CastleMoore News

Buy, Hold... *and* Know When to Sell™

KEEPING THE FAITH

By Ken Norquay, CMT, Partner

My oldest son is in shock. He found out how the American monetary system works by visiting a few websites that "expose" the "corrupt" monetary system and the Federal Reserve Board.

http://video.google.com/videoplay?docid=7065205277695921912# and http://www.youtube.com/watch?v=lieZHLTExws&feature=related are good examples.

These offerings are politically motivated anti-establishment websites. The way these educational economic snippets are presented is as if the presenter were exposing a corrupt and malicious system.

When I first learned how the U.S. monetary system worked, I was a trainee with Merrill Lynch. This stalwart American institution taught me exactly the same thing the conspiracy websites are teaching my son; but Merrill Lynch explained it to me in a matter-of-fact way: "This is how it works." The anti-establishment websites claim there is a dark conspiracy enslaving the American public. (The underlying pitch is that if you vote for such-and-such Politician, he will save you from this evil conspiracy.)

What intrigued my son was how U.S. money is created "out of thin air," whenever U.S. banks lend money. He had not realized that the total money supply of the USA is the same as the total debt of the USA. Economic expansion is accompanied by expansion of the money supply AND the expansion of debt. If people stop borrowing or banks stop lending, the economy gets stuck. If bank loans are paid off faster than new loans are made, the money supply and the economy shrink.

The Canadian system is fundamentally the same as the American. That's why our Finance Minister is so concerned about the high level of Canadian debt. If Canadians already owe the banks too much money, they can't afford to borrow more. If they stop borrowing the economy stops growing and the game ends. Prosperity ends.

The 2007/2008 US mortgage collapse illustrates exactly what can go wrong in such a system. People borrowed lots and lots of money to buy houses. This created lots and lots of growth. But they couldn't repay those loans. So they had to sell their houses. Now there are $400,000 mortgages on $300,000 houses. How much of that original $400,000 loan is still money? $300,000? Less? More? Right now, American banks are allowed to carry those loans on their books at face value. But everyone knows that a $400,000 mortgage loan on a $300,000 house is not really worth $400,000. Multiply this by millions and millions of homes in the USA and you will see it clearly: the game has ended.

That's why the FED is trying to re-kindle inflation. Inflation is the only way the Americans can save their system. The US Federal Reserve has also made it clear it would like portfolio values to be higher as an offset to housing prices. But, try as they may, the spark of inflation is falling on wet firewood. The American real estate collapse has thrown a giant bucket of cold water on the American monetary system. And our government is desperately trying to keep Canadian kindling dry.

I assured my son that no matter what he thought or said or did, he could not change the system. And if he thought some politician could change it, he was mistaken. My point was that it's futile to try to save the world: the best we can do is save ourselves. How can we manage our own personal money supply in such a system? How can we succeed even if the system collapses? How can we stay safe and dry in a storm?

In these first weeks of 2011 I offer you the same advice I offered him. "To thine own self be true." "Look out for number one."

At CastleMoore, we manage people's life savings. It's not our job to advise the Prime Minister how he should save the Canadian economy. It's our job (and your job) to save your personal part of the Canadian economy. Focus on investing your own portfolio so it will be safe in these unsafe times.

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Clearly the American system is in danger. When America's biggest bank, insurance company, brokerage firm, mortgage company and manufacturing company all had to be bailed out, it's clear the system itself is in danger. Buying blue chip American stocks and holding them for the long term is no longer a viable way for individuals to manage their own personal monetary systems. What used to be "blue chip" has become "black and blue." It is important, in these high risk times, to stay alert to the inherent danger in the American system. It is important to keep your personal portfolio invested in securities that are going up and avoid securities in down trends.

In 2008 we learned how serious a mistake it can be to buy and hold the stock market.

Great risk means great opportunity. Investments in precious metals and bonds have worked well in times when the stock market was not working well. Sometimes we can earn good profits by holding foreign currency. There are many opportunities for those who are looking for them. There is much risk for those who cling to the old ways.

