

"The intelligent investor is likely to need considerable will power to keep from following the crowd."

- Benjamin Graham



WATSON DI PRIMIO STEEL

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## Investment Perspectives

### A Soft Landing?

In our last publication of *Investment Perspectives*, we expressed concern as to whether recent higher levels of short-term interest rates were sufficient to control inflation or whether further interest rate increases would be necessary. Since then, short-term interest rates in North America have remained relatively flat while long-term interest rates have fallen about 10%. The existence of higher short-term rates has begun to work through economies and today, the main concern is whether we risk continued higher inflation or alternatively, too much slowing in growth. The latter bears the risk of pushing world economies into recession. In summary, the central banks of the world have a delicate balancing act to deal with going forward.

To help determine which direction central banks may take, we should review the relationship between long-term bond rates, earnings growth, and price earnings multiples. Typically, long-term rates at or near the low end of their recent historic range indicate a fear of recession, while the same interest rates near the high end indicate a fear of inflation.

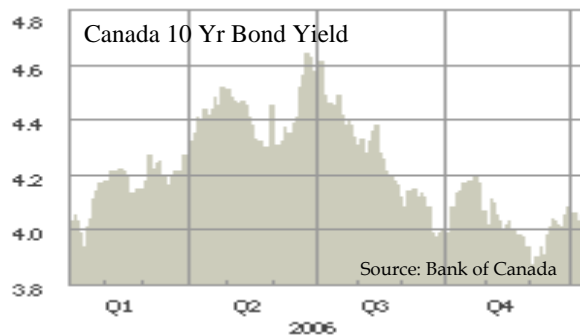
Looking at the Canada 10-year bond yield at 4.08%, we find that we have fallen to the middle of our 2-year range of 3.75% to 4.50%. Similarly in the United States, long rates fell to the middle of their 2-year range. Earnings growth is expected to slow to about 6% in Canada and 8% in the U.S. in 2007, while forward price earnings multiples are presently at a reasonable 15 ½ times. Taken together, a scenario pointing to lower inflation, lower interest rates and a soft landing for the economy becomes prevalent. Such a scenario bodes well for equity markets going forward.

However, there are some potential risks (as always) to this outlook. Mainly, the economic weakness needed for lower short-term interest rates could affect the earnings outlook and, therefore, equity markets. Specific to Canada, earnings growth is more vulnerable since it depends heavily on commodity prices. In addition, equity markets have been much stronger in the 2<sup>nd</sup> half of 2006 and appear to be overbought heading into the beginning of 2007. *Thank you for your continued support.*

### Equities:

As the charts on the left side of this page indicate, the TSX was up 17.3% while the S&P 500 rose 16.0% and the EAFE rose 27.3% in 2006, measured in Canadian dollars on a total return basis. Most markets recovered strongly since the middle of the year. This recovery, in combination with the perk-up of the U.S. large-cap market, could indicate that investors feel the U.S. Federal Reserve has successfully engineered a soft landing for the economy. Although the probability of this is high, the

answer to this question is still an unknown. In Canada, the TSX was led by the materials, information technology and financial sectors. Political promises aside, income trusts once again lagged the performance of the TSX in 2006 due to our new government's decision to tax this area. International markets out-performed domestic and U.S. markets in large part due to an increased flow of funds to these areas as investors continued to diversify globally.



## Fixed Income and Interest Rates:

During 2006, the Canadian bank rate rose from 3.50% to 4.50%, while the U.S. Fed funds rate increased from 4.25% to 5.25%. The yield on the 10-year Canada bond, as illustrated in the chart to the left, changed slightly from 3.97% to 4.08%. In the United States, the yield on the 10-year U.S. Treasury moved up 30 basis points from 4.40% to 4.70%. Consequently, and for the first time since December 2000, both the Canadian and U.S. yield curves

inverted in mid-2006 and remained that way for the duration of the year. This situation can sometimes forecast a coming economic slowdown. However, it is possible that long rates are so low due to the ex-U.S. savings glut. As emerging economies with excess savings continue to invest heavily into long government treasuries, bond prices are supported and interest rates have remained very low.

**\$CDW** (Canadian Dollar Index) INDX ©StockCharts.com  
29-Dec-2006 Op 86.34 Hi 86.34 Lo 85.78 Cl 85.81 Chg -0.52 (-0.60%)



**\$WTIC** (Oil - Light Crude - Continuous Contract (EOD)) INDX ©StockCharts.com  
29-Dec-2006 Op 62.44 Hi 63.20 Lo 59.90 Cl 61.05 Chg -1.36 (-2.18%)



**\$GOLD** (Gold - Continuous Contract (EOD)) INDX ©StockCharts.com  
29-Dec-2006 Op 625.00 Hi 639.10 Lo 624.70 Cl 638.00 Chg +15.70 (+2.52%)



## Currencies:

The Canadian dollar, which showed significant strength in the first half of 2006, finally broke against the U.S. dollar. Mid-2006 saw the Canadian dollar go over \$0.90 before it fell to just under \$0.86 at the end of the year. Much of this decline can be attributed to falling oil and other commodity prices as global economies showed signs of

slowing. This decline in the Canadian dollar has helped boost U.S. dollar denominated asset returns, supporting the importance of maintaining a globally diversified portfolio. The Euro continued to show strength, rising 11.4% against the Canadian dollar for the year.

## Commodities:

Commodity prices exhibited strength throughout the year, but signs of weakness have begun to show. Copper has fallen 27% from its 2006 high but is still up about 40% for the year. The fundamental reason for this may be that global economic growth is slowing, following the decline in the U.S. housing market - a big user of copper. Similarly, oil has fallen over 20% from its 2006 high, and is up only slightly from the beginning of 2006. Two contributing factors for the lower oil price have been a

warmer winter in the U.S. north-east along with a cooling world economy in recent months. Gold continued to be volatile for the year as it moved from \$513 at the beginning of 2006 to \$725 in May, closing at about \$640 for the year. Given that gold is typically seen as an inflationary hedge, this volatility highlights the delicate balancing act that central banks currently face when dealing with interest rates and inflation.

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