



Investment Outlook

April 2006

Unconvincing Gains

2006 started with a bang. In our January *Outlook* commentary we noted the excitement that gripped cable television reporters as the Dow Jones Industrial Average passed the 11,000 point threshold. Indeed, the first quarter of 2006 proved to be a good quarter for equity investors. The U.S. stock market rose a little more than 4% (its best start in years) and the Canadian market was up a whopping 8%. While these gains were led by the advance of shares in the energy and metals and mining sectors, other sectors, such as financial services in Canada and telecom services in the U.S., also performed well.

While we admit to enjoying the pleasure afforded by these continuing gains, we must also confess that we are a little surprised by how strong the markets were over the quarter. Without doubt there was good news. Despite a slowdown from previous quarters, economic growth in both Canada and the U.S. remained on solid footing and inflation data remained contained. However, there were also developments that ought to have worried investors. Oil prices moved back to their highs, squeezing companies and consumers alike. Gold, traditionally a harbinger of inflationary fears, or reflecting worry over the value of the U.S. dollar, has also resumed its upward march. Most importantly, interest rates, which befuddled most analysts in 2005 by continuing to fall, now seem to have some sustainable upward momentum.

To us, there is a disconnect between the mixed flow of news over the last quarter and the strong gains in stock markets. Accordingly, we find the gains of the last quarter unconvincing – perhaps based more on hope than on strong underlying fundamentals.

Is America's Resilience Waning?

Of the many risks we have monitored over the last several years, the potential for financial crisis in the U.S. remains high on the list. We've written frequently in the past of the many challenges faced by the U.S. and, despite our concerns, its economy has remained robust, the U.S. dollar has remained strong and consumers have remained resilient. Perhaps they always will. Nevertheless, we remain particularly worried about the U.S. trade deficit, which continues to grow month-by-month. As we've explained in the past, the U.S. relies on the kindness of strangers – principally foreign central banks – to finance its massive trade shortfall. With the announcement over the last quarter that the Bank of Japan may finally begin to raise rates, competition for the capital that the U.S. so desperately needs may intensify.

We've also written about the state of the U.S. housing market and discussed the possibility that it may be over-extended. Recent housing statistics seem to firmly indicate that a pull-back is at hand. For example, aggregate February new home sales fell 10.5%, the worst month-over-month decline in a decade. Home sales for "investment" (i.e., speculative) purposes fell 20%. Total new home sales have now fallen in five of the last seven months. At the same time that new houses aren't selling, housing starts, a measurement of the new supply coming to market, have continued unabated. The result of this disconnect is manifest in the inventory of unsold new homes in the U.S., which has risen to the highest level in ten years. Prices are also softening: the median new home price is down 2.9% year-over-year and 5.5% since the market peak in October. As David Rosenberg of Merrill Lynch points out, on average, anyone who has bought a home in the U.S. since the end of 2004 is under water.¹ And since much of the inspiration for consumer spending over the last five years has come from rising home equity, this is clearly not a positive development.

Exacerbating the risk posed by the weak housing market is the sustained rise in interest rates during the period. Early in the year, markets were buoyed by the sense that the U.S. Federal Reserve

¹ David Rosenberg, "Has the Roof Collapsed?", Merrill Lynch, 24 March 2006

might soon be finished raising short-term interest rates. It was not welcome news, therefore, when the press release following the March Fed meeting, led by new Chairman Ben Bernanke, spoke of the need to continue to raise rates. And, unlike 2005, when long rates continued to fall even as the Fed was raising short rates at meeting after meeting, the entire U.S. yield curve has moved significantly higher in recent weeks.

In sum, there seem to be many ways in which things can go wrong for the U.S. economy. What seems certain, however, is that in the face of rising energy prices and interest rates, and with falling housing values, the U.S. consumer will not be the source of robust economic growth. Whether the events we have described translate into a mild slowdown, such as now seems underway, or something more significant, remains to be seen.

