REVIEW & COMMENTARY
2^{ND} QUARTER 2005

Double, Double Oil and Trouble
Fires Burn and Cauldron Bubble

Our apologies to Shakespeare, however, it seems that this play on words holds some significance as we start the 3rd quarter of 2005. Some markets are bubbling - oil is one, real estate another. But will there be trouble, and if so, what will it mean for the equity markets?

Certainly one of the hottest topics these days is oil. Not only has it traded regularly at the $60US level, we have an old fashioned show-down approaching. On one hand, China is making a bid of $18.5 billion for Unocal, and on the other, the U.S. is worried that a successful bid for the company might threaten their national security. The stakes for both sides are enormous; probably the most important issue for both countries, as the two largest importers of oil, is to secure their own source of oil.

China has tried this unsuccessfully in the past. In 1997, when oil prices were about a third of their present levels, China invested $1.3 billion dollars in *one* of Iraq's oil fields. This investment failed when the UN imposed sanctions against the country and then problems further compounded when the U.S. later initiated military action. In 2003, China had agreed in principal to a $150 billion deal with a Russian company to tap into Siberian oil sources and build a pipeline into China. Unfortunately, this was with Yukos Oil and the deal never was consummated; the Russian government incarcerated the head of the company for tax evasion and subsequently dismantled the company into smaller autonomous units.

Thus, the show-down is set; the U.S., tightly aligned with the largest presently known reserves in the Middle East, against China, which after a number of failed attempts, is presently looking at having their latest ambition, the takeover of Unocal, thwarted by U.S. Congress. Certainly tensions between the two could escalate and bubble could turn to boil.

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In addition to trying to secure foreign reserves, China is also trying to develop their domestic oil fields. To date, they have had limited success but continue to explore within their borders. At a recent East Asian Investment Forum in Beijing, Zhang Hongtao, the deputy director of the ministry's China Geological Survey, made claims of great promise in their existing exploration activities and indicated that the vast amount of land yet to be explored holds great potential. Another reason why the Chinese may be looking to buy leading North American companies is to gain their expertise in exploration and development. If the Chinese are successful, it will allow them to secure their own supply of oil. Secondly, it will increase world supply which should allow crude to fall to more reasonable prices. Lower crude prices would benefit all industrialized nations, their economies and ultimately equity markets.

The other bubbling issue presently is real estate. Low interest rates have driven prices in some locations very high, very quickly. In *The Economist*, it was reported in a recent issue that in the U.S. "25% of all buyers made no down payment on their home purchase last year." In some cases, it stated, buyers can get 105% of the value of their home in financing. Further, they stated that so far this year, one third of all mortgages are interest only. This kind of leverage took place in the stock market back in the late 1920's – but even then they wouldn't let you borrow 100%: it is no wonder the real estate markets are bubbling in some areas. Further, close to 40% of all the new jobs in the past few years were related, in some way, to the real estate business. Thus, new jobs, a stronger economy, increased leverage and higher real estate prices have contributed significantly to the wealth and confidence of the consumer. However, if real estate prices falter, the ripple effect may be equally significant on the downside. The greatest threats to pricing may be twofold; a significant increase in interest rates and oil prices. If oil prices continue to rise, it will put a drag on the economy, in turn potentially halting the upward trend in housing prices. If interest rates were to rise, it may put additional pressure on those presently overleveraged; if prices wane and interest rates increase, bubble might turn to boil.

What chance is there that rates will increase? In a different issue of *The Economist*, it stated that one of the reasons that interest rates remain so low is that corporations are so flush with cash that they are investing the surplus in U.S. Treasuries. Certainly, emerging economies, such as China and India, have had some part in these lower rates by investing their vast trade surpluses in U.S. Treasuries, but if this new theory about U.S. Treasuries is accurate, then it may explain many things. One is the stock market, which with the exception of oil companies, has been relatively flat over the past few years. Imagine what might happen if the potential return for fixed income becomes less attractive than the potential return for equities. After all, many companies are increasing dividends and paying down debt, making their relative attractiveness grow, especially with rates so low. As well, these companies with increased cash, decreasing debt levels and attractive borrowing rates might start to consider mergers/takeovers a more attractive option than U.S. Treasuries. Together, this could provide a nice lift to the equity markets.

However, looking to the remainder of the year, if oil prices and interest rates can moderate and the Sino-U.S. tensions are resolved, equity markets may do quite well. So despite a few present bubbles, with some luck there won't be much trouble.

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