

June 9, 2006

## **A Vicious Cycle of Global Growth and Risk**

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In March 2006, we circulated an article regarding the dichotomy of higher growth rates inevitably leading to higher inflation, resulting in higher interest rates, and thereby curbing the same growth that started this cycle. At that time, we suggested the probability *of a change in the global interest rate (or global liquidity trend)*. We also gave three possible scenarios of how this global liquidity risk could come about i.e 1) through restrictive monetary policies, 2) higher consumer price inflation (CPI) or 3) bank failure and debt deflation. We had hoped for a more balanced outcome where growth is followed by modest inflation. Unfortunately, the events that triggered last week's downward global equity market correction suggest otherwise. In fact, two of the three above scenarios (1 and 2) are currently being played out.

The central banks of the world are taking liquidity out of the financial system. They provided the liquidity that drove asset prices (bonds, commodities, housing, oil, etc) to frothy heights, and we suggest that we are currently seeing the beginning of this turnaround. There is a marked likelihood of increasing volatility in the risky market and a further correction in prices.

The message from US Fed Chairman Ben Bernanke in last week's comment to a group of central bankers stated that the US is still facing an inflationary problem, implying that the measured pace of interest rate tightening may have to accelerate. That is likely to drive the US short term interest rate even higher, which is likely to force an inverted yield curve. An inverted yield curve is an anomaly when the short term interest rate is higher than that of the long term interest rate. When this happens, historically, it portends an economic slowdown in the US. Japanese and European central banks, as well as other central banks, are joining the US in this interest hike cycle.

### **What are the implications for the markets and how should we prepare for the current scenario?**

We suggest the following investment implications:

- 1) We have already seen a huge correction for gold prices which recently fell sharply from around \$730 to the current level of \$605 in a month, representing a 17.1% drop from the high. Other metals like silver and copper have also seen similar corrections. Fundamentally, commodity prices lead economic turnarounds or slowdowns through the

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global economic cycle. Since the world staged a global recovery in 2002, there has been tremendous commodity growth. This is perhaps most evidently reflected in our S&P/TSX composite index which saw a 120% gain from the lows of 5,678 in October 2002 to a recent high of 12,494 in April 2006 before correcting to our current level of 11,170. We expect further corrections in commodity prices. In terms of the TSX, it will most likely be dragged down by this correction and this drag may even be compounded by any weaknesses in oil prices. Technically the TSX has broken through trendline 1 support (see appendix), which is a bearish sign, and the next trendline 2 support level is around 10,145-10,500. If this area is broken, we could even see 9,261 (see appendix).

- 2) What about bonds? Expectations of a higher short term interest rate have negative implications for bond prices as these correlate inversely with interest rates. We could also expect more pressure on Canadian interest rates in the event of the US Fed possibly increasing their interest rates in July. Even without this pressure, the recent 32 year-low unemployment rate suggests that wages, inflationary pressure and our capacity for productivity will likely push the rate higher. However, that will only be short-term bearishness for bonds. From a long term perspective, perhaps late in the year or early 2007, when a slowdown in the US becomes more evident, less risky asset classes and higher quality asset classes are likely to outperform from there. Bonds are analogous to an umbrella that shields us from rainstorms.
- 3) Other quality asset classes such as cash, money markets and Treasury Bills are likely to be good parking funds to sit through some temporary storms in this market.
- 4) Global economies do not offer many places to hide from an equity correction. (While global diversification reduces the concentration in the resource sectors, which are a large part of the Canadian market, the downdraft on all markets means that all equity portfolios face greater risk of loss.) In the year-to-date equity indices performance for 60 countries, 2/3 are down more than 10% from their recent highs.

## Market and Portfolio Update

Over the past years we have often been tempted to include some commodities or gold funds to our PRISM Portfolio. (We are glad that we have not, instead opting to follow our disciplined approach of selecting less volatile asset classes/funds.) This temptation arose from other funds managers suggesting that we are experiencing an unprecedented demand for commodities due to China and India factors. Although there is some truth in the global demand factor, the volatility of these funds is usually not worth the risk, nor is it appropriate for most of our clients.

Most of our equity funds have given back some of their gains. We are still pleased that the year-to-date for our PRISM funds are still positive. Our fixed income funds are in negative territory but should recover later in the year.

Looking at a comparison between our PRISM funds (year-to-date - up to June 9, 2006; see appendix) versus the Benchmarks as measured by leading index provider MSCI, we find that:

- The US index is nearly flat at +0.088%, our US exposure through US Chou Associates is at +5.72%.
- The Canadian Index is flat at +0.627%, our funds have return between -0.52% to +6.97% for Canadian Markets.
- Although the World Market Index is down by -0.864%, our fund, Mackenzie Cundill Recovery Fund, managed a +9.09% return.
- And finally, for the European market, the index is down by -0.599%, whereas our fund, AGF European Equity, is up at +7.61%.

Credit must be given to our PRISM managers for their consistent out-performance against their index, without which we would be suffering from loss and not be able to preserve capital.

## **Recommendation**

Even more important than return is our objective to conserve capital and reduce risk through active portfolio management. We would like to recommend a 10% shift of asset class from both the fixed income and equity into cash while sitting through current equity cycle.

For some clients with shorter term investment horizons, we further recommend shifting some equity funds to their respective money market funds (same fund family) to reduce risk.

The risk to our recommendation is that we may miss a corrective rally from here. However, we could be saving a lot of money and emotional trauma should the current downtrend in the market continue. If there is a good maxim for all these portfolio changes, it would be "Markets will always be there but we might not" (let's conserve now, and live to take advantage of the investment market another day).

There will not be any charges for a 10% shift or switch to money market funds.

Our team will be reviewing each client file and recommending appropriate changes for the rest of this month. Please keep in mind that these are recommendations only. We encourage you to use your discretion when deciding whether or not to proceed with these changes.

In the meantime, if you have any questions, or would like to discuss any of these issues with us, we encourage you to call us.

Sincerely,



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**Appendix**

**Potential for Up Market**  
(S&P 500 Chart 1930-Aug 1, 2006)

