CastleMoore News

Buy, Hold... *and* Know When to Sell™

IF YOU CAN'T STAND THE HEAT...

By Ken Norquay, CMT, Partner

My hobby is the study of ancient wisdom and philosophy. In June that hobby took me to the high desert of Arizona to participate in an ancient aboriginal ritual called Sundance. It was hot: hotter than I'd ever experienced before. Parts of the USA had been caught in a heat wave and the electrical grid had failed. It was very hot, and the infrastructure had broken down.

My personal infrastructure was breaking down too. I found myself battling heat, dehydration, sunstroke, sunburn and dust inhalation. They warned us about rattlesnakes and scorpions. What on earth was I doing there? Surely there's a less risky way to study ancient wisdom!

Why couldn't I have stayed home and read a book? Why couldn't I watch some television program on the History Channel? But no, I had to do it myself. And there I was, in the middle of the high desert of Arizona on the solstice. It was like Hot Yoga with no escape. The heat was on.

Many investors find themselves in a similar situation. They want to learn about investing by doing it themselves. But, with the European Union in serious trouble, with problems in the real estate markets, and with unending international economic weakness, it's getting too hot in the investment world. Why can't we learn about investing in a time like the 1990s? In those days it was easy: you simply bought a high quality mutual fund and watched your profits roll in. We could buy a book on how to invest like Warren Buffett, or watch Lou Rukeyser on television and learn all about investing. But, we can't do that today. Today, the heat is on.

If you can't stand the heat, get out of the kitchen. This corny old saying seems very relevant in today's investing world. When I went on my Arizona adventure in June, my goal was to learn. Perhaps investors who manage their own affairs want to learn too. And the wild ups and downs of the stock market these past 12 years have been wonderful teachers. But it's getting pretty hot, isn't it? Sooner or later, it will be time to get out of the kitchen and leave the financial cooking up to the chef.

The trick is to select the correct chef to manage your investments. And how does one select the correct chef? Find out what his recipes are. What is his recipe for investment success? If his recipe sounds correct, you have found your investment chef. Then you taste it: you try him out for a while. If it tastes right, you can comfortably leave the kitchen knowing that you've left your financial assets in good hands.

Decision number one is: when should I leave the kitchen? When is it too hot? Decision number two is with which chef(s) should I leave my investment portfolio? Whom should I hire to do the cooking when I'm no longer in the kitchen?

CastleMoore would like to be on your list of chefs to interview. We'd like a chance to tell you about our recipes. We call them methodologies. Our methodologies are designed for times like now, when the heat is turned up. If you've been thinking about retiring from investing, send an email to info@castlemoore.com. Put the word "Recipe" in the subject line and your phone number in the body of the email. One of our staff will call to tell you about our recipes.

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SOME CONTEMPORARY MONEY MANAGEMENT AND PORTFOLIO CONSTRUCTION RULES

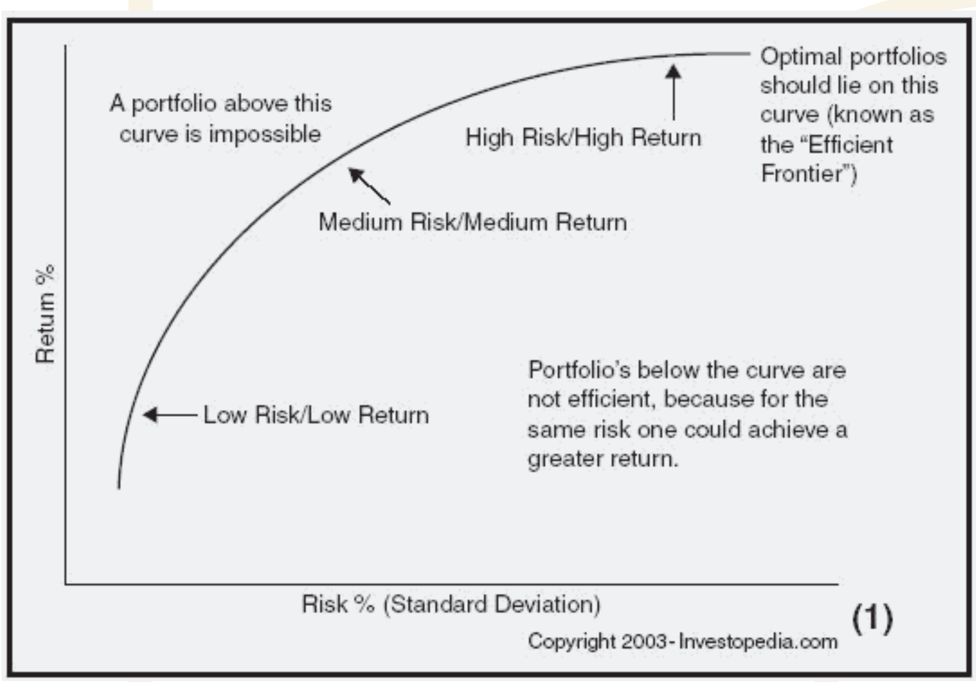
By Robert 'Hap' Sneddon, FCSI, President

In the days of the last secular bull market (1982-2000) a typical balanced approach to asset management stressed having non or uncorrelated assets that were rebalanced back to their original weighting at set intervals such a bi-annually or annually. This was all performed along an efficient market frontier or an arc that illustrates an optimal portfolio based on risk and reward.

