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Contents:

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CROSSROADS

In the past 18 months, we raised many red flags in relation to risks revolving around the US economy, which is strongly correlated to our economy. Growing Government deficits, rising consumer debt, the ever expanding real estate bubble and inflating energy prices could all contribute in sending the US economy and related economies in a tail spin.

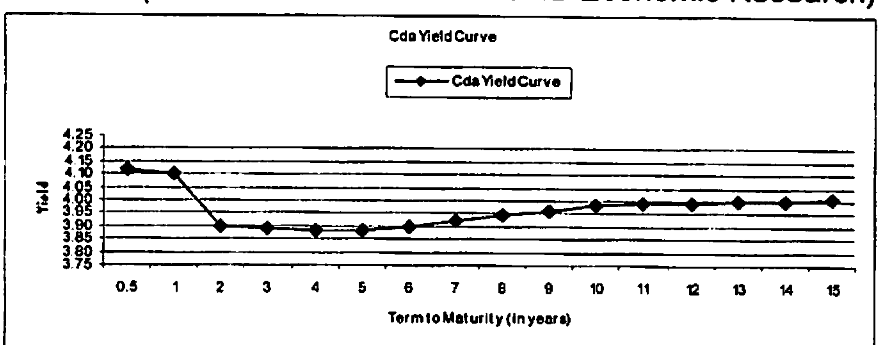
In our last three newsletters, we highlighted those increasing threats, and our response was to maintain an underweight exposure to those most vulnerable sectors without avoiding them completely. Such a strategy allowed us to participate in the growth with reduced volatility. Today's bad news is that the economy is slowing while the good news is that the economy is "only" slowing. In other words, the markets may step back before it resumes its forward march. Both BMO Nesbitt Burns chief economist Sherry Cooper and portfolio strategist Ben Joyce believe in the possibility of a soft landing of the economy.

It took seventeen consecutive rises in interest rates before the Federal Reserve Board felt it was enough. Mr. Bernanke, the Chairman, did not have unanimous support on that decision early last summer, but it turned out to be the right one. Now, some members are already talking about easing again! Although facilitating credit could help avoid a recession, so would lower energy prices ...and that could be the best offset. Indeed, lower energy prices relieve consumer cost pressures and increases disposable income.

While further rate hikes could have not only triggered a real estate collapse, but also financial distress, consumer confidence fall-out and potentially an economic depression, maintaining interest rates where they are for a while should not re-ignite the real estate speculative bubble.

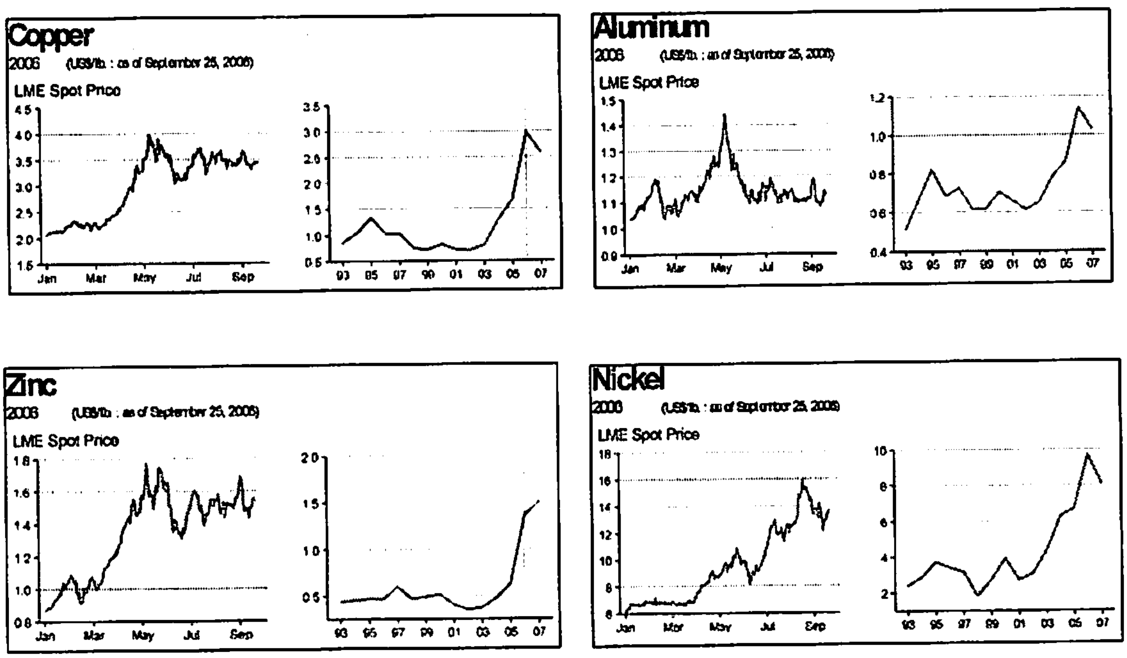
The recent drop in 10 year bond yields in the U.S. from 5.25% to 4.45% suggests an economic slowdown is in the works. However, the resulting inverted yield curve (when short-term rates are higher than long-term rates) has some forecasters calling for an upcoming recession. The next moves on interest rates are therefore, likely to be down.

