

April 2007

## Newsletter #37

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## **PLEASE REMAIN SEATED**

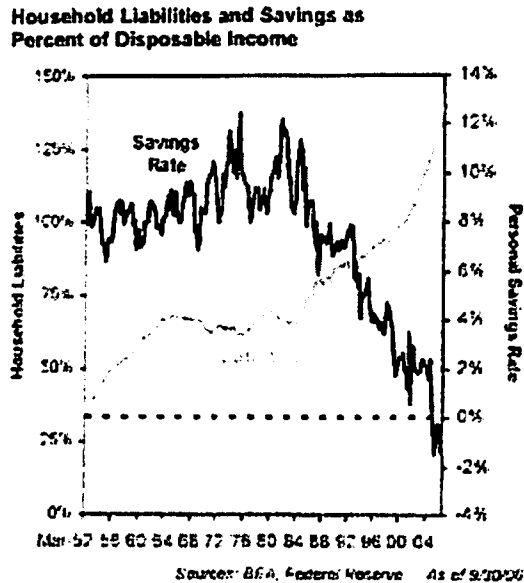
In January, our RRSP newsletter was entitled "Buckle-up" and, with hindsight, our recommendation of maintaining your RRSP contributions in fixed income investment instruments was probably a good idea. Although our outlook of a bumpier ride remains intact, we have had some positive developments. But first, allow us to express some of our thoughts on the increasing volatility in the market place.

Stock and market volatility is usually a function of corporate or economic news. Such news may affect a company specifically, and perhaps the related sector in which it operates. Likewise, economic news may affect a specific industry or a specific region. Depending on the significance of the news, equity markets can be more or less volatile. But there is a major factor that can significantly enhance the volatility and trigger irrational behavior driven by fear ... and that is excess "margin" or "leverage". The use of borrowed funds for investment purposes has its own cycle. It seems to come back into style at every market peak or during extended economic cycles. Borrowing for real estate has always been part of our customs since most individuals have rarely the wherewithal to pay for a new house upfront. Few are those who will borrow in the same proportion to buy equities. The rationale behind this behavior is that one needs a roof for shelter and to raise a family. It is a basic need and it is a form of "forced savings". It becomes an essential part of a long-term financial plan. An investment portfolio is not essential to survival and, therefore, borrowing against it is not as common a practice. Furthermore, stocks fluctuate constantly and, by the same token, so does their collateral value. If individual investors are forced to sell stocks to cover part of the loan, it is because the value has fallen and therefore they are obliged to sell at the wrong time (i.e. when stocks are low). Given that it requires significant knowledge and skills to manage a leveraged portfolio, specialists have sought to fill the gap with what are called "hedge funds". Their emergence provided investors the possibility of investing in funds that use sophisticated investment strategies that involve the borrowing of capital or "leverage", which enhances performance... (up and down), without having to monitor and select securities or adjusting strategies in a timely fashion. The professional portfolio managers of the fund itself do all the work on a discretionary basis. The popularity of such hedge funds has grown incredibly over the last few years to reach over a trillion dollars. When borrowed funds are used excessively to buy stocks, it creates a momentum. The higher the stock prices go, the better the performance and the more new money the fund attracts. However, when the market corrects, selling is accelerated by the constraint of having to cover the loan...and if one fund is forced to sell, it may have a rippling effect on other funds and could trigger an overreaction. In other words, the increasing use of leverage by hedge funds significantly increases the volatility in the markets and the risk of an irrational and massive sell-off.

In 1987, it was the growing popularity of unregulated use new electronic software, also called "program trading", which fueled the October 19<sup>th</sup> stock market crash. Program trading ultimately became regulated in achieve better control over market volatility. Today, 20 years later, neither the Securities Commissions nor governments are



## Chart #2



On the plus side, economic growth continued to expand despite a significant rise in energy and other raw material prices (such as base metals i.e. copper, nickel, zinc and aluminum) as well as real estate prices. It seems that low interest rates and the migration of the transformation sector or manufacturing industry to low-cost China has largely compensated for the rise in commodity prices. Inflation remains tame... for now.

History shows that inflation did not necessarily occur when energy prices rose. However, when fuel and food prices rise together, combined with excess monetary creation, inflation occurs.