The more out of sync the securities in the portfolio are (that is, the lower their covariance), the smaller the risk (standard deviation) of the portfolio that combines them. This approach is applicable to secular bull markets, not sideways ones.

Most investors today do realise now that the conventional approach to portfolio management has changed. If you are a portfolio manager who must now also think in terms of absolute return in addition to relative return, or rather, if you are a portfolio manager who sees the only client-based solution is to think in terms of absolute returns then you also must adopt appropriate and complimentary money management principles.

Seeking strength in any asset class or sector within equities to provide absolute and real return to clients requires a shift in money management principles. On the primary level, selling becomes a central tenant. The surest and most reliable way to reduce or manage risk is to sell positions that are not working before they become a serious drag on the portfolio and consume precious mental capital. To effectively implement a selling process or discipline you must know when or prior to purchasing a security what your risk management levels are. Quantifying potential error ahead of time not only overlays across the portfolio approach a sense of pragmatism, but it also reduces curve-fitting should re-analysis begin when seeing a position down substantially. Many tactical managers suddenly decide a position is long term when the intermediate term or moderate client investing timeframe goes out the window.



A portfolio methodology that makes strong use of price action or trend (technical analysis) must be more vigilant when it comes to money management principles. One knock on a pure price approach is managers may look up one day and ask themselves how they arrived at the portfolio composition they have.   Sure each

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investment idea or security must stand on its own merits but you also cannot simply be a sharp shooter. Waking up to realise 75% of your portfolio is in biotech or agriculture, let's say, is simply not prudent.

Another basic principle here would be concentration rules. At CastleMoore we have capped sector participation for portfolios at 25%. Again, selling allows a higher than historical allocation without increasing proportional risk. Similarly, adding to existing positions should only be done with confirmation of strength or more importantly confirmation that the investment is working. Adding to losing positions or averaging down is just as flawed as is determining a position is suddenly long-term when your initial shorter timeframe is shot because you are down 30%.

Aggregating the beta of your positions is also a reasonable tool no matter whether one is in a secular or non-secular market. Despite the primary principle of selling to reduce risk, a fair question to ask is what is the overall correlation of securities within the same market? For example, if you have equal positions in two stocks, stock A and stock B, whose betas are 1.30 and 1.10 respectively, you may determine the aggregate of the two is 1.20 or the sum of the positions makes the portfolio 20% more volatile than the market. Seeking volatility is good as it provides great profit potential, but to manage along a risk spectrum (low risk to high risk) and in the type of market we have today one must be more aware of aggregate beta than would be the case in a secular bull market.

Further, another question to ask is what is the level of non-correlation between appreciating securities or more realistically, asset classes? If a portfolio is composed of non-correlated positions that are all appreciating there is additional reduction in risk. This I would say is ideal portfolio state. Though selling always protects portfolios one may not always execute sales when you want.

Selling, maximum concentration allocations, and use of aggregate beta are just some of the tools that can be used in contemporary money management while pursuing absolute returns. They are effective if you prefer relative performance, though just not as much.

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GUEST COLUMNIST

NEW US TAX AMNESTY PROGRAM

By Ed Arbuckle, CA, FCA, TEP

In January of this year we wrote an article for this Newsletter for American citizens on US personal income tax compliance titled A Reprieve from Penalties for US Non-Filers. We have also written a number of other articles that are on our website at www.finplans.net.

It's very important for US citizens living in Canada to start filing US personal tax returns if they haven't done so already. US citizens must file US personal tax returns no matter where they live in the world. The returns are usually required even if no US tax is payable. Most countries only tax you if you live there but the US taxes you both on the basis of residence in the United States and US citizenship.

CITIZENSHIP

US citizenship is a difficult concept. You will be a US citizen if you were born in the United States, and sometimes even if you were born outside the United States if one or both of your parents are US citizens. It depends! Your Canadian passport shows your place of birth so it will be a source of information to US border officials that you cannot hide.

TAX AMNESTY

The United States has had a number of amnesty programs before 2012 to allow US citizens to get their tax filings up to date with reduced penalties. Effective on September 1, 2012, there is now both a new formal disclosure program for those who intentionally were not reporting non US source income and an informal disclosure for US citizens living outside the United States who didn't understand their obligation to file US personal tax returns. Previously, there was no clear direction from the IRS on the informal disclosure. Both were usually done anyway and generally the informal disclosure was accepted without penalties by the IRS because Americans living in Canada have no US tax to pay because of credits for Canadian taxes and several exemptions.

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RECENT IRS ANNOUNCEMENTS

On June 26 the IRS issued two IRS Newswires as follows:

- New Details on Voluntary Disclosure Program and Closing of Offshore Loophole (formal disclosure)
- Efforts to Help US Citizens Overseas, Including Dual Citizens and Those with Foreign Retirement Plans (informal disclosure)

A Globe and Mail article on June 27 provided a good summary of the informal amnesty program so you might want to check it out.

REQUIRED DISCLOSURE

For those American living in Canada who have not been filing US personal tax returns, they should do the following to bring themselves into compliance under the new informal disclosure option.

- File three years of personal tax returns (this will likely also include a number of information reporting forms beyond the tax return itself)
- File six years of the Report of Foreign Bank and Financial Accounts (FBAR – TDF 90-22.1)
- Enclose a letter with both filings for each year indicating why these returns have not been filed.

