REVIEW & COMMENTARY
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The Dove, the Hawk and the Bear- nanke.

Though Ben Bernanke was officially sworn in as Chairman of the Federal Reserve in February, it took a few months before he learned an invaluable lesson about how influential a few misplaced words might be. In an informal interview with a TV journalist at a dinner party at the White House, he stated;

> *"It's worrisome that people would look at me as dovish and not necessarily an aggressive inflation fighter..."*

Days later in early May this was reported on CNBC. This started the market to re-evaluate earlier thinking that the Federal Reserve was at, or close, to the end of a long string of interest raises that had started 2 years ago. What happened over the next several weeks was a significant sell off in the capital markets. Interest rates moved up, equities moved down, some equity markets rather sharply. With the prospect of an aggressive fight against inflation, many considered that the U.S. Federal Reserve might raise interest rates too far, causing a serious economic recession. This sent tremors throughout the markets worldwide and a quick and dramatic sell off in financial assets around the globe occurred in the following weeks. Equities, commodities, precious metals, bonds, just about everything lost ground. The dove had become a hawk and global markets got mauled!

History provides many lessons for those who find predicting the future too intimidating (few on Bay or Wall Street fall into this category). Alan Greenspan, Bernanke's predecessor Fed Chair, had witnessed a similar financial epiphany after roughly the same amount of time had elapsed after he had been sworn in, when the U.S. markets tumbled by almost a fifth of their value in October 1987. Whether he had made similar comments can not be verified but certainly the parallels are startling. Hopefully, we can remember this next time a Fed Chair is sworn in! Greenspan's reaction was quite different. He provided liquidity into the system to divert further panic. This time around, liquidity levels were already significant. We believe that in some cases, the extent of the sell off may have been a self-imposed reduction of leverage by many of the more aggressive market participants (namely Hedge Funds), many of which focus on short term returns. And when many of these participants are leveraged (borrow money to increase their exposure), they are quite quick to exit their positions when markets go against them.

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The economic background to this was that the U.S., Canadian and many other economies were strong and resilient. Economist at the International Monetary Fund had increased their estimates for global growth to 4.9% from 4.3% for 2006. Though interest rates had moved up, breaking the 5% level in the U.S., this was hardly the same kind of market backdrop that was evident in 1987. Yet, despite this, from May 11th to June 14th, the SP500 was down 6%, Oil was down 6%, Gold was down 22%, Japan down 15%, Russia down 28% and India down 28%. The S&P/TSX Composite was down over 12% and Bonds were selling off sending ripples through the housing sector, where many are already stretched with variable rate mortgages. In a matter of weeks, all that had been gained in the equity markets so far in 2006 had been given back. In some cases, even more.

To review, these fears were based on a 'hawkish' Fed Chairman, fears that interest rates would be raised too high causing a recession. But to put these fears into perspective, interest rates had been rising in the U.S. and Canada for almost two years. If inflation was a concern, why was gold not holding more of its value? Instead of the goldilocks economy, mid-June looked more like a Steven King novel where for some, it was better to sell and ask questions later.

What happened in June? The Ben (now the Hawk) Bernanke made the following comments:

> *"The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information,"*

Though this appears to be equally objective as his comments of late April, the market was jubilant that the Federal Reserve raised interest rates only 25 basis points. The hawk was perceived to be more dove-like and the Bear-nanke turned into a Bull-nanke. The financial markets have been recovering every since.

Here are some important facts- the U.S. Fed has hiked interest rates at 17 straight meetings since June of 2004 moving from 1% to 5.25%. The Bank of Canada has had a similar pattern but just recently in July paused. Rates are now the highest they have been for over half a decade but they are still quite manageable. North American economies are vital and strong and we have had close to 4 years of an economic recovery. Despite high oil prices and a military occupation overseas, the U.S. economy is very strong. First quarter GDP growth was recently revised upward to 5.6%. Despite a high currency and oil prices, recently the Canadian economy created more jobs than the U.S. on a nominal basis. Corporate cash levels are enormous, earnings are strong and the world continues to grow. Importantly, economic growth will slow- it should not come to a surprise when it happens- these are normal economic cycles. Conflict around the globe appears to be increasing- nuclear proliferation, terrorism, and escalating tensions in the Middle East. Of course, any calamity surrounding these events or others unforeseen can dramatically increase market volatility. As well, Hedge funds have grown in size to somewhere close to 2 trillion dollars in the U.S. alone and will continue to be increasingly influential in the capital markets. But remember, beware of a dove dressed up in a hawk's clothing, or a Bear masquerading as a Bull or vice versa. Stick to good quality investments, diversify and invest for the long term. And just maybe, we will all live happily ever after.

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