2011 has the potential to be another tough year for the stock markets. And another good year for precious metals and bonds, the Japanese yen and, perhaps, the US dollar.

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Portfolio safety is *not* the consensus now for most asset managers; at CastleMoore tending to client wealth growth *and* protection for the long term matter.

INVENTORY AND CREDIT RECESSIONS MAY APPEAR THE SAME AT FIRST, BUT THEY'RE NOT: An update almost a year later

By Robert 'Hap' Sneddon, FCSI, President

This article originally appeared in March 2010.

After a read of the original article I'll update the situation 10 months later.......

"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

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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, these types of recoveries are often anticipated or front run 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 supposedly 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 cranking 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 depress stock markets and raise bond values, as assets are sold, not bought and debt is paid down, not increased. Of course when savings reached a certain level, say close to 10%, then a new cycle begins anew.

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 to stock markets not to Main Street, not to job creation. Markets were the recipient because markets would 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. Consumers played their part too in accumulating goods of all sorts, and this kind of change is tough to break. Politically, who wants to be the leader to be associated with bad medicine when it's easier to have these longer term structural projects 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."

…well what has changed in the last 10 months?

The major stock markets, with the exception of China which was down 12%, have printed decent returns over the last year (For the record we at CastleMoore were too bearish on equities for the year), but the average Canadian has acquired more debt than ever! At 150% debt-to-income, a record, it forced Bank of Canada head, Mark Carney to mention it in two speeches (E-mail me for a copy) he gave, one in the fall, and another before Christmas. Mr. Carney deeply understands these structural problems.

And just recently, Agathe Cote, the Deputy Governor at the BoC, speaking in Kingston, reiterated the point. Why does it matter? Again, consumers represent 70% of the economy, and business and government the other 30%. She also addressed the consumer effect from the strong bounce back Canadians saw in house prices. Strong house values, in fact, represented the vast majority of the wealth effect Canadians saw since the depths of the financial crisis, including GDP. With house prices reaching all time highs, Canadians felt wealthier and tacked on more debt because of it. In the US, citizens' managed to pay down debt aggressively through to the beginning of summer, but then as fall approached, and the early Christmas sales appeared, they ramped up their debt again. As I said, it's hard to stop consumption, even if you know you need to.

Bullish sentiment (59%) – those who believe markets will go up or who are positioned as such – and bearish sentiment (19%) are at levels last seen just before the financial crisis began in 2008 and typical investors/advisors have only 3.7% cash. In addition, a hatchet wielding conservative US congress now in the House, is going to reign in spending and try to halt Fed Chairman Bernanke from enacting another round of stimulus (QE III). The Fed is also changing four of its voting members, from ones who were dovish on stimulus to ones who are hawks on it.

With average Canadians starting to receive the message (Q4 GDP was down slightly, in part because of the housing sector softening), average Americans now getting back on the wagon, and an air of fiscal restraint ahead, 2011 appears to be a year for prudent investment choices with portfolio cash flow or income the predominant portfolio attribute, whilst always protecting portfolio values.

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THE CHART PAGES

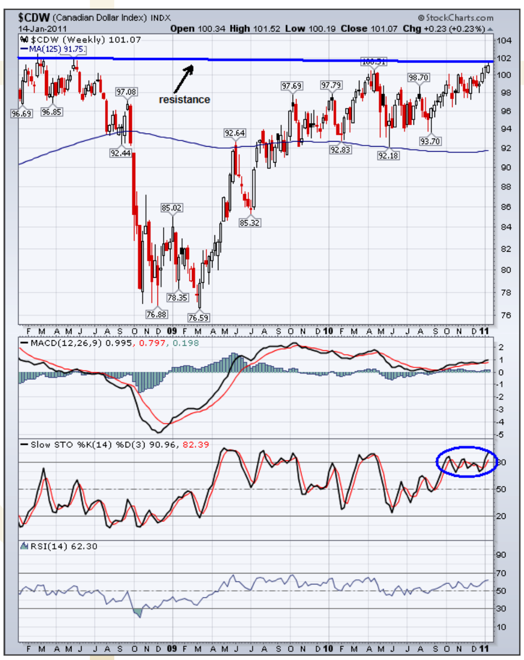
GOLD BULLION

Gold has recently started to correct. Since its peak in early December many of the indicators have quickly swung down. Further pushes lower on price and/or more time passing will create an oversold situation. As the long term moving average in the top panel shows, gold bullion is in a long term uptrend. We have a small bullion position for clients and will look to add more through selective opportunities.

