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Newsletter #33

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Website: www.pierremorin.com

Oil: The wild card

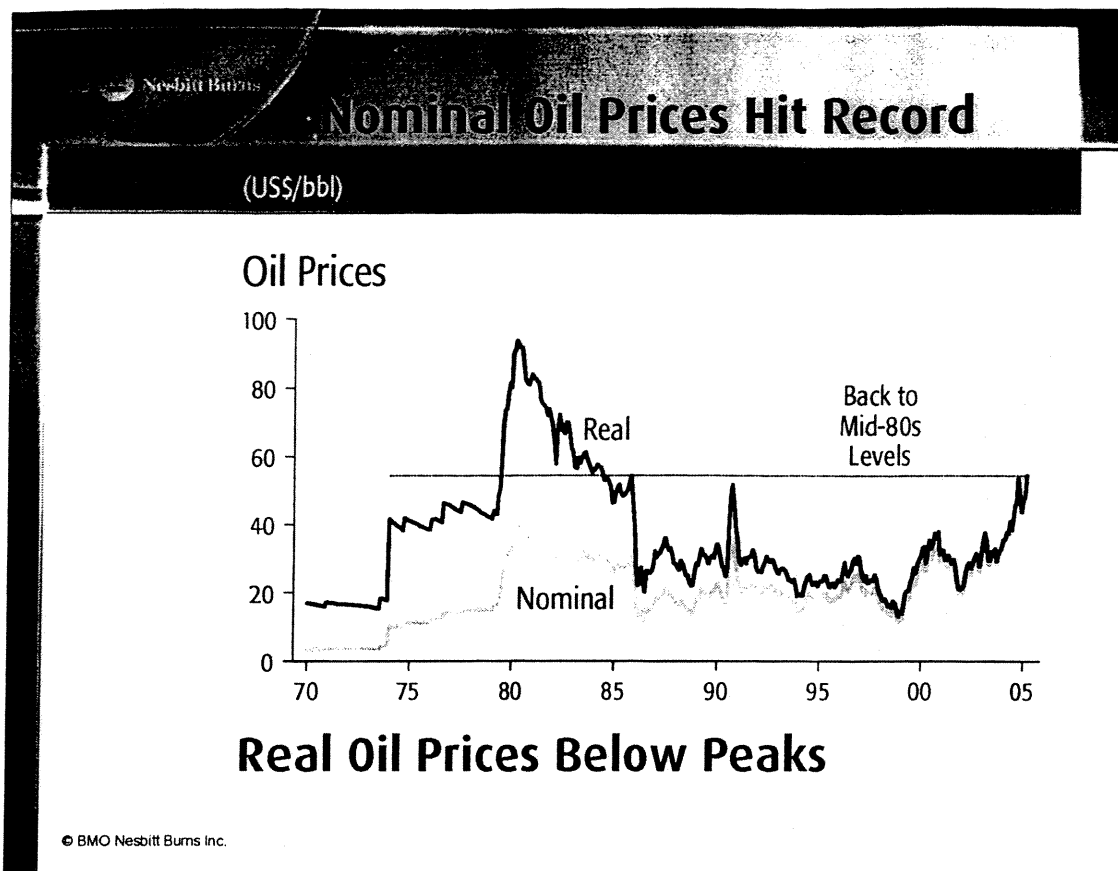
(March 2005)

The domestic economy has been growing steadily over the past few years with muted inflationary pressures and low interest rates. North American equity markets attested to that, delivering double-digit performances over the last two years compounded. We view this near-perfect economic scenario with skepticism given that many indicators are currently defying gravity, namely the U.S. trade and current account deficits, as well as the U.S. consumer debt per capita, reaching new uncharted grounds. This unparalleled financial state of the "all-mighty" United States of America has caused its currency to fall considerably over the past few years. A falling dollar translates into higher costs for imported goods (inflation), which represent approximately 70% of what Americans consume. Easy credit (low interest rates) for an extended period of time can create a false sense of comfort as economic expansion is financed by the excessive debt of consumers and their expensive, perhaps unaffordable, lifestyles. The ability of economists to forecast can be blinded by this phenomenon, which explains the large disparity in their opinions. Nevertheless the U.S. economy is expanding right now and Asia's is smoking. The key in maintaining global growth lies in the control of oil prices. We all know what happens when we pour oil on fire.

