

## Investment Outlook

July 2007

*It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair...*

Charles Dickens, *A Tale of Two Cities*

### A Tale of Two Markets

The opening lines of Charles Dickens', *A Tale of Two Cities*, allude to a tension in society and evoke a certain confusion over the environment in which his characters find themselves. We think that such a theme also describes the current investment environment. Using a more modern cliché we might ask whether the glass is half-full or half-empty. There seems to be a paradox at every turn as economic data and anecdotal evidence variously support the conflicting perspectives of the bulls and the bears.

As an example, North American stock markets are vibrant at the same time that the Canadian and U.S. economies are slowing. Within Canada, activity in the resource-rich West is booming at the same time that the rising Canadian dollar is seriously undermining the manufacturing economies of the East. In the U.S., watchers of the housing market, and the associated debt markets, remain on a death watch at the same time that U.S. consumers keep spending and employment rolls remain remarkably robust.

As we have discussed before, perhaps the most powerful leading economic indicator is the stock market. Canada's benchmark stock index, the TSX Composite, returned almost 23% over the last 12 months. Other markets also performed well. In the U.S., the Standard & Poor's 500 Index provided a 15% return in Canadian dollar terms (21% in US\$ terms). The Morgan Stanley EAFE Index, which measures stock market returns in most developed countries in the world other than Canada and the U.S., returned 21% in Canadian dollar terms. Stocks seem to be telling us that good times lie ahead.

In contrast, the market for goods and services – the economy – is perhaps not quite as vibrant as the stock market would suggest. In Canada, real GDP growth is expected to slow from a 2.7% rate in 2006 to 2.2% in 2007. In the U.S., 2007 growth is expected to be 2.1% compared to 3.3% in 2006. In both cases, growth will remain positive, but hardly the typical recipe for exciting stock market gains.

### The Resilient Americans

We commented in our April *Outlook* that the U.S. housing market, after a period of excessive growth, was finally showing cracks. This causes us concern because of the impact that falling house prices could have on consumer spending, which represents 70% of the U.S. economy. Over the last three months, the housing market has continued to weaken. To date, the decline has been orderly, but recent statements out of U.S. homebuilding companies suggest that no end to the downturn is in sight.

The risk to consumers from falling house prices is magnified by the extraordinary levels of debt taken on to finance them. We mentioned the specific issues around sub-prime mortgage debt in April and could write for pages on the topic. Clients may have read some of the extensive media coverage afforded the recent crisis at two Bear Stearns hedge funds investing in such securities. Instead, we will simply remind clients that the debt problem is large and the risk of negative financial repercussion real. One recent report highlighted that 23% of Americans with adjustable rate mortgages currently have *negative* equity in their

homes. The face value of these loans totals about \$693 billion. Losses could total hundreds of billions of dollars even if home prices fall no further and interest rates climb no higher.<sup>1</sup>

The wealth effect from rising house prices, and the mountain of mortgage debt that was added, had a huge impact on fueling economic growth in the U.S. between 2000 and 2006. This game is now over, and many fear that the positive impact this had on consumer spending will reverse. So far it has not; instead, the economy has simply slowed. The U.S. economy has been remarkably resilient based on continued strength in employment and interest rates that, even after a recent move higher, remain low by historic standards. While many Americans may have negative equity in their homes, they need somewhere to live. If they keep their job and can afford the interest payments, they may just keep paying, and the U.S. economy may keep chugging along.

### **Canada's Dirty Little Secret**

From the outside, Canada is the envy of the world, and certainly one of the most robust economies in the G8. In early July, the Bank of Canada raised short-term interest rates to moderate the economy and indicated another hike may be required. The strength in global growth, beginning in 2003, has been a huge benefit to our economy and financial markets. Canada is rich in natural resources, something that the world needs desperately to fuel its growth. Our prosperity is most obvious in Alberta, where strength in oil prices has lined the wallets of its citizens and paved the streets with gold. It is, indeed, the best of times in the West.

In contrast, the outlook in the manufacturing heartland of Ontario and Quebec is considerably more fragile. We have written before about the "Dutch Disease", which is the concern that our soaring currency will undermine our export industry. Between mid-2002 and mid-2006, the trade-weighted value of our currency appreciated 36%. In 2007, the currency has appreciated another 10% to a new 30-year high over 95¢. Currency movements typically take two or three years to fully impact the economy. So far, Canadian exporters have shown considerable resilience to this competitive headwind. With the large appreciation since March still to be digested, it is unclear whether this resilience can continue. Given the risks to U.S. consumption, and currency effects still to work through the system, it may be that our export industry faces a rough patch even as prosperity remains in the West.

### **One Day, Quality Will Matter**

Thankfully, clients don't pay us to predict the path of short term economic growth. Instead, we worry about evaluating the long-term prospects of individual companies in which to invest. The themes we have discussed present a backdrop for the sorts of companies we think will do well in the period ahead. We continue to favour companies that might be considered "defensive" in the sense that their business can do well even if economies in Canada and the U.S. continue to moderate, or even falter.

So far, our preference for quality has not paid the really big dividends we expected. Our stocks have done well; however, the surprising resilience of the U.S. consumer and the unrelenting flood of global liquidity has supported all stocks. Excess liquidity most recently has manifest itself in a torrent of mergers and acquisitions, most notably highly leveraged buyouts by private equity firms. The proposed takeover of BCE is probably the most public of these in Canada. Remarkably, 44% of the TSX's impressive 12-month gains have been provided by takeover premiums rather than fundamental stock performance. In the mining sector, takeover premiums have represented 100% of the gain.<sup>2</sup>

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<sup>1</sup> Stephanie Pomboy, MacroMavens, quoted in *Barron's*, July 9, 2007.

<sup>2</sup> CIBC World Markets Monthly Indicators, May 17, 2007.

We have been fortunate to have benefited somewhat by the current flurry of takeovers, but remain committed to our cautious approach to investing. We remain pretty fully invested, but defensive stocks continue to have much greater appeal than more economically sensitive ones. One of these days quality will matter, and we expect our more defensive stock selections to yield significant rewards.

## FINANCIAL MARKET SUMMARY

### Market Levels

<u>Canada</u>	<u>June 30, 2007</u>	<u>December 31, 2006</u>
TSX Composite Index	13,907	12,908
91-Day T-Bill Yield	4.43%	4.15%
30-Year Gov't of Canada Bond Yield	4.49%	4.14%
Prime Rate	6.00%	6.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.9404	\$0.8581

### United States

Dow Jones Industrial Average	13,409	12,463
Standard & Poor's 500 Index	1,503	1,418
30-Year U.S. Treasury Yield	5.15%	4.81%

### Market Returns For Periods Ended June 30, 2007 <sup>(1)</sup>

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years <sup>(2)</sup></u>	<u>Last 10 Years <sup>(2)</sup></u>
PC Bond 91-Day T-Bill Index	1.0%	4.3%	3.1%	3.8%
PC Bond Universe Bond Index	-1.7%	4.8%	6.0%	6.4%
TSX Composite Index	6.3%	22.7%	16.6%	9.9%
S&P 500 Index (C\$)	-2.0%	15.0%	3.1%	4.4%
MSCI EAFE (C\$)	-1.9%	21.1%	9.6%	4.9%

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#### Footnotes:

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

(2) Compound average annual return.