

REVIEW & COMMENTARY 4TH QUARTER 2002

Despite historical evidence that strongly supports the fact that no one can consistently foretell the future, the investment industry perpetuates this embarrassing ritual by asking member of the industry to make predictions regarding the future level of the markets. Recently, Bob Stodgell, our President, spoke at the forecast dinner for the Ticker Club at Toronto, January 8, 2003. For this quarter's "Review and Commentary", we thought it would be appropriate to share a few excerpts from his speech.

"Let's have a look at last year. It was the third straight down year. Few predicted it. 2002 was the first time in 90 years that the U.S. market did not rally in the first year of an economic recovery, despite having four consecutive quarters of growth, averaging roughly 3.3%, and productivity increase of over 5%. All this in the backdrop of September 11th and the cloud that it has cast across so many industries and the economy. Despite this good news, the markets were fitful. You have to go back 6 decades to find a more turbulent time- the SP500 was up or down more than 2%, on average, slightly less than one in six days. With continuing steady growth in the money supply, these factors should provide ongoing evidence that the recent December ISM numbers were merely a sign of better things to come...

Is four down years in a row likely? The probabilities are remote. The last time there were four down years was, coincidentally, 90 years ago, 1932. But if the average return over the last century was roughly 6.7%, and if you believe in regression to the mean, we could have a marginally negative return given that the Dow has provided over 12%, and the SP500 9.3%, over the past 10 years. The past three years have been tough but if you look at the SP500 from 1995 through to 1997, it more than doubled. The last three years have been defiant but as John Keynes said- 'the market can remain irrational longer than you can remain insolvent'....

So am I bullish, long term? Absolutely. Short term, not really. There are too many variables, namely Iraq and ongoing terrorism. Is deflation still a risk? I think President Bush will do everything he can to inflate the economy. His latest initiatives should be proof that he is seeking re-election. The MBA President, who no one thought would ever fire anyone, has cleaned his economic house. The replacement of Pitt, O'Neil and a few others certainly sent a clear message to the rest of the cabinet that they had better toe the Whitehouse line. Importantly for the bulls, markets love years preceding an election. And it's not as though the economy wasn't showing signs of inflating, even factoring that Oil prices have played a big part, the Commodity Research Bureau futures in 2002 were up well over 20%. In fact, given the strain the upcoming year may put on U.S. federal and state budgets, inflation risk may be a more topical issue at next year's forecast dinner....

Given low interest rates (and I would enjoy them while you can), low inflation and increased productivity, the U.S. economy will continue to grow. But given an accommodative Fed and an aggressive U.S. administration, there are many bright spots, however, there are a few things on the horizon that make me cautious in the short term....

Let's deal with Iraq and terrorism. One thing that bothers me is that the U.S., in all their superior technology and military intelligence can't find a 6'5" Arab on dialysis. And never has a war been so well promoted and advertised. The media even has possible dates, one toward the end of this month. Is George W. bluffing? He may, but that is not a common trait amongst Texans. Plus, there is a little Hatfield and McCoy family feud/grudge going on. On one hand you have the defiant Hatfield/ Hussein family going against those good ol' boys from Texas, the Bushes. Don't you think Don King would love to get in the middle of this one. Bush has put too much on the line politically to settle for anything less than having Hussein replaced. Unless Saddam decides to step down, which is unlikely, and go into exile, the retaliatory risk is serious, even if the U.S. soldiers prevailed as they did in the early 90's....

Even if the Hussein issue is diffused properly, we still have to deal with the ongoing threat of terrorism. The roots of hatred toward the West have grown deep – 41% of Arabs are under 15 and they and other Middle Eastern children are being brought up with a steady diet of U.S. and Western aggression. And while many of the people in the Middle East consider the Arab – Israeli issue of greater importance than Iraq, the U.S.'s actions, particularly if/when and by whom Saddam is replaced, could build up even greater animosity and resentment to the West.

And if that isn't enough to adjust your seats, what about North Korea? Starving them doesn't work, Mr. Kim is already doing that while he runs around Eastern Europe in his private train. Moreover, these are the same people who thought nothing of doing some nuclear testing over the heads of their neighbours, the Japanese. On New Years Eve, they kicked out U.N. inspectors who had been monitoring a nuclear reactor. I just hope that Bush's determination towards a diplomatic resolution matches his resolve about Hussein....

If geo-political risks escalate beyond containment, then I would think that the likelihood that we may see our fourth down year in a row is pretty high. But if Bush can contain North Korea and the displacement of Hussein goes relatively smoothly then I would think the market would rally once the dust settles, figuratively and literally. Particularly if oil settles back to the mid 20's.

In conclusion, the market fundamentals are improving. The recent stimulus package that President Bush has introduced will provide the economy fiscal stimulus. A resolution to geo-political conflict and the subsequent falling in crude prices will provide even further economic traction. This should set the stage for an impressive rally at year-end that will coincide with the U.S. Presidential election. The problem with this prediction is twofold; one is that short term concerns may overshadow these economic developments and I have never been able to predict anything, with any consistency, other than the fact that most people who are foolish enough to make predictions are wrong".