BMO Nesbitt Burns

BMO Nesbitt Burns Ltée/Ltd.
Tour McGill College
1501 avenue McGill College, Bureau 3000
Montréal, QC H3A 3M8

Tél: (514) 282-5810
Téléc: (514) 282-5883
1-800-363-6732

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Website: www.pierremorin.com

OIL: A SLIPPERY MATTER.

(October 2005)

How can it get better for Canada and for Canadian investors?

Over the last several years, the Canadian markets have outperformed the U.S. markets, as our country continues to enjoy budget surpluses, a stronger currency as a result of higher commodity prices, low inflation and interest rates that allow us to pay down mortgage debt faster and increase our purchasing power, etc. These are definitely good times. Meanwhile, this level of comfort has to be somehow contained and controlled. We must not be fooled by the seemingly indefinite extension of this quasi-perfect scenario.

As for the U.S., our biggest trading partner, things don't seem to be as rosy. Their economy has been tested many times in the last several years. With the bursting of the technology bubble followed by 9/11 and the subsequent war on terror, the U.S. has been spending excessively to maintain consumer confidence. On the surface, things seem to be working well, as real estate prices reach new highs, simultaneously creating wealth. Consumers aren't feeling the pinch.

But this new real estate bubble should be a big concern for U.S. investors as it carries so much leverage. Unlike the tech bubble, real estate is generally purchased with a significant amount of borrowed funds via a mortgage. Americans use mortgage borrowings to finance just about anything since mortgage interest is tax deductible. With real estate values increasing, many took advantage of lower rates not only to re-finance and extend their terms, but also increased the borrowed amount based on the higher market value of their property. This newly created wealth is being used for home renovations or to buy a new car, a boat or perhaps another real estate property for speculative purposes. Mortgage lenders have been very active, as they have found "paradise". According to a June 16, 2005 article in The Economist, this real estate bubble is a worldwide phenomenon caused by very low interest rates and favorable demographics. According to the National Association of Realtors, 42% of all first-time buyers, and 25% of all buyers in the U.S., made no down payment on their new home. Homebuyers were actually able to borrow 105% of the purchase price to cover buying costs!
Furthermore, this study also reveals that in California, 60% of all new mortgage loans this year are either "interest only" or "negative amortization loans" (i.e. the buyer pays less than the interest due, and the unpaid principal and interest is added on to the loan). Indebtedness has therefore increased based on speculative market values that are perhaps unsustainable. When the bubble bursts, the illusory wealth could transform itself into really big losses created by a devastating chain reaction, potentially taking down some financial institutions along with it. Suddenly it would be the bank's money that is lost since the collateral, i.e. the property, would be worth less tomorrow than today as more and more properties are put up for sale. This is where the real estate bubble differs from the tech bubble. I don't think that it was common to

buy $200,000 worth of Nortel on margin, but it is certainly not rare to buy a $200,000 home with a mortgage loan. A real estate bubble bursting will have a much more significant impact on the economy, both over the short-term and long-term, than the tech bubble did in 2001.

The Fed has been raising interest rates to slow the speculative momentum in real estate in the U.S., but higher interest rates could also trigger a sell-off and ignite the feared chain reaction.

The Fed is also facing ever rising oil prices, which could also contribute in slowing the economy as consumers' disposable income shrinks. Corporate profitability is also negatively impacted as energy and interest costs increase, resulting in job cuts, raising the threat of an economic recession.

Managing a soft landing for the U.S. economy in this cycle may prove to be very difficult. To make matters worse, not one but two hurricanes hit the Gulf Coast, significantly restricting the U.S.'s refining capacity and pushing gasoline and heating oil prices to record highs. To put this in perspective, back in the first quarter of 2005, the Saudis predicted that OPEC's spare capacity would reach near zero by the fourth quarter (table 1) and recommended raising production by 500,000 barrels/day over the second and third quarter in order to build inventory.

