# KAPITAL COMMENTARY

# A MACROECONOMIC PERSPECTIVE

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## The Year in Review

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The Year 2005 was a relative strong year for both economic growth and asset prices. My key call on the Macro front overhang from last year was the fact that contrary to the view of Warren Buffet and others, the US$ rallied strong against Major Trading currencies against the US$. In fact, that index showed a +8.0 percent increase and the US$ vs. the Euro appreciated by +14.5 percent. The C$ increased due to high commodity prices for the moment. On the stock specific front, a junior Axia Netmedia produced a +200 percent annual return while the worst performance was also shown by a junior Wi-Lan Inc. reporting a 50 percent negative return. On the less speculative side of the market, other stock pick performance included: Canadian Natural Resources Limited reporting a +135 percent return up to September of 2005; CCS Income Trust reporting a +76 percent return also to the fall of 2005; and Peyto Energy Trust reporting a +36 percent return for the same period. However, investors should be aware that Canadian Natural, CCS Income Trust, and Peyto Energy Trust, were first identified years ago and CCS produced a return of about 12 fold to the fall of 2005; Canadian Natural over 300 percent; and Peyto over +200 percent. Energy investors were advised to lighten up in/around the fall of 2005. For the year, Google was also up an additional +120 percent but is up 4.15 times since August 2004. Genentech reported a +63 percent return for the year while my value picks reported the following returns: ING +62 percent for the year; Fortis +46 percent; TSX Group of Companies +80 percent, and my value portfolio noted herein reported a +22.25% return in 6-months. My call on the gold sector resulted in 4/4 stocks being up and sold within 6-weeks with an average return over +11.0 percent and all 4 stocks were up. A key forward looking expectation is that there is slower global growth around the corner as long as energy prices remain high; however, I also expect that market to correct and both energy commodity and asset prices to fall going forward.

## I. Introduction

This note provides a simple summary of economic and financial highlights of the past 22 Kapital Commentary notes written in 2005. That is, each 'gist' or bottom line of each of the past notes is given followed by an 'actual' outcome that discusses what actually followed subsequent to a particular note's forecast. With this in mind, readers should also note that the Kapital Commentary notes are 'forward looking' or aim to write into the future by at least 3- to 6-months in order that financial market participants can take advantage of changes in the economy and financial markets well in advance of changes in stock, currency, and bond prices. In short, the Kapital Commentary notes aim to assist financial market participants either earn excess rates of returns in the market and/or prevent losses. Apart from being forward looking, the Kapital Commentary notes also aim to be at least as educational as informative. Finally, this review *does not* review the 200 plus daily macro monitor notes also written throughout the year. Also, many of the current expectations have not yet worked themselves out in the market as my writing is ahead of developments.

## 1. Kapital Commentary Number 1, 2005
**Date: January 12, 2005**
**Title: WiMAX and Competition**

**Article Gist:** This note discussed the introduction of WiMAX technology into the wireless sector in the telecommunications industry and the expectation that WiMAX would become an increasing important form of technology in the economy.

**Actual Outcome:** WiMAX technology became commercial in 2005 and industry participants in the WiMAX forum continues to grow quickly including large cap companies such as Intel and AT&T to juniors such as Wi-Lan Inc. I continue to expect that growth will be excessive in this area, especially once the energy market corrects.

## 2. Kapital Commentary Number 2, 2005
**Date: January 27, 2005**
**Title: Sectors**

**Article Gist:** This note discussed expected risks and returns in the Canadian economy and financial markets in 2005. This note wrote that cash flows and earnings would remain high for commodity based assets but should a commodity price shock occur, commodity based assets could demonstrate considerable volatility and losses. Financial stocks were expected to provide a moderate return with limited volatility while the healthcare sector would report positive price growth along with the technology sector – at the cost of high volatility.

**Actual Outcome:** Commodity based companies did report continued high cash flow and earnings and volatility entered the energy sector in October, which led to lower prices for many companies, a few of which recovered by the end of 2005. Gold stock companies reported positive price gains and volatility at the end of 2005. Healthcare/pharmaceutical stocks remained out of market favour until late 2005 when investor sentiment began to shift and this sector is expected to produce excess returns going forward. The technology sector produced fundamental growth in 2005 and at the end of 2005, the technology industry reported 'real' growth rates of 35.2 percent for October and 35.6 percent for November. North American technology indices reached multi-year highs, but this sector is still viewed as being undervalued, especially on the *expectations* side of the valuation equation.

