MARKET OBSERVER

4th Quarter 2004

The Markets

The year 2004 was reasonable for most investors. The world's economies grew and the important world stock markets were positive, thanks to a strong rally after the U.S. Presidential election. The S&P index in the U.S. returned 9.0%, with the NASDAQ just behind at 8.6%. The Dow Jones index was the laggard at 3.1%. To Canadian investors, these gains were largely negated by the 8.2% rise of the Canadian dollar. Staying close to home was a better strategy as the S&P TSX index rose a strong 12.5%.

Even though monetary policy was tightened, economic growth was strong, inflation rose and oil prices reached record highs, the bond market had a reasonable showing. The U.S. Treasury market was one of the world's laggards, with a mere 3.5% return for 2004 but the "hard currency" Canadian bond market was up 7.1%!

A "Bushwacked" U.S. Dollar

The spectacular implosion of the U.S. dollar was the major economic story of 2004. A "Bushwhacked" U.S. dollar sold off against most currencies and fell further after the reelection of George W. Bush in November. The 8% rise of the Canadian against the U.S. dollar was modest compared to the 22% rise of the Polish Zloty, that perpetual haven of value, against the beleaguered Americanski buck. Investors gave up their faint hopes of any "Made in the USA" solution to the growing U.S. trade and fiscal deficits. The returning Bush Administration didn't seem too upset at dollar depreciation and displayed no urgency to deal with the burgeoning federal government budget deficit.

Insatiable Chinese

The other 2004 surprise was oil rising to a record level of $55 U.S. per barrel and significant increases in most other commodity prices. China was awarded the blame for the skyrocketing prices of anything consumable. Most commentaries used the adjective "insatiable" to describe this huge and rapidly growing source of demand. While Westerners were happy to unleash the supply side deflation of trade with China, they now seem stupefied that Chinese consumers actually consume. We agree that Chinese demand is here to stay, but the unanimous view of uninterrupted growth leaves wondering about the downside from a hiccup from this demand and supply beast.

Let the Dollar Do It!

The preference of U.S. policy makers seems to be for exchange rates to bear the brunt of the dislocation caused by the imbalances in U.S. financial policies and the large U.S. trade deficit. This seems to working for now, as U.S. bond yields have actually been falling in tandem with the U.S. currency. As we have mentioned in prior reports, the currency depreciation gives little relief to U.S. manufacturers competing with Chinese companies since the Chinese Yuan is pegged to the U.S. dollar. It will be interesting in 2005 to see if there is any response from the Chinese government to U.S. complaints of Yuan undervaluation. So far, the Chinese answer seems to be "not if you are asking".

Russian or Asian Contagion?

We believe that economic strength will continue into 2005, given the large stimulus delivered by both monetary and fiscal policy by the U.S. over the last few years. This momentum will be hard to slow with the cautious tightening being applied by the U.S. Federal Reserve. It takes some time for restrictive monetary policy to bite, and current speculation in the financial markets indicates that we are a long way from cash scarcity. When few can see any downside to markets, something always comes along to bring fear back to the fore. In 1998 it was a combination of the Russian debt collapse and the "Asian Contagion". We think there is a reasonable risk in 2005 that Russia or China could shock the world financial system in some fashion.

Are Chinese Central Planners That Good?

The West seems happy to leave the global problem of the huge Chinese supply and demand curves to the central planning bureaucracy of the Peoples Republic of China. This is curious, given the fashion of western democracies to discount the effectiveness of any government economic involvement. We witnessed an example of this great divide between China and an actual market economy late in 2004 when the Aviation Ministry announced there would be no new passenger jet orders allowed in 2005.

It seems overinvestment by state-owned Chinese airlines has caused overcapacity in this rapidly expanding sector. The solution was a bureaucratic fiat to suspend new aircraft orders for all airlines rather than let the inefficient ones to go bankrupt as in any western economy. Robert Milton must look wistfully at the Chinese market and hope that Paul Martin learns the value of government regulation from his friends on the Central Committee.

The day after the Aviation Ministry announcement, after Boeing and Airbus had a chance to run screaming to their political masters, the announcement was refined to reduce its impact on future aircraft orders. This was a relief to the important U.S. and European aircraft industries, given that China is one of their few growth markets.

The Question No One Asks

China makes it quite clear that criticism is not welcome from any potential business partner. If the central planners of the People's Republic of China get either supply or demand too far wrong, as seems to be the case in their airline industry, the effects will be felt well beyond China's borders. One has to ask the question however, that with China growing in economic clout, how can historically proven inept central planning be good for China and the rest of the world? Unfortunately, no politically correct Western politician, bureaucrat, businessman or investor can ask this critical question.

Putin Learns From China

We also think that Vladimir Putin of Russia is learning from the Chinese example. Tired of being lectured by the West and disgusted by the impact of free market and democratic reforms on Russian power, he seems to be remaking Russia in China's image. Putin's ideal Russia seems to be a state-controlled economy that only allows capitalism that doesn't impinge on his political and government power. With China considered a global economic powerhouse and success story that attracts western politicians and businesses like bees to honey, who needs democracy and free markets?

We have to look no farther than the Yukos bankruptcy and recent auction of its Yugansk production subsidiary for evidence of this trend. Despite the protestations of western commentators and a Chapter 11 filing and injunction in Texas, the Kremlin auctioned off the Yugansk in December at a firesale price to Rosneft, an affiliate of Gazprom, the state energy company. Putin economic advisor Andrei Illarionov had this to say about the transaction: *"The sale of the main oil-producing asset of the best Russian oil company … and its purchase by Rosneft company, 100% owned by the state, has undoubtedly become the scam of the year"* (LA Times, Dec 29, 2004). Despite the criticism, it seems there is no lack of western banks willing to provide financing to Gazprom once the dust settles. The lure of participation in a potential share issue is too hard for a profit minded financial institution to resist.

Putin's inclination towards the Chinese role model was revealed at his news conference on the deal, at which he questioned the effectiveness of Russia's 1990s ideological makeover. As recounted by the Los Angeles Times:

"Putin bluntly described last week's controversial takeover of the private oil company's core asset by a state-owned firm as a step to redress injustices of Russia's post-Soviet shift from communism to capitalism. " (LA Times, Dec 29, 2004)

Russia's state-controlled oil and natural gas industry is too important for the West to entertain serious objection to this "internal matter." Just for good measure, in a sheer stroke of genius, the Kremlin let it slip that the Chinese state oil company might participate in up to 20% of the purchase. Who in the West can criticize a state-owned Chinese company?

CANSO INVESTMENT COUNSEL LTD.
is a specialty corporate bond manager based in Richmond Hill, Ontario.
Contact: Heather Mason-Wood (905) 881-8853; heathermw@cansofunds.com