Although consumers have benefited from what seems to be an unlimited source of cheap labor in Asia to fill their savvy appetites, new inflationary pressures in "comestible commodities" could be on the horizon. In his State of the Union address in January, President Bush raised the 2005 U.S. Congress target of increasing alternative fuel production from 7.5 billion gallons a year by 2012 to 35 billion gallons a year by 2017. According to the U.S. Renewable Fuels Association, the U.S. produced 4.9 billion gallons of ethanol in 2006 compared with 1.6 billion gallons in 2000. To reach President Bush's ambitious objective, the U.S. would have to increase current production sevenfold, or more than twenty times year 2000's production. Why does this matter? Ethanol is mainly a corn by-product, although it can also be made from other bio materials such as crop residues (straw, corn stover, etc.), forestry waste (sawdust, etc.) and even wheat. The U.S. produces 40% of the world's corn and is its largest supplier. The ethanol-driven corn rush has pushed corn prices up from U.S. \$2.09/bushel in August 2006 to U.S. \$4.13/bushel in early March 2007. The previous all time record-high season average corn price was U.S. \$3.24/bushel in 1995/1996. The burden of record corn prices is felt mainly in the livestock and meat sectors and, ultimately in

In a stagnation state, corporate profit growth slows and stock prices fall, as price/earnings ratios contract until inflationary pressures are back under control. The size of the correction can vary depending on consumers' ability to adjust. Eventually, interest rates will fall to kick start the engine again (i.e. consumer spending). Japan had

pushing inflation even higher. the soft economy and huge consumer debt, and unable to cut interest rates and risk caught between a rock and a hard place, not in a position to raise interest rates given when inflation expands even while the economy slows. Mr. Bernanke could find himself Typically, a deceleration in economic activity does not stimulate either consumer behavior or inflation, unless the economy falls into a "stagflation" mode. This occurs Recently the U.S. economy has shown signs of slowing and so have corporate profits. inflationary pressures. But is the U.S. economy able to afford an interest rate hike? change its bias towards tightening its monetary policy (raising interest rates) to offset Still, if food prices increase, the Central Bank would, under normal circumstances, year.

(a money supply indicator) was pulled out of publicly available information since last for Mr. Bernanke, the U.S. Federal Reserve Chairman. Remember, however, that M3 supply has been well contained and well managed to date, and is not a major concern higher, which could accelerate the rise in prices. Fortunately, the growth in money stimulate inflation. For example, one could build up inventories before prices move can trigger emotionally-driven decisions that could alter economic growth and ultimately believe inflation is headed out of control. The simple presence of this vicious thought fashion so that no consumers, investors, union leaders or businessmen are led to through interest rate adjustments allow continued money growth but in a controlled But then, what about monetary growth? Monetary policies set by central bankers spill over and could create a chain reaction. producers would slip below their break-even point. Still, some food inflation is about to Fortunately, this could turn out to be only a nightmare scenario because, as the price of corn reaches \$5.00 a bushel, there may no longer be an incentive to produce ethanol as

stability that consumers have enjoyed for years may be in jeopardy. State of Indiana in corn crops, according to an A.G. Edwards analyst. Food price three years, in order to meet ethanol targets, farmers need to add the equivalent of the for 2007, the most since 1944, while soybean acres may fall by 11%, an 11-year low. In prices as well. The U.S. Department of Agriculture confirmed a rise of 15% in corn acres bushel. That leaves less room for other foodstuff, curtailing supply and bumping up their More and more land is dedicated to planting corn as prices reach U.S. \$4.00+ per

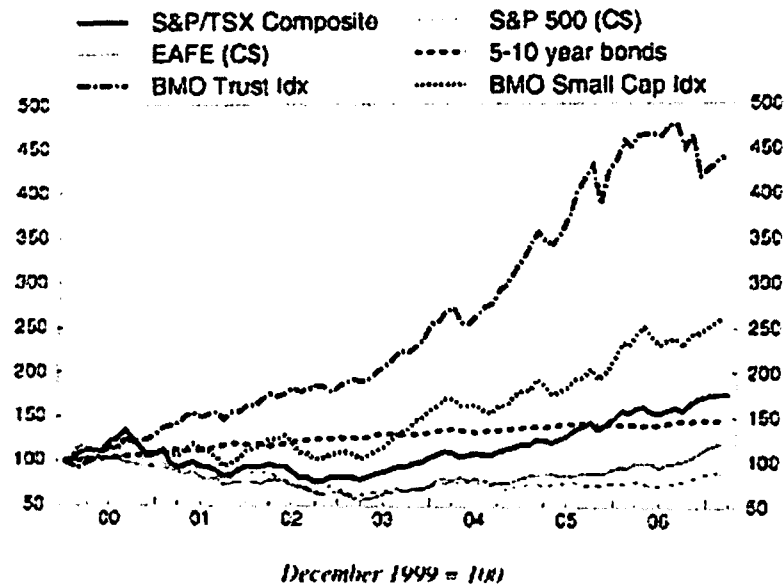
does the demand for grain as feedstock for the animals. them to alter their diet in favor of more meat. As cattle and pork demand increases, so commodity prices (i.e. copper, steel, aluminum, etc.). But their new status also enables them to build new homes and purchase cars, which explains the rise in basic Chinese reach middle-class status every year. Their financial accomplishment allows consumers' food bills (i.e. food inflation)! As well, it is believed that about 40 million

to cut rates to 0% to get consumers going again. That depression lasted 15 years (1990 to 2005).

