CastleMoore News

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ENERGY IN MOTION: E-MOTION

CastleMoore takes the emotion out of investing by relying on mathematical market models. We do this because our emotions betray us so often in our drive for investment returns. At tops, the market appears to offer easy profits to the overly enthusiastic investor. At bottoms, it seems to offer financial disaster and a fast track to the poor house. The twin tyrants of greed and fear cost inexperienced investors dearly. In the artificial world of dollars and cents, ration trumps emotion.

But we are human beings, and we do have emotions. How can we enjoy our emotional humanity and still find success in the financial world? Is there some secret we can exhume to experience the joys and sorrows of our lives without paying the price the over-emotional investor pays?

Ancient traders and merchants had a way of separating their emotions from their intellects. This technique allowed them to live in both the emotional world and the intellectual world without one messing up the other. This is what I reaffirmed on Remembrance Day, November 11, 2010.

I attended the ceremony at Canadian Forces Base Borden, where I trained as an Officer Cadet in the mid 1960s. About 1000 officers and men were on parade that chilly autumn morning. As they marched out onto the parade square, memories flooded back. There was a day when I marched on that very parade square. My father was a veteran just like those old legionnaires who had turned out for their annual day. My father died earlier this year. My beautiful memories triggered serious emotions on that cold autumn day.

There is a look that every soldier learns. It's a look that separates soldiers from civilians. After all these years, those 80-year-old veterans still have that look. I still have that look. It's that look that embodies the separation of emotion and intellect. In battle, our intellect tells us we shouldn't be there. It's irrational to be exposed to the danger of a military battle. Even in military training, it's irrational to march in column of route or to stand still for over an hour in the cold. It's our male emotions that keep us there: the feel of esprit de corps… and that resolute look of defiance that makes every soldier fight. Once you learn the look, you become unconquerable. And if you do lose, you don't care. Your intellect is focused on winning, not escaping or indulging. When you are losing, you fight even harder. And when you win, you become humble. And what I found out on November 11, 2010 is, once you learn the look, it never leaves you. Our emotions come and go, like wind blowing through a pine tree. But the look never leaves you.

The ancient traders and merchants knew this look. In most ancient tribal societies, military service was compulsory. They all had to learn the look and the feelings that go with the look. And when the survivors grew older and wiser, the look stayed with them. This pattern produced whole societies of warriors who became great business men.

If we want to succeed in today's financial wars, we need to learn that look.

And, if there is no opportunity for us to learn it, we need to rely on mathematical models to keep us calm when the struggle gets intense.

Let's look at the Standard & Poor's 500 Index – the financial proxy for the biggest blue chip stock market in the world. This chart shows the action for 2010, ending mid-November.

In January 2010, an emotional sell-off lopped almost 10% off the market in three short weeks. By April, she rose about 17% in a flurry of optimism. By the end of June, it had dropped below the January low – and by late October it had rallied back above the April highs. This series of ups and

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downs has been fired by human emotion. The declines brought fear that another 2008-style market crash could come. The rises bring fear of missing out on a great bull market like the short term bounce off the March 2009 lows, where the Canadian stock market went up 150% in six months. Baby boomers fear losing their dreams of a cushy retirement. But they desperately want to make back what they lost in 2008. These are the emotions captured in this chart of the S&P 500. Try to just look at it. Look with that air of defiance… that look that it doesn't matter if the stock market goes up or down. You don't care if the market goes up or down. Try to feel that not caring. And if you find you DO care, call us. The more you care about the stock market, the more you need us. We can help you use mathematical models in your investing instead of indulging in the emotional swings of aging baby boomers.

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QUANTITATIVE EASING: WHAT DOES IT MEAN, AND WILL IT WORK?

By Robert 'Hap' Sneddon,
FCSI, President

Most of us have probably heard of the term "quantitative easing". Some of us maybe not. In the last year, like much in life, the term that describes federal bankers' attempts to stimulate economies has been reduced to an acronym: QE. On November 3rd, a day following US mid-term elections, Federal Bank Chairman Ben Bernanke announced a second round of easing by the US, the largest of the "easers". This one was called – yes you guessed it - QEII. What is quantitative easing and will it work?

