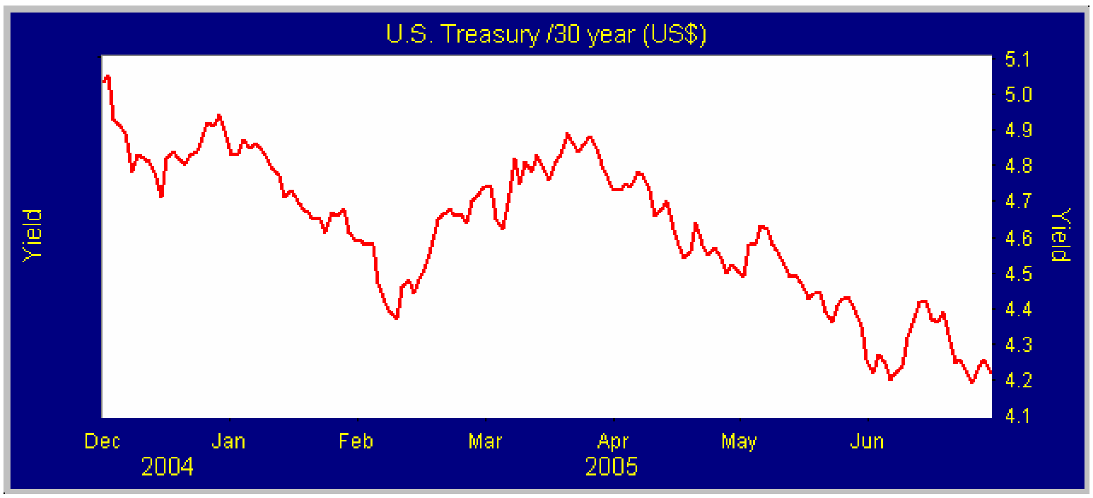
MARKET OBSERVER

2nd Quarter 2005

Markets confound! Or more appropriately to the sentiment of bond managers: Confounded Markets! In the first six months of 2005 the U.S. bond market has returned 2.9%, with a strong second quarter offsetting the 0.6% setback in the first quarter. This performance came from declining long-term interest rates despite monetary policy tightening by the Federal Reserve, a robust U.S. economy and oil prices rising to record levels. The market maxim of *"Don't Fight the Fed"* seems a little stale dated in today's bond market.

US Long Term Yields (Year to Date)



On the other hand, the U.S. equity markets have continued to languish despite the bullish economic picture. So far this year the Dow Jones Industrial Index is down 4.7% (-2.2% in the second quarter) and the higher tech Nasdaq Index is down 5.5% (+2.9% in the second quarter). Even Alan Greenspan is confounded. His public musings about the "conundrum" of falling long-term interest rates despite his increase of U.S. short-term interest rates reflects a very evident confusion in the economic intelligentsia.

Canadian Investment Idyll

Canada confounds on the interest rate front as well, with a considerable bond market rally of over 4.5% in the quarter and over 11.8% in the past year. Canadian stocks are behaving with some normalcy, showing commodity-induced later cycle strength. The S&P TSX return of 15.9% over the year to June 30th thumps the negative returns of the major U.S. indices for the same period. With both the stock and bond markets at double digit returns, Canada has been an investment idyll for the past twelve months.

Loopy U. S. /China Feedback

The huge and growing trade between China and the developed world is dominating financial markets and is to blame for all the market confusion. The Chinese are maintaining their currency peg to the U.S. dollar despite a growing chorus in U.S political and economic circles. The recent move to a flexible exchange rate regime against a basket of currencies and the slight revaluation upwards of the renminbi against the dollar is a large policy change for China. Its effect on the staggering trade deficit between China and the

U.S. will not be great however, as it does little to alter the substantial cost advantage of Chinese manufacturers compared to their U.S. competitors.

Since the Chinese do not consume anywhere near the amount of U.S. goods or services necessary to offset their exports to the U.S., the Chinese central bank keeps accumulating more and more dollars. The export revenues eventually find their way into U.S. dollar investments, particularly U.S. treasury and agency bonds. This U.S./China currency "feedback loop" has the effect of driving down U.S. longer term interest rates, even as the U.S. economy does well. A stronger U.S. economy means stronger U.S. consumer spending and stronger Chinese manufacturing imports. This begets further currency interventions and investment in U.S. bonds which lower U.S. interest rates. This strengthens the U.S. economy, particularly housing, and raises the trade deficit which causes further currency interventions.

A Labour Cost Ratio of 80 to One

Despite the complaints by the U.S. and other western countries about the Chinese currency peg, we really don't think that the massive substitution of lower cost Chinese manufacturing capacity for higher cost U.S. capacity will be affected by the renminbi revaluation in the near term. An investment banker made a revealing quote in a Wall Street Journal article on the interest by Chinese appliance maker Haier Ltd. in Maytag Corp. *"Paying workers $40 an hour, you can't compete with workers offshore who are paid $4 day."* Using this example of $320 versus $4 per day (assuming an optimistic U.S. 8 hour day) gives us a labour cost ratio of 80 to one. This implies that the Chinese renminbi would have to appreciate 8000% versus the U.S. dollar to achieve labour wage parity between appliance workers.

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China is already dominating the market for smaller consumer durables due to its cost advantage. Between 2001 and 2004, Chinese manufacturers (domestic, contract and foreign OEM) have moved in market share of microwave ovens from 33% in the U.S. to 64% (CFSB). In Europe, the substitution of domestic for Chinese manufacturing is nearly complete, rising from 43% in 2001 to 90% in 2004!