Chart 1 –Yield Curve (Source: Reuters and BMONB Economic Research)



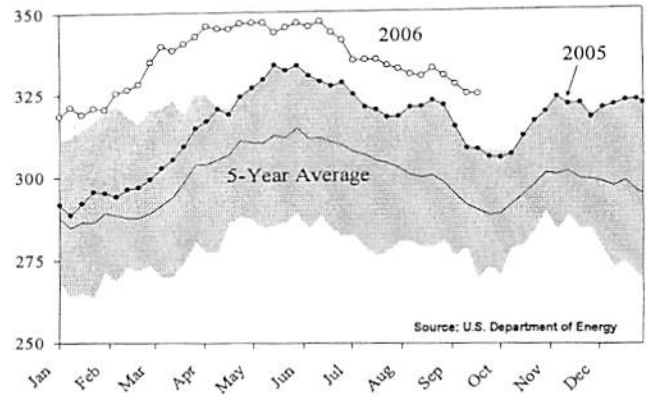
The current yield curve might evolve to look like a hump-back in the months ahead as the risk of "deflation" and/or stagnation returns to haunt the Fed and economists, which will cause both short-term and long-term yields to head lower. This will act as a stimulus once again and potentially trigger a market rally based on stronger fundamentals, i.e. higher earnings and expanding price earnings multiple. Until then however, most commodities have reached unsustainable price levels and the current economic slowdown will address those excesses.

Chart 2 (Source: BMO Capital Markets, The Goods, September 26, 2006)



Energy prices, which hit new highs after the Katrina hurricane last year, have split trends in the last year. Natural gas prices dropped sharply as inventory rose in anticipation of another stormy summer, which didn't materialize. Meanwhile, oil prices remained high given the world's political instability, such as Iran's uranium enrichment program, and the Israel/Lebanon crisis. Most experts valued crude oil's geopolitical premium at about $15 to $20 a barrel. With political tensions at ease for the moment, oil prices have fallen from the $75/barrel to roughly $60/barrel today. Further weakness could be on its way, mainly caused by excess inventories.

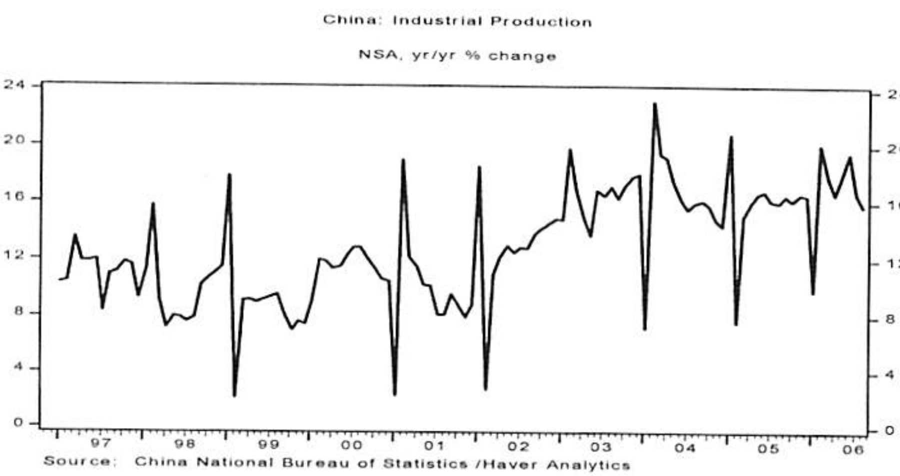
Chart 3 - Oil Inventories vs. 5-year average