We routinely have prepared such letters for our clients in the past to help them catch up on their US filings. Explanations which will influence the acceptance of your disclosure by the IRS are as follows:

- Explanation for not meeting your filing obligation
- Indication that your Canadian filing compliance has always been met
- Indication that you filed as soon as you were aware of your obligation
- Indication that non filing was beyond your control
- Never been penalized by the IRS
- Recent changes to tax law or forms that you were not reasonably aware of
- US tax complexity is beyond your grasp
- Unaware of the filing law requirements but made a reasonable and good faith effort to do so when found out
- Could not be reasonably expected to know of filing obligations

The new US amnesty program is effective for returns filed on or after September 1, 2012 so you probably shouldn't file delinquent returns before that date. The IRS Newswire also indicates that new procedure will allow tax filers to get up to date with respect to certain foreign retirement plans (such as RRSPs) for which a special election to defer income and other annual information is required each year on Form 8891.

Other information forms that usually are applicable to complete the US filings are as follows:

- 3520/3520A – Foreign trust reporting (RESPs and TRSAs)
- 8938 – Statement of foreign (non US) banks and financial assets (2011 and later years)
- 8621 – Return for foreign investment companies (non US mutual funds)

All of these forms are very detailed and take a lot of time to prepare. Quite frankly, US citizens would be better off if they didn't own TFSAs. RESPs and Canadian mutual funds but this probably needs review on an individual basis.

In the past we have filed six years of the US tax returns and related information returns to get US taxpayers up to date so we are thankful it is now only three years. Taxpayers no doubt are pretty happy too.

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RECENT MEDIA

BNN Appearances **http://www.castlemoore.com/businessnewsnetwork.php**

GUEST COLUMNIST

THE FALSE DEITIES OF ECONOMISTS

By Barry Ritholtz

"Economics is a faith-based pursuit forever in search of a new deity . . . Each of the gods has been worshipped with the fanatical fervour of the convert. What is curious for those sitting outside the sacred circles is that the apostles show not the slightest hint of self-doubt. The Treasury has become to economics what cults such as Opus Dei are to Catholicism."

-Philip Stephens

Fascinating discussion at The Financial Times about the failures of economics by Philip Stephens. Wondering how "a compassionate God" could "allow such terrible misery to be inflicted on life's innocents," Stephens attempts to "square the circle" of ongoing economic errors, suggesting a leap of imagination is what's required.

Monetarist fundamentalism proved a false prophet; efforts to regulate broader measures of credit failed; focus on exchange rates went nowhere; fixing the value of the pound with a cap on inflation did not work; full independence for the Bank of England failed. Borrow-till-you-are-broke approach failed, as did Austerity. The latest economic catechism is fiscal flagellation. It too crashed and burned.

In the US, we tried sanctifying Markets as all-knowing and all-powerful. They were neither, and collapsed in a heap. The fallout form, the damage they inflicted required a taxpayer funded bailout.

Stephens invokes the idea of the Hedgehog and the Fox by noting "the fervour with which economists propagate this or that theory is usually in inverse proportion to the evidence. Fanaticism is thrown as a cloak over the absence of empiricism." The concept of the single big idea as the solution to our woes, and the misplaced confidence economists have in those single big bold and typically wrong ideas cannot be denied. Consider that view in context of the politician's embrace of economists and financiers, from Milton Friedman to Arthur Laffer to Robert Rubin to Larry Summers. Then consider the lasting damage each has inflicted upon the nation, as their flawed philosophies wreak ruin.

Skepticism, and reality based policy is what is required. Not blind devotion to disproven fantasies. The sooner the world's nations recognize this, the better off we will all be.

What most countries on this planet need is a benevolent technocratic philosopher king — and not yet another partisan meglomaniac . . .

In 2010, Barry L. Ritholtz, named one of the "15 Most Important Economic Journalists" in the US, writes a column on Investing for The Washington Post and also contributes occasional column to Barron's and Bloomberg. He is a regular guest on CNBC, Bloomberg, Fox, CNN, ABC, CBS, NBC, PBS, MSNBC, and C/SPAN.

GUEST COLUMNIST

LOVE THY NIFTY

by Makul Pal

From the start of the year, a business TV programme editor wrote me numerous mails to have me as a market commentator during my next visit to London, Delhi or New York. After I finally made it to the hot seat, it turned out to be a brief affair.

TV host: Mukul, what is your view on the market?

MP: We are long on the market.

TV host: Why is that so?

MP: Because, Indian markets have underperformed its global peers and this underperformance should reverse and lead to performance.

And, it was over. It took me a while to realise that our work on mean reversion did not generate causal explanations. The mind is strongly biased towards causal explanations and does not deal well with "mere statistics". There is an insistent demand for causal interpretations. When our attention is called to an event, associative memory looks for its cause and causal explanations are evoked whenever regression is detected.

According to Daniel Kahneman (Nobel Prize 2002), humans love this narrative causality. "However, the explanations are wrong because regression to the mean might have an explanation, but it has no cause." Regression is a temporal event. In his book, Thinking Fast and Slow, he explains mean reversion and how society pays people quite well to provide interesting explanations of regression effects. A business commentator who correctly announces that "the business did better this year because it had done poorly last year" is likely to have a short tenure on the air. The phenomenon of regression is strange to the human mind. Simply putting, mean regression suggests "what goes up comes down and vice versa."