CHINESE STOCKS (XINHUA 25)

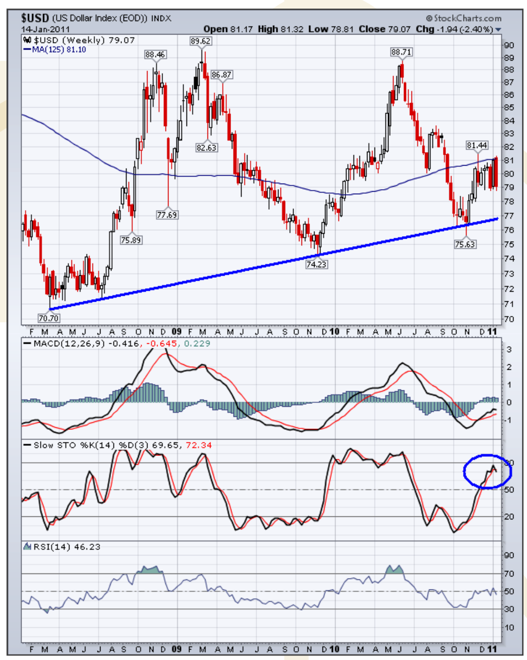
This 3 year chart of the Chinese stocks (represented by an ETF) shows they are further along in their corrective phase than western markets. In 2010 the Chinese market was down between 10-13% (depending on the market) which would seem counter intuitive to the conventional wisdom that Asian economies will drive the global engine. Authorities have raised bank reserve requirements many times to stem domestic inflation in housing, food, and speculative lending. The state's economic controls, coupled with the efforts of western central banks, would suggest that you can engineer markets. With most indicators bottoming, a 7% move above resistance will provide support; until such time the market is trendless, if not just weak.

LOONIE



In the last issue of the CastleMoore Investment News we drew readers' attention to the over bought condition of the Loonie. The blue oval in the middle panel shows that it continues to be so in mid January – the reading now is becoming extreme. Like many markets, it is coming up to pre-crisis levels which will act as resistance. Should it break through $1.02USD the next target will be $1.10.

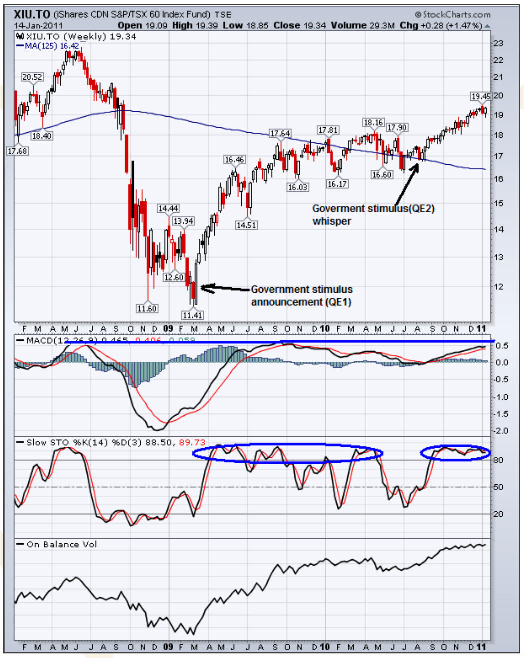
US DOLLAR



The US dollar index as measured against a basket of global currencies is modestly higher over the last two months. There is no indication that the newly established long term trend which began March 2008 at 70.70 is still not in effect, despite the rhetoric in the investment media. In the near term it's possible for a test of that trend in the 77-79 range.

