



Investment Outlook

July 2006

It Isn't Supposed to be Easy

Sadly, all good things must come to an end. In fact, we started our *Outlook* comment three months ago with the suggestion that the strong stock market gains of the first quarter seemed a little at odds with the mixed economic conditions we observed. As luck would have it, within days of when we mailed the *Outlook* to clients, stock markets in Canada and the U.S. commenced a significant correction.

After several years in which investors enjoyed abnormally low volatility in stock markets, volatility has returned with a bang in 2006. Between January 1st and April 19th, the TSX Composite Index rose 1,215 points (10.8%). From April 20th until June 30th, the TSX gave back 874 of these points (-7.0%). But for a rally in energy stocks over the last few trading days of the quarter, the TSX would have given back all of its first quarter gains over the course of the second quarter.

What's troubling the markets? Ongoing terrorist plots, missile tests by North Korea, and the worries about Iran's nuclear ambitions certainly don't help. But the reality is that we face pretty typical conditions for late in an economic cycle, namely, slowing economic growth, pressure on inflation, and an increase in volatility in stock markets. Such conditions are challenging for economic policy makers and investors alike. As stocks raced ahead in the first quarter, investing seemed easy. It isn't supposed to be easy.

Still Happy to be Canadian

In Canada, economic conditions continue to be among the best of any industrialized nation. Economic growth remains decent, and inflation, while higher than it was a year ago, remains much less of an issue than in the U.S. By any measure, the West is booming. While the manufacturing-based economies of Ontario and Quebec aren't quite so robust under the weight of our rising currency, so far they have adjusted to a stronger Loonie better than we had anticipated.¹

On July 11, after more than doubling the Bank Rate from its August 2004 low of 2.0%, the Bank of Canada paused its program of interest rate increases and left the Bank Rate unchanged at 4.25%. In the accompanying press release, the Bank expressed its belief that it had reached a neutral policy stance and re-confirmed its outlook for balanced growth and modest inflation. Good news for Canadian investors. The only concern we have with the Bank's statement is the fact that one basis for its pause is the expectation that Canadian growth will slow as the U.S. economy slows and our strong currency undermines exports. As well, the effects of higher interest rates and higher energy prices on domestic demand take time to work their way through the system, and the Bank will be attentive to any monetary adjustments that might be needed to adjust for the effects of these factors.

The *Outlook* primarily is concerned with the economic and investment environment we face and typically avoids issues that are political in nature. Nevertheless, in our opinion, an important development of the last six months is that the new Harper government is doing a better job than was widely expected. Confidence in the government by domestic and international investors obviously is helpful to the investment environment. As well, the government has followed through on many of its campaign commitments related to easing the tax burden on investment returns. For this we are truly grateful, and hope for more to come!

¹ Recall earlier discussion of the "Dutch Disease", where rapid currency adjustments undermine a country's industrial base.

Walking a Tightrope in the U.S.

As implied by the Bank of Canada's recent statements, and as has been the case for some time, economic conditions remain relatively more worrisome in the U.S. than they are in Canada. While growth remains positive, the U.S. economy clearly is slowing from earlier periods. As well, many of the risks we have articulated in the past – a burst of the housing “bubble”, the excessive levels of consumer debt, rising energy prices, a weakening currency, and its breathtaking trade and budget deficits – continue to plague the U.S.

Repeatedly, we have described how U.S. consumers sustained economic growth by borrowing against the growing equity in their homes and taking the proceeds to the mall. In recent months, evidence is building that the housing market may no longer support these sorts of transactions. While existing home sales dropped by a modest 1.2% in May, the real story seems to be in the number of homes listed for sale which are not selling. The inventory of detached homes for sale now sits at 6.3 months of sales, up 50% from a year ago and at a nine-year high. Condominium inventory is at 7.9 months, the highest level ever recorded by the National Association of Realtors. Unsurprisingly, with this backup in the housing market, mortgage re-financings have fallen 54% from June 2005.² The concept of a house as an ATM, as it has been described by several commentators, may be a thing of the past.

Indeed, retail sales in recent months have been weak as consumers have been pinched by the softening of the housing market, rising interest rates and rising energy prices. At the same time, inflationary pressures – fueled by full employment and high raw material prices – have not moderated in the same way. The U.S. Federal Reserve faces a tough choice between continuing to flex its inflation-fighter muscles by raising rates higher, and taking its foot off the brake to see how the slowdown plays out. The Fed has faced this situation in the past and often got it wrong, usually by over-tightening. It will be interesting to see how the new Chairman, Ben Bernanke, handles the challenge. So far, he has not won the confidence of investors.

Whither the Markets?

The bumpy ride in Canadian stocks over the last three months has been widespread, and particularly significant in the shares of energy and mining companies. Avid readers of the *Outlook* will recall that in our April edition we referred to some work on commodity markets by Rich Bernstein of Merrill Lynch. Bernstein attempted to demonstrate that the sharp rise in commodity prices was driven as much by speculators as it was by real demand. Despite the pull-back in commodity prices and mining stocks over that last three months, Bernstein recently updated his work and found that, while less so than in April, prices of many commodities still are trading at levels that are consistent with a significant speculative component.³ How energy and mining stocks perform over the next several quarters will obviously have a significant impact on Canadian market returns.

Uncertainty and volatility are part of the cost of doing business in the stock market. Our comments above suggest that these two challenging aspects of investing are at heightened levels at the moment. Will the U.S. Federal Reserve tighten too much and send the economy into recession? Will it pause too early and allow inflation to gain a further toe-hold? Will the strength in the Canadian dollar finally undermine the ability of Canadian exporters to compete and cause new economic problems in our own economy? Is Rich Bernstein right about speculation in commodities, and will there be a collapse in these markets when speculators all try to get out the door at the same time, as seems to always happen. Our crystal ball seems unusually cloudy at the moment. What we do know is that we believe the portfolio of companies in which we are invested will earn more money next year than they will this year. And we fully expect them to earn more the year after that. By investing in growing businesses at reasonable prices, we expect to earn good investment returns over time. Keeping one's discipline and long-term perspective is never more important than when the near term is uncertain.

² Housing data from David Rosenberg, “Housing Update: Finding Some More Loose Bricks”, Merrill Lynch, June 28, 2006.

³ Richard Bernstein, “Still Significant Speculation in Commodities”, Merrill Lynch, July 10, 2006.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>June 30, 2006</u>	<u>December 31, 2005</u>
TSX Composite Index	11,613	11,272
91-Day T-Bill Yield	4.30%	3.46%
30-Year Canada Bond Yield	4.61%	4.03%
Prime Rate	6.00%	5.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.8969	\$0.8598
<u>United States</u>		
Dow Jones Industrial Average	11,150	10,717
Standard & Poor's 500 Index	1,270	1,248
30-Year U.S. Treasury Yield	5.19%	4.53%

Market Returns For Periods Ended June 30, 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⁾	0.9%	3.2%	2.9%	3.7%
SC Universe Bond Index ⁽³⁾	-1.6%	-0.7%	6.9%	7.3%
TSX Composite Index	-3.5%	19.6%	10.5%	10.6%
S&P 500 Index (C\$)	-5.9%	-1.2%	-3.6%	6.2%
MSCI EAFE (C\$)	-3.8%	15.1%	3.4%	4.3%

Footnotes:

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

(2) Compound average annual return.

(3) Scotia Capital Inc. index returns.