In Newsletter #34, we reflected on this matter and wondered how long the market would overlook the fact that inventories were well above 5-year averages. Recent events make us believe the market might be starting to put more importance on these numbers. Firstly, when British Petroleum announced on August 10th that it had to shut down its operations at Prudhoe Bay, Alaska, that meant that as much as 400,000 barrels a day had to be replaced and fast. Roughly half of that production resumed on August 28th and another third on September 22nd. The market was easily able to absorb this new unexpected shortfall as if nothing had happened, which signals that there was a lot of spare oil in the system.

Secondly, on August 18th, the People's Bank of China unexpectedly raised interest rates again, this time by 27 basis points (slightly above 0.25%), which shows the determination of its fiscal leaders to keep growth in check. This action could hamper GDP growth, which had exceeded 10% in the second quarter. It may also slow China's growth in oil demand.

Chart 4



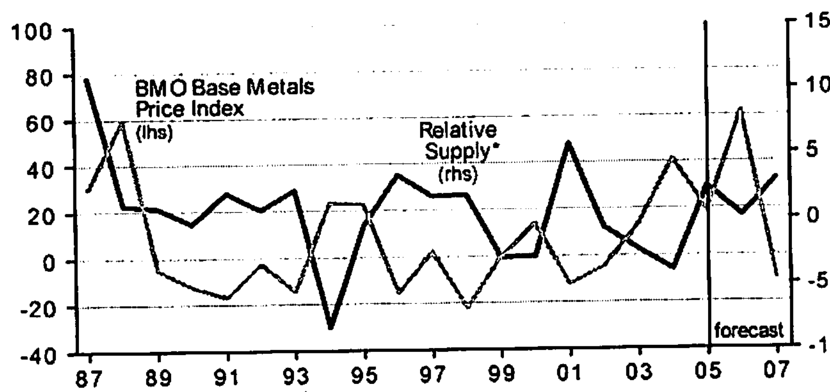
China's industrial production and consumer price index started to show signs of retraction as early as July. Slowing demand growth for oil in China at a time when inventories are above 5-year averages could again put downward pressure on prices, at least in the short term.

Thirdly, we are entering a soft season weather wise, with regards to energy consumption. However, this situation could change as early as cold weather is noticeable again.

These factors, combined with a slowing U.S. economy, could cause the oil prices to be dragged lower and perhaps spike down before resuming an uptrend again. Be aware, however that while OPEC was helpless to stop oil prices from surging, caused by very low spare capacity in the sector, **the cartel is able to cut production easily to support prices.**

Chart 5 (Source: BMO Capital Markets, The Goods, September 26, 2006)

Metal Supply/Demand Balance Improving
(y/y % chng)



* Supply growth – Demand growth (Aluminum, Copper, Zinc, Nickel & Lead)

Base metals face a similar situation but inventories are not as significant as energy. With an improvement in the supply/demand balance in most of the base metals, a correction in the prices is unavoidable, but not to the levels of four to five years ago. We do not expect a massive decline in Chinese demand for energy and metals, but a slowdown from the dizzying growth rate to a more modest one, at a time when the U.S. economy is also moderating. Meanwhile, lower oil prices should have a positive impact on production costs at a time when a majority of companies have strong balance sheets, low indebtness and are flush with cash. It should be noted that many base metal producers trade at very low price to earnings multiples, discounting lower metal prices. As copper is the most vulnerable metal due to its dependence on housing starts, copper producers are subject to be the most volatile stocks of the group. Quadra Mining, for example, trades at an extremely low price/earnings (P/E) multiple of 2.5 times 2007 earnings, based on a copper price of $3.50 lb[1]. Obviously, with copper prices down to, say, $2.25/lb, the stock price could fall sharply but would still have an attractive P/E multiple. What becomes most important is where we believe metal prices will be in the long-run. Although we believe base metal prices are vulnerable for a correction, they should remain relatively high based on historical averages.