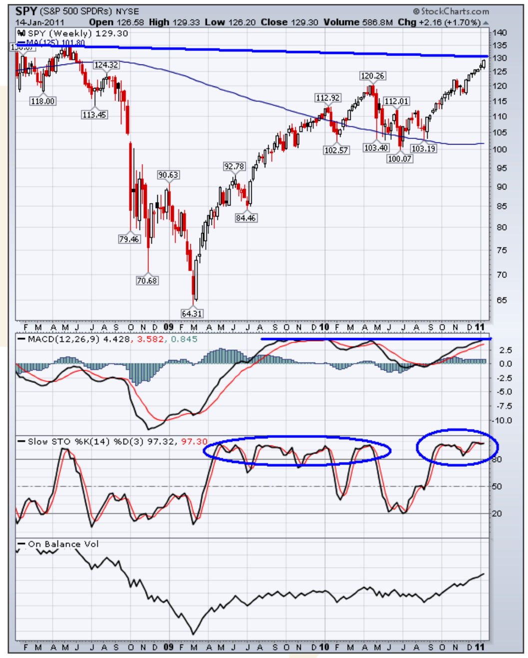
THE CHART PAGES

CANDIAN EQUITIES



Most western stock markets and North American in particular, have moved higher in the last two months. While corporate earning comparisons have been decent year-over-year, we wonder how they will behave without the government stimulus in 2011. As mentioned in the Chinese market section, the investing public and media now believe that all governments can control or back stop markets if they want. US Fed Chairman Ben Bernanke stated that if investors feel wealthier from their stock holdings they may spend (consumers are 70% of GDP). What? The Canadian market is due for a 10% pullback after outperforming the US thanks mostly to US fiscal policy. The long term moving average in the upper panel has still not turned up after all the action since the bottom.

US EQUITIES



The US market is reaching resistance just overhead. By all measures it's overbought too. But we have seen this condition exist in the recent past without a meaningful correction occurring. The announcement of a second round of stimulus (shown on the CDN equities chart) clipped short a correction that was underway at the time (government engineering again). A new Republican congress and 4 new hawkish FOMC members may break this disease of government meddling.

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HOW WILL YOU HAVE YOUR INVESTMENTS MANAGED IN 2011? (Hint: Seek gains but for gosh sakes worry about losses)

By Thomas Kleinschmidt

First, don't think that since the TSX is almost back at where it was before the collapse that your retirement is 'back on track'. Now is the time to worry about losses and put an action plan in place to deal with the next market slump. This might entail switching portfolio managers or advisors, or even plunging into self-management.

Why worry now? Here's why. Most non-client readers of this newsletter lost at least 10 years of gains in the equities markets with buy-and-hold philosophies. Starting in 1987 there was a setback of 25%, 11 years later a 30% sale, two years after that a 45% slide and the final 2008 sell off was another 45% sucker punch. This time IS different and you need to decide the best course of action – stay with the current management approach or do something different. Just remember what you promised your portfolio New Year's Eve 2009 and start from there.

Doubts? Last month I wrote about how behavioral finance sheds some light on why individual investors do so poorly with selecting equities (recall I added my own 'Bentley Theory' to the list, using the analogy of a Bentley automobile as a physical representation of a $300K+ portfolio). To help in your considerations I'd like to use the same behavioral points from last month to show why I think investors do poorly with selecting portfolio managers or financial advisors. Briefly, if you are doing any one of these you might be putting your retirement in jeopardy:

- **Prospect Theory** – investors who chase funds based on past performance and ignore the fact that mutual funds' prospectuses restrict the fund manager's actions – i.e. the fund is a such-and-such fund that can only invest in such-and-such and must remain X% invested at all times (regardless of conditions) – thus 96% of mutual funds perform according to economic, business and other cycles and not according to the manager or firm. Said plainly, it's not their fault when their fund plunges in value. Remember, they're your shekels but they are the ones with the shackles.

