

"Investors repeatedly jump ship on a good strategy just because it hasn't worked so well lately, and, almost invariably, abandon it at precisely the wrong time."

- David Dreman



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U.S. Recession?

In our last issue of Investment Perspectives, we indicated that talk of an economic slowdown, or soft landing as it is often referred to, had shifted to expectations of renewed economic growth. The concern then was that higher economic growth could lead to higher inflation and ultimately higher interest rates. At that time, the U.S. central bank ("the Fed") was aware that pushing interest rates too high, in order to control inflation, might cause the economy to enter a recession. More recently, investors are troubled that the U.S. economy is experiencing dramatic fallout from housing prices continuing to drop, and the collapse of both the sub-prime mortgage and collateralized debt obligation (CDO) markets. In past years, many consumers in the United States have been financing their spending by borrowing from increased equity values in their homes and now are no longer able to do so. With housing prices falling in the United States and higher fuel costs also reducing the amount of money available for the consumer, the

risk is increasing that we will experience a slowdown in consumer spending. Due to these and other factors, some prominent economists feel the U.S. is currently in a recession while others estimate the odds of an imminent recession to be between 30% and 60%. The Fed, also concerned, reduced short term interest rates by a full percentage point over the last four months of 2007 and current expectations are that additional rate cuts are warranted. The decision makers at the Fed are now treading a thin line between cutting interest rates further in order to stimulate the economy out of a potential recession and the need to raise rates to avoid fueling future inflation. These conditions not only cloud the economic picture but foreshadow weakening corporate earnings and, therefore, warrant an appropriate cautionary approach to portfolio management at this time.

As always, we thank you for your continued support and confidence.

Equities:

The charts, on the left side of this page, show the 12-month total return performance of the S&P/TSX Composite (TSX), the S&P 500 and EAFE indices. In 2007 the TSX generated a 9.83% return while the S&P 500 lost -10.55% and the EAFE fell -5.34%, after adjusting for the strength in the Canadian dollar. Globally diversified portfolios would therefore have had difficulty generating positive returns due to the strength in the Canadian dollar. The continued increase in the TSX was primarily due to its

higher concentration in cyclical stocks (i.e. materials and energy). Nonetheless, in foreshadowing an economic slowdown, one must be aware that these sectors generally tend to exhibit higher risks to the downside. In contrast, the usual market stalwarts such as banks and insurance companies underperformed due to issues relating to the U.S. sub-prime market and the Canadian asset backed commercial paper market.



Fixed Income and Interest Rates:

During 2007, the U.S. Fed funds rate fell by a full percentage point from 5.25% to 4.25%. Over the same period the Canadian overnight target rate rose from 4.25% to 4.50% in July before falling back to 4.25% in December. The yield on the 10-year U.S. treasury fell from 4.68% in January to 4.04% at the year end. In Canada, the yield on the 10-year Canada bond, as illustrated in the chart to the left,

rose sharply from 4.05% in January to 4.62% in June. By the end of 2007 it had fallen back to 4.09%. Yield curves returned to a more normal (non-inverted) position by the middle of 2007 and have stayed there. Normally sloped yield curves are typically a long-term positive for equities, particularly financial stocks.

Currencies:

The Canadian dollar, as illustrated in the chart to the left, rose from about \$0.86 at the beginning of the year to almost \$1.01 against the U.S. dollar by year end. This represents an increase of approximately 17%. The Canadian dollar's out-performance was not limited to the U.S. dollar. In 2007, the Canadian dollar also rose strongly against the Euro, Yuan, Japanese yen and the Australian dollar. Since the Canadian dollar bottomed at \$0.62 in January 2002, it has appreciated by almost 65% against the U.S. dollar. The appreciation in the Canadian currency has made generation of any

positive gains in both U.S. and foreign equities difficult for Canadian investors. The strength of the Canadian dollar has been the result of a number of factors: higher commodity prices, particularly oil; lower interest rates in the U.S.; and, the stronger relative economic performance in Canada. Hedge funds and speculators may also be contributing to the strength and volatility of the Canadian dollar. Our Canadian manufacturing sector is now experiencing significant hardship and U.S. cross-border shopping by Canadians has picked up dramatically.

Commodities:

One year ago, oil was trading at about US\$55 a barrel. The chart to the left illustrates the rise in oil to almost US\$96 a barrel by the end of 2007. Geopolitical risk, supply concerns and, BRIC (Brazil, Russia, India and China) demand are all reasons supporting this price increase. Gold, as indicated in the chart on the bottom left, began the year at just under US\$625 an ounce. By year end, gold had risen by almost 35% to close at about US\$840 an ounce. Gold is seen as an inflationary hedge and persistent long-term concerns about inflation

may be adding to the metal's recent strength. During turbulent economic periods, gold is also seen as an alternative safe haven currency versus the U.S. dollar. Investors may be purchasing gold not only to protect against a decline in the U.S. currency but also due to recent financial market instability. In contrast, other metals such as aluminum, nickel and zinc fell in price last year, possibly pointing towards a slowing in global demand, particularly from the BRIC countries.



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