Oil prices, at \$56.00 U.S. a barrel and pushing higher, fuel inflationary pressures exponentially in the U.S. while the country must also counter a falling currency. Given the financial state of both the Government and consumers, a rise in interest rates to fight inflation could well be the catalyst to provoke an economic crisis.

The U.S. economy has absorbed an oil price increase from \$12.00/barrel in 1999, just 6 years ago, to \$45.00/barrel in 2004 after reaching an all time high of \$54.00 U.S. Although this represents a significant run, it remains far short of the inflation-adjusted, all-time high of nearly \$100.00 U.S./barrel in 1978 (see chart #1). Some economists believe that the U.S. can afford \$50.00 U.S./barrel of oil because its economy is less energy-intensive than it was in the past. America has evolved from a manufacturing country (primary and secondary sectors of the economy) to a more service and technology oriented economy (tertiary sector), which is less dependant on energy (see chart #2).

Chart #1



However, looking at the energy consumption on a per household basis, we see a very different picture. In 1970, the average home size was 1,500 square feet, households had no air conditioning and only one car per family. Today, the average home size in the U.S. has reached 2,100 square feet, houses have air conditioning and there is at least one utility vehicle (truck or van) and more than likely a second car for the aging generation Y in the driveway. Notwithstanding the improvements in home insulation and fuel-efficient engines, households still consume significantly more energy today than in the past (see chart #3).

This leads me to conclude that it is the consumer that will be most affected by higher oil prices, and that may, in turn, curb his consumption habits and slow the economy all together. The Fed is probably hoping for this scenario to slow consumer appetites rather than raising interest rates, which could have a devastating effect on real estate, and trigger a hard landing and a major recession or worse, a deflation.

Although higher oil prices may soften the landing of the economy on the domestic front, it could expose the U.S. to a new reality. The U.S. needs to finance a \$600 billion deficit and they are certainly relying on foreign buyers of U.S. treasuries. The countries that have been financing the U.S. deficits are, for the most part, those nations that have trade surpluses with the U.S. such as China and Japan. These surpluses (which help finance their own growth and