- **Overconfidence** – investors who overestimate their goals and/or the returns they can make in the markets act as if the markets care what they think and, regrettably, think that their broken portfolios can recover within their individual timeframe needs (they also do not want to hear otherwise).

- **Confirmation Bias** – investors who only listen to hopeful stories instead of ignoring opinions and seeking facts don't realize that most reports/studies are developed with too short a time horizon yet are expanded into the future 20 years or so. This is like thinking there will not be another slowdown on the DVP just because you got above 60km/hr. Whatever they do they convince themselves that all is well so hope remains strong.

- **Noise Traders** – they switch advisors when the current news finally triggers their fear-or-greed reflex.

- **Escalation Bias** – investors do the "Smith Maneuver" yet again and at yet another market top.

- **Bentley Theory (new!)** – now that their Bentley is returned to them – albeit over 2 years later, no explanation and a funny sound in the motor – they again love their current portfolio driver. Hey, if you gave your new Bentley up for lost you'd kiss the guy too. This too follows the 'hope' idea – investors seeing their January 2009 statements could only 'hope' and 'wait and see'

Intelligent investors seek self-control to turn the above points upside down. As an intelligent investor you:

- do not chase performance but seek a methodology that works for the current market
- thankfully take what the market returns but buy and sell with logic, not emotion
- ignore opinions and stories, seek facts and diversify your portfolio according to methodology
- have a handle on your fear and greed reflex or let someone else manage your investments
- use methodologies that indicate when it is time to sell and when it is indeed time to re-invest
- know your portfolio is as real as a $500,000 Bentley and not some fluctuating number on a piece of paper

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CASTLEMOORE IS LAUNCHING UNIQUE EQUITY PORTFOLIOS!

For investors that want risk managed exposure to the equities markets

CastleMoore is pleased to announce that we are teaming up with Strategic Analysis Corporation (SAC), with SAC as consultants on two new portfolio types. Many of you will know Ross Healy over the years from appearances on the Business News Network (BNN TV). Mr. Healy is also the former Director of Research at Merrill Lynch Canada.

CastleMoore will be utilizing SAC's Structural Valuation Analysis® (SVA®) in the development and management of these new equity portfolios. With staff having past retail experience with Ross and his team, in some cases for more than a decade, we have the pleasure of working closely at the institutional level bringing investors an investment edge with two new portfolios:

- **S&P/TSX 60 True Value Portfolio**
- **DOW 30 True Value Portfolio**

Investors who wish to dedicate a portion of their portfolios to stocks now can have them managed in a discretionary manner with methodologies that seek capital gains yet are able to manage risk beyond the usual ways. These unique portfolios have the mandates and means to beat their benchmarks. All of the portfolios have a built-in rotation strategy and can employ hedging to outright selling to manage risk beyond conventional methods. How would you like to know what the dollar risk to your portfolio is – today?

SVA® goes far beyond fundamental and technical analysis and gives both precise buy and sell signals for indexes and individual stocks in the TSX Composite, S&P500 and Nasdaq100, dovetailing nicely into CastleMoore's investment philosophy with the "knowing when to sell" philosophy to manage risk. Indeed these precise buy and sell signals actually invert the thinking that 'higher reward = higher risk'. Investors will no longer need to accept higher risk for potentially higher returns. The entire aim of the selection process is to minimize risk-to-capital first.

With SAC's methodology on our desks, CastleMoore can offer clients the opportunity to participate in the North American equity markets with a defined capital preservation strategy. To make things more attractive, we also leave out the deadwood. SVA® also signals when to safely capitalize on price fluctuations.

Why would investors consider these unique portfolios? Simply put they are built upon a solid methodology that turns the incumbent idea that you have to take on more risk for more return on its head. No longer do investors have to wait-and-hope, enduring stock market sell-offs, and setting their retirement and financial goals back years, time and time again. SVA® analytics show "structural" values based on the company's balance sheet (think Graham and Buffett). However, modern fundamental and technical analyses are not aware of these critical points. SVA® clearly identifies companies, sectors and indexes that are: (a) low priced true value investments; (b) fairly-valued and most likely going sideways (dividends); (c) under-valued true growth investments; and (d) over-valued investments that must be shed.

