RBC Dominion Securities

Money
NEVER SLEEPS

The Newsletter for the Informed Investor

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Vice President & Director,
Investment Advisor
Vito Finucci
(519) 675-2011
vito.finucci@rbc.com

Alyson Medeiros
Associate
(519) 675-2505
alyson.medeiros@rbc.com

Jodie Fuller
Associate
(519) 675-2511
jodie.fuller@rbc.com

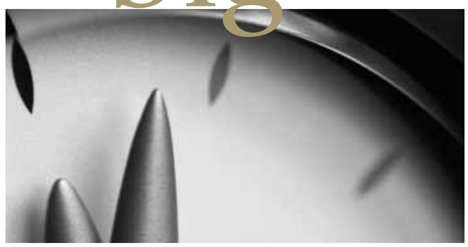
Trish Boughner
Assistant
(519) 675-2021
trish.boughner@rbc.com

Melissa Ruberto
Associate
(519) 675-2036
melissa.ruberto@rbc.com

Fax: (519) 675-2020

RBC Dominion Securities Inc.
148 Fullarton St.
Suite 1900
London, Ontario N6A 5P3

The big Picture



"BETWEEN A ROCK AND A HARD PLACE"

Now is not the time to Blink

From the moment the Fed started raising US rates in June 2004, the economic impact of those rate hikes have been widely debated. Rate hikes were going to hurt the equity markets, slow the economy, and pop the so-called real estate bubble. If I had told you then we would have 12 interest rate hikes, oil would hit $70, we would have the devastation of Katrina, and yet the markets would be flat, no one would have believed me. I hear often how the markets have not gone up, which is true, but I would take a different view, they haven't gone down either, despite all of the fears, the markets continue to face. The third quarter was the first positive one of 2005 with the S&P up 3.1%; the third best quarter for US stocks since 1997. For the record, September 2005 was the best one since 1998. The last four Septembers have been disasters.

Market concerns are many, but I believe the #1 issue is interest rates and how far the Fed will raise them. Monetary policy, more than any other subject in economics, causes confusion. The six month lag it takes for rate changes to cause an economic reaction is difficult enough, but additional confusion is created by the wide variety of economic indicators used to judge the effect of Fed policy. But here we are 16 months into rate increases and the economy shows no signs of slowing down. In spite of that, some have argued rates may decline in 2006. Some analysts suggest that hiking rates at this juncture is harmful to an economy reeling from previous rate hikes, Katrina, and high oil prices.

I would argue the Fed is unlikely to pause and will take US rates to 4.00 – 4.25% by year end. There are three reasons I believe this: First, even after Katrina the economy remains resilient and robust. Katrina rebuilding may even add to inflationary pressures. Second, the Fed funds rate is still well below neutral (rates inflation adjusted). Third, Alan Greenspan does not want to risk his inflation fighting legacy of 17 years when he hangs up the skates at the end of this year.

US government spending is soaring, tax cuts are in jeopardy, and some are calling for tax hikes. All of these place pressure on the Fed to keep rates low. Greenspan has the political capital to withstand the pressure of raising rates. A new Fed Chairman might not.

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Big Picture

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It is interesting to see that high oil prices do not appear to have affected the consumer in a major way… as of yet. Oil prices averaged $26.10 per barrel in 2002, $31.14 in 2003, $41.44 in 2004, and $53.05 for the first half of 2005. But, believe it or not, as incomes and wealth rise, the percentage of income spent on energy has declined over the years. Between 1975 and 1982, energy consumption as a percentage of personal income averaged 6.2%. In 2005, with the highest prices in place, consumers spent just 4.8% of their income on energy. Consumers continue to spend as if there is no tomorrow, in spite of energy prices.

Interestingly, the idea that the US was losing its attractiveness as the top place to invest foreign funds has been tossed out the window. In July, foreigners purchased over $71 billion of US treasuries and corporate securities, well ahead of the $58 billion trade deficit. Such good news could help fuel or play a role in the future breakout of the major indices.