It's this love for narrative causality that keeps us hooked to the "love thy Nifty" (National Stock Exchange of India) spell, so much so that the talk of Nifty and 5,000 can be an endless market saga. We are not in the 1980s when charts were made on graph paper and market cult had few followers. Today, 5,000 psychological levels don't mean much. Markets are much more complex now, compared to the 1980s. It's my belief psychology attached to round numbers is a redundant thought. If psychological numbers were important, prices would trend when the respective levels were broken. In the last 34 months, Nifty has crossed 5,000 a total of 17 times. How can a key psychological level be tested 17 times and still be important?

Above this, if a section of the market is a zero sum game—i.e. someone's gain is someone else's loss—manipulation to some degree should be a legal process. Keeping this is mind, don't you think that after 12 quarters of struggling above Nifty 4,700 levels, the bears won't give it a last short to break 4,700 and rake in some real profits. What better time for a bear to change into a bull, after

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4,700 breaks and prices head to 4,500?

The breakdown would create more panic, generate a cheaper entry, dig a bigger trap, a result in a larger reversal.

Though talking about volatility is sensationalising, which a columnist or TV commentator should avoid, our objective here is to help you identify a potential risk. The best part is that there is a way to hedge against this potential volatility. This brings me back to my brief incomplete TV interview. Worst performers not only statistically illustrate extreme reversion, but are also less correlated to market movements. We are long on the market, with 30 components which are the worst performers in the BSE 500 and the lower the Nifty goes, the better it should be for accumulating depressed valuation stories. This offers a natural hedge to a portfolio. We love the worst outlier stories and prefer to be cautious when the only excitement is a green Nifty above "psychological" 5,000.

mukul@orpheus.asia, Orpheus Capitals
Orpheus Capitals' vision is to revolutionize the world's understanding of TIME and build research analytics around it.

WAIT A SEC! – HOW SECTORS BEHAVE SO CAN YOU

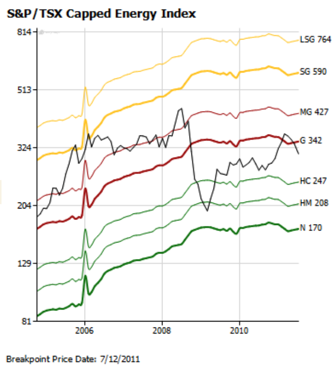
By Thomas Kleinschmidt

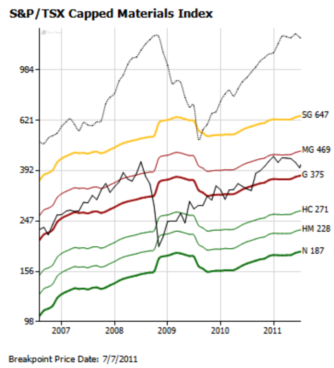
To understand the movements of the broad market indices we need to take a look at how their component sectors are performing within them. Doing so also sheds some light on how the market perceives the economic climate.

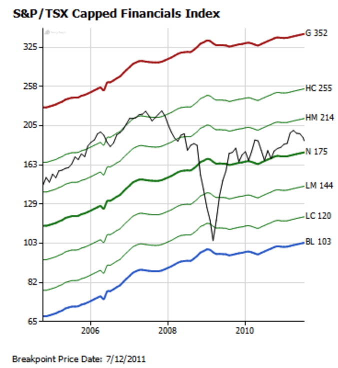
Indexes such as the TSX Composite and S&P500 are an aggregate of constituents from all 10 economic sectors, as defined by Morgan Stanley Capital International and Standard & Poor's under their "Global Industry Classification Standard" or GICS. These are: materials, energy, industrials, financials, consumer discretionary, consumer staples, telecommunications, utilities, health care and information technology.

Investors try to both predict and interpret sector movements against the backdrop of economic news, business cycles, commodity cycles and the like. Right now investors like you are most likely trying to determine sector movement and broad index movement for a number of scenarios – from a normal sector rotation in a normal economic cycle to another across-the-board market correction! Personally, I choose to simplify my work and look beyond all the mundane cud-chewing news reports and seek enlightenment through the theory of Accounting Dynamics developed by Verne Atrill Ph.D seen visually in Strategic Analysis Corp.'s Structural Valuation Analysis® (SVA®) graphics, which show "structural lines" against price movement. Should you wish more info on this you can give me a call directly or visit http://strategicanalysis.ca/Library/.

Index investors who trade only the index ETFs perhaps would do best to remain focused on only the index charts, however, to glean greater (bottom up) insight we shall take a look at some of the key sectors, beginning with the TSX Composite's most heavily weighted sectors: energy, materials and financials.

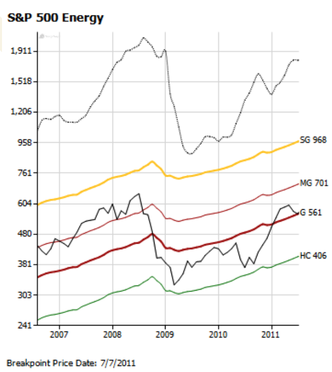


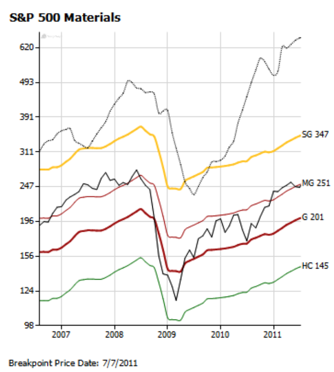


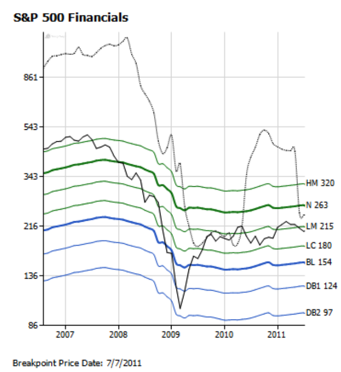


Hmmm…are they strong or weak? We see that the energy sector came down from a higher structural support in late 2008 and has now regained most of the losses but is struggling to get back into the "growth zone" as defined by SVA®. As for the materials sector (which contains Metals & Mining and Gold Producers) it did get back into the "growth zone" but looks like the market wants to see more proof of economic growth for higher prices.