Tab.#1

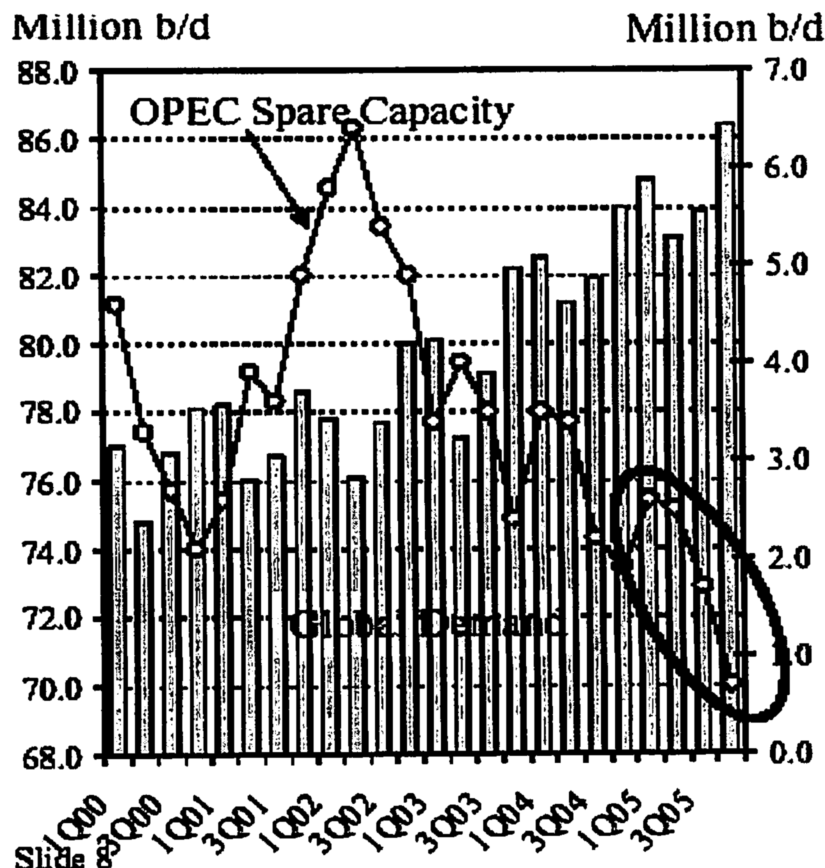


Table 2 shows the rise in U.S. crude oil inventories since Q1 compared to last year and the five-year average.

Tab.#2

US Crude Oil Inventories

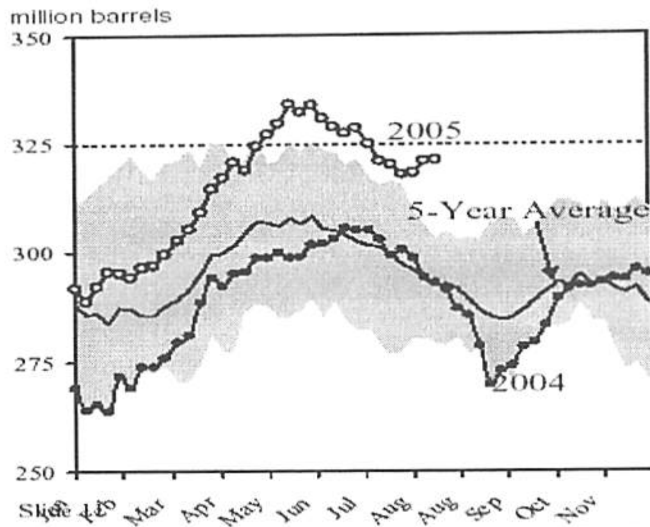
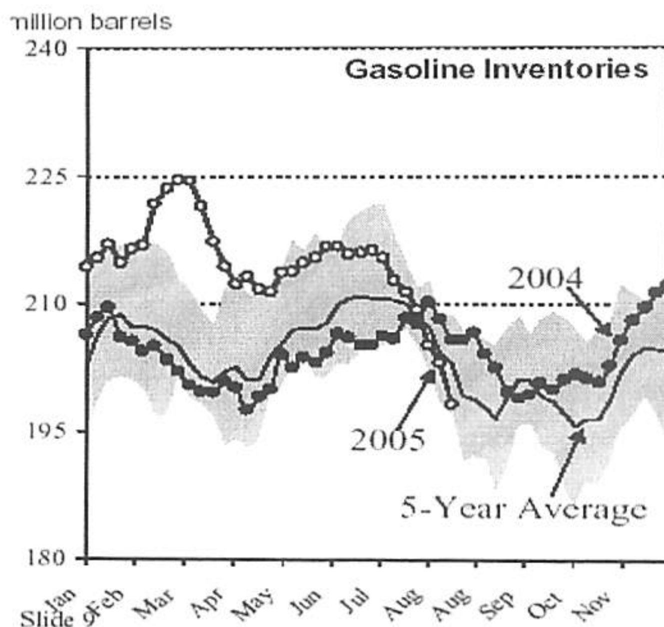


Table 3 shows the U.S.'s inability to convert excess oil inventories into gasoline as the country had reached its maximum refining capacity prior to hurricanes Katrina and Rita! These hurricanes cut US's refining capacity by nearly 20% for more than a month.