The Japanese have a proverb that says, "A wasp stings a crying face." This essentially means that though things are bad, it could actually get worse. Hurricane Katrina had already pounded the Gulf coast oil and gas refineries, only to be followed by Rita, which statistically was a bigger storm, but it changed direction just in time to avoid a major disaster. Before Katrina, the economy was actually performing very well by most measures. The Fed's recent comments implied that although Katrina would cause some short-term dislocation, the threat of inflation was larger in the Fed's eyes.

The US dollar has lost ground against all other major world currencies, particularly the Euro and the Yen. Gold has inched up. Stocks of non-essential items have leaked as of late. These include retailers, hotels, and gaming stocks, and these are acting as de facto bellweathers of waning consumer confidence.

After September 11th, it was swift action by the Federal Reserve that initially put the breaks on the big slide in the markets. Then, it was the courage to keep lowering rates coupled with tax cuts that propelled the economy back to life. If the Fed announced tomorrow that it was not going to raise rates again, I believe the US economy would begin to purr rather than hum along in fits and starts.

We are heading into another earnings period, and so far there have not been any major disappointing preannouncements.

Coming into the fall, I was anticipating a strong move to the downside, and now I'm not sure if that happened as a consequence of the hurricanes or if there is a different, more fundamental pothole on the horizon. I still believe the markets will be higher on January 1, 2006 than they are today, however, I am still looking for that trigger, an inflection point, a catalyst. Making this even more challenging is the notion that much of the economic data scheduled for release over the next few weeks could be dismissed out of hand as aberrations or incomplete. How many CEOs will use the hurricanes as excuses for bad numbers?

Politically, it's going to take more than some lipstick to make Bush and the Republicans look better. The president's approval ratings are lower than New Orleans. The Iraq situation is at a standstill, the handling of Katrina, scandals within the GOP party, and the spending ($200 billion here, $200 billion there, etc.) all starts to add up.

With the Fed marching like a Roman legion cutting off vital monetary stimulus to the economy, most businesses are hording cash, which stifles innovation and bold moves that are vital for economic growth. Businesses are weary and consumer spending, which has carried us the last five years could not only slow to neutral, it could grind to a complete halt.

The last few months of the Greenspan era are going to be chalked with many twists and turns. It would be nice if we could watch the curtain go down and applaud the performance, instead of looking like someone yelled "fire" and the theatre spills out in panic.

At this moment markets are discounting the health of the economy. I'm still looking for a strong finish to the year, sparked by earnings reports which beat consensus, supported by lower oil prices and a signal to the end of interest rate increases.

The US economy has been much maligned and under appreciated (much like ours in 1998/1999 before it took off). It doesn't mean it has to go up, but it does appear that there is value to be found. The right move, it would seem, is to have patience and to take advantage of our high dollar to buy some quality US names.

Around the globe

Canada (Selective Buy)

- ❖ Solid growth, low inflation, booming commodities helping our fortunes.
- ❖ Fortunes, however, still linked to USA.
- ❖ Strong dollar will hurt exporters.
- ❖ Growth expected at solid 3% for 2006.

USA (Strong Buy)

- ❖ Economic growth moderating as Fed Reserve removes monetary stimulus and high-energy prices start to bite.
- ❖ Hurricane Katrina and Rita full effects not yet known.
- ❖ Real estate speculation rampant and decline could hurt consumer confidence.
- ❖ US dollar starting to look cheap?

Europe (Switch)

- ❖ Stumbles along as continent goes through constitutional reform and economic restructuring.
- ❖ Growth remains below potential, but threat of recession low.
- ❖ Karen Marshall (who moved to England) tells me gas is at $6 per gallon in UK.

Asia (Trading Buy)

- ❖ Japan seems to be reviving from 15 years of stagnation – growth average 3.7% last four years.
- ❖ China still growing over 9%, benefiting Hong Kong and Korea.
- ❖ Over capacity, credit tightening and economic bottlenecks may threaten growth.