**3. Kapital Commentary Number 3, 2005**
**Date: February 9, 2005**
**Title: Income and Lower Volatility**

**Article Gist:** For investors seeking income and lower price volatility, this note recommended that the shares/units of Fortis Inc., Great Lakes Hydro Income Fund, and the TSX Group of Companies as buys.

**Actual Outcome:** The price performance of Great Lakes was flat to slightly negative throughout the year and was identified as a sell for lack of performance. Fortis Inc. produced a return of +46.0 percent while the TSX group of Companies produced a return of +80.0 percent.

**4. Kapital Commentary Number 4, 2005**
**Date: February 23, 2005**
**Title: Three Percent Plus**

**Article Gist:** This note discussed the Federal Reserve's expected future changes in its Federal Funds rate. The key comment of this note was that it was expected that the Fed would continue to increase short-term interest rates up to June 2006 and then stop.

**Actual Outcome:** The Fed continues to increase the Federal Funds rate after 13 consecutive quarter point increases and the market is expecting the Fed is almost finished increasing the Federal Funds rate as Federal Funds Futures are pricing in a 4.75 percent Federal Funds rate by the spring of 2006.

**5. Kapital Commentary Number 5, 2005**
**Date: March 9, 2005**
**Title: Japan**

**Article Gist:** This note identified that Japan's economy was shaping up in a very positive manner. In particular, Japan was reporting high rates of investment spending and corporate profits were on their way to exceeding pre-bubble highs. Accordingly, the future outlook for Japan looks very favourable.

**Actual Outcome:** The end of 2005 continued to confirm this note written in early 2005. Investment spending and profitability remain high in Japan and deflation looks like it's on its way out. Japan's stock market reported another positive year resulting in stock prices increasing by +43.0 percent for 2005.

**6. Kapital Commentary Number 6, 2005**
**Date: March 23, 2005**
**Title: Small Cap and Value**

**Article Gist:** This note recommended the shares of Gaylord Entertainment ("GET" – NYSE) for value investors aiming to achieve a +12 - +25 percent return within 18-months.

**Actual Outcome:** The shares of Gaylord Entertainment increased by +15.66 percent within 7 months and finished 2005 at $43.50/share and remains a Kapital pick. The impact of Hurricane Katrina resulted in the stock coming off its high although the stock is up about +4.8 percent from initial pick price.

**7. Kapital Commentary Number 7, 2005**
**Date: April 6, 2005**
**Title: Liquidity**

**Article Gist:** This note served more as an informative and educational note as to how 'liquidity' impacts asset prices with an emphasis on stocks. Key points included how stock prices have demonstrated a tendency to 'melt down' rather than melt up, or it takes several years to produce stock highs or excess returns that can literally disappear within a financial quarter.

**Actual Outcome:** This note remains an important writing for investors to keep in mind **–** especially current energy investors. That is, all post World War II energy price cycles have shown how quickly energy stock returns collapse at the end of their cyclicality. Moreover, the late 1990's energy sell off is a close example as is the late 1990's – early 2000' technology stock boom/bust sell off. Thus, I remain of the view that the world is not in a <u>*brand new*</u> energy environment that many believe it to be in.

**8. Kapital Commentary Number 8, 2005**
**Date: April 20, 2005**
**Title: The Business Cycle and Stock Returns**

**Article Gist:** This note identified and emphasized the statistical reality that stock prices are very much macro-economically valued. That is, high rates of economic growth are followed by high stock prices and vice versa.

**Actual Outcome:** In the fall of 2005, investors were advised to sell off and take the profits on composite stock price indices in the anticipation of lower future economic growth and stock returns while the Nasdaq Index is viewed as a hold. Composite stock returns including NASDAQ reached multi-year highs by December 2005 but began to sell off towards the end of December in anticipation of lower economic growth in 2006 and are erasing 2005 gains.

