RBC Dominion Securities

Money NEVER SLEEPS

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

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The big Picture

BURNING DOWN THE VILLAGE IN ORDER TO SAVE IT

Are you FED up?

Taking time to smell the roses isn't what investors want to do. So it is in this fast-paced world, nobody likes to take the pedestrian route. It has to be done . . . . . yesterday! This kind of mentality has taken its toll on investing as well.

With all the misguided talk of inflation, disinflation, stagflation in the economy, the real sin these days is when the markets stall for even a second. Big-Time money mangers are sitting out the game because they are too confused to play. Smaller investors are shifting gears so often they are turned inside out. Hedge funds are chasing performance in such a manner they now seem like amateurs.

Thus, we end up with the chicken and the egg element to this market. Money is on the sidelines, and it won't come in unless stocks move higher; stocks won't move higher until money from the sidelines comes in. The result? Stagnation, which adds to the angst of investors, which makes for difficult mental terrain.

Inflation fears, slowing economic concerns and more hawkish statements from the Federal Reserve, continue to take their toll on investors. Sentiment polls, money outflows and heavy short-selling activity all indicate investors are literally "FED UP" with the markets at this point, following several weeks of losses which have all but wiped out gains from January to April.

The bulls' confidence seems easy to understand. No matter what bad news seems to come into focus, it seems to be easily and quickly ignored. The game plan, for some time now, has been to stick with the "in" sectors (precious metals, energy, materials, commodities) and you'll be just fine. In fact, given some of the returns delivered by these groups, they've been able to manage more than just "fine" returns year-to-date.

The problem is that the best-laid plans can often go awry.

Just when the crowd is convinced these sectors have zero downside risk, the market proves otherwise. In my experience, in a healthy market, it finds a way to force a strong rotation from hot and overvalued areas of the market to more undervalued areas, but that has yet to transpire in a big way. For now, everyone seems to be shooting at the same ducks, which raises the levels of risk when conditions and perceptions of those sectors inevitably change.

Since the TSX began to recover in 2002, oil and gas producers now occupy six of the top 15 positions in the index. In October 2002, Energy represented 32%, Financials 32% and other sub-indexes 36% of the S&P/TSX sector weightings. In March 2006, these numbers were 46%/30%/24% respectively. Does anyone remember way back in 2000 when Nortel represented 40%+ of the TSX?

With Canadian unemployment the lowest since 1974, the Canadian dollar up from .62 cents in 2003 to .90 cents in 2006, it puts a lot of pressure on the Bank of

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Canada. Value has outperformed growth by such a margin from 2000 to 2005, that it has surpassed the magnitude of growth vs. value bubble in the late 1990s.

For several years now, the fortunes of China and India and other developing nations have been driving global growth. Every year we expect their economies to slow down and every year they continue to surprise. In the most recent quarter, GDP growth for India was 9.3% and China is still running at 10.3%, so here we go again. These kinds of numbers will drag us along kicking and screaming despite the skepticism.

Another trend, which I see coming to pass, is that of the celebrity CEO. With Bill Gates announcing he will step down in 2008, the era of the celebrity CEO has officially come to a close. Now it's back to anonymity, and getting results. The celebrity CEO was always around on Wall Street, but it was the leaders who created wealth for their shareholders that became famous. Trailblazers like Rockefeller or incredible managers like Thomas Watson of IBM fame. Followed by the likes of Goizueta, a Cuban immigrant, who ran Coca Cola and created huge value. Throw in Lee Iacocca and, yes, even Bill Gates during Microsoft's growth years and all the money he made for shareholders (and himself!). Well even visionaries run out of ideas, lose their desire, or simply can't get energized. It's hard to take over the world when you already won it. I will also add that his goal to help the world will be considerably harder than running Microsoft. Everyone will want his money, no one will want his advice. The very people who once demonized him, will now bless him and take his money.

The celebrity CEO brought up Dennis Kozlowski, Martha Stewart and Ken Lay, and so many other crooks that felt they were above the law because of the fawning admiration of their adoring public. The irony is the last flashbulbs they saw were of cameras taking photos of their walk to jail.

Currently there are a lot of good managers running good businesses with the skill of a diamond cutter. They don't seek the spotlight, and that alone is a good reason to celebrate the shift.

