In Your Interest
2006 INVESTMENT OUTLOOK

It is said that the most useless investment advice comes from predictions, whether these be earnings per share, future interest rate prices or a country's gross domestic product growth. So why is it that each New Year brings forth the pundits? In my case it is probably because of my background in sports. It was always necessary to have a game plan or strategy based on previous scouting reports (last year's economic conditions) in order to prepare for the upcoming contest. Hopefully, the prior year's predictions bear some resemblance to actual events.

Last year my prediction was an expectation that stock and bond markets would be "down, and quite probably, significantly". Wrong. The major American indices were positive but barely so; while the Toronto market was up nearly 20%. U.S. ten-year bonds were off 2.3% but similar Canadian bonds were ahead by 12%. So the Canadian markets were much stronger than their U.S. counterparts.

I expected the U.S. dollar to be strong and wasn't disappointed. I wrote "The concern about a collapsing dollar has gained such credit that it is now approaching conventional wisdom. Therefore it is likely that the dollar will begin to stabilize." From the beginning of 2002 to the end of 2004 the US$ index went from 120 to 80. Last year it recovered to 91. More specifically, at the beginning of 2005 the US$ could buy only .6 of a Euro. At year's end it bought .73.

I also suggested that the gold price could strengthen as creditor nations began to convert some of their long bond holdings to gold. Gold moved from about $420 per oz. to over $500 by the end of December. All metals were strong with copper leading the pack. The evidence is that most of this movement was caused by hedge funds in America and retail investors in China and India. This year the buyers could be the Central Banks of those two "developing nations". Obviously I expect a continuation of the move in precious metals.

The major reason that I predicted a market downturn last year was because of the bullish attitude of most investors. That ebullience does not exist at this time. Yet I am still very cautious. I will repeat what I wrote last year. "But, in my view, the most important influence on the market will be the level of interest rates. Both short and long rates will need to rise in the U.S. this year. Over time this rise will make stocks less attractive than fixed income. It should also influence rates worldwide and the money on the sidelines is more likely to move towards fixed income."

It must never be forgotten that the most influential economy and market is still America. They still have an enormous current account and trade deficit and their national debt is beginning to destabilize world economic conditions. So I believe that my last year's prediction has been delayed in the United States – kind of marking time. This is the second year of a President's term, which is the worst performing year for the stock market in the U.S. Caveat emptor.

The most surprising event last year was the performance of the Income Trust market in Canada. This was partly caused by the inept handling of this file by the Finance Minister. But the poor performance of the I.T. market was also influenced by the short history of this asset class and the market's misunderstanding of this investment.

The rise of this investment class is directly related to taxes and low interest rates and a trade-off between risk and reward. Capital gains have the lowest tax rate but the highest risk. Interest has the highest tax rate but the lowest risk. Dividends on Canadian companies is intermediate between the two classes. But dividends are taxed doubly; they are levied once on the corporation after expenses but before dividends and once again in the hands of the investor after they have been declared by the corporation. Obviously, a way to circumvent this double taxation is to eliminate one of the sets of taxes. Voila the Income Trust.

This investment is set up so that the income generated is not taxable to the company and all or most of the cash flow is distributed to the investor. This allows the company to pay a larger amount of income than a normal company because it does not need to retain capital to grow its business. So, the ideal investment trust is in a slow growth or "sunset" industry that has no need for the copious cash flow that it generates. This is an ideal investment for a person who has need for income, does not wish high risk and whose income tax level is relatively low. So it was largely an investment for retirees. Initially, the government found this an acceptable and beneficial investment.

More recently, Finance became concerned because of the tax leakage that was occurring. Remember the double taxation? But there were other problems. Pension funds and nontaxable entities were not initially interested because these investments were not subject to limited liability. When this changed and the pension funds became investors the number of companies converting to the I.T. model became a torrent. Finance then became concerned that the structure would lead to depletion in growth companies which are traditionally the ones that create most of the employment growth. When Finance then announced a probable change in the tax status, the sector imploded.

My suggestion: do not believe that this investment sector is rational. Uncertainty creates opportunity. But tread carefully. One of my investment beliefs is that one should try to own investments that pay a regular income because one may never be sure when the market will zig when you thought it would zag. This problem with I.T. is verification of that principle. So although the capital has declined, it is unlikely to be permanent and, in the meantime, the investment is providing income.

A second surprise this year was the strength in petroleum prices. This factor and metals prices were largely the cause of the TSE strength. I have difficulty believing that we will see $105 oil in the near future but I have no trouble recommending significant holdings in oil and particularly natural gas stocks for the foreseeable future.

Will this be the year that the U.S. economy succumbs to the overabundance of government and personal debt? Consider these statistics: In 1985 Real Estate assets as a percent of U.S. Gross Domestic Product was 100%; in 2005 Real Estate assets have risen to be 150% of GDP.
In 1955 household mortgage debt was 20% of GDP; in 2005 it is 65% of GDP. I would call that a bubble. The author of the article containing these statistics concludes, "…this unprecedented dependence of the U.S. economy to real estate will force the Fed(eral Reserve Bank) to react at the first weakness in housing."

So to conclude this missive we think that precious metals will continue to climb and interest rates are likely to move higher as well. The U.S. stock market should decline because of the interest rate movement and because of the historical second year presidential cycle. Fixed Income should decline because of the rise in interest rates. House prices are very likely to weaken especially in the U.S. and the U.S. dollar could resume its slide against international currencies. Oil prices should remain higher than $35 but will weaken from their present price as we move into spring and summer. My guess would be that only a political shock will move prices over $70.

It may interest you to know that the historical P/E of the market averages 20 minus inflation. Thus if the inflation rate is 5% the average P/E should be 15. In the late 1970's the P/E was about 7 when inflation was rampant. In a perfect world of no inflation we would pay about $20 for $1 of earnings. Historically, earnings have grown at about 7% and investors have generally been willing to pay 2 times for that growth rate of top companies. In other words investors are willing to pay $14 for a dollar of earnings for a top company. The average dividend paid is, historically, 3%. So if you add these two numbers you get 17 which is close to the average historical P/E. And the historical average inflation rate is 3%. The average P/E is 17 (20 minus 3). This information provides you with a simple tool to determine if a stock may be over or under valued. Then you look at the rest of the important factors to conclude the analysis.

May 2006 bring you health and happiness. And may I provide some of the rest.

Kindest regards,

Wayne D. Armitstead