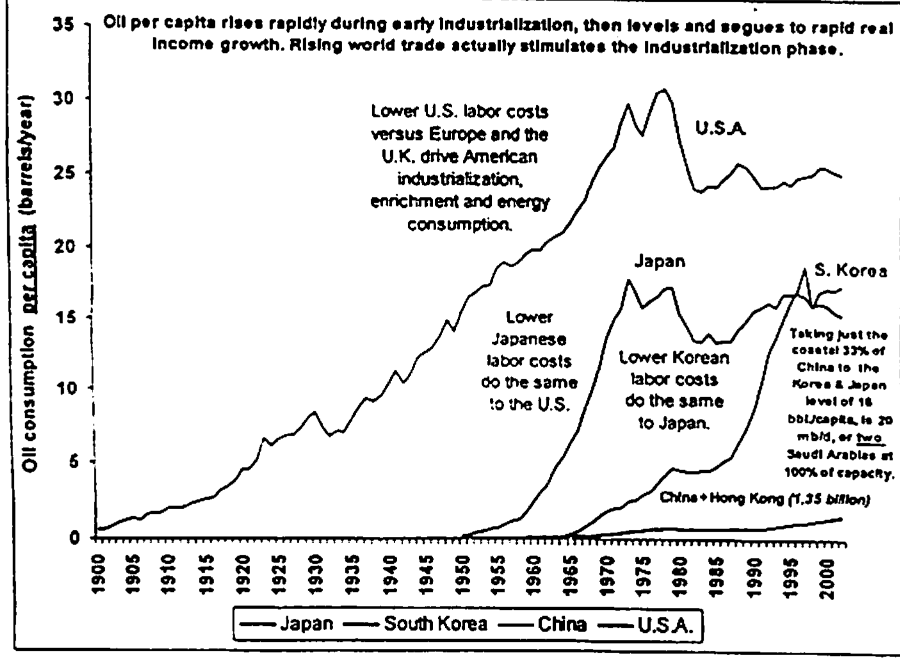
Tab.#3



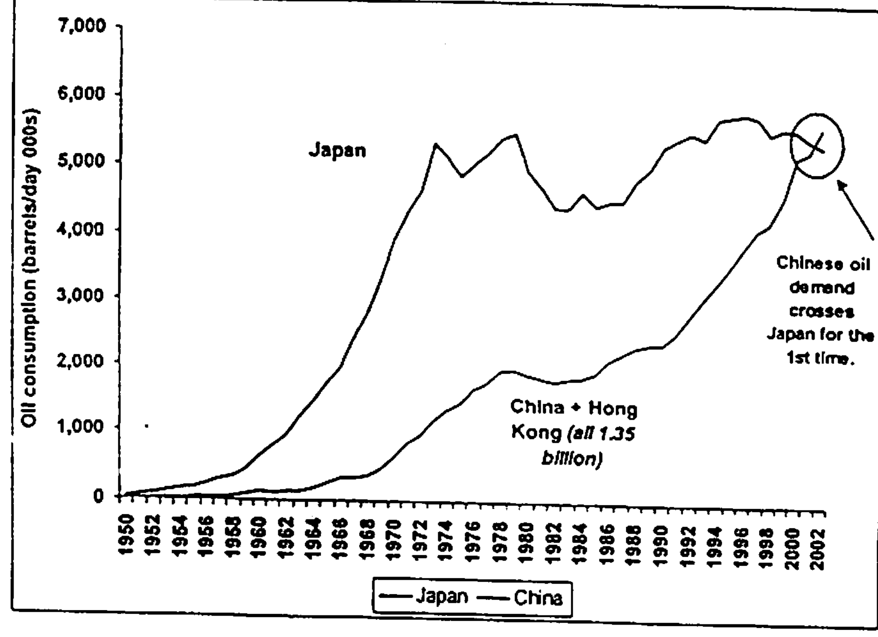
Tab. #4

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

Although oil and gas prices have pulled back from their recent peaks, we still face very tight supplies over the medium to long term. World oil demand has been increasing quite rapidly over the past few years, driven mostly by Asia, namely China. Although China's consumption is still at 1.7 barrels per capita, it already consumes more oil, as a nation, than Japan where consumption stands at an average of 16 barrels per capita. We reflected on this issue in our previous newsletter, but we believe it is worth mentioning again. (See table 4).