Over the next six months, we believe food prices might be our best indicator of where the economy and the markets are headed. We have to remember that Canadian investors have enjoyed hefty performances over the last four years. The TSX returned 27%, 14%, 24% and 17% respectively since 2003, outperforming both U.S. stocks and global equities (see chart 3).

**Chart #3**

### Total Returns from Asset Classes



The key to the sustained worldwide economic expansion has been a combination of very low interest rates without an inflation spiral. From 2001 to 2006, the TSX's operating earnings grew an average of 20% per annum, which is unsustainable. The price/earnings multiples have expanded and are now above historical averages. For 2007 and 2008, BMO Nesbitt Burns portfolio strategist Ben Joyce is forecasting earnings will grow only by 7% and 5% respectively.

## **Conclusion:**

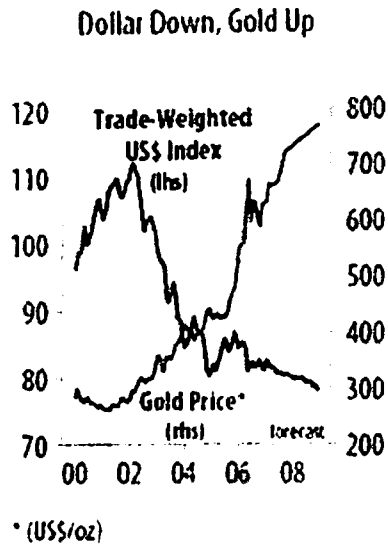
When the economy slows and profit margins compresses, the time for an asset mix review has come. Chances are that five years ago, you might have owned a larger proportion of fixed income investments than today given that it has been diluted by the significant improvement in the equity portion. We should return to basics and realign the fixed income portion by selling securities that might be more at risk. Those would be the ones that either:

- 1) Don't pay a dividend
- 2) Have excessive debt and a weak balance sheet
- 3) Are more sensitive to economic slowdown
- 4) Are not core to your portfolio
- 5) Are over-weighted in your portfolio

Remember that when the market falls, it becomes very costly to hold a stock that doesn't pay revenue, and those who do pay a solid income or dividend are the first stocks to rebound. Furthermore, it is nice to have access to cash when the market gets cheap. As for the equity weight distributions, we are still maintaining a roughly 8% exposure to oil and gas stocks (Petro Canada, Suncor, Canadian Oil Sands, EnCana and Anderson Energy), 6% to 8% in base metals (Alcan, Teck, Sherritt, Quadra and Canadian Royalties) and at least 5% in gold as a hedge against the U.S. dollar (chart 4) and inflation (Barrick, Newmont, GoldCorp and Virginia Gold Mines).

We still like utility income trusts and REITs for their revenue stream for at least 15% of your portfolio (see income generating equity table). These would protect you if the economy stalls (stagflation) or falls into a depression. Financial services such as Bank of Montreal, Bank of Nova Scotia, Manulife Financial, Power Corporation and Industrial Alliance should account for 15 % to 18% of the equity portfolio. As for the transport industry, we still like Canadian National Railway as a long-term core holding.

**Chart #4**



Slumping US Dollar helping gold graph

Source: Focus page 6. March 30<sup>th</sup>, 2007

Food inflation has historically favored food retailers, fertilizer and agricultural equipment companies. We are currently evaluating Saskatchewan Wheat Pool, as well as Finning International. As for food retailers, our favorite is Metro, followed by Alimentation Couche-Tard.

**ASSET MIX OF MODEL PORTFOLIO**

**INCOME PORTFOLIO**

**BALANCED PORTFOLIO**

Oct 2006	March 2007		Oct 2006	March 2007
5%	15%	CASH (CSB, QSB, T-BILLS)	5%	10%
45%	40%	FIXED INCOME (BONDS)	25%	25%
25%	20%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	20%	20%
15%	15%	EQUITIES	40%	35%
10%	10%	FOREIGN	10%	10%



