2007 INVESTMENT OUTLOOK

Prognostication is not a four-letter word although it sometimes feels like it to those who practice it. The practitioners of the art do so by proffering their head to the audience. They either have it handed back to them on a platter or adorned with garlands. It is time, once again, to review last year's letter and suggest a likely economic passage for 2007.

History has not been kind to me. The historical record shows that the first two years of Presidential terms are likely to be down to flat. Since 2005 and 2006 were the first two years of the most recent term, and with all of the problems of debt and deficits in that fair Republic, I suggested that the market was likely to swoon. The prediction that the markets would be down both of those years managed to be wrong both times. On the positive side, we managed to make money in all of the portfolios in spite of those calls.

The rest of the crystal ball for 2006 was relatively clear. We suggested that precious metals would continue to move higher. The price of an ounce of bullion moved from about $520 in January to $600 by year-end with a spike to $700 in May.

The call that long-term interest rates would move higher, causing bonds to decline, was also correct as long term rates finished the year higher than the start.

A quote from last year's letter was "House prices are very likely to weaken especially in the U.S. and the U.S. dollar could resume its slide against international currencies." Both of those predictions came to pass and the worst investment move last year was probably not selling short the U.S. housing stocks.

There was an atmosphere of panic in the petroleum complex in late December. If you recall, natural gas prices neared $15 per million B.T.U. and, amid fears of $105 per barrel of oil, I suggested that oil was likely to decline considerably. Oil ended the year near $60, and natural gas near $6/mmbtu.

Quite a lot of effort in last year's letter was spent reviewing the Liberal government's efforts to destroy the Income Trust market. I suggested that it was quite likely that prices would recover, which they did. The Canadian public then tossed out the Liberals and elected the Conservatives in the late winter election. Almost exactly one year later the Conservatives did exactly the same thing to the Income Trust market. It would be useful to review the comments about Income Trusts in that letter. If you have "lost" last years Outlook and are interested, you can find the letter on the website, www.armitstead.ca.

One positive outcome of the Income Trust controversy was the increase in tax benefits that accrue to dividends on Canadian corporations. For those of us who believe in dividend-paying investments, this was an unexpected bonus.

The factor that was overlooked the past two years was the excess liquidity in the financial system. Liquidity is a fancy word for "easy money". When banks have cheap and available credit, individuals and businesses tend to borrow more readily and this greases the wheels of commerce. The Federal Reserve Board in the U.S. is the prime source of liquidity in the U.S. but there are other sources of liquidity as well. As an example the Japanese central bank, in an attempt to stave off deflation in that country, dropped short term rates to 1% and below for years in the 1990's. This led to what was called the "yen-carry trade" in which investors, worldwide, borrowed funds in Yen for costs of 1% and invested in other countries for higher yields, earning the yield differential.

This excess liquidity was one cause of the asset bubble in Nasdaq stocks. The Index went from less than 1,000 to over 5,000 in March of 2000. The Fed drained liquidity from the system causing the Nasdaq to retreat from its high back to 1,000 in November of 2002.

In the meantime the tragic events of September of 2001 occurred in New York. Additional liquidity was injected into the system to counter this trauma producing the consequent real estate bubble. For the past two years the Fed has been draining funds from the system to counter that problem. The big questions in the markets at present are "Has the Fed gone too far?" and "Will there be a recession in the near future?"

The third year of a Presidential term is usually very positive for equity markets. Using history as a guide one would normally predict 2007 as a positive year. And the majority of financial pundits are saying so. But there are still major distortions in the system. The American consumer whose activities govern 70% of their economy is heavily indebted and the wealth effect from high house prices has decreased; the U.S. Federal government still has huge deficits and debts; petroleum prices seem to be determined more by global politics than by supply and demand; and weather has a strong effect as well and the weather is totally unpredictable.

My strongest feeling is that the Fed has wrung the excess liquidity out of the system. This should lower economic activity. It should result in slightly higher jobless numbers and unemployment. This should, in turn, reduce interest rates both short and long term. If rates drop, there is a possibility of price/earnings ratio expansion and so the stock markets may not be harmed as earnings growth slows.

My predictions are for slightly rising bond markets and slightly falling or stable equity markets. At present the precious metals supply/demand equation appears to be in balance. Petroleum markets should trade with a slightly upward price bias. The portion of the commodity market that may be surprisingly strong are the grains because alternate fuel demand is growing using grains as one source.

What would compromise these forecasts? An extension of Middle East hostilities would raise energy prices as well as contribute to falling stock prices, faster rising bond markets and a strong precious metals group. I have a controversial suggestion. Google might be a better short than a long this year.
Best wishes on a pleasant and rewarding 2007.

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