Chart #2

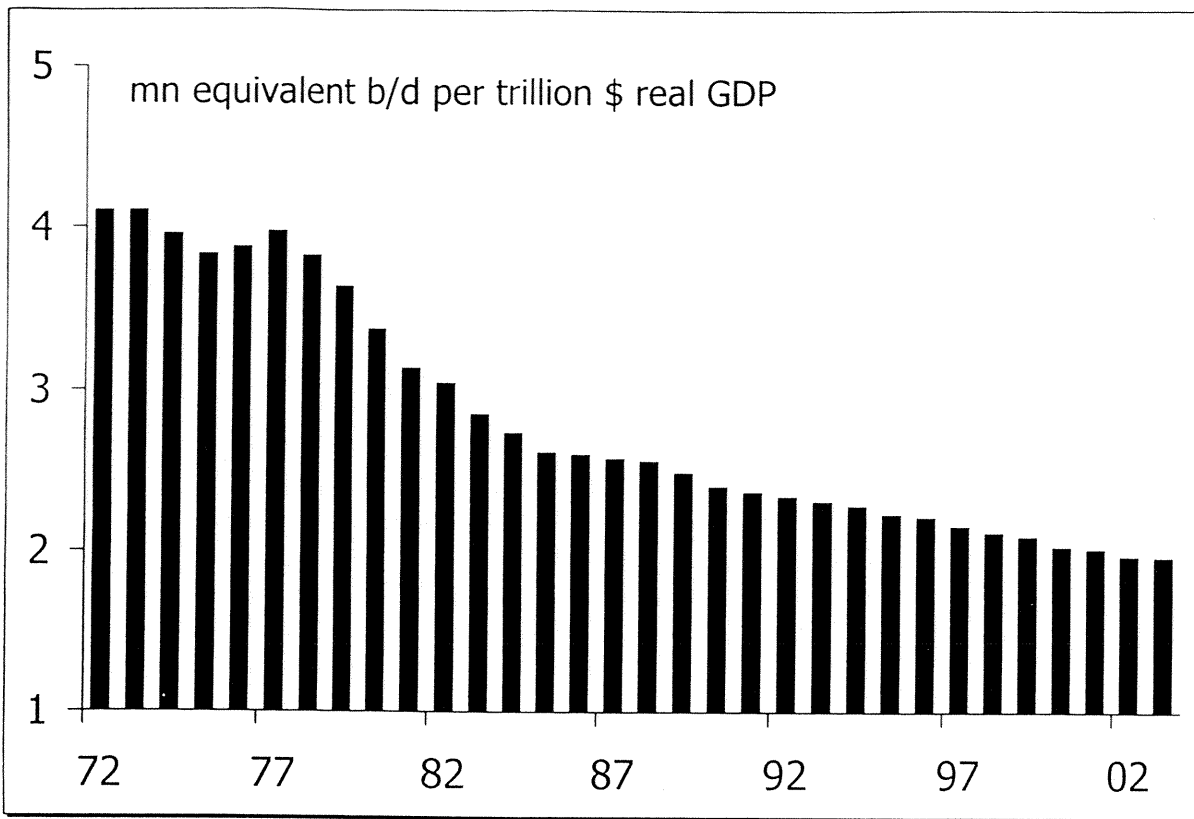
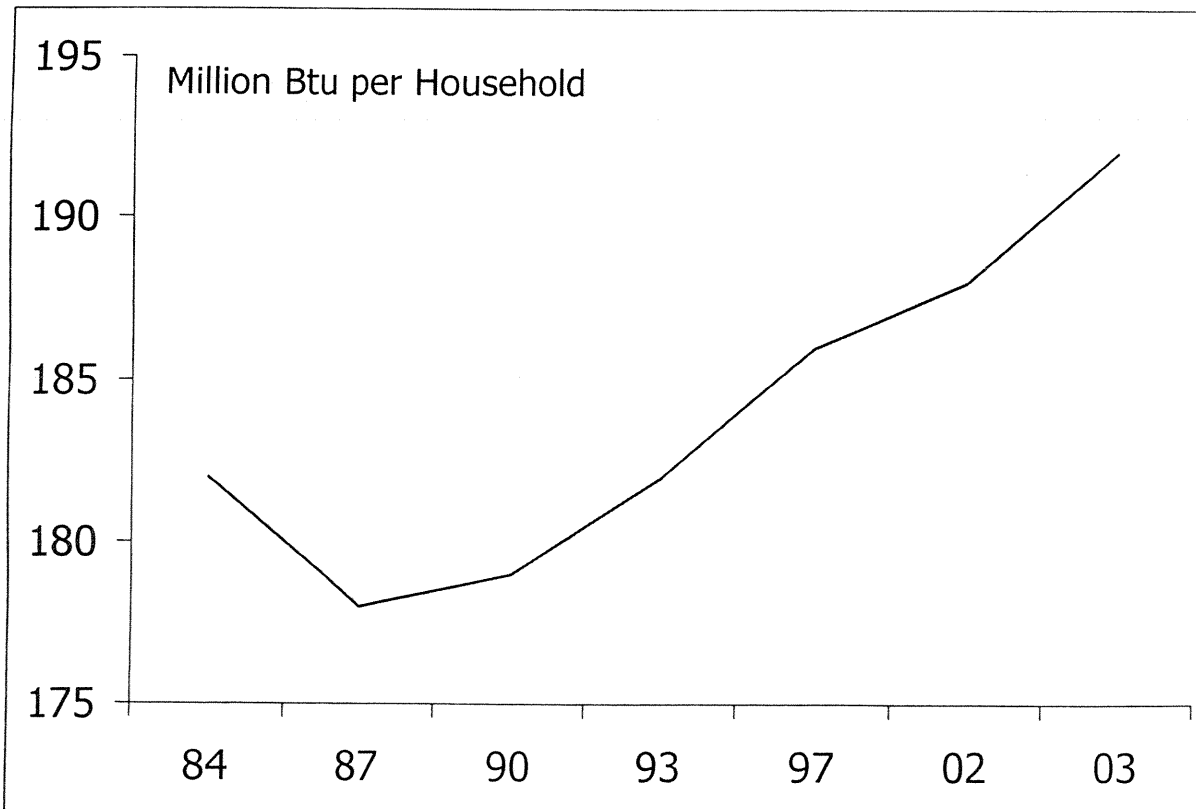


