MARKET UPDATE

Financial Velocity

Economic events are operating at the financial equivalent of warp speed. My most recent letter dated October 19, 2008 stated, “A case can certainly be made that the Toronto market could see its value reduced by half. That would mean a value of about 7,500 to 8,000 at the bottom. We are presently at slightly under 9,600 so there is room left to decline.” I expected this to occur sometime during the first quarter of 2009. In fact, the low of 7,647.11 took place on November 21.

Importance of Volume

Volume plays a significant part when analyzing securities trading. Markets are ebullient when stocks are rising and investors are aggressive buyers. Accompanying these high spirits are high trading volumes. Stock technicians compare the volume of stocks trading higher with the volume of lower trending stocks to get a picture of how overbought shares might be. Traditionally, the ratio of “up volume” to “down volume” where danger signals were given is about 10 to 1. Ratios such as that would warn investors that a sell off or at least a breather was imminent.

The same signals are given on the downside. Investors are pessimistic when down volumes significantly exceed up volumes. This was the situation from October 19 when I wrote the letter until November 21. On that day the volume of declining stocks overwhelmed the volume of rising stocks by 57 times. I have never seen markets skewed as severely as that. The market was so oversold that it then rose 20% in five trading days. The question is “Was that the bottom?”

Inflation vs. Deflation

My response is “That is the first bottom.” I expect the market to test this bottom at least once again.

Employment figures, earnings results, interest rate levels, commodity prices – almost any economic feature that can be considered - shows a global economy in retreat, investment risks being expunged, and severe psychological damage being inflicted on individuals, industries, corporations and governments.

My last letter also pondered the question of inflation versus deflation. While we are presently in the throes of a massive deflation, government action in America is setting the stage for a return of inflation. It becomes increasingly difficult to see how the monetary stimulus being injected into the financial, and other, sectors can be removed in time to prevent inflation’s reoccurrence. Inflation is a monetary phenomenon but what really ramps the problem into a crisis is the velocity of money. Velocity refers to the speed with which money is moved into and around various sectors of the economy. When there is uncertainty, as there is now, no amount of prodding can encourage economic units, whether they are individuals or corporations, to take up and spend the freely available money. But when authorities lose the ability to retrieve the excess liquidity, inflation results.

One of the most unusual features of this economy has been the strength of the United States dollar. Considering the rising unemployment rate, the distressed banking system, significantly declining earnings, corporate and individual negative outlooks, trade deficit, current account deficit, and increasing national debt it is counterintuitive to think that the dollar could be strong.

A currency is strong only so long as investors have confidence in it. I believe the U.S. currency is strong because liquidating hedge funds are repatriating their funds to the U.S. and are buying the greenback. The second reason is the uncertainty that exists globally. Traditionally, the U.S. has been the sanctuary for uncertain global investors. The strength of this movement of funds to the U.S. has largely found its way into Treasury Securities.

The purchase of Treasuries has been so massive it has caused interest rates to drop dramatically. The Exchange Traded Fund of 20 year old U.S. Treasuries has moved from $93 to $120 in slightly more than one month. This is a parabolic trajectory and is clearly not sustainable. I believe that we are witnessing a bubble in the U.S. Treasury market. A second example of an unprecedented interest rate decline is last week's auction of U.S. 3-month T-Bills with a yield of .0005%.

The strength of the greenback may be coming to an end. Technically, the dollar is weakening against many foreign currencies. If investors believe that this is a trend, the money flows will reverse. Since most commodities are priced in U.S. dollars, commodity prices could begin to rise, leading to inflationary pressures.

It is now prudent to add to precious metals holdings. Assuming that inflation risks are rising, it seems reasonable to begin increasing the percentage of precious metals in portfolios to at least 5%.

Energy

We have become accustomed to think of Petroleum Resources when discussing energy concerns. We have recently been reading some of President-elect Obama thoughts on that subject. His intention is to make the U.S. self-sufficient in Energy but considers environmental concerns part of that issue. He also realizes that petroleum will not provide the solution and has made it clear that alternative sources of energy will play a much larger role in that space. Nuclear energy investments as well as renewable energy sources will be essential investments.

Markets Going Forward

The poor economic conditions should continue to make this a trading market. We have seen the North American markets lift 20% from their bottom. Normally this would constitute the beginning of a new bull market but that is unlikely in this cycle.

I believe there is still bad news to come on bankruptcies and consumer spending and therefore expect a retest of the 7,500 to 8,000 region on the S&PTSE. I hope this price holds, otherwise we are in danger of slipping into a repeat of the Great Depression.

Should this price hold then it would be time to begin buying for the next bull market. The first clue would probably be financial companies outperforming the index. I also think that technology companies and energy stocks will outperform in the initial stages of the new bull market.

It is difficult to tell when we might see this change but it will come from a severely depressed investor base and quite likely when important publications begin predicting a new Great Depression. The speed with which the economy and markets are moving could see this resolved by the end of the first quarter next year.

In previous recession bottoms we saw wonderful companies in such bad condition that they were selling convertible securities with high coupons and low premiums. We have already seen that happen in the U.S. with Berkshire Hathaway investing in General Electric and Goldman Sachs. We will try to have plenty of room to put those in the portfolio.

Wayne D. Armitstead **December 17, 2008**