REVIEW & COMMENTARY
4TH QUARTER 2006

Capital Punishment.

An odd title perhaps but it sums up our take on the Federal Conservatives- at least for the moment. Referring to their Halloween treat on the pending treatment of Income Trusts, it was the equivalent of suggesting that renovating a house may best start by burning it down first. It seems extraordinary that in order to avoid "tax leakage" of a few billion dollars, they hammered the market into losing close to 30 billion dollars! While not expecting any changes to the proposal, we would not be surprised if the Senate abandoned its historic tendency to placidly endorse Government initiatives and exercise some legislative objectivity given that Prime Minister Harper is seeking Senate reform. Further, we think the Federal Conservatives will experience significant political punishment in the next election, regardless of what fiscal promises they make, after all, they made several about the sanctity of income trusts during the last election campaign.

As we now do at the end of each year, we will make some predictions for the upcoming year. But before we do that, let's look at what we predicted last year. Last year we thought:

> *"Interest rates will rise marginally in the first half of the year then moderate thereafter."*
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> *"Oil prices will not reach new highs in 2006 … we would not presently overweight portfolios in energy-something we didn't do in 2005 either."*
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> *"Once the US Federal Reserve stops raising interest rates we think that the US equity markets will do better, despite marginally slowing of the US economy, which should allow the US equity markets to outperform the Canadian equity markets for the first time in many years."*

It certainly looks like we were right on the first one. The U.S. Federal Reserve, after 17 consecutive interest rate increases, paused toward the mid part of 2006. After the pause in late summer, interest rates did show modest improvement moving down towards the end of the year. Interest rates, as measured by 30 year bond prices, in both Canada and the U.S. moved up until mid year then moved down thereafter.

On our second prediction, we were wrong. Oil prices did reach new highs mid -summer, close to $77 U.S. dollars per barrel for crude oil. Though we take comfort in the fact that the spike up was temporary, geo- political instability was more to blame than supply/demand metrics. Given that crude prices ended 2006 at marginally unchanged prices gives us some comfort that our prediction not to overweight the sector was appropriate. The TSX/SP energy index posted a gain of 3% for the year.

On our third prediction, we were close. U.S. markets did perform well after the U.S. Fed stopped raising interest rates. The Dow Jones and SP 500 hit all time highs in 2006. And while our prediction of the U.S. equity markets outperforming their Canadian counterparts fell short, it wasn't by much. Unadjusted for currency, the TSX/SP Composite outperformed the SP500, but only by 90 basis points. Quite frankly, we consider this a draw given so many had predicted the Canadian dollar was bound to achieve parity with the U.S. dollar at the beginning of the year.

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Now for '007.

Oil prices will stabilize; the first few days of 2007 have been terrifying to those investors who have over-weighted portfolios in oil. There are several things that suggest that while the health of the U.S. economy is a significant determinant in the price of crude, there are other significant factors. One is China. Another is the Middle East.

As the second largest consumer of oil, China is becoming increasingly uneasy about the lack of control they have over their supply of oil. Furiously exploring their own country for the black gold has yielded disappointing results. Being rebuffed in an attempt to buy North American companies in 2006 has reinforced China's ambition to become less reliant on producers (and probably no less determined to try Canada next time). So, they are embarking to build up the equivalent of the U.S.' Strategic Petroleum Reserve. Ultimately, they would like to secure reserves of over 100 million barrels within the next five years. At the moment, according to the Economist, they have 3 million.

Another factor is political unrest in the Middle East. A Democratic led congress wants out of Iraq while President Bush wants to limit the damage to his administration and future legacy. Iraq appears to be on the verge of a civil war and certainly, George Jr. wouldn't want to repeat his father's mistake of retreating early. Add to this mix, an increasing appetite for 'nuclear independence' by Iran. As well, OPEC looks like they are getting more serious about restricting output. Weather aside, we feel that oil will not drop significantly but will exhibit the same volatility as it did in 2006. Look for crude prices to bottom in the first quarter of 2007.

Income Trusts will do better than the majority of investors predict in 2007. Capital markets are awash with cash and once the new rules are voted into law, many of these income trusts will be either taken private, merged or re-engineered. After all, if interest rates stay low, many of these trusts still offer attractive yields regardless of whether they will be taxed in 4 years or not.

With the levels of liquidity rising, interest rates may not rise substantially but we do think that interest rates are close to their bottom. If the U.S. economy falls into a significant recession, which could be led by either a significant fall off in real estate values or a downward run on the U.S. dollar, then interest rates will drop. But unfortunately, the U.S. will be in a difficult position, though they have lots of debt, lower rates will lower the value of the dollar. Given the amount of foreign holders of U.S. treasuries, they have to be careful not to let the value of the dollar go into a free fall. Thus, unless either of the two above scenarios appears, interest rates will remain steady and move up towards the end of next year. Given this, we feel that equities will outperform mid to long term bonds, especially for taxable investors.

Finally, our last prediction is that we will be equally as accurate as we have been in past years. But one thing we have been comfortable predicting for years is that our conservative balanced approach has proven to weather financial uncertainty extremely well. It did quite well in November and we expect equally good things in the upcoming year. Thank you for your confidence and support and best wishes for health and prosperity in 2007.

Stodgell Investment Management Ltd.