Ditto for the financial sector in the "normal zone". Bottom line: if good economic times are indeed ahead of us then both energy and materials sectors will remain in the "growth zone", if only okay times, then I expect meandering about "G" and if poor times, clear market unwillingness to keep prices up and the implications of big drops as it is evident that the market has priced in "good times" indeed, at least for the TSX.



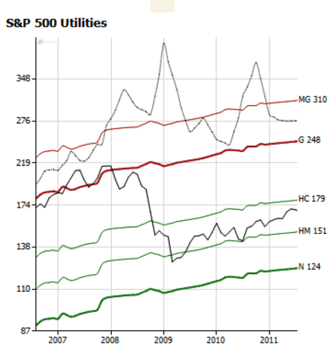


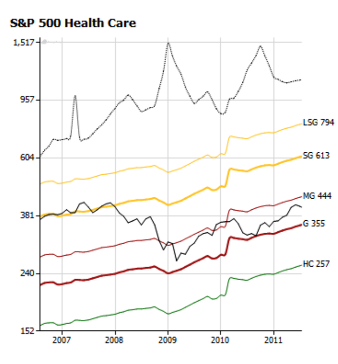


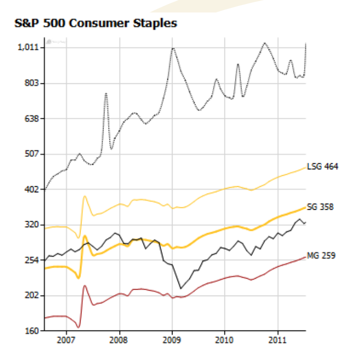
Comparing the Canadian to the S&P counterparts, Yankee oils and materials do look stronger than ours but we'll see…they are in danger of breaking supporting structural lines as they are priced like they were back in 2007-8. And their banks are struggling with their issues. Not good for any of these sectors should the economy be anything but decent, eh?

For the remaining sectors I'll use the S&P versions as that broad index is a more balanced index across the 10 sectors.

As expected, similarly high valuations for industrials and consumer discretionary sectors exist as in the oils and materials, but what about the defensive sectors – the utilities, telecomm, health care and staples? Well, the staples are trading like the Nasdaq, the health care sector is trading around the same price as it was before the crash albeit 'cheaper', and utilities sector is apparently lagging.







As evident in these key sectors, I'm going to say that the market has priced in a decent level of economic growth.

Or, perhaps, there is a new 'normal' for the markets coming up? Economic woes would trip open the trap door for those sectors that are on structural support, theoretically then exposing lower levels as potential support.

For example, if economic weakness comes too fast most likely we'll see the industrials and consumer discretionary indices falling down a structural support level (or two) too, spooking all investors and sending the weak or questionable sectors to lower supports also.

Luckily, on the sector rotation side of the coin, it appears that such sectors as the financials, health care, utilities and staples all seem to have some room to move upwards to receive fleeing investment capital and still not be too pricey or overvalued as they were in 2008 despite a weak economy.

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THE CHART PAGES

GOLD BULLION

We now own gold bullion. The risk-to-reward is strongly in our favour. We sold out all bullion last August at the highs, protecting client portfolios from the 19% drop since. This recent purchase is part one of a three tranche plan. We will add to gold on a targeted break out level.

CANADIAN BONDS

Long bonds - both CDN and US government – represented the longest positive trend in the investment world, going back 30 years. This weekly three year chart shows that the trend has not changed. We had up to 40% of portfolios in long bonds until we sold one half at the late winter 2011 peak. We anticipate another buying opportunity in the next few months wherein we intend today to add to holdings.

LOONIE

The Loonie has tracked the TSX and crude oil very closely – all three are almost perfectly correlated. Correlations, mind you, come and go. But today as goes oil so goes the other. A break below the triple bottoms lows – Sept 11', Nov 11', and May 12' – would signal a larger problem with all commodities, not just oil, and quickly usher in $0.90/USD possibly.

US DOLLAR

Of course on the other side of the Loonie as a Canadian is the US dollar. We are long a bullish dollar unit that is priced in US dollars in most client portfolios. Because the unit trades against the global basket of currencies (and is rising against them) and because it also trades against the CDN dollar (and rising against it) we are getting positive inputs from two sources. A break above levels overhead will trigger additional purchases.

THE CHART PAGES

CANDIAN EQUITIES

We own Canadian equities – Jean Coutu, Enbridge, BCE, Agrium, and TransAlta – but they are the strongest and are mostly up, substantially. As this chart indicates, the broad market which is dominated by energy, metals and mining and gold (we own none), has not been positive since early 2011. Today we expect that if the price action holds or only falls modestly (not terminal damage) in the next couple weeks and we begin to get accompanying global stimulation by major governments, particularly the US (QE III), a new positive cycle will begin lasting to the year end.

