RBC Dominion Securities

PPM Group

PROFESSIONAL PORTFOLIO MANAGEMENT

Integrity, Trust and Experience

Discretionary Portfolio Management

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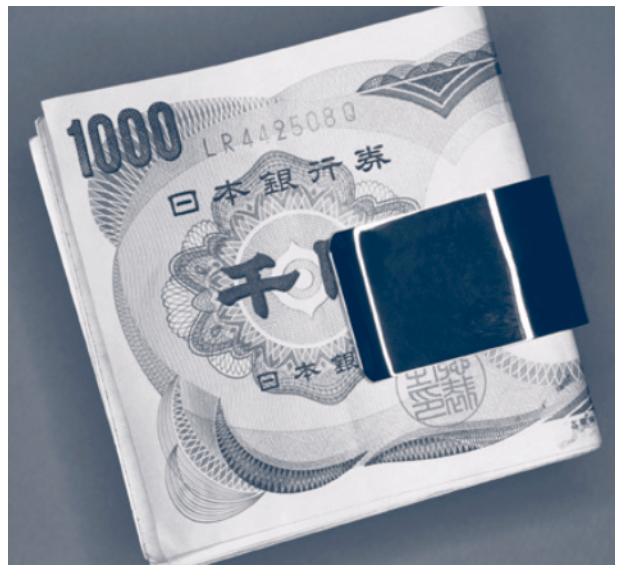
Economic Commentary

The Sun Also Rises



The title of Hemingway's novel seems appropriate at this juncture in the world economy. This is because the sun is a symbol of Japan, and the re-emergence of their economy after a decade of deflation and economic malaise is likely one of the most significant trends today. Following the bursting of a stock market and real estate bubble in the early 1990s, Japan struggled with economic and policy restructuring to try to reverse the seemingly endless spiral of deflation. One of the policies implemented was a "zero interest rate policy", which essentially made money free, as an attempt to print their way out of deflation. With one of the world's largest supplies of savings, and no-cost borrowing, much of the excess capital migrated offshore in search of better returns than were apparent at home. In the late 1990s, much of the world's excess savings chased the only game in town – the US stock market, centering on high technology. This led to an over-inflated US dollar, and stock market. In the past five years, the excess capital was directed to China and India, and then to the resources required to feed these emerging economies. Brazil, Russia, Canada and Australia benefited from increased interest and investment in their natural resources that had been out of investment favour for many years.

However, things have been changing over the past several months. The US economy has been growing well for some time, and the Federal Reserve there has been raising rates for over two years, in order to contain inflation and cool speculative behaviour in real estate and hedge fund investing. More recently, other central banks have begun to follow the US lead and have, or are about to, raise rates. Europe has raised rates, but it is the continued strengthening of the Japanese economy, and the ending of their "zero interest rate" policy that may be the most important event today. Consumer and business sentiment is optimistic there, economic growth is accelerating, and excess manufacturing capacity is shrinking, boding well for future investment.

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I believe that the re-emergence of Japan to economic health signifies a return to more normal world economic conditions. In the past 10 years or so, we witnessed economic deflation in a major part of the world economy – and an economy with much of the world's excess savings. The lack of opportunities for investment there, coupled with the free money policy implemented to cure their illness, created ample capital in the world to chase speculative investments. It also likely contributed to surging asset prices and unprecedented trade imbalances that have built up in this period – most notably, the US trade deficit. If this unusual period of excess world liquidity is ending, then we should not be surprised by the recent market volatility. Investors that relied on cheap, easily available money are having their source cut off, or costs rise. In many ways, the world is returning to a more balanced environment, and a weird period of unusually low interest rates may be ending. Inflation may be lower than in the past due to inexpensively manufactured goods and brisk trade, but the return of a major economy to health, and a diminishment of its export of cheap and ample liquidity to the world is bound to have an effect.

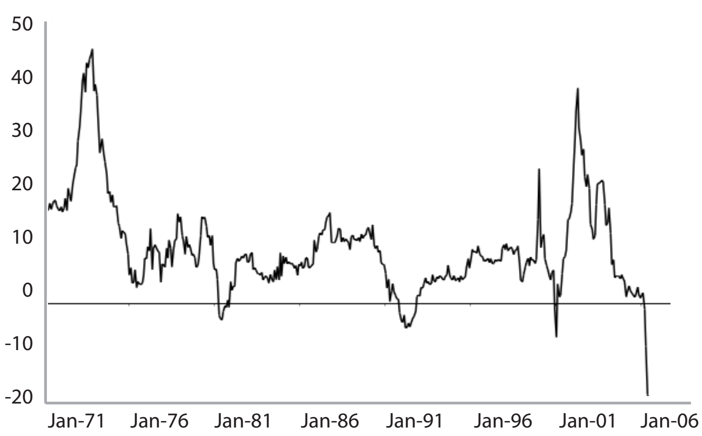
The changes described above have consequences for almost all assets. The liquidity available until recently may have planted the seeds of inflation. With rising inflation and increasing interest rates, valuations of many asset classes will need to be recalibrated in the months ahead. If the US economy slows ahead of other areas of the world, the US dollar may see further weakening. Gold should perform well with a weaker US dollar, inflation concerns, and with newer central banks diversifying out of US dollar reserves.

At this point, I see interest rates continuing to climb, and therefore do not see much opportunity in longer-term bonds or interest-sensitive areas of the stock markets. The US consumer appears exhausted, with high debt levels following a consumption binge. Real estate prices have increased rapidly in some areas, and with rising interest rates making home ownership more costly, this is bound to affect behaviour there, and may mean a slowing US economy in 2007.

The return to balanced world is good, but the transition may be bumpy. Emerging economies like China and India have helped older mature economies like Japan move forward, and this new demand has increased demand for scarce resources. This is likely to be a long-term trend that will be in place for some time. There will be good investment opportunities in the volatile months that are likely ahead. I will do my best to capitalize on these, and as always will protect your interests.

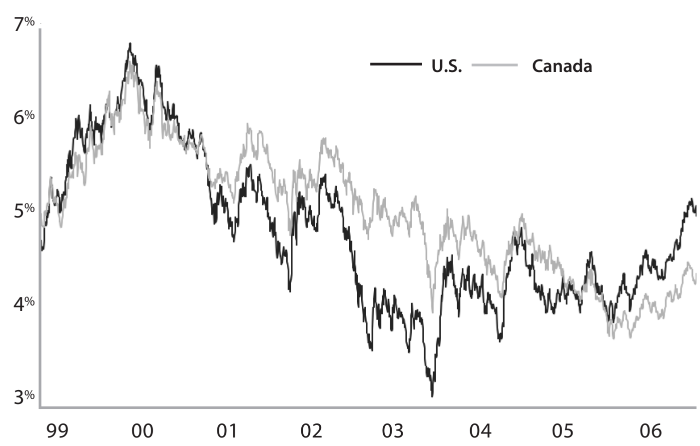
Tony Pringle, CFA, June 30th, 2006

Japan's Monetary Base (yoy% chg)



Source: RBC Capital Markets

Canada & U.S. 10 Year Bonds



Source: Federal Reserve Board, Statistics Canada