In small print you can read: "Taking just the coastal 33% of China to the Korean and Japanese level of 16 barrels/capita is equivalent to 20 million barrels a day or two Saudi Arabias at 100% capacity." The simple thought of this is hair-raising. China is obviously aware of this shortage and it explains why they attempted to buy Unocal, a U.S. oil company, this past summer. Given that the deal was not particularly well received by the Americans, Chevron Corp. outbid the Chinese. They were, however, successful in obtaining an interest in an oil sands project in Alberta. It is worth mentioning that China has oil sands of its own and is eager to learn the technology that will eventually help it develop its domestic capacity. But China's interest goes even further. They have expressed a desire to financially participate in the construction of a new pipeline that would end up in a deep-sea port off British Columbia, allowing significant exports of oil from Canada to China. This is not a very popular idea south of the border given that, currently, 100% of Canadian oil exports is destined for the U.S. Let's not forget, however, that in the 1980s, many American utilities ripped up oil and gas supply contracts from Canadian oil producers when world oil prices fell below what they were legally required to pay. Although this was a breach of contract, Canadian producers had to accept lower prices or face a loss of business or lengthy and expensive court battles. An alternative destination for that oil and gas could have altered the buyers' behavior and/or the suppliers' way of doing business.

China also needs to accumulate a strategic oil reserve of its own. They are expected to start building an inventory program early in 2006. Given this additional demand, it is unlikely that oil prices will fall anytime soon. Opinions do vary significantly on this matter as CIBC World Markets calls for oil prices to reach US$100 a barrel next year compared to TD's forecast of US$45.00. Regardless, the cost of extracting a barrel of heavy crude from oil sands varies from US$7.00 to US$13.00 and is just over US$25.00 for WTI light sweet crude. In addition, Big Oil companies filed an application with the SEC (Securities Exchange Commission) to establish new standards in the calculation of oil reserves to include the oil sands deposits. These new standards are expected anytime soon, and could trigger another round of consolidation aimed directly at the oil sands producing companies such as Canadian Oil Sands and Suncor among others.
The long life reserves of our oil sands make them very attractive to foreign investors.

A BMO Nesbitt Burns analysis suggests oil stocks are discounting a future oil price of approximately US$48/ Bbl (August 2005).
Unless China's economy falters we believe oil and gas investments remain your best hedge against inflation. Other materials, such as base metals, also provide protection against inflationary pressures. Gold, on the other hand, is a great hedge against a financial meltdown and/or a U.S. dollar devaluation. We believe that no one can afford not to be somewhat protected.

There have been many comparisons between the current state of the U.S. economy and the situation that preceded Japan's deflationary recession which started fifteen years ago. In 1990, Japan's real estate bubble burst and it still hasn't rebounded.

Although there are many similarities, there are also some major differences. Among other things, their demographics are quite different, as 30% of Japan's population will be over 60 years of age and 6% over 80 by 2010. Table 5 shows the percentage of appreciation in house prices between 1997 and 2005 in the developed nations of the world. Japan is the only industrial country where housing prices have actually declined in recent years. Japanese demographics might be partly responsible for that.

Tab.#5

The Economist's house-price indices
% change:

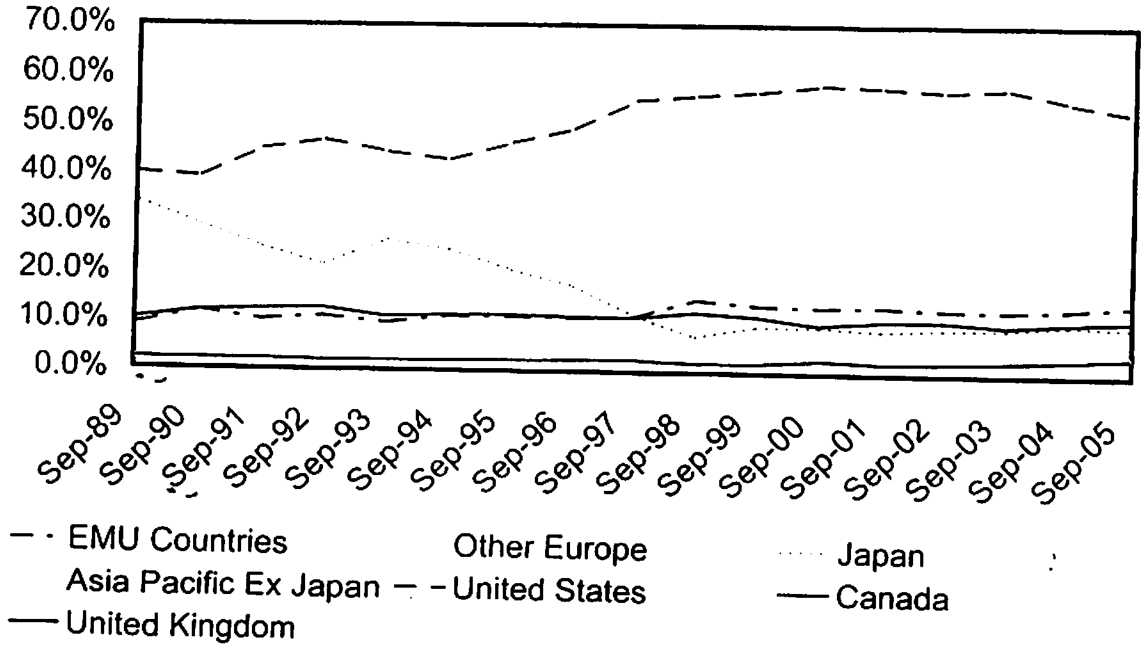
	on a year earlier		1997-2005
	Q1 2005*	Q1 2004	
South Africa	23.6	28.1	244
Hong Kong	19.0	17.4	-43
Spain	15.5	17.2	145
France	15.0	14.7	87
New Zealand	12.5	23.3	66
United States	12.5	8.4	73
Denmark	11.3	6.0	58
Sweden	10.0	7.7	84
China	9.8	7.7	na
Italy	9.7	10.8	69
Belgium	9.4	8.8	71
Ireland	6.5	13.2	192
Britain	5.5	16.9	154
Canada	5.2	5.7	47
Singapore	2.0	-1.5	na
Netherlands	1.9	5.5	76
Switzerland	1.0	3.4	12
Australia	0.4	17.9	114
Germany	-1.3†	-0.8‡	-0.2
Japan	-5.4	-6.4	-28

*Or latest †2004 average ‡2003 average
Sources: ABSA; Bulwien; ESRI; Japan Real Estate Institute; Nationwide; Nomisma; NVM; OFHEO; Quotable Value; Stadim; Swiss National Bank; government offices

The good news about Japan, however, is the strong mandate given to Prime Minister Koizumi to reform the financial system and privatize the Japanese postal system. This is nothing less than the only thrift institution offering depositors a government guarantee. It is Japan's largest bank and it is government-owned. This will change the landscape of financial institutions in Japan for the better, by no later than 2007. These changes may attract foreign capital to Japan for the first time in over a decade, but could it be detrimental to U.S. capital markets?

Table 6 shows the world capital flows by region over the last 16 years as expressed by the MSCI index. While Japan's weight in the index peaked in 1989 at 37% of the world market capitalization it fell to below 9% as the NIKKEI dropped from 39000 to 8000. A new record was set as U.S. stocks represented near 60% of the world market capitalization in 2001, down to 52% today. In the U.S., the bursting of the real estate bubble could result in a flight in American investments like in Japan in the 1990's. To own a small interest in Japanese equities today seems to be a defensive perhaps even a preventive investment as well. It would also be something to build on as we go forward. "Follow the money..."

Tab.#6



Can we learn anything else from the Japanese debacle of the last fifteen years? The only asset class that provided a positive rate of return in Japan over those years was long-term bonds. To pull out of this deep deflationary recession, Japan's central bank cut interest rates drastically, and yields on long term Japan bonds (20 years) fell from 7.25% to as low as 0.8%. This was unprecedented. Table 7 shows the market price of a 20-year bond carrying various coupon rates.

TABLE 7

20 year bonds @ 0.8% Yield to maturity (YTM)

Maturity	coupon	par value ($)	market value ($)	yield to maturity
20 years	6%	100	**196**	0.8%
20 years	5%	100	**177**	0.8%
20 years	4%	100	**159**	0.8%
20 years	3%	100	**141**	0.8%

Our model portfolio includes high quality utility income trusts that pay a high income and that are very interest sensitive. Although they are by no means "guaranteed investments," their performance would be similar to the trend in long-term bonds. Currently, inflationary pressures are mounting, pushing short-term interest rates higher. As bond yields and mortgage rates move higher, the real estate bubble will start to deflate, hopefully in an orderly fashion. At that point it could be an appropriate time to buy long-term bonds especially in your RRSPs, to further hedge yourself against a deflationary recession, and compound the interest, tax free. This will enhance your purchasing power at retirement and provide you with some protection against the risk of deflation.