**9. Kapital Commentary Number 9, 2005**
**Date: May 4, 2005**
**Title: Inflation: The Past and Expected Future**

**Article Gist:** This note provided a 12-month core inflation forecast for the U.S. economy of 2.0 percent.

**Actual Outcome:** By the end of 2005, actual inflation growth was as follows from May – November 2005, or the 7-month outcome is as follows:[1]

| Inflation Measure | % Change |
|---|---|
| Core Producer Price Index | +0.2 |
| Core Consumer Price Index | +0.9 |
| Core Personal Consumption Expenditures | +0.7 |
| Average | +0.6 |

**10. Kapital Commentary Number 10, 2005**
**Date: May 18, 2005**
**Title: Long Term Bond Yields: A Comment**

**Article Gist:** This note argued that U.S. long-term bond yields would begin to rise.

**Actual Outcome:** From June – November 2005, U.S. long-term bond yields increased from about 3.90 percent to a peak of almost 4.70 percent by early November before dropping to a current level of 4.37 percent in anticipation of slower U.S. economic growth in 2006.

**11. Kapital Commentary Number 11, 2005**
**Date: June 1, 2005**
**Title: Income and Capital Appreciation**

**Article Gist:** This note argued that the total return expectation for the shares of Microsoft Corporation ("MSFT" – NASDAQ) would be at least +28 percent within a 12-month horizon and the company is recommended as a buy.

**Actual Outcome:** At the end of 2005, the share price of Microsoft Corporation is $26.46 and is still viewed as a buy but remains 'flat' from its initial pick price of $26.39.

[1] Most recently available data.

**12. Kapital Commentary Number 12, 2005**
**Date: June 15, 2005**
**Title: Pre-Tech**

**Article Gist:** The 'pre-tech' era or 1997 – 1998 macroeconomic conditions were identified and discussed including: much higher interest rates; low inflation expectations; strong consumer confidence; declining profitability in the U.S. economy; and a crash in energy stock prices and returns.

**Actual Outcome:** Many of the 'pre-tech' macro conditions exist in the U.S. including: relatively higher short-term interest rates; strong consumer confidence; and declining corporate profitability. However, the energy market continues to attract high return expectations and U.S. future inflation expectations have risen to a multi-year high of 4.6[2] percent for most recently available data for October 2005.

At the same time, the higher inflation expectations are directly linked to high energy prices. Thus, I remain of the view that when energy prices drop, so too will future inflation expectations along with energy stock prices and returns resulting in a shift of investment capital into the technology industry.

**13. Kapital Commentary Number 13, 2005**
**Date: June 29, 2005**
**Title: Speculation and Asset Price Risk**

**Article Gist:** This note defined and discussed speculative bubbles in stock markets along with how all stock sectors are cyclical. The meaning of the note essentially signalled that there is a coming large sell-off in the energy sector due to current excess optimism, speculation, and the cyclicality of the energy industry.

**Actual Outcome:** It is too early to fully appreciate or measure this note; however, the energy stock price volatility shown in October is expected to be a small signal of what is to follow for energy stock prices.

[2] University of Michigan data for November 2005.

**14. Kapital Commentary Number 14, 2005**
**Date: July 13, 2005**
**Title: Portfolio Note**

**Article Gist:** This note discussed a lower Canadian economic growth outcome for 2005 – 2006. In turn, a portfolio of financial shares were recommended as a hedge against lower future economic growth that included the shares of TD Bank; Bank of Montreal; Royal Bank; TSX Group of Companies; and ING Canada Inc.

**Actual Outcome:** Since July 13, 2005, the shares of these companies have produced the following returns not including dividend payouts:

| **Company** | **% Return** |
|---|---|
| TD Bank | +11.36 |
| Bank of Montreal | +13.15 |
| Royal Bank | +20.80 |
| TSX | +22.87 |
| ING Canada | +48.11 |
| **Portfolio Return** | **+23.25% in 6-months** |

**15. Kapital Commentary Number 15, 2005**
**Date: September 14, 2005**
**Title: Consumer Spending and Stock Prices**

**Article Gist:** This note pointed out the significance of consumer spending for economic growth and stock prices. Moreover, this note also stated that future U.S. consumer spending – durable goods spending in particular – would decline along with composite stock prices as an asset class.

**Actual Outcome:** The big four U.S. automobile manufacturers reported a significant and rapid drop in September sales and financial problems due to *reduced consumer durable goods spending* on automobiles in the fall of 2005. In addition, composite U.S. stock prices began to report monthly lows at the end of December 2005 due to 'lower future economic growth concerns' and lower consumer spending.[3]

[3] Bloomberg, December 27, 2005.

