MARKET OBSERVER

July 2007

The economy slowed somewhat in the United States over the second quarter, as headwinds from a slowing housing market ate into an export boom fed by the depreciating U.S. dollar. Discerning economic direction proved difficult, as statistics were available to suit most viewpoints which created volatility in the financial markets. The U.S. Federal Reserve examined this murky economic picture and voted to sit on its hands, leaving the Fed Rate at 5.25%. Fed Chair Ben Bernanke and his colleagues refused to pander to Wall Street's pleadings for interest rate cuts. Wall Street economists had singled out the sub-prime mortgage meltdown as worthy of an interest rate reduction by the Fed. Unfortunately for the financial class, perhaps thinking of the recent and obscene $500 million bonus to Goldman Sach's CEO, Mr. Bernanke displayed remarkable sang-froid towards the self interested pleadings of Wall Street and chose not to act.

Bernanke Stays Out of the Fray

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Professor Bernanke prefers to let the financial markets sort out their excesses on their own, a refreshing change from the monetary rescues of Alan Greenspan. Even the meltdown of two Bear Stearns hedge funds was not enough to lure the resolute Bernanke Fed into interest rate cutting mode. Alan Greenspan, retired and undefeated financial heavyweight champion of cash and credit pump priming, must be disconsolate at the spectacle of Wall Street being left to deal with the Bear Stearns debacle on its own. To add insult to injury, the politicians of Congress are now considering taxing the profits of private equity and hedge funds at a higher rate. What's a poor Wall Street billionaire to do?

The Federal Reserve has left its discount rate at 5.25% since June 2006 in an attempt to "normalize" monetary policy and interest rates in the U.S. This seems to be working as the U.S. Treasury 30 year bond yield has moved .3% above the 2 year TBond yield. The 30 year TBond yield was lower than the 2 year yield in early 2007. This caused many economic commentators to warn of recession early in 2007 as an "inverted yield curve" (short yields above long yields) has a pretty good track record of predicting recessions. Now that the yield curve is positive (long yields above short yields) the yield curve is "steep" and "normal" which augers well for economic growth.

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The Fed is staying "vigilant", as they have said in their FOMC minutes, and watching inflation intently, as they should. The Fed has been waiting for inflationary pressures to subside before easing monetary policy. Critics of the Bernanke Fed's inaction are raising the alarm of economic weakness. As we have said consistently for some time now, monetary policy cannot be considered "tight" by even a Wall Street imagination. With the Fed rate at 5.25% and inflation between 2-3%, we're not talking onerous real interest rates at 2-3%. What the critics really want is to let the Greenspanian good financial times roll again. With energy and commodity prices sticky near their highs and food prices showing the first significant inflation since the 1970s, it is only prudent for Mr. Bernanke and his colleagues to err on the side of caution.

The Economic Calm before an Inflation Storm?

Employment and spending in North America have stayed strong enough to keep wages growing in the 3% range and inflation smoldering above 2%. While the current U.S. slowdown could give the Fed pause to consider its monetary pol-

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icy, The Bank of Canada is seeing continued growth in wages and stubborn inflation above its 2% target. If things heat up economically after the current bout of weakness, which looks increasingly likely in the U.S., Canada might lead North American interest rates upwards.

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The rest of the world is continuing to grow at a stronger pace than in the U.S. World central banks have recognized this and have continued to raise interest rates in a global "normalization" of world interest rates. It is hard to slow things down once economic momentum has taken hold. Countries as diverse as New Zealand, China and India have been implementing credit controls and other non-monetary restrictions to slow their economies in addition to raising interest rates.

The Bull Market in Milk (pun intended)

Given our penchant for economic trivia, a couple of stories on milk prices have caught our eye. The well known demand of China and India for energy and commodities is being joined by more basic human appetites. It seems that increasing incomes in the developing world have contributed to rising demand for dairy products. The huge "Butter Mountains" and powdered milk stores of the European Union and the United States agricultural surpluses have literally been eaten up. This has pushed the price of industrial milk up 60% and caused the economy of milk exporter New Zealand to boom. As we said earlier, rising milk prices are just one of the pieces of evidence of the first significant general inflation in food prices since the 1970s. Since milk in its various forms is used in many other food products, this pressures prices for cheese, pizza and even bakery products. Food Aid organizations are now worried that scarce powdered milk stocks, a staple of world food programs, will affect their ability to help feed people in drought stricken areas.

