RBC Dominion Securities

Money
NEVER SLEEPS

The Newsletter for the Informed Investor – http://dir.rbcinvestments.com/vito.finucci **October 2006**

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The big Picture

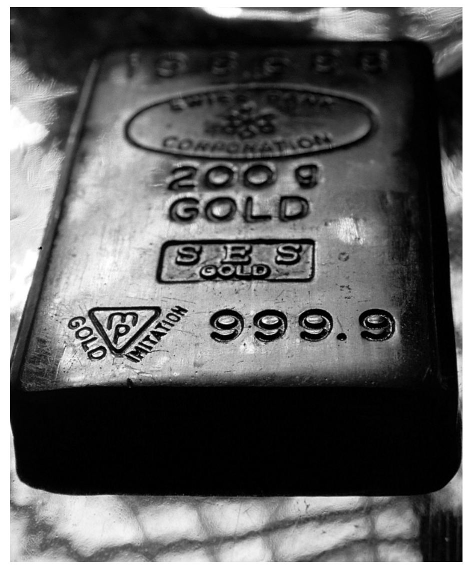
ROCKING BUT NO ONE KNOWS IT

"When the facts change, I change."
John Maynard Keynes, Noted Economist

The DOW JONES touched a new high the last week of September but there was no jubilation or celebrating. Most broader indices remain well below their 2000 highs. Maybe it's old hat or maybe it's just that we were all so naïve in the past that we thought reaching one milestone would automatically lead us to the next one. However, there isn't that kind of buzz in the air that once existed when the Dow was at 10,000 or more recently at 11,000. In many respects, this is a good thing because it is more difficult to dash high hopes when they don't exist.

For the first time in many years, the actual index number of the Dow Jones surpassed that of the TSX, which I think is more significant than many may think. This is coming together at a moment in time, just as the world (and many Americans) had begun to write off the relevance of the US market and its leadership. I think it's a large mistake to make such assumptions. The Dow is actually up huge since the Iraq war began, and the latest boost comes from lower crude oil prices; lower in large part to a reduction in the so-called terror premium.

The US (and North American) economy is working through the latest asset bubble: housing. While the landing will take 2-3 years to filter all the way through, I do not believe it will be as hard a landing as many predict.



It is but a done deal the US Federal Reserve is done raising rates. Odds are they went too far as recent economic data reflects a US economy slowing down. Which raises the next logical question: If they are done raising rates, when will the first rate cut take place signaling the next cycle?

In the long run, it is interest rates that are the most important determinant of stock market fortunes, as they are a reflection of and in combination with the health of the economy. A close second determinant would be corporate profitability. Entwined with those comes the level of inflation and the perception of the level of future inflation. This alone is probably the most important determinant of interest rate

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levels and direction.

For all of 2005 and the better part of 2006, the markets (and Central banks) have focused on how high inflation (and ergo interest rates) might go. In my opinion, that is changing, and this will be exceptionally positive for global markets. Oil has reversed from $78 to the low $60's. Gold has reversed (a historical inflation indicator). Most commodity prices have come off. Natural gas prices are down about 40% from highs. If housing has peaked, that will also push prices down for all the materials that go into them.

While natural resource stocks will experience trading rallies, I believe they have seen their peaks for this cycle.

In my opinion, the Fed overdid rate hikes by 1% to 1.5%, mainly due to a new Fed Chairman trying to send a message that he, like his predecessor, is an inflation hawk.

I think interest rates will start declining by year-end or early 2007. And they will, on average, remain historically low, for in my opinion, the expanding pool of cheap world labour combined with improving productivity, will pressure inflation (and thus interest rates!) to remain low. Wages represent almost 75% of GDP, commodities a mere 12%. Thus wages are 6X more important, and if they remain constrained, combined with good worldwide economic growth, we would have a "perfect storm" best of both worlds – low inflation, low interest rates, global growth…and a Bull market.