Chart #3



development) are dependent on the American consumer's appetite. They therefore have a direct interest in buying U.S. treasuries at low rates, since by keeping rates low, the U.S. consumer continues to buy those imported goods. But what happens if the U.S. consumer slows the spending spree? Will China and Japan be willing to continue to buy U.S. treasuries, in a potentially depreciating currency, to help finance the U.S. deficit as their surpluses narrow? And what if they don't? Who will replace them and at what rate? It seems that even a soft landing might be an illusion, as even the better scenario can turn out to be as devastating.

According to Stephen Roach, chief economist at Morgan Stanley, long-term bond yields could jump as much as one and a half percentage point if foreigners stop subsidizing the U.S. bond market. He is wary of the fact that foreign investors currently hold about 43% of all outstanding U.S. treasury debt. That makes the U.S. "dependant on the kindness of strangers"... not very comforting is it? But America is an active participant in China's development as more and more North American companies are building manufacturing plants in China and taking advantage of low cost labor.

Many American companies are consequently enjoying better profit margins resulting in higher share valuations, as this seems to be the currency of choice (stock options) in paying big fat bonuses. This short-term view may have a significant long-term impact on American economy. One could argue that much of our technological knowledge, management skills and intellectual property are being transferred to the Chinese in exchange for short-term profits. Soon enough, the Chinese could build manufacturing plants of their own and compete against American companies for market share and force profit margins to retract and stock prices as well. Wealth in the form of paper money could evaporate.

Meanwhile in China, the economy is booming with the GDP growing 9.5% in 2004 regardless of their Central Bank's attempt to slow its pace last year. A slowdown would most likely be welcome news in China, as it is currently suffering growing pains. There are shipping and transport delays everywhere, which cause production delays. This could prove to be disastrous for a young banking system in a developing nation who finances those plants as it waits for loan repayments to begin. A slowdown would help to resolve the bottlenecks and to restructure, and would give a second wind to this unprecedented massive wealth creation. Mr. Roach is confident China's mixture of administrative and monetary policies will slow its economy without creating a hard landing that would damper growth prospects far beyond its borders. China would also increase its prospects of a soft landing if oil prices pulled back to the \$40.00 to \$45.00 range.

On a longer-term investment perspective, it seems to me quite obvious that we need to find a way to participate in the building and development of the potentially biggest trading block of the world, Asia. Much like the West after

World War II, China and India represents the largest consumer group in early development stage. During the 1950's, we witnessed the creation of a new middle class, which turned-out to be the catalyst for the only long-term resource cycle in the century. A typical resource cycle would normally last anywhere from 1 and 2 ½ years but in the 50s, the cycle lasted almost the full decade. It is assumed that roughly 150 million people attained middle class status during that decade both in America and in Europe, causing demand for raw materials to outstrip capacity. Estimates range from 250 to 500 million people in the Asian block that could move to middle-class status in the next 5 to 10 years. This situation comes on the heels of the longest bear market in history for those same commodities (more or less 20 years). The impact is therefore even more vicious for three reasons:

- 1- 20 years of consolidation
- 2- 20 years of excess supply
- 3- 20 years of lack of exploration

Consolidation during that time significantly reduced the number of producers. The objectives of consolidation are to close higher cost operations, reduce manpower by attrition and plant closures, and try to regain some pricing power. The excess supply and capacity created continuous price wars and reduced the ability to generate a profit contributing to deflating prices. Finally, this was hardly an attractive environment to stimulate exploration only to find something you couldn't sell at a profit.