Looking forward, 2011 will be an exciting time for CastleMoore as we roll out the partnership with Strategic Analysis and bring added value to our portfolio management methodology. Our goal is to make 2011 a rewarding time for our clients with these unique portfolios despite these challenging economic times.

Thomas Kleinschmidt will spearhead this company initiative, and accordingly be our point man with the public. Please contact him directly at **905-847-2713** or by e-mail, **thomas@castlemoore.com**, or any of our staff, for more information and to get on the list for upcoming webinars.

GUEST COLUMNIST

AN OUTLOOK FOR NORTH AMERICAN EQUITY MARKETS IN 2011

By Don Vialoux, CMT

Prospects for North American equity markets are better than average in 2011. However, there will be surprises along the way. North American equity markets are expected to continue to follow the four-year Presidential Cycle and investors can benefit by adding equity exposure during the first half of the New Year.

Historically, the best time to own North American equity markets during the Presidential Cycle has been from October prior to the U.S. mid-term election to its high in October in a pre-election year. Since 1950, the 12-month rally from the mid-term election year low to the pre-election year high averaged a gain of 24 percent for the S&P 500 Index, 19 percent for the Dow Jones Industrial Average and 23 percent for the S&P/TSX Composite Index. Positive returns were recorded by the S&P 500 Index in 15 of the last 15 periods. Returns ranged from a low of 5.87 percent in 1978/1979 to a high of 40.12 percent in 1986/1987, with 11 of 15 periods showing gains topping 20 percent. Since the beginning of October, the Dow Jones Industrial Average already has gained 7.9 percent, the S&P/TSX Composite Index has added 9.4% and the S&P 500 Index has advanced 11.1 percent.

The reason why the Presidential Cycle works is because of the U.S. political process and its impact on North American economies. Historically, a U.S. president will use much of his political capital on contentious issues during his post-election and mid-term election years. Frequently, contentious issues increase economic and political uncertainty prior to the mid-term election. After the mid-term election, uncertainties are reduced. In addition, the President tends to become more compliant to issues that either will help him to become re-elected or will set the stage for someone in his party to become elected. Sound familiar?

Unfortunately, there is a catch in 2011 that will cause North American equity markets to vary briefly from their historic pattern. North American equity markets already are short term overbought after the bull market rally since the beginning of September. Key indices are vulnerable to a brief correction in the first quarter. The correction, if any, will provide an opportunity to add to equity positions in order to take advantage of the remaining Presidential Cycle "sweet spot". Preferred equities are economically sensitive sectors including materials, industrials, energy and consumer discretionary.

What are some of the issues that are likely to influence North American equity markets in 2011? The $600 billion quantitative easing program in the U.S. and the economic stimulus program passed by Congress near the end of 2010 will have a favourable impact on corporate earnings, economic growth and employment during the first half of 2011. Equity markets are poised to benefit. Unfortunately, increasing government deficits eventually will have a negative impact on the U.S. Dollar. Other developed nations already have taken steps toward fiscal and monetary responsibility. Eventually, the Federal Reserve and the U.S. government will be forced to move if the U.S. Dollar is to remain the international currency of world commerce. When the Federal Reserve and U.S. government take away the economic stimulus punch bowl, North American equity markets are vulnerable to a significant correction.

Despite near-term vulnerabilities, gains by North American equity markets in 2011 are set to reach approximately 15 percent from current levels. This implies an upside target on the S&P 500 Index to 1,450 and 15,500 on the TSX Composite Index.

Jon and Don Vialoux are authors of free daily reports on equity markets, sectors, commodities and Exchange Traded Funds. Reports are available at www.timingthemarket.ca and www.equityclock.com . Follow us on Twitter@EquityClock