From my experience, there always tends to be one high-profile climactic event, which signals that the sector is done. For commodities it may be the Amaranth hedge fund, which made a big bet on natural gas futures and in the resulting fiasco proceeded to lose $5 billion (yes, billion) in only a week, losing approximately 50% of its value. In fairness, lots of money was made in commodities over the last several years, but it simply reinforces the fact that commodities remain volatile and risky, and just because there may be more demand from China and India, it does not necessarily mean they will only trade in an upward direction.

Canada is still perceived by the world to be a commodity based economy, so recent action may be unnerving for many. Of course, Canada is concerned about the economic prospects for the US, for the US remains Canada's most important client. However, Canada has done a great job in diversifying its reliance on the US, diversifying its economic fortunes away from the US and towards Asia and Europe. Thus in the past, we always heard when the US economy caught a cold, we caught pneumonia. One can legitimately argue now that if the US economy catches a cold, Canada's economy gets a modest fever at worst.

But the bigger issue with the US economy may be its massive debts. Mortgage debt is estimated above **$10 trillion**. Total US debt has been calculated to be **$44 trillion**. All this debt has to be carried, and it takes cash flow (money!) to carry debt. Otherwise debt will curb consuming and spending, which is deflationary. So many argue the only way the US government will get out of this is to inflate, which reduces the power of the debt over time. Regardless, deflation is the most evil of all the evils that can attack an economy.

To summarize, I do not think housing will crash, but it has peaked and will leak slowly. I do not think commodities will crash, but I think they have peaked for this cycle. I believe inflation will not soar and interest rates will go lower in 2007. Finally I believe all this sets up for a strong year-end rally for 2006, followed by a strong 2007. All the above will also occasion a change in market leadership.

I believe the US financials and drug stocks have bottomed and have begun a new cycle upward. My third member of the new market triumvirate leadership, technology, is basing and turning upwards. Witness this month's action in Cisco, Oracle, Motorola and Research in Motion to name a few. After six years of very difficult performance, I think their time has finally come. Remember folks; oil was $10 a barrel in 1998 but the biggest gains in that sector were made 2003 to 2006.

While the Dow may be on top of the world, at least as far as the record books are concerned, there is still along way to go for most names. The Nasdaq is still off more than 50% from its 2000 highs and will not revisit there in the foreseeable future. Nonetheless, I believe that is where the best action will be for the next 2 to 3 years.

Around the globe

Canada (SELECTIVE BUY)

❖ Commodity cycle appears broken – Oil has dropped from $78 to $62, Gold from $700 to $590

❖ Rates expected to hold – Only G7 economy with budget surplus (9 years in a row).

❖ Have to look for buys outside of oils, gas, mines, metals, gold and banks which now represent over 80% of the TSX

U.S.A. (STRONG BUY)

❖ Impact of 17 straight Fed rate increases starting to bite.

❖ Housing market appears to be turning down quickly.

❖ Rate decreases next step? Late 2006 or early 2007?

❖ New sector leaders – financials, healthcare, techs

Europe (HOLD)

❖ Above target inflation in most countries calls for tighter monetary policy which will lead to weaker 2007

❖ Exports outlook weaker.

Asia (HOLD)

❖ Japan has continued economic recovery and as result raised ranks in July after years of ultra loose monetary policy.

❖ China maintains 9.5% – 10 % growth

❖ Dropping energy prices help region immensely as all oil is imported.

Latin America (AVOID)

❖ Not much, except the last 5-6 elections, which implemented "left-wing" governments which generally take 2-3 years to filter through and cause economic havoc.

Looking ahead

October

❖ Known as junk month due to crashes in 1929, 1987, 1997 and tough Octobers in 1978, 1979 and 1989.

❖ Yet a "bear killer" and turned the tide in 11 post WWII bear markets.

❖ In midterm election years (like 2006!) Octobers are #1.

❖ Great time to buy depressed high tech stocks for cyclical moves.

❖ Best month since 1998!

November

❖ #2 S&P month since 1950

❖ Starts best 6 months of the year, usually very good in mid term election years.