Turning now to the main focus of the past quarter, the new Fed Reserve chairman Ben Bernanke. Could it be Mr. Bernanke is some kind of genius? Was it all planned? Years ago Greenspan learned that the jawbone could be as effective a weapon as the hammer, (.50 basis point rate hikes), when he uttered his now famous "irrational exuberance" comment that derailed a raging bull market, if only temporarily. Certainly if inflation was the main concern, a correction in commodity prices was exactly what the Fed wanted to see. It will be interesting to see what kind of bounce they receive, as a trading move won't alarm the Fed, but a move to double-digit highs will likely spur the heavy artillery (big rate hikes). All the "hot " sectors were pounded with the commodity correction: hot Russian stocks, hot Indian stocks, Japan, and Emerging Markets are down, some as much as 50% in less than two months.

It is a difficult period, and newer investors who experienced markets from the late 1990s only, will assume this is another period like the tech meltdown: it isn't. Valuations in most sectors are not out of whack, and the economy is doing well. The outcomes depend on the intentions of the Fed. Sure the economy can handle another couple of rate hikes, but we've learned these rate hikes take 6 to 8 months to reveal their effects and then one fateful day the economy hits a brick wall instead of a higher speed bump.

The hottest stocks and stocks with the highest valuations were the biggest victims of the recent downdraft, which is reasonable, although I question the depth of the slide. Bernanke seems to be focusing only on the inflation side of the equation, while ignoring the growth side. Mr. Bernanke is an academic who seems to believe for the time being he will be able to find clarity, however in time he will learn that he will never have the level of clarity he seeks. Like his predecessor Mr. Greenspan, Bernanke might not be able to achieve the perfect point on interest rates and will go beyond that point every time trying to find that perfect spot. In the game of cat and mouse that goes on between the Fed and financial markets, there is the issue of how far the Fed can go without inflicting serious harm. This is sort of like when your mother used to say, "wait until you father gets home." Ben Bernanke came in under the banner of a friendlier Fed, a more direct communicator of policy. He has publicly admitted the economy is moderating, and yet the focus in the statements remains hard-line.

The Fed seems to understand there is a cumulative effect of two years of constant rate hiking, but he appears to want to err on the side of over-tightening than miss out on a chance to squash inflation. Big Ben has turned out (so far) to be a younger version of Alan Greenspan. And maybe that's why the markets are falling apart.

The stock markets serve many purposes and roles. At times it is an oracle and other times a proxy for the emotions of investors. The global sell-off in recent weeks has been a combination of both roles. The emotional part of the equation is obvious, although I believe the lack of big volume is an indication the large institutions weren't so sure about how far the Fed will go. The market is not afraid of a super strong economy, but rather concerned about an economy that may be weakening…fast. And while I want to say the depth of the recent decline wasn't fair, fairness is not in the lexicon of Wall Street.

The stock market is many things to many people, but right now it's just a room filled with long-tailed cats and a bunch of rocking chairs. The selling may be overdone, the recovery will be choppy and there may still be an air pocket or two downward. The good news is the economy hasn't fallen off a cliff. The bad news is the Fed may want it to.

Around the globe

Canada (SELECTIVE BUY)

- ❖ Less attractive valuations as a result of boom in resource and material stocks (now 45% of TSX).
- ❖ Faces twin challenges of rising currency and higher interest rates, but economy adjusting.
- ❖ TSX at upper end of valuations.
- ❖ Unemployment at 30 year lows.
- ❖ Much of good news already priced in.

U.S.A. (STRONG BUY)

- ❖ Decline of US dollar has accelerated as attentions shift from interest rates to global imbalances.
- ❖ 17 consecutive 25 basis point hikes, Fed near end of rate hikes.
- ❖ Valuations remain below fair value.

Europe (BUY)

- ❖ Recovery is gaining traction; expect 2.5% growth in 2006 and 2007.
- ❖ German economy (Europe's largest) seems to be turning.
- ❖ Tax rates to fall as competition for investment intensifies?

Asia (HOLD)

- ❖ Japan GDP rising, 2006 growth forecast of 3.0%, economy finally emerging.
- ❖ China remains strong despite attempts to slow it down (GDP @ 10.2%!).
- ❖ Vulnerable to high oil prices.
- ❖ Korea firm, Taiwan robust.

Latin America (AVOID)

- ❖ Six out of last six elections have elected left wing governments.
- ❖ Brazil OK but Venezuela a wild card with Chavez.
- ❖ Fears nationalizations will reduce foreign investment.