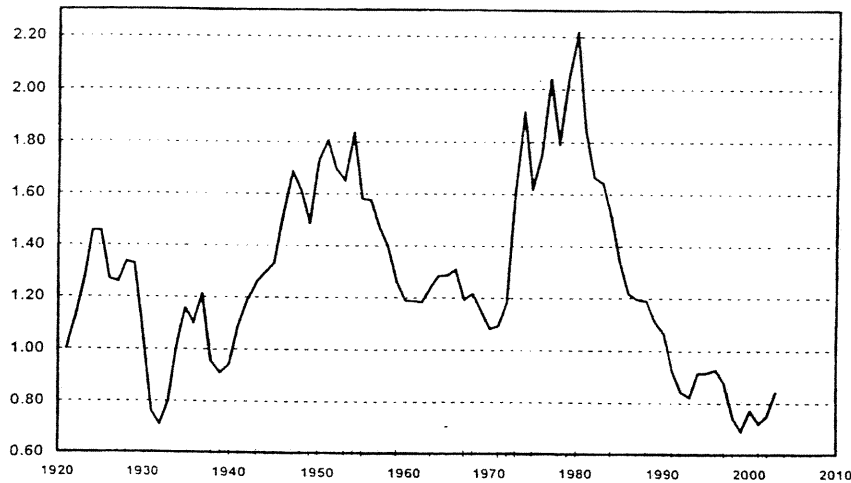
Today there are very few mining companies left, those that remain have all the pricing power they need. Demand should outstrip supply for years to come, as there hasn't been much exploration and very few new discoveries. Consequently, supply should remain tight as long as Asia's demand remains strong. The good news for producers is that exploration takes time and a new discovery takes even longer to put into production. All in all, this cycle has the fundamentals to be a long one. Chart #4 shows the impact of the 20 year drought in pricing power of commodities and, conversely, the potential pricing power in the years to come (inflation adjusted).

Conclusion:

Historically, neither inflation nor deflation has been kind to equity markets. Given that the potential risk of inflation or deflation has risen in view of the weakened financial strength of the U.S. economy and the country's dependency on foreign capital, I believe it is important to raise the fixed income component of the portfolio to at least 20%. Furthermore, the risk of further devaluation of the U.S. dollar is compelling enough to have at least 5% of your portfolio in gold and/or gold stocks.

Chart #4

COMMODITIES ADJUSTED FOR CPI, 1920-2004



Source: Di Tomaso Group

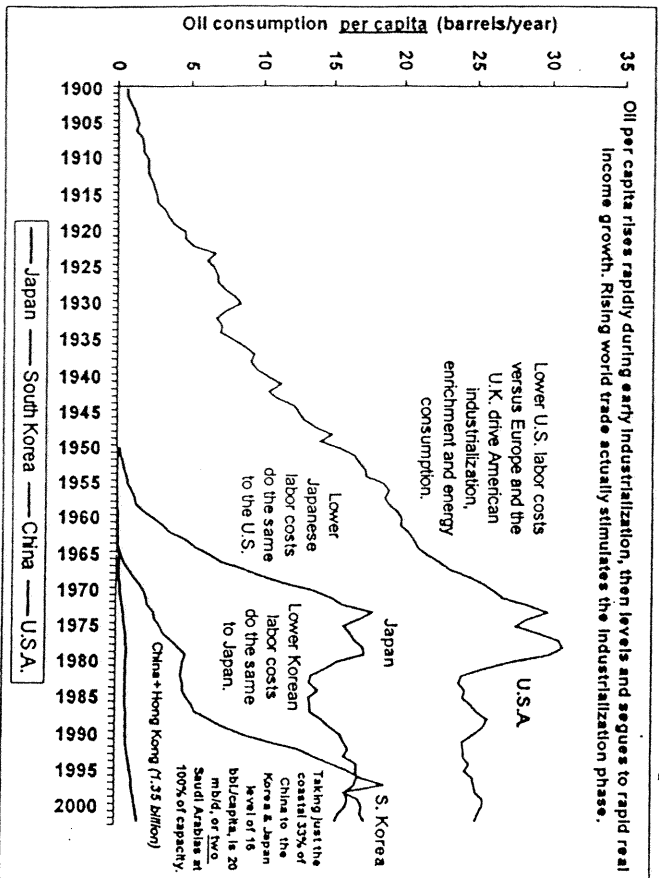
Marc Faber Limited
25/5/04

China's thirst for oil exceeds all expectations. Already China consumes more oil than Japan although on a per capita basis China's consumption stands at one tenth of Japan's! (See Chart #5.) According to Dr. Marc Faber, a world-renowned macro-economist, if the coastal 33% of China were to consume oil equal to Japan or South Korea at 16 barrels per capita, it would require two Saudi Arabias at 100% capacity or 20 million barrels per day.