US EQUITIES

The US market is far more positively constructed than the TSX is. In fact, it's one of the strongest markets based on our proprietary relative country ranking models. It too is set up once we get through the earnings season (occurring now) and begin to hear coordinated global stimulation talks heat up for a strong run into the year end. Part of the spring in the coil that will lead to an upside move is sentiment. Right now the bears are running very high and the bulls very low.

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GUEST COLUMNIST

POST CARDS FROM EUROPE

By William Chin

A PANORAMIC VIEW

The Euro zone crisis has been and continues to dominate financial headlines on almost a daily basis. The enormous complexity of the issues is often difficult to decipher. Since these are uncharted waters, it appears that it will be the 'players' who are the key to future developments.

The Euro zone remains, in many ways, an experiment. The members share a common currency and proclaim a common monetary policy as decreed by the European Central Bank, but they do not share a common Treasury, or similar tax policies. Furthermore, the European Central Bank is responsible for the liquidity of European banks, but not for their solvency. (Supervision and regulation are carried out by the respective national central banks and the European Banking Authority, established in 2010 has the responsibility to "monitor and assess market developments as well as to identify trends, potential risks and vulnerabilities stemming from the micro-prudential level". It is the EBA that conducted the 'Stress Tests".) As a result, the cohesiveness of Euro zone members completely relies upon self-policing by each member as to whether they can stays within pre-agreed upon budget deficits and inflation targets.

As it turns out, a lot has gone wrong under this arrangement. Member countries with lower credit ratings like Spain, Greece and Portugal, accustomed to relatively weak currencies and higher interest rates in order to attract capital, found that after joining the Euro zone, they inherited a strong currency (the Euro) and much lower interest rates (each being lumped with Germany and other members with stronger credit ratings). The stronger currency eroded away their industrial competitiveness (Germany being the prime beneficiary), while the lower interest rates fueled asset bubbles like housing. A less productive economy with rising home prices eventually ended with burst housing bubbles, leaving behind mountains of debt against overpriced collateral, which has become extremely unaffordable given the weak economies. Cheap sources of borrowing also encouraged governments to borrow and spend and build bigger state apparatus and a wider safety net. The housing bubble in Spain and the bloated government in Greece are no accidents.

It is becoming ever more apparent that the weakened European banks now have too much bad debt on their books against fast disappearing capital, and governments are running enormous budget deficits. It does not take long for the credit markets to issue their judgement – they demand higher yields to compensate for these rising risks.

At first, the response from the membership of the Euro zone was to save its weakest members. Bailouts were put together and funds disbursed (to Greece, Portugal and Ireland), but these came with tough conditions. The recipient was required "to prove" that they would turn a new leaf by adopting the austerity measures imposed by external parties like the IMF. Very soon, the incumbent government lost the support from its people. The incoming governments, by default, are therefore pro-growth instead of pro-austerity; such is the case of new French President Hollande. However, they are also pro Euro, because while life is tough under austerity, it is still much better than the alternative.

It can be presumed that without the protection and bailouts from the Troika (EU, ECB, IMF), interest rates demanded by bond investors would be even higher. A return to national currencies will also mean a massive plunge in asset prices in Euro terms as the new national currency will depreciate dramatically against the Euro, in which the old debt was still denominated in. Life time savings will be wiped out, massive losses and failures will sweep across the banking sector and other creditors. Even in the best case scenario, just re-denominating everything back to the old currency represents a logistic and legal morass; no one would want to propose to their fellow citizens that much work!

ZOOMING IN

Therefore, a new game has evolved. The failing members (Greece and Spain, as the most recent examples) will want to reject austerity (or, in more formal parlance, conditionality) but still want to remain in the Euro zone; that is, give me more money, but forget the austerity. These games are at the heart of all the recent headlines. The stronger members responded with strong words and try to enforce 'conditionality' to secure the future return of their bailout money, but usually cave just at the critical times to keep the Euro zone from falling apart.

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handle. In such a case, resolves are even more difficult; will the rest of the Euro zone kick out a particular member, or might a member, especially a stronger member, leave?

As we have briefly touched on earlier, a disorderly exit from the Euro zone could be disastrous for all involved; both for the member country and for the rest of the Euro zone. An orderly exit (complete with exchange and capital controls, bank withdrawal limits etc) would be equally challenging; because if it is orderly and therefore relatively painless, other members would become tempted to leave to dodge the austerity measures imposed upon them.

With these in mind, let us look at some 'key' players:

Thus the mechanisms of the ongoing negotiations are complex and difficult to follow. However, one can still gain an understanding and follow the developments in the Euro zone with relative ease if certain underlying themes and self-interests are kept in mind.

The balance of this issue will try to provide more description and further analysis from the political, economic, and perhaps, psychological standpoints; our aim being to better define the magnitude of the problems and the behavioral patterns of the 'players' involved.

Of course, events could escalate to the point where a member state turns completely defiant, or is considered too difficult to

GERMANY

Germany, the country with the most resources and influence, has actually also been the primary beneficiary from creation of the Euro zone.

The following charts explain it very well. Without the ability to devalue their currencies, many of the entrants to the Euro zone have become increasingly less competitive, resulting in their poor export performance and high unemployment rates.

The German export machine, faced with lessened competition, and ever more receptive markets (easy money for consumers across the Euro zone) boomed.

