OCTOBER 2006 FINANCIAL UPDATE

My July newsletter enumerated a litany of woes providing resistance to economies and markets worldwide. The concluding sentence was "It is difficult to see how that translates into rising equity markets". Normally that would have been a very safe prognosis for the markets because September and October are the worst months for equity value increases. So, naturally, the Dow Jones Industrial Index rocketed to a new all-time high.

When an expected outcome fails to materialize, it is necessary to rethink the assumptions under which the outcomes are based or consider the facts to determine if one has overlooked some salient features and conditions. Looking firstly at the markets it is clear that the rise in equity values is not consistent across all markets. The Dow has risen almost 10% in a short time period but Nasdaq, Toronto, and the S&P 500 have been muted. Moreover, European and Asian bourses have been more consistent with the latter markets than with the DOW 30 stocks.

It is impossible to isolate the specific reasons for the Dow movement but it is most likely due to the large and liquid nature of the shares of those large corporations comprising the DJIA. To explain, it has been estimated that there are between 8,000 and 9,000 hedge funds now operating in the marketplace. These funds have huge assets and, therefore, they find it necessary to be involved with the largest and most liquid companies. Institutional investors also tend to avoid the illiquid companies and so in times of uncertainty as we are now, money tends to move toward the larger companies. A second reason relates to the DOW's relative underperformance against smaller companies in recent years. It could also be a case of the DOW playing catch up because investors view larger company shares as more reasonably valued than their smaller brethren.

Whatever the reason, nothing has emerged to alter my view that markets are fully, if not over, valued and that caution is warranted. This is the period of the year from October through May that equity markets do best. This requires a modest exposure to stocks but warrants higher than normal levels of cash.

There is a quotation that has been attributed to John Maynard Keynes that is appropriate in the present circumstances. "Markets are able to stay irrational longer than investors are able to stay solvent."

More specifically, this is the period of the year when petroleum markets strengthen. Exploration increases, weather conditions are favourable to consumption, and there is more media exposure to oil and gas in this time period until March. We have begun to experience this with the latest OPEC meeting. The weakness in the Canadian marketplace can be attributed somewhat to the weakness in energy shares.

Wayne D. Armitstead
(250)727-9275
armitstead@shaw.ca