Proud to be Canadian

Canada remains the envy of many in the Western world. Our economy is strong, our many resources are in demand, and our government finances are being managed responsibly (at least comparatively so). Perhaps the big news over the past quarter was the election of a new government and a new Prime Minister. For investors, the new government brings with it the hope that we might ultimately enjoy lower taxes on dividends and lower taxes on capital gains. Yet while the Conservative government has espoused a number of policies that are very sensible from an economic or investment point of view, it remains to be seen how much they can accomplish in a minority parliament.

While headline data on the Canadian economy are impressive, the economic dichotomy that we described in previous *Outlooks* continues to dominate the Canadian landscape. Our resource sector is hot and our industrial sector is not. While the Canadian dollar seems to have stabilized for the time being in a range between 85¢ and 88¢, it is still at a level that presents immense challenges to the industrial base in Ontario and Quebec.

As much of our current prosperity relates to the boom in many commodity markets, it is natural to question the sustainability of the boom. The case for continued strength in metals and energy is well-told and compelling. It is premised on the assumption that the industrialization of China and India will ensure that demand for raw materials remains strong for years, perhaps decades, to come. On the other hand, we naturally worry about things when they seem too good to be true. In a very thought-provoking piece, Merrill Lynch strategist Rich Bernstein tried to quantify the same worry.² He looked at the price of different commodities that are demanded by industrializing economies. Some, like copper or nickel, trade on exchanges and can be bought for industrial uses or as speculation. Others, like steel or rubber, do not trade and can only be purchased for real use. Bernstein discovered that escalation of the price in tradable commodities compared to non-tradable commodities has never been more extreme. In other words, speculation, not Chinese or Indian industrialization, accounts for a large component of the increase in many of the traded commodities. At present, Canada is rolling in its resource riches. Time will tell whether some of that is illusory.

Investment Posture

Warren Buffett once observed that it is reasonably easy to predict what markets will do, it is just impossible to predict when they will do it. Regular readers of our *Investment Outlook* will note that we have been reasonably cautious about the markets for many quarters, yet they have moved smartly higher. The ungenerous among you might call us “wrong”. Those feeling more charitable might call us “early”. The good news is that, despite our caution, client portfolios have prospered throughout this period.

Given the risks arrayed on the investment horizon we believe that it is not the time to lessen our vigilance. One of these days, preserving capital will be talked about as openly as outperforming benchmarks. Stocks won't go up every quarter and every year. Over time, however, a diversified selection of well managed and reasonably valued companies will enable portfolios to earn a good return and our clients will generate additional real wealth.

² Richard Bernstein, “Commodity Speculation & Materials Stocks”, Merrill Lynch, 10 April 2006.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>March 31, 2006</u>	<u>December 31, 2005</u>
TSX Composite Index	12,111	11,272
91-Day T-Bill Yield	3.86%	3.46%
30-Year Canada Bond Yield	4.26%	4.03%
Prime Rate	5.50%	5.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.8568	\$0.8598

United States

Dow Jones Industrial Average	11,109	10,717
Standard & Poor's 500 Index	1,295	1,248
30-Year U.S. Treasury Yield	4.89%	4.53%

Market Returns For Periods Ended March 31, 2006 ⁽¹⁾

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years ⁽²⁾</u>	<u>Last 10 Years ⁽²⁾</u>
SC 91-Day Treasury Bills ⁽³⁾	0.8%	2.8%	2.9%	3.8%
SC Universe Bond Index ⁽³⁾	-0.4%	4.9%	7.0%	7.7%
TSX Composite Index	8.0%	28.4%	11.7%	11.2%
S&P 500 Index (C\$)	4.3%	7.8%	-2.1%	7.3%
MSCI EAFE (C\$)	9.5%	20.0%	3.2%	4.9%

Footnotes:

(1) Represent total returns, including income and capital appreciation (or depreciation).

(2) Compound average annual return.

(3) Scotia Capital Inc. index returns.