While still in the throws of the Great Recession in early winter of 2009, the US Fed announced that it would start to purchase assets other than short-term US treasury debt to try to kick start the economy. It undertook this because its traditional policy option of lowering rates had failed to work. Over night lending rates to banks – the federal funds rate (prime for Canadians) – was already down to 0.25%. It was clear that going to something less than this was not going to have much effect, and seeing the rate at 0.0% may have some type of psychological impact.

The Fed announced in late March 2009 that it was going to buy $1trillion of long term bonds – again very different from its usual buying of shorter term treasury paper which in effect raises or lowers lending rates. By doing so it hoped to drive down long term rates which are determined by the market not by Fed. This would stabilize the US real estate markets, and increase private lending. The net effect was to hopefully increase the velocity of money, or how often the same dollar passes from hand to hand. The more often the same money passes from new hand to new hand, the more it stimulates an economy. The end result is growth, and eventually inflation. They wanted to create inflation! In fact, because the stimulus was in effect done by simply printing the money, most market players have already discounted that inflation will be historically high sometime in the future. Some have even used the words hyper-inflation, such as occurred in Zimbabwe in the last decade or in Germany's Weimer Republic early in the 20th century.

We have covered it often enough in our client-only missive ***Current Investment Themes***, written about it here in our newsletter or mentioned it in our various media appearances in print and television, that deflation is a bigger concern to us and also obviously to both Mark Carney, Canada's central banker (Please request Carney's recent speech from me for a read on this issue of deflation concerns) and Bernanke. While the topic here is centred

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on the US, it matters a great deal to Canada and the world. The focus of investors and economists has been on the US because they are in the lead on acting on their concerns. The rest of us will be impacted either way.

The US Fed not only wants to have economic growth, but moreover, it wants to lower the unemployment rate and have a spill on wealth effect to consumers. If you can get people back to work, and simultaneously make them feel richer because their home prices have stabilised and their stock portfolios are up, spending will increase. After all, in US, and most western countries for that matter, consumption makes up 70% of GDP. The status quo of a juiced up stock market, decent corporate earnings from cost cutting and a weak US dollar, and a commodity boom again because of a weak US dollar, has not addressed a stubbornly high US unemployment rate.

Now let's assume that getting the consumer back spending is the proper course of action even with US consumers holding a debt-to-income level of 126% and Canadians at the astronomical level of 147%. The jury is still out on its efficacy though stock markets bounced off the lows in March 2009 and more recently off of the July lows. It is noteworthy to point out in the first instance, the market came to the conclusion eventually that QE would help. In the more recent instance, markets and media started clamouring for it as economic data was in fact tilting towards a double-dip recession. It became built into the stock prices well in advance of the actual announcement date. Today, in mid-November the masses are already whispering about QEIII it worked so well for stock markets though the cycle and effect of it are exponentially waning. QEIV? Et al?

If the first instance of quantitative easing didn't work, why bring out a weak sequel a few weeks ago that was only $600 billion? For sure, the original version improved quarterly GDP numbers and corporate earnings. GDP numbers have softened dramatically putting the economic trend in jeopardy. Normally, when following a recession and if a lasting recovery is at hand GDP moves off a bottom and doesn't peak in year one. It softens or pauses in years two or three.

What the Fed understands is that the velocity that matters is escape velocity. Escape velocity is the speed at which you must travel at to escape the force of that which is pulling on you. Think about a rocket escaping the earth's gravity for example. It can go fast but it must go a minimum speed to get into orbit. The Fed and many economists understand that in the present situation, economic and financial conditions are not conducive to providing the escape velocity necessary to improve unemployment, housing or spending.

Nothing has really changed in the last year. Sure Canada has done better, but we got an extra boost, besides our own deficit spending, from what the US did. Our economic data is weakening now too. The rest of the world has done pretty much the same with the emerging markets performing the best. China was the first to stimulate and did a massive one at that, but now is raising rates to cool off its stock speculation and housing. Emerging markets were at a different spot in the economic cycle than the west was so the stimulus did actually cause inflation, not just the certainty in the west that it's actually coming.

Will it work? That's a hard question to answer. I could give both the bullish and bearish case for it. I could point to Japan's 20 plus years of experimenting with stimulus to no avail. I could point to the fact that we had US bond supply fall in the 90's and Canadian supply went up (we have some big deficits you'll remember back then) and bond prices sank. I could point to the fact that supply has increased dramatically over the last year and prices have risen well. I could talk about how Andrew Mellon, the US Treasury Secretary, tightened too quickly and caused the recession in 1930's to become a depression.