Upward Pressure on Finished Goods Prices

This huge supply side pressure on manufacturing costs is not likely to be offset by the recent 2% increase in the renminbi exchange rate to the U.S. dollar or even the 27% tariff being proposed by the U.S. Congress. These measures would certainly result in higher prices for Chinese goods in U.S. dollar terms. This is the reason that Alan Greenspan has been speaking out recently against substantial upwards revaluation on the renminbi or tariffs on Chinese goods. Mr. Greenspan is very aware of the inflationary impact of these proposals. He knows full well that the vaunted U.S. productivity miracle in the last 10 years has much more to do with cheap Chinese manufacturing than technological innovation and Yankee ingenuity. Any reasonable currency revaluation or trade tariff would not really change the terms of trade enough to affect the U.S. trade deficit with China.

The broadening of Chinese imports well beyond WalMart's store shelves is increasing the pressure on politicians in Washington and Beijing to reach a further accommodation. Over the longer term, the sheer magnitude of China's cost advantage suggests a quota style solution to the trade tensions. Since "voluntary" trade quotas are the rule with major trading partners such as Canada and Japan, we expect that American politicians will extend this form of "managed trade" to China. Whether the solution is a higher renminbi, tariffs or quotas, the effect will probably put some upward pressure on U.S. finished goods prices.

Commodities Depend on Chinese Exports

As well as buying U.S. bonds, China is spending its U.S. dollars on purchasing commodities. The rise in commodity prices in U.S. dollar terms can be seen as a weakness in the U.S. dollar against China. This Chinese hunger for commodities is well known. The popular explanation for today's high commodity prices is domestic Chinese demand: *"One billion Chinese consume a lot!"*

In an excellent piece on Chinese manufacturing and the capital cycle, CSFB researchers analyzed capital investment in China and compared it to that of other countries. Their conclusion is that Chinese capital investment does not depend on margin, profits or return on equity but rather seems to be directly correlated to revenue growth. Given that revenue growth in Chinese manufacturing is highly dependent on exports, this means that Chinese capital investment is very dependent on export-led growth.

CSFB makes a distinction between "apparent" and actual Chinese demand for commodities. It is not well understood that the Chinese buy a lot of commodities for use in their export industries and for capital investment in export industries. If export demand falters, there will be a substantial retrenchment in demand from Chinese exporters for many commodities and great dislocation in many commodity markets.

Commodity producers are now gearing up large capital projects based on the current high prices sustained by what they see as unlimited Chinese demand. While we believe that Chinese demand is here to stay, we also understand that commodities are ruled by the capital cycle. Large resource extraction and refining projects take years to complete and often the new capacity comes on stream just as demand wanes. Project economics based on rosy price projections are soon replaced by a desperate attempt to just cover variable and operating costs. This leads to the inevitable drop in commodity prices as market share and revenue maintenance trump return considerations.

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The strong current consensus around high commodity prices suggests to our contrarian natures that we are seeing a cyclical peak in commodity prices. We still believe that the combination of loose monetary policy and the increasing prosperity of the developing world will keep the secular rebound in commodity prices intact. Over the shorter term, however, we could see significant setbacks in many commodity prices when economic growth weakens.

Tony the Mortgage Tiger

The downside to this cycle is likely to be felt more in the prices of financial assets than in the "real world" of commodities. We include residential housing in financial assets. If the economy is the manner by which societies allocate their scarce resources, the resounding choice of most western nations has been to direct capital into residential housing investment. The housing sector has always been important, but the recent credit expansion has led to a central role in wealth creation far beyond that of the construction of housing on the economy. We turn to Tony Blair, the Prime Minister of Britain, during the recent British election for our evidence. In a speech just before the election he implored voters: "Which party is better for your mortgage, the economy….?" British voters obviously knew the answer, since they reluctantly returned him to power. Iraq and personal unpopularity aside, Blair and his Labour Party instinctively know that home equity and the credit capacity it confers are the really important issues to the British voter.

Upside Down Housing and Weak Consumers

We've spent considerable time in our past reports discussing the impact of low interest rate policies and lax credit standards on the housing markets in the developed world. Where it is generally understood that the consumer is of paramount importance to the economy, it is not as well understood that how important the housing market is to the consumer. Increasingly, the credit available through mortgages and home equity loans is translated into consumer spending by the modern consumer credit system. A retrenchment in the housing market would act like an increase in margin requirements for the stock market. While lenders probably wouldn't yank loans as dropping prices put them "upside down" (more loaned than collateral value) there would certainly be less home equity borrowing. Borrowers under cash flow strain would also be tempted to walk away from their negative eq-

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uity putting further strain on housing values. This would certainly translate into economic weakness in a variety of areas.

A weakening in consumer demand in the developed world would lead to pressure on corporate profits and moderating commodity prices. We are concerned that the financial markets have moved to very expensive valuations based on the "China Story". If it becomes clear that some of the Chinese demand was "apparent" and based on exports to the West, there could be considerable downside to many manufactured goods and commodities that now seem to be scarce. The Haier Ltd. interest in Maytag is a case in point. Where most microwave ovens and air conditioners sold in the U.S. and Europe are now manufactured in China, the same is not true for washing machines. In 2004, Chinese-manufactured washing machines were only 1% of sales in the U.S. and 5% in Europe. Despite the higher transportation costs, Haier's interest in Maytag suggests a rocky road ahead for appliance manufacturing in North America.

The current financial markets are expensive, with very low compensation for risk. Credit spreads are ridiculously tight. Equity valuations are historically high on a price earnings basis with dividend yields very low. New issues are very speculative with the very risky junk bonds and income trusts offering an attractive up front yield and almost certain capital losses to unwary and yield starved investors.

"We're in a sweet economic sweet spot" say the ever optimistic market strategists. "It can't get any better".

Our point exactly! When imbalances and imprudences reign supreme, it is time to take some money off the table.

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