Canso MARKET OBSERVER

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The world economy continued to grow in 2006, defying monetary policy tightening and higher energy prices. Federal Reserve Chair Ben Bernanke declared a ceasefire on increases in the Fed Rate in June and waited for the U.S. economy to slow. The financial markets took this as the all clear signal for this monetary cycle and began to anticipate a drop in interest rates. This caused the previously faltering stock and bond markets to rally strongly in the final 6 months of 2006.

Risk taking was rewarded in 2006. The Dow Jones Industrial Index in the U.S. was up 16.3% for the year while the technology oriented Nasdaq lagged somewhat with a 9.5% return. Global equities did well with the MSCI World Index recording a strong 21% return. The U.S. bond market put in a respectable showing with the investment grade Merrill Lynch Bond Market Index at a 3.8% return which lagged the strong 11.8% return of the Merrill Lynch High Yield Index. The Canadian equity market benefited from strong commodity prices with the TSX Index up 14.5%. The Canadian bond market was respectable with the Scotia Capital (SC) Universe Index up 4.1%. The Canadian income trust sector was savaged by a reversal of government policy and saw a sharp 10.9% decline.

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Premature Bond Bull

We find the bullish sentiment in the bond market a tad premature. We think the anticipation of a relaxation in monetary policy and decreasing interest rates in the U.S. is wishful thinking, given the extent of monetary stimulation that had been provided by the Fed since 2000. The problem, it seems to us, is that the restriction of monetary policy accomplished by the Fed to date is far less than the stimulus it previously supplied.

Detailed study of monetary aggregates is not needed to conclude that "living is easy" in the world's financial markets. The obscene year-end bonuses of investment bankers are testament to the vast sums of money being placed into increasingly expensive and dubious investments. The crescendo of this dissonant symphony of greed and stupidity comes from the private markets. Corporate bond investors and bankers are falling over themselves to provide funding for the highly levered deals of private equity firms. Financing is even readily available for the sponsors of recent deals to take their money off the table by way of special dividends and repayment of shareholder loans.

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Economic forecasting is not our craft but our simple view is that there still is ample money and credit available for U.S. economic growth to continue well into 2007. The current market consensus believes that the U.S. economy is slowing due to the weak housing market and that the Fed will begin to relax monetary policy and lower interest rates in 2007. The reality is that the slowing of the U.S. housing market is both understood and less severe than feared. The service sector, capital investment and exports are all continuing to show strength. Growth might have slowed from its previously blistering pace but the need for the Fed to stimulate by lowering rates is tempered by continued low U. S. unemployment and strong wage growth. The current level of U.S. wage increases is above 2%. This suggests that core inflation in the U.S. is likely to stay above 2% given the strong historical relationship between wages and inflation.

Monetary and fiscal policies outside of the good ol' USA are becoming more important to the world financial order. A U.S. centric world economic view

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is rapidly being made obsolete by the growing profile of the Euro currency bloc and the rising consumer demand from China, India and other developing nations. Even with growth slowing domestically, we expect to have the U.S. dragged along by growth in the rest of the world. We think that even a slower economy will see persistent inflation above 2%. This means that the Fed might have to raise interest rates, which would come as a shock to those in the bond market waiting for the Fed to ease.

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Given our forecast for continuing but slowing global growth and rising interest rates, our outlook for equity markets is mixed. We expect corporate profit growth to slow, as rising compensation and interest rates bite into stagnating revenues. In the cyclical sectors, the major capital expansion programs brought about by high commodity prices should see supply outgrowing demand. This will keep energy and metal prices moderating. Our slowing economic and moderating profit picture combines with high valuations to limit the upside that we see to the stock market. We think single digit returns for equities are likely in 2007. If the Fed does prematurely move to ease and lowers interest rates, the stock market would respond enthusiastically, recognizing the Federal Reserve's implicit guarantee of Wall Street. The potential downside is substantial, as speculative activity and higher interest rates have increased the chance of a financial accident.