What does seem to be understandable is that the level of personal debt in the west must come down. In order for that too happen consumers must save more and spend less. Sure, no one wants to be one of the leaders on the watch when secular changes like this happen, but we cannot escape the structural changes that are going on. The sooner we allow things to take their natural course instead of relying on these artificial and distortive policy decisions, the better off we will be in the long run.

Ludig Von Mises of the Austrian School of Economics, a movement that felt price alone regulates things the best, an adherence to a natural economic order, said the following on credit expansion:

> ***Credit expansion is the government's foremost tool in their struggle against the market economy. In their hands it is the magic wand designed to conjure away the scarcity of capital goods, to lower the rate of interest or to abolish it altogether, to finance lavish government spending, to expropriate the capitalists, to contrive everlasting booms, and to make everybody prosperous.***
>
> Human Action, 1949

We are all grown-ups here. Whether the QE's work or not who knows. But trying to find the escape velocity may be too dear now and especially later when the bill comes in.

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THE CHART PAGES

GOLD BULLION

Gold continues to be front and centre in the media and investors mind. Much of the talk has been on gold's ability to hedge against inflation though gold moves higher during deflationary and/or periods with global currency problems like there is present today. As the chart indicates we are now in a corrective phase for gold; the question is just how it corrects. This can happen by moving down or by moving sideways. Each of regions marked by a red line, excluding the last one of course, represents areas of support.

CHINESE STOCKS (XINHUA 25)

Though there has been an short, month and a half upturn in Chinese stocks since our last publication its rather odd that the "on-balance volume" (OBV) has been waning for the better part of 2 years. OBV, shown in the lower panel, takes up day volume and subtracts it from down day volume to produce a trend. Conventional wisdom has it that investors should be increasing their holding of Chinese securities not reducing them. The longer term trend is stabilising as is the last few months of the OBV, conditions that may lead to an upswing in conjunction with a mild correction in other global markets that is appears to be under way now.

LOONIE

The Canadian dollar, like the Auzzie and Kiwi dollars, is still an excitable currency, moving with any weakness in the US dollar. Weakness in the US dollar shows up in up moves in oil and gold. It's a bit circuitous really. Despite all the volatility the Loonie has been in a band between $0.92-$1.00 USD much of the last year. The last up move was a weak one; a correction is underway.

US DOLLAR

This chart of the US dollar index shows some pretty large swings too. Because of the impression that the US Treasury is "printing" dollars to finance its deficit sentiment towards the greenback has been ardently negative. Despite this since 2008 each low has been higher, and the sentiment panels now reveal an upswing or bottoming. First resistance is at 80.5 on the index, a measurement against a basket of world currencies, including the Loonie.

THE CHART PAGES

CANDIAN EQUITIES

The Canadian stock market had gone no where in a year until recently when it spiked above resistance as shown by the blue line in the top panel. We have entered some type of overall correction with conditions at present overbought. As mentioned previously things may correct by going down or by simply going sideways for a period of time sufficient to bring the readings down. OBC is decent, showing that investors have been accumulating shares in Canadian equities.

US EQUITIES

An assessment of US stocks reveals some differences with Canadian stocks: they haven't been accumulated as Canadian stocks have (balanced really) and they did not break out from a long pattern though they did marginally make a new high. That said, they have formed a double top and are overbought now. Again, a new entry point into US stocks will depend on the nature of the correction over the next few weeks.

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THERE'S A PUNGLE IN THE JUNGLE
(and why you don't want Tigger as your advisor)

By Thomas Kleinschmidt

Whether you are talking about an equity index, sector index, metals index, stock, currency or interest rate the answer to "what direction will it go" is always the same…" up, down or sideways". 100% of the time. Guaranteed.

Consider the equity, bullion and bond markets as "the investment jungle" (if you haven't read Ken's book, please do so). For this article let's review one of the main investor biases – overconfidence – overestimating news, analyst forecasts, etc. and acting to affirm your level of confidence. I'll do it with the idea that at times the news, forecasts, et cetera indicate that an investment should be a good one, and more and more investors buy up the finite supply of specific stocks and they pungle up the prices, sometimes affecting the entire index! Rather than a sound investment it is just a pungle in the jungle.