Companies might reassess the cost of building compared to acquiring a competitor. With material and construction costs so high, labor shortages, endless environmental expertise and obligations, we can expect any weakening in equity prices to be a consolidator's dream. While avoiding the risks of contracting and building, along with environmental red tape, consolidators could increase both reserves and production immediately without increasing overall capacity, keeping supply tight. In addition, many of these potential consolidators are currently flush with cash and could use their own stocks as currency or low interest rate loans. This action would also eliminate a competitor and provide a better pricing environment for the remaining players, as well as being able to better absorb future increases in energy costs. Currently falling energy prices could also help to cut operating costs at least for the short term and justify consolidation action.

Although both North American economies might avoid a recession, it seems obvious that an economic contraction is on the way, both in Canada and the U.S. Canadian equity markets might be more vulnerable given its heavily weighted index in energy and materials. Furthermore, given its underperformance versus the Canadian indexes over the last several years, the U.S. market might be more attractive on a relative basis. With the Canadian dollar trading at nearly $0.90 U.S., currency risks are not as worrisome for Canadians as they once were. However, the U.S. dollar is not out of the woods. Given the large increase in foreign debt in the past few years, with a cumulating annual deficit, America's debt payments are now exceeding revenues from investments abroad by $2.5 billion in the second quarter of 2006, for the first time in 90 years. Jim O'Neil, chief economist at Goldman Sacks in London is concerned about the nation's credit worthiness and the U.S. currency if this trend persists[2]. However, for the first time in several years, we would suggest to **moderately** invest in U.S. stocks in sectors not well represented in Canada, particularly in companies with strong balance sheets, little debt and strong cash flows, to better diversify portfolios. Similarly, we also believe in diversifying outside America, namely in Japan and benefit from the change in the guards with new Prime Minister Shinzo Abe who inherits of a very solid economic foundation set by his predecessor Mr. Koizumi.

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[1] BMO Capital Markets, August 15,2006 Research Report, Quadra Mining.
[2] Wall Street Journal, Monday September 25, 2006 "U.S. Foreign debt obligations finally coming home to roost".

Conclusion:

Let's summarize the situation: we have stable to potentially lower interest rates in 2007 (good news) combined with falling oil prices and to a lesser extent, lower base metal prices (good news/bad news). Although this scenario slows earnings growth for related companies, it should allow the world economic expansion to continue, albeit at a slower pace, and benefit the users of those commodities with regards to their profitability (good news).

We can also expect to avoid a hard landing of the real estate market and appreciate that price inflation should be held in check at least for the foreseeable future (good news).

It is also most probable that consolidation will accelerate as the equity markets pull-back, due to the fact that the long-term trend remains intact (good news).

So, given that we are witnessing the greatest growth in global liquidity of all time without inflation and that we keep adding a few million people per week joining the middle class, we can hardly worry about short-term adjustments in the new inter-linked world economy.

Canada is a great country but it is falling victim of its own success. Losing such companies as Dofasco, Falconbridge and Inco is just the beginning of a new international consolidation phase which favours long-term in the ground reserves in secure parts of the world.

Commodities should be supported by the developing infrastructures in India, China and other emerging nations. Furthermore, 1990's new environmental protection rules mean that many new mine and oil field development projects cannot occur without higher commodity prices. After that, it is a question of supply and demand.

The investment strategy therefore, is to maintain investments in resource companies that relates to the previous description, i.e. long term in the ground reserves owned by companies with strong balance sheets and cash flows, with marginal debt, trading and relatively low multiples. In this group we find Suncor, Canadian Oil Sands, Petro Canada, Teck Corp, Alcan. In replacement of Inco, we are considering Phelphs Dodge and Inmet Mining.

The topics of deflation and stagnation will most probably make the headlines again as the correction runs its course and your best protection here will be long-term bonds and/or highly rated public utilities income trusts. Here we own Epcor, Innergex, Northland Power and Algonquin Power in electricity, Pembina Pipelines, Gaz Metropolitan and Fort Chicago energy for pipelines, and Bell Alliance, Yellow Pages for telecommunications.