December

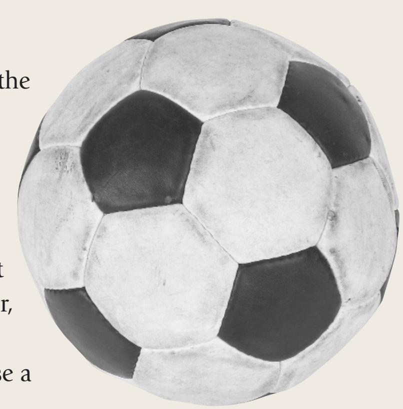
❖ #1 month with average 1.7% gain since 1950

❖ 2002 was worst December since 1931, down 6%

❖ Only 4 Decembers down in last 14 midterm election years.

(Source: 2006 Stock Traders Almanac)

The Little Picture



Several clients chastised me for an omission on the last issue of "Money Never Sleeps". Was the omission about the economy or markets or politics? A sound "No!" It was about soccer! I had completely omitted mentioning the Italian win in the World Cup. I am a proud Italian everyday, but that day our chests stuck out more than usual! My apologies! The irony is of all of the people who mentioned it, not one was Italian!

As many of you know, I have been helping with the Children's Golf Classic for 17 years. Last year we raised an incredible $180,000! We have great news for next year's tourney. Mike Weir, maybe the highest profile Canadian golfer in history, will be joining us on June 25th at Sunningdale Golf and Country Club. Along with the Weir Foundation, we are hoping to raise a lot of money for our local Children's Hospital. Stay tuned!

Notes

Beginning January 1st, 2006, 330 baby boomers turn 60 years old every hour in North America.

The state of California (36 million people) has over 500,000 real estate agents. (Gartman Letter)

Iraqi crude oil production is now over 2.5 million barrels per day. Oil production there is now the highest since Saddam fell. They hope to produce 4.3 million barrels per day by 2010 and challenge Saudi Arabia as the world's largest producer by 2015. Heady goals, but attainable. (Gartman Letter)

Despite the daily news that would make us think otherwise, 2005 was the quietest and safest year in modern history when it comes to the number of wars being fought. According to the University of Uppsala (Sweden) there were 17 "armed, active conflicts" being waged at the end of 2005, down from the all time high of 31 in 1991.

Portfolio Corner Summary

(as of close September 29th, 2006)

This Quarter's Recommendations:

Altria (NYSE – MO $76.55) – The former Philip Morris has always been a long-term favourite of mine. A cash cow with revenues last year of almost $70 Billion. Businesses include cigarettes, grocery products, snacks, beverages, cheese etc. Brand names include Kraft, Marlboro, and Parliament. Break up value over $100, pays nice dividend yield of 4.5% down from recent high of $85.00. Hold for 18-24 months. (12 month range – Hi $85.00, Lo $68.36)

March Networks (TSX – MN $18.82) – Run by Newbridge founder Terrance Matthews, March provides digital video to banks, retail, government, law enforcement etc. Revenues are up from $11 million in 2004 to over $76 million in 2006, and growing. Very profitable, a clean balance sheet and virtually debt free. Aggressive but lots of upside potential. Hold 18- 24 months. (12 month range – Hi $42.00, Lo $15.50)

A special welcome to all new clients who have joined us.

Thank you, especially to clients who have mentioned our name to people they know. As a sign of gratitude, four times a year we'll randomly select a client who has introduced our services to a friend for special acknowledgement through a nice dinner at one of the finer restaurants in London.

Congrats to Steve F.

Our winner this quarter!

"Quotes"

Procrastination: A hardening of the oughteries.
Anonymous

"Diplomacy is utterly useless where there is no force behind it."
Theodore Roosevelt

"Ambition is so powerful a passion in the human breast that however high we reach, we are never satisfied."
Niccolo Machiavelli

Democracy: A process by which the people are free to choose the person who will get the blame.
Laurence Peter

"Architecture begins where engineering ends."
Walter Gropius