Looking ahead

July

- ❖ Usually the best month of Q3.
- ❖ First trading day up 13 of last 16 – recent record 9 up, 13 down.
- ❖ Average gain 0.4%, ranking ninth.
- ❖ Huge gain in July usually provides better buying opportunity in next 4 months.
- ❖ In mid-term (US) election years, worst for Nasdaq.

August

- ❖ Harvesting made August the best month from 1901 to 1951. Now that less than 2% farm, it has become the worst month over the last 18 years.
- ❖ End of August very bad last six of nine years; average Dow -2.9%, Nasdaq -2.4%

September

- ❖ Biggest % loser on S&P, Dow and Nasdaq
- ❖ Day after Labour Day up nine of last 11 years.
- ❖ Opened strong 8 of the last 10 years but tend to close weak due to end-of-quarter mutual fund portfolio alignment.

(Source: 2006 Stock Traders Almanac)

The Little Picture

Children's Miracle Golf Classic – 17th Annual

The time seems to go fast. This year's tournament is rapidly approaching, July 12th at Sunningdale Golf and Country Club. I have been the major sponsor of this event for the past 14 years and I am proud to say last year we raised an incredible $150,000 (net) for our local Children's Hospital. Of course, we are hoping to do better this year. If you or your company are interested in contributing cash or in kind, please let me know. All donations over $10 are tax deductible and all dollars raised stay local.

Notes

General Motors lost $4.8 billion in the three month period ending Dec 31st, 2005 and $8.6 billion for the year. Yet ironically, the company sold the second largest number of cars in history and established new sales records in Asia, Africa, Latin America and the Middle East. Still, the fact is the company is losing market share in the US and globally, which is down to 14.2% from 14.4%. (Wall Street Strategies 1-27-06)

Divorce rates in the USA are dropping. 41% of men married pre-1984 were divorced before 10 years of marriage. That number is now 30% of those married after1990. Further, 1/3 of males who did not live with both parents by age 14 were divorced, compared to 1/4 of males who did. Finally 17% who married for the first time at or after age 26 divorced, compared to 27% for those prior to that. (Gartman Letter)

The great Canadian Healthcare system? According to the Fraser Institute, Canadians took twice as long to get medical services as they did a decade ago. On average, Canadians waited 4-1/2 months for 'services' versus nine weeks for the same services in the early 1990's. Topping the list were orthopedic services at 38 weeks, plastic surgery at 36 weeks, and ophthalmology at 29 weeks. Shortest were radiation oncology at two weeks and cardiovascular surgery at 4.2 weeks.

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 Ashley H.
Our winner this quarter!

Portfolio Corner Summary

(as of close June 27, 2006)

This Quarter's Recommendations

Cedar Fair (NYSE-FUN $26.50) – Operate hotels, amusement and water parks. Cedar Point is well known locally, but is one of seven parks. Five of the seven have 130-140 operating seasons. Last year they earned just under $200 million on sales of $568 million. Public since mid-1980s, they are a steady performer. Pays a solid 7.10% on a dividend under its Limited Partnership structure. (12 month range – Hi $33.01, Lo $25.60)

Bank of Montreal (TSX-BMO $59.15) – One of Canada's big five banks. Price has corrected from $70+ to its current level. I think BMO will not be standing within 3 years as bank mergers, I believe, are inevitable. In the meantime it pays 4.19% on a dividend while you wait (12 month range – Hi $70.24, Lo $56.00)

Intel (NDQ-INTC $18.25) – The world's largest semiconductor chip maker with approx. 80% of the market. Was almost $76.00 in Aug 2000, it is very out of favour, but still did $38 Billion in sales last year, netting almost $9 Billion in profits. Pays a decent dividend of 2.20% in the meantime. Buy for a 24-36 month hold. (12 month range – Hi $28.80, Lo $16.75)

"Quotes"

"Always remember, a person is not rewarded for having brains, but for using them." *Unknown*

"Catching a fly ball is a pleasure, but knowing what to do with it after you catch it is a business.".
Pro ballplayer, Tommy Henrich

"There is no faith which has never yet been broken, except that of a truly faithful dog." *Konrad Lorenz*

"Time is the only critic without ambition."
John Steinbeck

"We must use time as a tool, not as a couch."
John F. Kennedy

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