industrial companies

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calls for an average (median) 18% decline. Consensus estimates for the fourth quarter calls for only a 4.4% gain. Look for analysts to lower third and fourth quarter estimates in September implying no recovery until at least the first quarter of 2010.

Post U.S. Presidential Election Influences

History is repeating itself!

History shows that U.S. equity markets tend to move higher in a post Presidential election year during the political “honey moon” period from March to July and tend to move lower from August to mid November after the political “honey moon” period is over. The August to mid November period focuses on uncertainties caused by the President’s inability to achieve key election promises. Sound familiar?



Technical influences

Technical indicators for most equity markets either are significantly overbought or have rolled over from overbought levels. Technical indicators, that are intermediate overbought, include Bullish Percent Index, Percent of stocks trading above their 50 and 200 day moving averages, Relative Strength Index, Moving Average Convergence Divergence and Stochastics.

What to do

Equity markets are overdue for at least a shallow correction into September. Preferred strategies include taking trading profits on investments with a short term time horizon and selling at the money calls against optionable longer term holdings. Calls expiring in October and November are preferred.

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. Mr. Vialoux does not own Exchange Traded Funds on indices mentioned in this report.

WHAT MAKES CASTLEMOORE UNIQUE AND VALUABLE?

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

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