Latin America (Hold)

- ❖ Has had good quarters led by Mexico and Brazil markets.
- ❖ Will leverage off US recovery and imports/exports.

"Quotes"

"You're only young once, but you can be immature forever."
– Anonymous

"The function of socialism is to raise suffering to a higher level."
– Norman Mailer

"There's always somebody who wants your place. Someone coming up who's younger, stronger, and hungrier. I stay nervous and hungry."
– Lance Armstrong – July 2005

"An unbreakable toy is useful for breaking other toys."
– Van Roy's Law

"There are a number of devices that increase sexual arousal particularly in women. Chief among them is the Mercedes Benz 380SL convertible."
– PJ O'Rourke

Looking ahead

October

- ❖ Known as jinx month due to crashes in 1929, 1987, and large drops in 1978, 1979, 1989, and 1997.
- ❖ Yet a bear killer – turned tide in 10 post WWII bear markets.
- ❖ Worst 6 months of year ends in October.
- ❖ Best month on Dow Jones 1998 – 2003 with 5.9% average gain.
- ❖ Historically great time to buy depressed high techs.
- ❖ Last five years up after tough Septembers.

November

- ❖ #2 month for S&P returns since 1950.
- ❖ Record; 36 up, 18 down.
- ❖ 2003 broke 11 year winning streak week before Thanksgiving.
- ❖ Dow down only three November's last 14 post election years.

December

- ❖ #1 S&P gain since 1950 – Average 1.7%.
- ❖ Down only three December's of last 15 post election years.

(Source: 2005 Stock Traders Almanac)

Notes

Russia, Estonia, Latvia … have all gone with flat taxes, and all have enjoyed materially higher tax revenues as a result. Russia went to a flat tax of 13% four years ago. After the new, low flat tax, revenues to Moscow rose 25% in 2002 (the first year imposed).
(Source: Gartman Letter August 2005)

Unemployment in Zimbabwe under dictator Mugabe is now 80% and rising.

Ownership works! Toronto is having a wonderful experiment where individuals, after taking an examination to show driving competence, to own their own cars and make them "ambassador" cabs. Those who drive must own the cab and in ownership comes pride. One can now tell the difference between an "ambassador" cab and a fleet, rented cab at first glance.

Hewlett Packard spends $4 billion per year on research and development and on average produces 11 new patents on a daily basis.

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 Frank D.
Our winner this quarter!

Portfolio Corner

(Prices as of close October 5, 2005. Full research reports available on request.)

Recommendation

This Quarter's Buys:

Deutsche Telecom ($18.00 – DT-NYSE) – DT is Germany's largest telecom company. Stock traded as high as $100 in 2000 to today's $18+. Stock pays a 3.50% dividend. I see it as a three-way play: One on the tech/telecom sector, one on the US dollar, and one on the beat up German economy. Give it 18-24 months, somewhat aggressive.

Canfor ($14.65 – CFP–TSE) – Canadian Pulp and Paper giant. Only commodity sector which has gone zero due to high Canadian dollar, energy costs, and softwood duties. A well-managed company, strong balance sheet, and out of favour sector. No dividend yield but great cash flow allows for a special dividend. Trading at book value of $14.35. Buy for 12-18 months.

Bank of America ($41.96 – BAC-NYSE) – US Banking giant. Well managed and pays a solid dividend of 4.70%. US banks have lagged their Canadian counterparts and I think once the market thinks rate increases are done, these usually do well. Also JP Morgan Chase ($33.45) I still like (originally recommended July 02 at $18.90). Both conservative and for 18-24 month holds.

Open Text ($16.47 – OTC–TSE) – Canadian tech story which produces knowledge management software $44.00 in 2000. Good margins, strong cash flow and has a global customer base. Valuation cheap to peers. Acquisition candidate? Aggressive name for 12-18 month hold.