

MARKET UPDATE

The Toronto Stock Exchange is sitting near an all time high. The Dow Jones Industrial Average IS at a closing high. The Nasdaq Exchange is at its highest point since it suffered its meltdown in 2000.

The financial news is replete with new takeover stories and equity buyouts. Interest rates are at near historic lows (at least since the 1950's). Inflation is placid. Jobs are plentiful – in fact there is a shortage of skilled labour, especially in Western Canada. Obviously then, stock markets are on a roll and one should be fully invested to take advantage of this opportunity to become wealthy. That is, perhaps, the conventional wisdom.

I am very concerned that stock markets are near a tipping point into a bear market. A number of events occurred last week that were very unsettling. I would like to make some comments regarding China, Banks, Equity Takeouts and the United States economy.

China has a population of 1.3 billion people. India has almost 1 billion. Russia has discovered capitalism (so to speak). And Brazil is the new economic power from South America. These countries represent BRIC, the new financial Atlantis toward which, it is suggested, that new investments should be targeted. I admit that I am not totally familiar with all of these nations but I am familiar enough with China that I am concerned that China's economy could implode.

The Chinese Communist Party has allowed considerable freedom and discretion by Provincial bureaucrats to implement market-based policies in order to stimulate the economy. The results have been phenomenal. Unfortunately, there have been negative side effects. Corruption is a problem. There is a significant and growing gap between rich and poor that is creating social disruptions. Economic incentives are providing for huge infrastructure investments in roads and buildings but there is a lack of consumption by the population. It is estimated that the savings rate by the public is close to 50%. The United States has a huge trading deficit with China; and yet the Japanese have just become China's largest trading partner. So the dislocations in the economy are obvious.

China's huge positive trading balance has resulted in foreign exchange holdings of more than a trillion dollars. This cannot persist. If China succumbs to American pressure and allows their currency to increase it will lower economic activity and create additional tensions amongst the have-nots of Chinese society. I expect we are likely to witness this result. A slower Chinese economy will in turn, put negative pressure on commodities. In my opinion, that possibility is not anticipated in present investment thinking.

There was an interesting report from the Bank of Montreal last week. They suffered a significant write down on natural gas trading activities. This was surprising because B of M is probably the most conservative of Canadian Banks. It reminded me that the Canadian banks suffer periodic setbacks. I am reminded of the Real Estate and Energy debacles in the late 1970's, lending to Third World Nations in the 1980's and the Enron and related problems in the 1990's. I am waiting for word on hedge fund trading and

mortgage lending to create the next problem. Certainly we haven't heard the end of either lending to hedge funds or the private equity investments that are presently all the rage. It is not unusual for hedge funds to lever their investments 10 times the amount of equity placed in the fund. Those borrowed funds come from large financial institutions.

Equity takeouts have replaced hedge funds as the investment du jour. The last two years were not rewarding for most hedge funds. The simple reason is that as the number of funds increase and as their sizes get larger there is more competition for the available investments and the margins decline. And so now we see the move toward Private Equity Investment. It is likely that we will see a major problem with one of the hedge funds as greater risk is taken to provide the desirable return. As competition heats up amongst the private equity funds, missteps are possible there as well. As an example of what is taking place in the private equity space I offer up Sobey's Stores. We bought those shares in the Summer of 2003 because we felt they had more value than the price of \$36 at which they were trading especially because they had just brought in a new GM with strong credentials. We felt that he was the catalyst that could get this company moving. A year later, with even more competition in the form of WalMart stores we decided to concede defeat. Almost four years later with the shares only \$3 higher, the parent company has offered \$59, which is about 50% higher than Sobey's shares were trading. The competition is even more intense than four years earlier so this becomes a very questionable purchase.

My final reason for concern for the equity markets is the state of the U.S. economy. At a recent 1.5% quarterly increase, this is the slowest economic advance in several years in spite of interest rates near historic lows. They have suffered a significant mortgage problem recently. The U.S. auto industry is under significant pressure from foreign companies and an overstretched consumer. Since those two industries are major factors in the U.S. economy, they have significant potential to negatively impact economic growth. The government can stimulate growth by reducing taxes and lowering short-term interest rates. These are not realistic options for the government because lowering short-term rates will create inflation and add fire to a liquidity problem that is already too lenient. Reducing taxes will also worsen an enormous current account deficit.

It is true that the stock market anticipates the economy by about six to nine months. On that score a case can be made that the strong equity market is anticipating a strong economy near the end of this year. I choose to believe that we are witnessing the top of the market. It will take about one to one and a half years for the bear market to play out. So I foresee an economy that declines for about two years. That will produce a bear market of monumental proportions.

The stock market is being driven by financial engineering as opposed to fundamental economic factors. That is a concern. It is time to get defensive.