If history serves as a guide, financial stocks tend to outperform once the Fed stops tightening. Lower interest rates increase the bank's operating margins and their high dividend yield further attracts investors. BMO Financial Group, Bank of Nova Scotia, Manulife Financial, Power Corp and Industrial Alliance remain our choices.

We continue to like Canadian National Railway and Groupe Laperrière & Verreault for industrials. As for consumer non discretionary, we own Metro and we may recommend some US counterparts within this group to increase diversification in the U.S. market. Guardian Group of Funds' Japan Fund is our choice for offshore diversification.

As for gold, it remains our conviction to maintain a 5% exposure given the risk of a devaluation of the U.S. dollar and/or a re-balancing of Japan's and China's central bank reserves. Our favourite stocks in that group are Barrick and Goldcorp.

ASSET MIX OF MODEL PORTFOLIO

INCOME PORTFOLIO			BALANCED PORFOLIO	
Mar 2006	Oct 2006		Mar 2006	Oct 2006
5%	5%	CASH (CSB, QSB, T-BILLS)	5%	5%
45%	45%	FIXED INCOME (BONDS)	25%	25%
25%	25%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	25%	20%
15%	15%	EQUITIES	35%	40%
10%	10%	FOREIGN	10%	10%

Pierre Morin - Josée Dupont

INCOME-GENERATING INVESTMENTS

	CURRENT PRICE	DISTRIBUTION MONTH-LY	QUARTER LY	SEMI-ANNUAL	ANNUAL DISTR. $	CURRENT YIELD	YIELD TO MATURITY	(5) ESTIMATED % TAXABLE	(1) CURRENT AFTER-TAX YIELD	RECOMME NDATION	TARGET PRICE	(2) CREDIT RATING CBRS
DEBENTURE												
PEMBINA PIPELINES CONV DEB	$149.00			3.68	$7.36	4.94%		100%	2.47%	Hold	$100.00	
INCOME TRUST (3)												
ALGONQUIN POWER	$10.30	0.08			$0.96	9.32%		55%	6.76%	Hold	$10.50	S-3
BELL ALIANT	$34.95		0.3996		$1.60	4.57%		100%	2.29%	Buy	$38.00	S-2
CANADIAN OIL SAND	$29.82		0.306		$1.22	4.10%		80%	2.26%	Hold	$41.00	S-4
EPCOR POWER	$32.27		0.63		$2.52	7.81%		70%	5.08%	Buy	$33.00	S-1
FORT CHICAGO ENERGY	$11.58	0.079			$0.95	8.19%		85%	4.71%	Buy	$11.15	S-2
GAZ MÉTROPOLITAIN PTS	$17.60		0.31		$1.24	7.05%		100%	3.52%	Buy	$18.25	S-1
INNERGEX POWER	$13.95	0.077			$0.92	6.62%		34%	5.50%	Buy	$13.00	S-2
LABRADOR IRON ORE	$26.99		0.65		$2.60	9.63%		100%	4.82%	Hold		S-3
NORTHLAND POWER	$15.11	0.083			$1.00	6.59%		82%	3.89%	Hold	$14.00	S-2
PEMBINA PIPELINES	$17.35	0.088			$1.06	6.09%		75%	3.80%	Hold	$16.50	
RIOCAN	$24.01	0.106			$1.27	5.30%		63%	3.63%	Hold	$23.50	S-2
TRANSALTA POWER LP	$7.75	0.066			$0.79	10.22%		55%	7.41%	Sell	$7.25	S-1
TRINIDAD ENERGY SERVICES	$14.60	0.115			$1.38	9.45%		100%	4.73%	Buy		
WESTSHORE TERMINALS	$9.75		0.325		$1.30	13.33%		100%	6.67%	Reduce	$11.00	S-4

1) Assuming a 50% marginal tax rate.
2) Varies between S1 to S7, S1 being the highest
3) Income may be subject to fluctuations.
4) Current net asset value $16.73. Redeemable at n.a.v. in August 2007.
5) Source: BMO Nesbitt Burns Income Trust Review September 2006