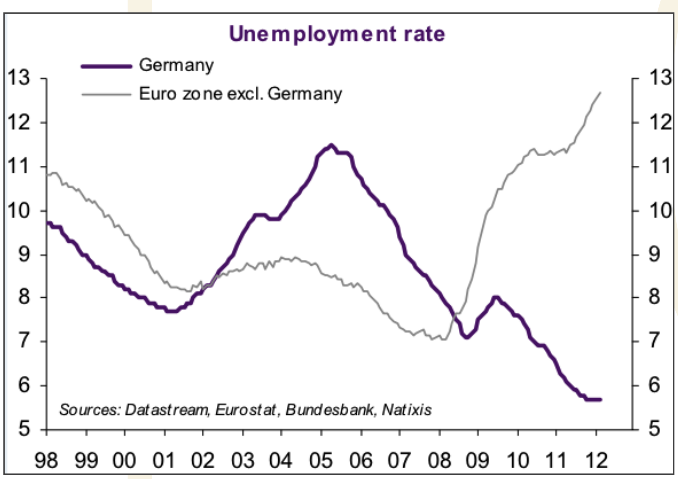

Chart: Euro Zone Unemployment Rate

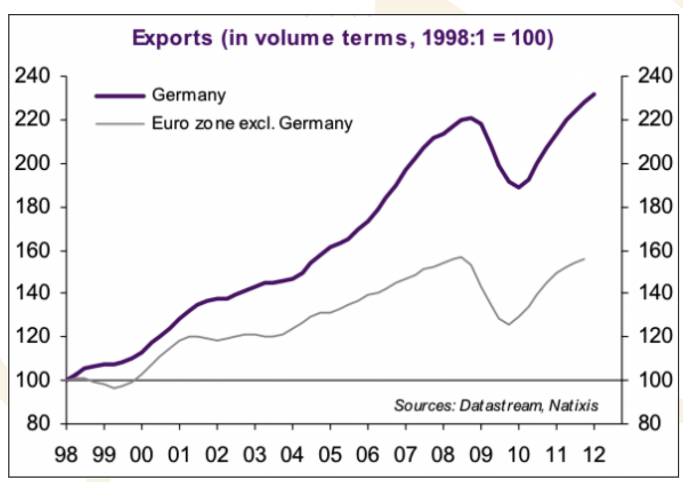

Chart: Euro Zone Export Performance

On top of that, German banks lent heavily into Greece, Spain and the other PIIGS (and into Eastern Europe, but these loans are not yet on the "radar" of the media). This lending was actually a form of 'vendor financing', creating an environment which holds enormous incentive to keep the customer(s) alive.

Of course, German taxpayers, who like most, do not appreciate the intertwined economics, are mostly disgruntled over the prospect of writing more cheques to bail out the failing member countries (and their banks). The German population (together with smaller Finland and the Netherlands) is perhaps the most anti-Euro, believing that their "hard-earned" money is being siphoned by the undeserving, out of their hands; even though its politicians might actually be 'stealthily' pro-Euro..

THE ECB

The last line of defense likely will come from the European Central Bank, who has (at least, theoretically) the power to print unlimited amount of Euros; perhaps even enough to bailout everybody, although there will likely be severe political hurdles and for certain, economic ramifications.

Putting this aside, the ECB has its own strong reasons to prevent a member country from leaving the Euro zone. Right now, all the Greek and Portuguese debt, amongst others, that are on the ECB's books through bond purchases in the open market (called the SMP – Securities Markets Program) are valued at par because the ECB is exempted from losses on such debt. A member leaving the Euro zone will by extension default on its debt, and if it is no longer a member, the ECB will have to mark-to-market on these bonds, creating huge losses.

Politically, no ECB President wants to be labeled as one who does nothing (print money, that is) while the Euro zone disintegrates. Sure enough, both the ECB and Germany continue to talk tough, each trying to extort as much as possible out of every Euro zone member. At the same time, the Greeks and the Spaniards are also aware of, and engaged in, this game of chicken; they too are trying to extract their best possible deal from the process. Spain, in their display of brinkmanship, refused to take bailout loans even as its bond yields soared, until the weekend of June 9/10 when Spain accepted a bank recapitalization bailout of 100 billion Euros which was provided with incredibly lenient terms: 3%, 15-year term including an initial 5 year grace period.

ZOOMING OUT

The ECB President, Draghi, had used extremely strong words in his recent address to the European Parliament, referring to the current framework as 'unsustainable', thus putting tremendous pressure on the EU politicians to find solutions. He is absolutely correct in his assessment. The Euro zone will either break up, or has to move into a tighter fiscal and political union. Right now, the signs are pointing towards convergence, rather than a break-up.

Ultimately, long-term political reforms must be carried out to get to the roots of this crisis, departures from the zone not being a palatable option to any party. Furthermore, Euro zone members must concede that self-policing simply does not work. A European Treasury needs to be put in place that will exercise authority to consolidate the unmanageable debts and to tax within all Euro zone member countries to service and finance these sums to bring them under control. It will be difficult to predict how such a confederacy can result from the present, but it remains a much better than the alternative to a disintegrated Euro zone. There are indications that the politicians, at least, are closer to this than before.

Clearly, between now and then, national budget deficits will get worse before they will get better. For one, Euro zone economic performance will remain very weak. Barring Germany and the other smaller "core" countries, the rest of the Euro zone will experience mild to perhaps, even severe recessions, further reducing their ability to cut budget deficits. To finance these deficits when the credit markets are skeptical, the ECB will likely be forced into action – printing more money to buy members' national debt.