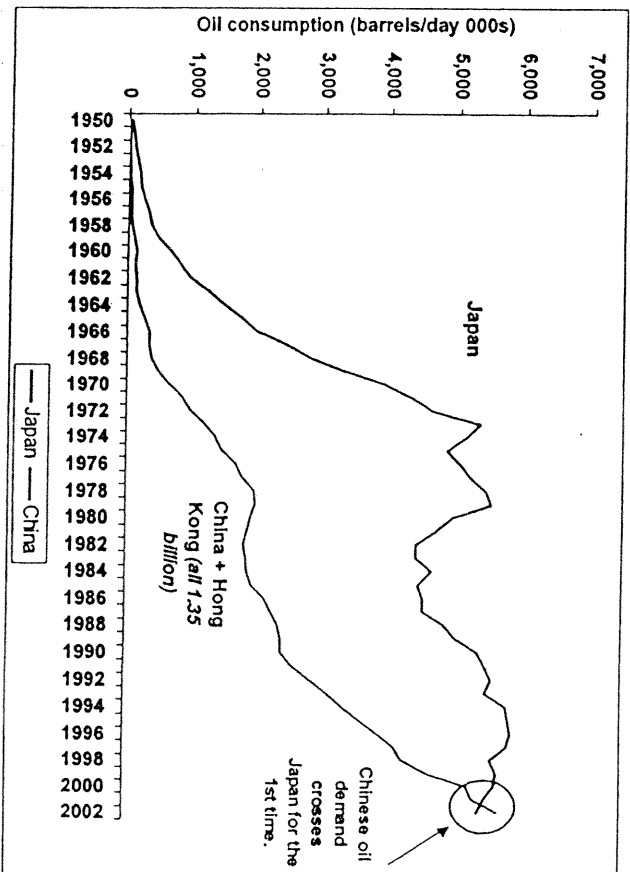
With the demand for energy expected to grow along with Asia's development, it is important to maintain roughly a 7% to 8% participation in the oil & gas sector. This represents an underweighted position when compared to the TSX, which has over 20% oil & gas content. Canada's oil sand reserves have been added as official oil reserves by the World trade organization (WTO) relatively recently. Although Canadians discovered their existence in the sixties, it was only recognized as a world-class reserve when Canada began producing 3 million barrels a day at a cost of approximately \$12.50/barrel. Canada now stands second only to Saudi Arabia with its oil reserves (see chart #6). Canadian Oil Sands Trust (owners of 35% of Syncrude) and Suncor are quickly becoming world-renowned, and are attracting new investors worldwide.

OIL CONSUMPTION

Oil consumption and industrialization, 1900 to present



Oil consumption in total, China vs. Japan



Source: BP Statistical Review of World Energy; US Census database

Marc Faber Limited
9/9/04

Bullish on oil sands

Wall St. brokerage house Lehman Brothers has published a report saying investors who feel bullish about oil's price outlook should consider "undervalued" Alberta oil sands producers.

Lehman Brothers picks

FIVE OIL SANDS OPERATORS THE INVESTMENT FIRM RECOMMENDS FOR BULLISH INVESTORS

Company	Weighting within sector
Canadian Natural Resources	Overweight
Deer Creek Energy	Overweight
OPTI-Canada	Overweight
Canadian Oil Sands Trust	Equal weight
Western Oil Sands	Equal weight

World oil reserves

ESTIMATED RECOVERABLE RESERVES IN BILLIONS OF BARRELS

1 Saudi Arabia	250
2 CANADA	175
3 Iraq	113
4 Venezuela	78
5 Russia	60
6 U.S.	22

Top producers, 2003

ESTIMATES IN MILLIONS OF BARRELS PER DAY

1 Saudi Arabia	9.8
2 Russia	8.5
3 U.S.	7.5
4 Iran	3.9
5 Mexico	3.8
6 China	3.4
7 Norway	3.3
8 Venezuela	3.0
9 CANADA	3.0

Top producers, 2015

ESTIMATES IN MILLIONS OF BARRELS PER DAY

1 Saudi Arabia	6.6
2 Russia	7.6
3 U.S.	6.6
4 CANADA	5.0
5 Iran	3.4
6 Mexico	3.3
7 China	3.0
8 Norway	2.9
9 Venezuela	2.6

SOURCES: ALBERTA ENERGY AND UTILITIES BOARD, U.S. DEPARTMENT OF ENERGY, BP WORLD OIL REVIEW, NEB, LEHMAN BROTHERS ESTIMATES