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Slowing Profits Will Hurt Equities

On the equity front, earnings are slowing from their rapid growth earlier in the cycle. Companies are still reporting rising labour and material costs which combined with higher interest rates pressure profits. Slowing earnings growth and rising interest rates are not the best environment for equities. The boost to stock prices from the private equity acquisition binge is getting long in the tooth, as debt financing becomes harder to get due to the well publicized credit problems of Wall Street. We think the equity markets will moderate with the economy and possibly settle back with higher interest rates, with a severe downturn dependent on the prospects for recession. We don't think a recession is in the cards imminently, since monetary policy is still not restrictive. After the ultra low rates of the late Greenspan period, it sure feels like rates are high, but they aren't from a historical perspective.

Maid(less) in Shanghai

The domestic Chinese equity market is a major area for concern, however, as it has all the signs of a speculative peak. Retail investors are driving the Chinese stock market as they remove low interest rate savings from the banks and chase historical performance. Anecdotally, it has become hard to find maids in Shanghai as many have quit their jobs to day trade in the surging stock market. The Chinese government has restricted lending for stock speculation in an effort to cool things down. This has resulted in retail investors using credit card debt and phony store purchases to finance their equity holdings.

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The price earnings ratio of domestic Chinese A shares is stratospheric at 45 times, which is far higher than Chinese stocks listed on the Hong Kong or Singapore stock exchanges. This results from the dearth of short sellers in the domestic Chinese market as foreigners cannot participate in any meaningful way. Despite government warnings, the market continues to boil at a fever pitch. The

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"stamp tax" on trades was increased to settle things down but the losses from this overt government action were soon made up by the overwhelming enthusiasm of retail investors.

The Shanghai Shivers

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The Chinese government is of two minds on the speculation in its stock market. A rising stock market makes for happy citizens and burgeoning national pride so the Chinese government has historically supported the market in its down periods. The senior Chinese leadership is now very uneasy, however, at the frothy nature of the retail investing but understands that a stock market crash would cause it major political and social dislocation. The Chinese government has implemented restrictions on margin credit and raised the stock transaction "stamp tax" to try to limit retail speculation. It is also now liberalizing the restrictions on foreign investing by institutional investors and mutual funds in the hope that a shifting in demand to external markets will help to calm the domestic market. A global economic slowdown or rising Chinese interest rates would have the potential to unleash a vicious bear market in Chinese equities. The several sell-offs in the Chinese market in the last couple of years have been felt in other global equity markets, termed the "Shanghai Shivers" by market wags. A serious setback in the Chinese market could precipitate a global bear market in equities worldwide so developments in China bear serious scrutiny.

Outlook

As most of the world's central banks are already tightening, this will add to the downwards pressure on the prices of financial assets as interest rates increase.

We expect the U.S. economy to continue to grow into the fall, with the possibility of stronger growth than most expect. This would force both the Federal Reserve and the Bank of Canada into action, resuming monetary tightening and interest rate increases to head off further increases in inflation. As most of the world's central banks are already tightening, this will add to the downwards pressure on the prices of financial assets as interest rates increase. It should also drive investors into higher quality investments, as higher yields on "safer" investments draw money away from more speculative areas and the ill-advised deals of the last few years default.

Given the extent of the speculation in the financial markets since 2002, we think the downturn will be severe. This will be felt the most in lower quality debt and loans, as stricter credit standards and rising loan losses affect the behaviour of lenders. This will also feed through to the equity markets, as investment dealers restrict their margin lending. Hedge funds will move from the "no lose" category to the "loser" category when margin calls and client redemptions result in forced selling of illiquid portfolios. As always, the damage will be most severe when margin collateral is liquidated by anxious lenders.

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