What causes this? Tigger. In the investment jungle Tigger is trouble. As you remember, Tigger is energetic, friendly, full of enthusiasm and fun. Makes a great friend but does not make a good advisor or investor. When news and forecasts seem good he's all for the investment. Tigger would have been buying shares of Bre-Ex right to the top.

We, untiggerlike investors, thinking seriously about our invested assets, hope we don't get caught up in all the excitement that affects other, less serious, tiggerlike investors: Investors who would eagerly pungle up the price of something in the investment jungle. We hope that if we do our due diligence with good research or good advice we'll get behind good investments, investments that go up and give us a positive rate of return, ideally in line with our retirement goals.

Today, as it is, we've got simply way too much information to go through. After work where's the time? Even if you are retired, and love the topic of investing, there are other issues that demand your time. And remember the learning curve…investing isn't easy. You've played the scenarios over and over…both the good and the bad. And you're very aware of how much income you'll need during your retirement years and how you want to protect that and the well being of your loved ones. But the information we get is of both "opinion" and "fact", and we must inwardly wrestle with our emotions at the time of this information onslaught. Not only that, you'll recall in my last article that Bentley Theory says that we tend to view risks and reward quite differently.

You know what Tigger would say when you meet him in the jungle, anytime, anywhere (and thus the pungling that happens in the investment jungle). So, how do you not get caught up chasing the product or position of the month? Did you miss the pungling of Potash or were you a part of it? Do you still hold or did you get the big gain and now sit in cash? What about RIM? Gold? The TSX itself? And weren't bonds supposed to keep going up?!?! With QEII and inflation (or is deflation coming?) and the economy and the Chinese and interest rates washing up on the beach, where is a safe place to invest now? And how? Don't forget that dividend paying stocks have been getting the pungle-treatment for quite some time… what good is monthly income with having to live with a capital loss down the road? When the pungling stops, prices typically fall from the trees.

Fortunately, there are some good discretionary portfolio management firms like CastleMoore who also use clearly defined methodology and financial techniques to thwart a Tigger attack. A good advisor/firm will see the forest for the trees and the Tiggers in the leaves. Not that a methodology won't get a bouncing upon from time to time but the effects should be minor with good risk management controls in place, so your retirement goals stay in sight.

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GUEST COLUMNIST

BEN'S PARADOX

by Paul V. Azzopardi BA(Hons)Accy; MBA
Portfolio Manager, APV Investment Management

I have always taken the approach that while one must run money in the context of the overall economy, the most important thing of all is how securities and other assets are actually behaving.

Looking at how prices are actually moving will not only hopefully make you buy assets which are moving up but also give you an early indication of when to sell. Often, you cannot afford to wait until you know the reasons to sell because it would then be too late.

During my investment career I have therefore endeavored to develop tools which are very robust – tools with wide applicability, which can be applied to different economies, to different levels of an economy, to a wide variety of securities, and to different settings. They tend to be simple tools rather than complex ones because complex tools tend to have a limited range of uses.

One way of developing robust tools is by looking at the critical elements in any complex system. These are the elements which motivate the system or on which many other elements depend. By translating what's happening in terms of a few critical forces allows us to understand the system better and to have a better idea of what might happen next.

I would like to illustrate this by an example from the world of art. Although I was always interested in painting and drawing, it was only rather late in life when I turned 40 that I took up painting as a serious hobby. We all know how it feels when we come across a beautiful piece of art – there seems to be something deep within us to which art speaks and I guess the wiring into our brain is so deep that it accounts for the great difficulty we encounter when we come to define what art and beauty are.

Don't worry, I am not going to presume to tell you what beauty is but, rather, would like to turn our attention to how judges approach the task of choosing a winner in an art contest. They usually break the process down into a set of criteria such as the colours used, the structure of the painting, its inspiration, composition, how creative and original the artist was, and such. Once a judge looks at a painting in terms of these simple but robust concepts, he or she would have a much more informed opinion about the painting – his or her judgment is never going to be "objective" but it would be "reasoned".

In the second part of my recently published book, ***Behavioural Technical Analysis – an Introduction to Behavioural Finance and its Role in Technical Analysis*** (Azzopardi, Harriman House 2010), I develop three sets of tools to help readers analyse what is going on in markets. The central tool is the concept that price is always determined by SEP, that is, by participants' Sentiment, the Economics of the situation, and by the Price of the security itself. At any one time, it is usually only one of these that are the main driver.

