REVIEW & COMMENTARY
4TH QUARTER 2005

Happy New Year

One of the more humbling things to do each year is look back on our predictions to see how they have done. Like most, we made a few good calls and few that don't quite measure up. So before we do the same for 2006, here are some of the things we thought at this time last year.

We had correctly predicted that interest rates would move up. We stated in our year end commentary last year that 'fixed income investments would have a tough time making their coupon' which is a fancy way of saying that bonds returns would be positive but they would only be modest. While we were right in the short to mid term, long bond yields had done considerably better that we had expected.

After a very good 2004 for equities, we had thought that 2005 returns would be more modest- 'we would welcome mid to high single digits' in terms of index returns. Well, we couldn't have been more modest given that the SP/TSX index posted returns in excess of 20%. Of course, we can fall back on our almost flawless record of inaccuracy when it comes to oil prices to explain our inaccuracy. Several times in 2005, we had predicted moderating oil prices and while it would appear that this may be happening now, we had not correctly anticipated prices moving into the $70 range. In our first quarter 2005 *The Last Spike,* we viewed the Goldman Sach's $100 estimate as far too ambitious in the foreseeable future but we almost had to eat those words given Katrina and Rita. We still do.

We had predicted that China would continue to grow faster than many had predicted thus supporting our view that cyclicals would find favour throughout 2005. While we were right on this count, it almost comes under 'the forest for the trees' category in that their appetite for oil would be equally ravenous. In *Double Double Oil and Trouble,* we had discussed some of the risks that higher oil prices might bring to the global political landscape as China's national oil company's efforts to buy Unocal for 18.5 billion was met with great resistance by the world's leading capitalists, U.S. politicians. While the Chinese eventually withdrew, they recently announced that they are willing to spend close to 2.3 billion for 45% of a Nigerian oil tract. They are obviously serious about securing their own supply source as much as the Americans. In 2005 over 450 billion dollars were spent on energy acquisitions. So far in 2006 it looks as if it may be more of the same. Sadly, many of our great Canadian companies may become targets.

Finally, one of the things we discussed at length was the potentially negative impact higher oil prices would have on the economy. Higher oil prices tax the economy through higher gas costs to run our cars, and eventually increases the cost of goods since well over two thirds of all North American goods are transported by land. And even though inflation statistics can be released ex-energy and food- we are not sure why this should be viewed as a reliable benchmark- while volatile energy and food prices are staples- the costs of higher fuel prices are evident in the inflation numbers. Thankfully, it did not take as big a toll on the economy as we first thought but we strongly believe it will eventually. In fact, while we don't predict GDP – even economists don't get it right- it is important to note a significant contributor to the strength of the U.S. economy in 2005, real estate.

While rising real estate prices are part of the 'wealth effect' that encouraged people to spend more, mortgage refinancing was an important catalyst to the economy. To give you an idea of how substantial mortgage refinancing was, Goldman Sachs estimated that it provided close to 900 billion dollars in additional purchasing power. That is almost the equivalent of Korea's GDP in 2004! While it is not material to the U.S. economy, it is significant representing approximately 7% of GDP. An integral part of the refinancing boom was stronger real estate prices and relatively low interest rates; however, without these two factors in 2006, the likelihood of this benefit reappearing to support the economy is slim. Thus, the U.S. economy should slow marginally in 2006.

Balance sheets, in general, were very strong in 2005. In Canada, general corporate health was invigorated by the boom in resource prices though costs have started to move up as well. In the U.S., corporations experienced similar good fortune but from slightly different causes. One was fiscal prudence and that low interest rates allowed many companies to refinance their debts. Another reason was the U.S. government allowed many U.S. multinationals to repatriate earnings in foreign subsidiaries at favourable tax rates. Corporate financial health is at an all time high and companies will be faced with rising cash balances. What will they do- spend, at least we hope so- on dividends, on acquisitions and greater efficiencies through technology. This should make up for the diminishing financial fire power of the consumer.

Now for 2006.

Interest rates will rise marginally in the first half of the year then moderate thereafter. Greenspan's replacement is apparently not as hawkish when it comes to inflation but odds are that the economy will start to pause from higher oil prices and the absence of spending that had resulted from mortgage refinancing. The only threat to this scenario would be a rapid and unexpected devaluation of the U.S. currency which, while we consider it a possibility, it is a remote one at best.

Oil prices will *not* reach new highs in 2006. Given our past track record either two things should happen- oil prices will hit all time highs or we will be right. (We are bound to be right eventually.) We know and understand the arguments of limited supply translate into higher prices. However, with a slowing North American economy demand for oil should moderate. After all, it is worth speculating what oil might be trading at if there weren't five category 5 hurricanes in the U.S. this past year. Importantly, this does not mean that we think prices are going to drop precipitously or that we would be big sellers of oil companies. Instead, we would not presently overweight portfolios in energy- something we didn't do in 2005 either.

If we are accurate about interest rates and the economy then our style of balanced investing should do well, particularly if the Federal Government, whomever that might be, maintains the present government's promise to make dividends more attractive. Though the Canadian dollar may trend higher, we do believe that the majority of the appreciation of the Canadian dollar is behind us. Once the U.S. Federal Reserve stops raising interest rates, we think that the U.S. equity markets will do better, despite marginal slowing of the U.S. economy, which should allow the U.S. equity markets to outperform the Canadian equity markets for the first time in many years. Regardless, no matter what the markets do, given our style, we hope to, as we said last year, "outperform in bad markets and participate in, to a healthy degree, the good ones".

Best wishes to you and your family and thank you for your patronage in 2005.

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