Riding the Cash Rapids

A significant economic risk comes from the financial markets where asset pricing and credit are showing a serious departure from reality. The Wall Street Journal titled a year-end 2006 article *"Investors Riding the 'Cash' Rapids"* and characterized an "(investment) *world awash in cash".* When as august a publication as the WSJ speaks to its readers in this manner, one has to wonder about the efficacy of the prior tightening of monetary policy. Despite its skepticism and given its Wall Street base, the WSJ concludes that the benign conditions should persist: *"But for now, the river of cash seems unlikely to suffer a dollar-related drying up. Indeed, it can be very hard to figure out what will end the flood of liquidity."* -WSJ

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Given our contrarian souls and many credit cycles of experience, unlike the WSJ, we do not have any difficulty imagining circumstances that could end today's financial orgy. Our prime suspect is the lack of caution in the credit markets that will eventually prove its own undoing. Many commentators suggest that the securitization by banks of loans into Collaterized Debt Obligations (CDOs), Collateralized Loan Obligations (CLOs) and the development of Credit Default Swaps (CDS) will insulate lenders from the foibles of their borrowers. Since the banks, it is argued, have sliced and diced up their loan books, sold them off to investors and can insure what is remaining in the CDS market, there is not the risk that lending will shut down as in prior cycles. This argument amazes us by its sheer inanity.

Impossible to Default?

The first order naivety of this argument is that banks are not concerned about the risk of the loans that they are underwriting. In their yearend piece, (*CDOs – A View from the Tranches (Jan-07))*, Merrill Lynch points out that the loans being put into Collateralized Loan Obligations (CLOs) are showing increasing leverage and deteriorating structures. Debt/EBITDA levels for the issuers in the pools are rising. Concentrations of loans to Leveraged Buy Outs (LBOs), 2nd lien loans, loans with fewer convenants and loans that are funding "shareholder friendly purposes" are all much higher for CLOs than for the loan market at large. This means that banks are laying off their riskier loans to the third party buyers of their CLOs. The Merrill Lynch analysts do not find this trend concerning, they rationalize a benign outlook for 2007 in the same watery metaphor as the WSJ:

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"In a market awash with cash, it seems virtually impossible for a high yield company to default, particularly as loan credit underwriting gets increasingly lax." - Merrill Lynch

CDOs are made attractive to third party investors by the sycophantic and "stress tested" credit ratings made by credit rating agencies eager for structured product rating fees. Now that banks are creating CDO Squareds (CDO2), CDOs composed of CDS, banks can keep their loans and buy protection from CDO2s. As we mentioned in our last report (October 2006), this daisy chain of risk abandonment is nearly universally seen as virtuous. We do not agree. We believe that this separation of lending and ownership is encouraging very poor credit formation which will inevitably lead to severe credit losses when the cycle finally turns.

The second order naivety of this financial innovation argument is that as banks are decreasingly suppliers of credit; they act as mid-wives to third party investors who buy their credit wares. This is an important development, which shouldn't be underestimated. In the old system, banks inevitably made risky and ill-advised loans and monetary authorities rescued them in their hour of need. Big borrowers were protected by the havoc they could wreak on loan books and regulators and investors conveniently allowed book value accounting by banks for obviously impaired positions.

Today's brave new world of bank credit is market based. This presents a very clear and present danger to today's credit market complacency. When the situation deteriorates in the public markets, the pain is very quick and sharp. Experienced corporate bond investors know that there will be no or very low bids for suspect investments at critical market junctures. A few busted deals and large bankruptcies will quickly deflate loan market optimism. The change from a rush to invest to a rush to close positions will be very rapid. Centralized "risk management" in financial institutions means a tweak of a spreadsheet can cause billions dollars of damage to valuations. When the risk manager says liquidate, there is no choice in the matter.

With the Fed on hold, the prospects are for continuing growth in the U.S. and world economies. If U.S. core inflation remains above 2%, as we expect, the Fed will inevitably be forced to tighten monetary policy further, joining other world central banks. This will cause havoc with speculative investment strategies and weak credit structures.

The fuel for a financial conflagration seems very obvious to observers after the fact. Before, prudent investors must watch from the shadows as the greed crazed mob cheers the financial thrill seekers who throw gasoline onto the fire, not realizing its incendiary danger. When the excess fuel causes an explosion, the crowd recoils in horror at the carnage, not able to admit its role in the fiasco. Rather, it demands Enron-like accountability and protection against further disasters.

It's tragic that the Dot.com bust and Enron resulted in the Sarbanes-Oxley governance craze and the easy money binge of the Greenspan Fed. The current private market and hedge fund mania is a direct result of these efforts. It shows in spades that bureaucracy cannot protect investors from the base human emotions of greed and fear!

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