Let us take an example from what is happening today in the markets. We have the Ben Bernanke Paradox: on the one hand, securities and commodity prices climbing at a steady clip; on the other, sluggish economies in the US and Europe. How can we best look at the problem?

We start with the "E", the economics, because that's what I see as the main driver right now.

The real economy in the US faces high unemployment (much higher than the official figures say), surplus housing, budget deficits, high debt, and a stable graying population with little immediate prospects of growth. Janet Yellen, Fed vice-chair, told the Wall Street Journal a couple of days ago that she was "having a hard time seeing where really robust growth can come from" and that the economy had "real downside risk." So far, here in Canada, we were somewhat protected from this so our economy is doing better. Part of the reason is that China, Brazil and India are still growing and creating demand and this is helping resource-based economies like ours and Australia's as well as the multi-national companies who are selling there. One little known fact is that about half the sales

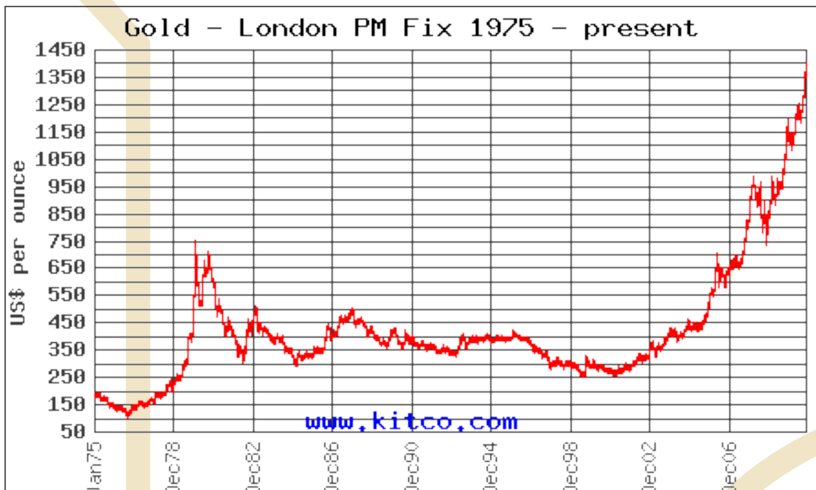
by companies in the S&P 500 are foreign, i.e. non-USA, so when the S&P 500 goes up, it's not just a vote on the US economy. Europe is struggling with big credit problems principally the result of profligacy.

That's what's called the real economy. On the monetary side, we have the Ben Put, a follow through on the Greenspan Put which is one of the main reasons we're in such a mess: a solemn declaration by the Fed that it will do whatever is in its power to avoid deflation, to get the economy going, to raise employment. The first and the last of these are the Fed's mandate and the only tool it's got right now is quantitative easing, a program where the Fed buys bonds and pays for them with newly created money. The Fed argues that it's just doing what the banks are not – creating credit – and that it has the tools to stop the party whenever it wants. The market begs to differ. How do we know?

Let's now look at the "P", the price. This is the second driver we have.

First, the "P" of the US dollar. The US dollar has been sliding in value since 2001, and not just against the Canadian dollar, but as measured by the so-called dollar index which measures the value of the US dollar against the Canadian dollar as well as various other currencies including the Euro and the Japanese Yen. After falling steadily for ten years, the index is now trying to form a base just above the lows it dipped to in March and April 2008. Were it not for the lack of a better alternative currency, the US dollar would be much weaker than it is. At one time the Euro was playing the alternative role but the lack of a common European treasury is a dent in its armour.

Second, the "P" of stock prices and commodities. We start with gold. Gold has been in an uptrend since 2001, mirroring the loss in value of the dollar. (You can see, by the way, that between 1978 and 2001 it was a dreadful investment.)