Base metals' demand should continue for many years to come although it could be a choppy ride. One should be aware that if oil prices move up too rapidly, it will have an impact on cost of base metal production and affect profitability. On the other hand, if oil prices were to drop, base metal producers' profitability would be enhanced. The best outcome for both groups would be realized with a more stable oil price in the \$40 to \$45 range. Since base metals and oil hedge each other quite well, we recommend matching your weightings between them at 7% to 8%.

High quality utility income trusts remain an important part of a balanced portfolio. The stability and sustainability of their distributions is the key to success. However, as good as these investments can be in a keep deflationary market, they can be just as bad in an inflationary environment. In the later scenario, their market prices may fall more than long-term bonds. This drop should be offset by the rise of your inflation-sensitive stocks. But if you own a highly rated utility Trust, chances are your 8% or 9% revenue will keep pouring in and compensate for at least part of the loss. Together with your inflation-sensitive stocks they form a great tandem.

The rest of your portfolio should be your "foundation stocks" which pay a decent dividend and have a history of increasing dividend paid out to shareholders. Banks, Insurance and Real Estate companies and a few special situations such as CNR, Metro, Astral, Jean Coutu, are some examples.

In summary we recommend a hedging strategy, which we believe, would better protect you in these volatile markets.

- 1) 20% short-term fixed income (4 years max.) should provide you with liquidity if the market corrects, allowing you to capitalize on opportunities, and should reduce the volatility of the portfolio.
- 2) 20% of inflation-sensitive stocks, such as oil & gas, base metals and gold, will allow you to participate in the Asian boom by investing in Canadian companies while hedging your portfolio against inflation.
- 3) 20% in utility income trusts as they act in a fashion similar to long-term bonds and provide the holder a protection against deflation and much lower interest rates.
- 4) 20% in high quality Canadian stocks with strong balance sheets and a strong and rising dividend policy.
- 5) 20% should act as a buffer and allow us to adjust to your specific investment profile and needs.

ASSET MIX OF MODEL PORTFOLIO

INCOME PORTFOLIO

Oct 2004 Mar 2005

10% 10%
45% 45%
25% 25%

10% 10%
10% 10%

CASH (CSB, QSB, T-BILLS)
FIXED INCOME (BONDS)
CONVERTIBLE DEBS.
AND INCOME GENERATING
SECURITIES
EQUITIES
FOREIGN

BALANCED PORTFOLIO

Oct 2004 Mar 2005

10% 10%
25% 25%
25% 25%

30% 30%
10% 10%

World Markets Returns

Market	Year to date *	2004	2003	2002	2001	2000
S&P/TSX	3,96%	12,48%	24,28%	-13,97%	-13,94%	6,18%
DOW	-2,59%	3,15%	25,32%	-16,76%	-7,10%	-6,18%
S&P/ 500	-2,59%	8,99%	26,38%	-23,37%	-13,04%	-10,14%
NASDAQ	-8,10%	8,59%	50,00%	-31,53%	-21,05%	-39,29%
FTSE 100	2,12%	7,54%	13,62%	-24,48%	-16,15%	-10,21%
DAX	2,90%	7,34%	37,08%	-43,94%	-19,79%	-7,54%
DJ EURO STOXX 50	3,59%	4,30%	10,50%	-35,04%	-16,97%	-3,90%
NIKKEI 225	2,04%	7,61%	24,45%	-18,63%	-23,52%	-27,19%
HANG SENG	-5,19%	13,15%	34,92%	-18,21%	-24,50%	-11,00%
MSCI WORLD	-1,54%	12,84%	30,81%	-21,06%	N/A	N/A
MODEL	3,25%	13,46%	23,09%	2,73%	10,03%	31,70%

* year to date (March 31, 2005)