**16. Kapital Commentary Number 16, 2005**
**Date: September 28, 2005**
**Title: Capital Shifts**

**Article Gist:** This note argued that financial markets would be shifting to more defensive assets going forward such as services stocks. In turn, the shares of Starbucks Corporation were recommended as a hedge.

**Actual Outcome:** Since September 28, 2005, the share price of Starbucks has appreciated by +27.29 percent.

**17. Kapital Commentary Number 17, 2005**
**Date: October 12, 2005**
**Title: Price Changes and Assets**

**Article Gist:** This note discussed the significance of inflation growth in the U.S. economy and its impact on asset prices.

**Actual Outcome:** Key measures of actual inflation growth and inflation expectations are at multi-year highs. For example, actual U.S. inflation growth in the U.S. is as follows year-over-year.

**Inflation Growth and Inflation Expectations**

| | **Inflation Measure in %** | |
|---|---|---|
| | **2004** | **2005** |
| **Consumer Price Inflation** | +2.00 | +1.70 |
| **Producer Price Inflation** | +1.98 | +0.90 |
| **GDP Deflator** | +1.96 | +1.46 |
| **Core Personal Consumption Expectations** | +1.90 | +1.40 |
| **University of Michigan Inflation Expectations** | +2.80 | +4.60 |

**18. Kapital Commentary Number 18, 2005**
**Date: October 26, 2005**
**Title: Gold: A Fundamental Review**

**Article Gist:** Due to higher global inflation expectations, this note demonstrated that both the fundamentals along with speculative expectations were and would be strong for gold going forward. In turn, 4 gold producing stocks were identified as 'trades' or speculative buys over the period of this note to early December 2005.

**Actual Outcome:** The four gold picks produced the following returns over the horizon of their recommended buy and sell dates, or about 6-weeks:

| Company | Return in % |
|---|---|
| Anglo Gold | +12.53 |
| Newmont Mining | +8.76 |
| Gold Fields Inc. | +21.92 |
| Barrick Gold | +2.60 |
| **Average** | **+11.41% /6 weeks** |

**19. Kapital Commentary Number 19, 2005**
**Date: November 9, 2005**
**Title: Value and Yield**

**Article Gist:** This note recommended a value pick, Power Financial Corp., for defensive and long-term income and capital appreciation and low expected price volatility investors.

**Actual Outcome:** Since November 9, 2005, the shares of Power Financial Corp. have produced a +4.0 percent rate of return.

**20. Kapital Commentary Number 20, 2005**
**Date: November 23, 2005**
**Title: Global Growth and 2006**

**Article Gist:** This note identified the key macro risks in the market going forward, or: high energy prices; high inflation expectations; rising interest rates; and slowing investment growth in China. In turn, a lower global growth forecast for 2006 was given along with the view that cash and bonds and certain stock sectors would be in demand for 2006.

**Actual Outcome:** At the end of December 205, stock prices as an asset class began to report monthly lows due to lower future global expectations and bonds were attracting investment capital.[4]

**21. Kapital Commentary Number 21, 2005**
**Date: December 7, 2005**
**Title: Japan and Semiconductor Update**

**Article Gist:** This note argued that both the Japanese economy and the global semiconductor market are strengthening and are anticipated to produce strong growth in 2006 and beyond.

**Actual Outcome:** Financial markets are very bullish for Japan's recovery in 2006 as it is anticipated to exit its multi-year cycle of its deflation trap. Japan's stock market is up +49.0 percent for the past 24-months and a hike in short-term lending rates is expected in 2006. The global semiconductor industry is expected to be strong up to and including 2008 and share prices of Qualcomm Inc. and Nokia, along with their forecasts, are supporting a high future growth expectation.

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[4] Bloomberg, December 27, 2005.

**22. Kapital Commentary Number 22, 2005**
**Date: December 21, 2005**
**Title: Developing Economy Asset Growth**

**Article Gist:** This note argued economic growth in 2006 would be higher in emerging market economies. Moreover, the American Depository Receipts (ADR's) of Mexico's Telecommunications Company Telmex were identified as a buy at U.S. $24.04 /ADR for growth and excess return oriented investors.

**Actual Outcome:** The current ADR price of Telmex is $23.95 and it is too early to comment further on this asset as the note was just written.