Dr Copper, as it's called, is at historical highs as well:

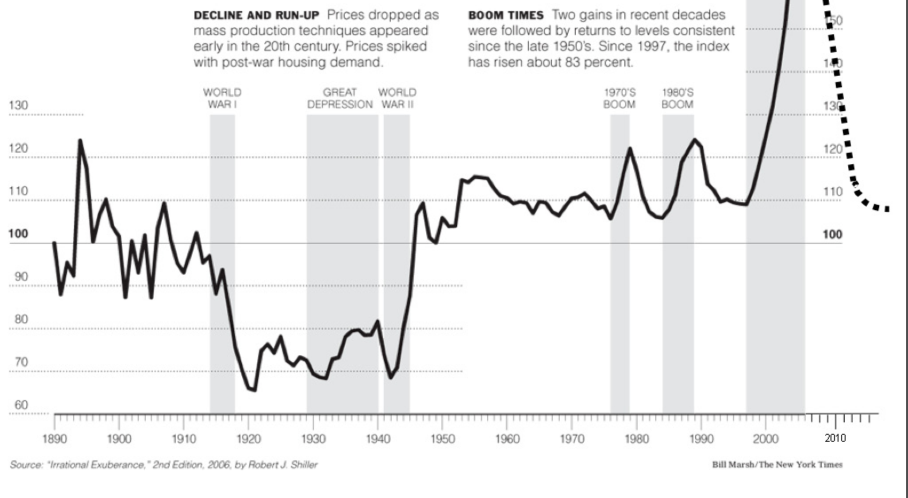
Other commodities are trading at high prices.

Stock markets generally jumped back up in March 2009 and have been increasing ever since, most of them now at around the mid-point of the highs reached in 2000 and 2007 and the lows of 2002/2003 and 2009.

House prices in the US may have some more to fall, especially if unemployment remains so dismal and if even more bad paperwork keeps surfacing, but prices now seem to be meeting some resistance to dipping below 2000 prices. House prices, therefore, are basically back to where they were ten years ago.

So, if we combine our "E" and our "P", we see that while the real economy, except in emerging markets, is lethargic and still trying to cope with credit shocks, the Fed is pumping big money into the economy by buying bonds, and keeping interest rates artificially low. Banks are again having a heyday while retirees, pension funds, depositors and people buying bonds are being penalized a second time, or, perhaps worse, being forced into risky assets.

Money is fleeing financial instruments and getting into stocks and commodities. That's what the "P" is telling us. One firm I follow reports the flow of funds between different asset classes and it has just reported that for the first week of November, money flows into equity funds was the highest for any week since 2008! Further, the flows into bond funds are down to a 22-week low.



You can now see how prices are taking their cue principally from the monetary side of the economy, and to a much lesser extent from the real side.

The Fed's actions are seen as leading to inflation and further devaluation of the currency. Note that, basically, inflation and devaluation are different aspects of the same thing: in inflation the price of the currency falls against goods and services; in devaluation the price of the currency falls against other currencies.

No wonder China and other holders of US dollars are so uncomfortable – their only option would be to turn devaluing dollars into hard assets and this is why they're buying resources, land, etc.

If these trends continue, expect to see more competitive devaluations in currencies (led by the US dollar), as each currency block vies for exports, and higher commodity and stock prices.

Sentiment, our "S", is mixed and follows the dichotomy in the economy – good sentiment on money pumping and asset prices, neutral-to-bad sentiment on the real economy.

As you may have realized, this paradox creates precisely the conditions for the formation of another bubble, this time in stock and commodity prices! Like any other paradox, though, this one too has the seeds for its own destruction.

Alan Greenspan, asked to explain how government bond yields were so low in 2005, described the situation as a conundrum – he guessed things were just right when, in fact, those low yields were sowing the crisis which soon followed. One could not help but feel a sharp slap of deja vu when one hears Fed leaders explain how they want to stimulate economic growth via higher asset prices as a result of "credit easing" (aka "printing money"). Also, can the economy recover if oil and other essential commodities are being inflated?

Asset prices are likely to keep following the monetary cue and keep increasing until, at one point, we realize that the emperor really has no clothes, that prices are totally divorced from economic reality, and then it's a rush for the door, and prices again collapse in a jiffy, perhaps accompanied by an exodus from the US dollar. These are some of the (unmentioned) risks which quantitative easing is engendering.

But in the meantime, as an investor, while the party lasts, and Ben's Paradox is just a party game, try and catch good quality US and Canadian stocks, real estate and commodities during one of their rebounds, like we're seeing these days. Diversify away from US dollars for now, until perspicacity again regains the upper hand.