It is important to note that, while the worst case scenario - one of a disintegration of the Euro zone - seems unlikely, the best case scenario will still mean years of slow growth, budget cuts, and high unemployment. This is not a path that will lead the beleaguered countries back to their previous "normal", because that "normal" is what brought them to this state of affairs. Responsible government and restrained tax-paying citizens will have to evolve, a monumental reincarnation by itself.

The reality suggests there will be tremendous volatility coming through the markets. It is clear that during times of distress, U.S. and Canadian government bonds are sought as safe havens and during times of optimism, U.S. equities clearly outperform equities of other regions. Therefore, a balanced portfolio consisted of U.S. or Canadian government bonds and U.S. equities will eventually benefit. Such a portfolio will also have a lower volatility of performance, defined by portfolio management academics as "risk".

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GUEST COLUMNIST

SEASONAL INVESTING IN GOLD AND GOLD EQUITIES

By Don Vialoux, CMT

The period of seasonal strength for gold bullion and gold stocks is approaching.

Thackray's 2012 Investor's Guide notes that the optimal time to invest in gold bullion for a seasonal trade is from July 12th to October 9th. The trade has been profitable during 11 of the past 14 periods. The optimal time to invest in gold stocks and related ETFs is from July 27th to September 25th. The trade has been profitable in 11 of the past 14 periods. Average return per period during the past 25 periods is 7.1%

Prospects for the seasonal trade this year are higher than average.

Demand for gold is increasing. Central banks including Russia, China, Japan and India are rumored to be significant buyers. China continues to take action to diversify its reserves outside of U.S. Dollar investments by adding to its gold holdings. China and India are rumored to be buyers of gold for use in a gold-for-oil arrangement with Iran. The Bank of Japan recently announced plans to increase asset purchases including the likely purchase of gold.

In addition, investor demand for gold is increasing due to concerns that central banks are trying to stimulate their economies essentially by printing more money.

The United Kingdom and Europe and China recently announced additional monetary stimulus programs and a third quantitative easing program by the Federal Reserve during this summer is widely anticipated. More money chasing a relatively stable amount of gold will lead to higher gold prices.

On the charts, gold at US$1,586 per ounce is showing early signs of recovery prior to its period of seasonal strength.

An intermediate low was reached in mid-May at $1.526.70 U.S. per ounce. Gold recovered by early June to US$1,642.40 and has formed a potential base building pattern. Strength relative to the S&P 500 Index and TSX Composite Index has been slightly positive since the beginning of April. A break above US$1,642.40 implies intermediate upside potential to US$1,766 where previous resistance is indicated.

The S&P/TSX Global Gold Index also has an improving technical profile.

The Index bottomed at 265.99 in mid-May, reached an intermediate high at 340.71 in early June and is forming a base building pattern. A break above 340.71 implies intermediate upside potential to 436 where previous resistance is indicated. The Index has outperformed gold bullion since mid-May.

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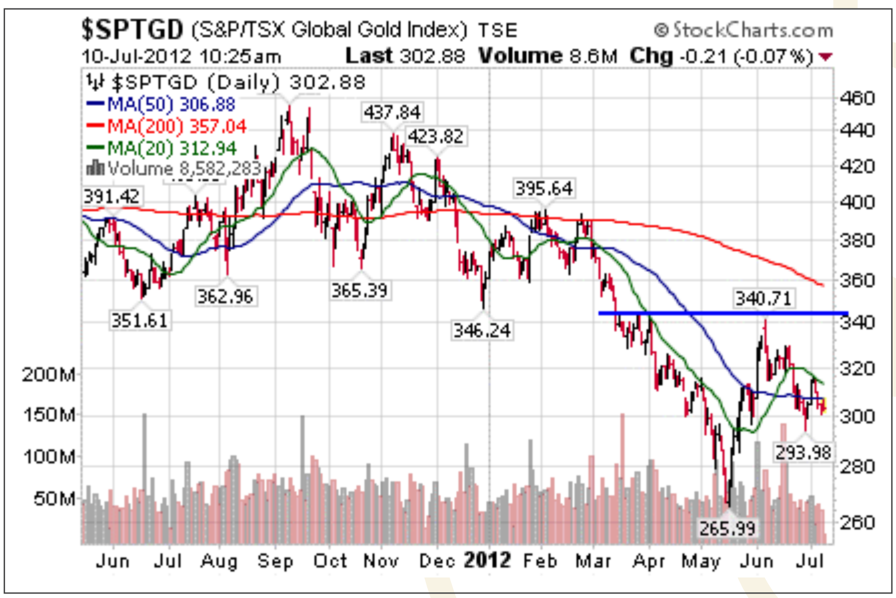
Canadian investors can choose between six gold bullion Exchange Traded Funds that trade in Canadian Dollars on the Toronto Exchange.

Selection depends upon the investor's investment objectives.

A wide variety of gold equity ETFs also are available on the Toronto Exchange.

The most actively traded equity ETF is iShares S&P/TSX Global Gold ETF (XGD $18.85)

Preferred strategy is to accumulate gold bullion, gold stocks and their related ETFs at current or lower prices for a seasonal trade lasting until October.



Jon and Don Vialoux are authors of free daily reports on equity markets, sectors, commodities and Exchange Traded Funds. They also are research analysts for JovInvestment Management Inc. Reports are available at **www.TimingTheMarket.ca** and **www.EquityClock.com**. Follow us on **Twitter@EquityClock**.