Personal opinion on income trusts

Income trusts in general have been the investment product of choice for many investors seeking income in the past few years. As their popularity reached unprecedented levels, many corporations were about to convert themselves in these structures at an alarming rate. Even banks were considering converting some of their

operations into trusts. This raises two issues: one, the FED's apparent opportunity loss in tax revenues and second, the transformation of corporate Canada into a less productive structure. Mr. Goodale intervened and froze any ATR (advance tax ruling) needed to complete a conversion until February 2006 or budget/ election time. Changes in the taxation of income trusts could affect the whole Canadian corporate tax system. Such changes could require an in-depth restructuring of corporate tax laws, which could take time and money. The problem here is related to the thirst of investors for income-generating assets at a time when interest rates are at forty-year lows. So Canadian corporations are creating value to stockholders as they transform some of their stable assets into income trusts at a premium. By delaying further conversions until February, perhaps Mr. Goodale could calm the demand for trusts if, for instance, another asset class started providing investors with a higher income! Just in time for the next elections, Mr. Goodale could reduce taxes on dividends which would make preferred shares and high dividend common stocks much more attractive to investors and corporations, reducing the excitement and demand for more income trusts. This action by the government of Canada could put them in line with the U.S., which capped taxes on dividends at 15% last year. (See attached BMO Nesbitt Burns's research comment on Income Trusts.)

Conclusion:

The simple fact is that long-term bond yields have remained low even though the Fed has increased short-term rates 11 times in a row. This is telling us that global demand for long duration bonds is outstripping supply. Seemingly, the world is trying to tell us that 4.39% on a 10-year bond and 4.7% on a 20-year bond is a great deal (i.e. they expect those yields will go lower). Perhaps when the U.S. economy finally begins to weaken with high oil prices, rising unemployment, the widening of its current account deficit and falling real estate prices, we will understand why it is important to protect yourselves to face most eventualities. A balanced approach using the appropriate mix of asset classes and industry diversification to offset various economic scenarios. Here are some suggestions:

5% Gold (Placer Dome, Newmount)
15% Utilities Income Trusts (see income generating investments table)
10% Oil & Gas (Canadian Oilsands, Suncor, Petro Canada, Encana)
8% Base Metals (Inco, Teck Cominco, Sherritt, Alcan and Quadra Mining)
5% Japan Fund (Guardian Group of Funds and Toronto Dominion)
5% Long Term Bonds (later)

High quality blue chip stocks with strong balance sheets and high dividends combined with short-term fixed income should complete your portfolio. This balance will provide you with income, liquidity, security, flexibility and growth in the portfolio.

ASSET MIX OF MODEL PORTFOLIO

INCOME PORTFOLIO			BALANCED PORFOLIO	
Oct 2005	Mar 2005		Oct 2005	Mar 2005
10%	10%	CASH (CSB, QSB, T-BILLS)	10%	10%
45%	45%	FIXED INCOME (BONDS)	25%	25%
25%	25%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	25%	25%
10%	10%	EQUITIES	30%	30%
10%	10%	FOREIGN	10%	10%

World Markets Returns

Market	Year to date *	2004	2003	2002	2001
S&P/TSX	19.09%	12.48%	24.28%	-13.97%	-13.94%
DOW	-1.99%	3.15%	25.32%	-16.76%	-7.10%
S&P/ 500	1.39%	8.99%	26.38%	-23.37%	-13.04%
NASDAQ	-1.09%	8.59%	50.00%	-31.53%	-21.05%
FTSE 100	14.35%	7.54%	13.62%	-24.48%	-16.15%
DAX	19.03%	7.34%	37.08%	-43.94%	-19.79%
DJ EURO STOXX 50	18.42%	4.30%	10.50%	-35.04%	-16.97%
NIKKEI 225	17.73%	7.61%	24.45%	-18.63%	-23.52%
HANG SENG	8.18%	13.15%	34.92%	-18.21%	-24.50%
MSCI WORLD	4.70%	12.84%	30.81%	-21.06%	N/A
MODEL	***12.87%***	***23.09%***	***2.73%***	***10.03%***	***31.70%***

*année à ce jour 30 septembre 2005