

Market Timing

Interest Rate Update: The US 10-year Treasury yield has broken through 5.13%!

In our last newsletter we reported that the benchmark 10-yr treasury note in the US was testing the significant level of 4.9%. In the past month it has not only broke through 4.9%, but it is today testing 5.13%. This represents capitulation by bond traders, who have finally acknowledged that inflation is headed higher than they had previously hoped. The 10-year note yield sets the benchmark rates for mortgages as well as the equity risk premium required to attract stock market investors. The higher rates go, the less people are attracted to stocks and to mortgages. Last summer, the 10-year yield was stuck at an unbelievable 3.4%. At the same time, one-year rates in Canada were yielding a mere 2.2%. Since then, as rates have continually moved up, one-year bonds in Canada are now yielding a much welcomed 4.1%. Investors that were holding long bonds and bank shares have so far lost about 10% of their market value over the past 9 months. Our strategy of keeping interest sensitive terms short over the past year has been a beneficial one, protecting holdings from market declines, and allowing us to roll your money into higher yielding bonds as rates move up. The rate tightening is not yet done in North America, indeed the majority of economies all around the world continue to raise rates out of mounting concern for accelerating inflation. History shows that unexpected inflation is what moves interest rates higher and bond and equity markets lower. Near the peak of an economic cycle people tend to be too optimistic in their belief that inflation can remain well contained despite big spikes in commodity prices and rising wage pressures.

It is hard to give up spending habits developed during a period of abnormally low interest rates. Typically it takes a much bigger move in rates than hoped to dampen consumption and slow inflation. In this sense, spending is like a locomotive engine, once rolling at top speed, it takes a lot of extra energy to slow its pace. Once it does slow, growth tends to slow too much too suddenly, frequently causing recession. Rate manipulation is a crude tool with lagging impacts, but in the end it is one of the few tools the government has to influence our behaviour.

Falling US dollar, rising oil, rising gold --all spell inflation

One of the hardest things for investors can be the challenge of seeing relevant truths through the positive spin in the news everyday. The fact is that most of us prefer to hear good news. We can understand why people get confused, when most events are

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reported with a positive bias. For example, if one did not realize that a falling US dollar is inflationary, and therefore leads to increasing costs and decreasing real consumer spending, one might think a stronger loonie is good for Canada. Just ask anyone you know who exports products to the US how they find a strong C\$. (85% of Canadian sales go to US customers, and our dollar is now the most expensive it has been since May 1978.) If one did not realize that the lowest unemployment rate in 50 years is inflationary and leads to lower profit margins for corporations, one could think low unemployment is another good sign. If one did not realize that investors have traditionally bought gold as a hedge against a falling stock and bond market and mistrust of the benchmark currency (US) government, one might also think rising gold prices are a positive trend. And if you did not realize that record oil prices present a large drag on economic growth, you might be tempted to see that one favourably as well.

Fortunately, we are able to see through the gloss and connect the dots on these developments and that is why we are able to protect your capital when risks are the highest and put it to work at times where others see only downside.

The longer the relative out-performance of a sector or a market, the more drastic the inevitable correction to restore the mean, that is just the truth about the way markets work. Oil has become the topic of cocktail parties in the same way that tech stocks were the rage in the cycle peak of 2000. Local bookstores now carry whole sections devoted to our national obsession with oil: *A thousand Barrels a second, Beyond Oil, The End of Oil, The Final Energy Crisis*. Etc. etc.

A recent survey asked people if they believed oil could fall to less than 40 dollars a barrel, most did not believe that it could. When oil was at \$11 a barrel in 1999, the same survey reported that the majority of people could not imagine oil over \$25 dollars a barrel again in their lifetime. Humans tend to be notoriously bad at seeing things beyond their present reality. We like the perspective of charts because it has the discipline of making us see our present in context. The following chart gives us a long-term view of the price of a barrel of oil through its regular ups and downs over past economic cycles and geo-political crisis. As you will see, it has been remarkably volatile. The average price of a barrel over the peaks and valleys marked in this 16-year time frame has been \$23.37, but the ups and downs around that mean have been shocking. We thought we would show you a picture so you can see this for yourself on the last page of this newsletter.

Bloomberg interviewed Carl Icahn, a renowned investor who has taken some big and successful contrarian bets over the past many years. What is his secret? "You've got to go in when nobody wants it." Timing is everything. Owning the hottest picks of the day is a course for ultimate failure as an investor. And it takes great discipline to not get sucked into the popular hype and fray.

As we write this, the TSX is at 12,250. The current Index is now 41% dependent upon the sustained price of oil and commodity prices and their ability to resist gravity at the end of this economic cycle. National Bank has set their end of 2006 target at 10,500 (-14%) for the TSX. Our work suggests 9,800 (-20%) as the first meaningful downside test over the next 8 months.



Some perspective on Oil: the risk of the terror premium

Although price gains have been parabolic since 2004, world oil supply has been increasing and is now at its highest levels since 1998. As with all rational markets, higher supply must lead to lower prices eventually.

This chart shows the price swings of a barrel of light crude since 1990 from the start of the first Iraq war to the present. Each correction, the average price decline has been about -50%.



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