Chris Horan, Financial Advisor

January, 2005

Mark Your Calendars
March 30, 2005
The Living Workplace,
Soul, Spirit and Success
in the 21st Century

I am pleased to announce that best selling Canadian author, Ann Coombs, will be speaking at a private session exclusively for clients and friends of Chris Horan, Financial Advisor.

Ann will be leading us in a discussion on the roles of leadership, values, ethics, discernment … and more!

Ann is the author of the best selling book "The Living Workplace, Soul, Spirit and Success in the 21st Century", and the winner of the International Pinnacle Award for Communicator of the Year. She is a futurist, a "Thought Leader" and consults to major international corporations and organizations on ethics in the workplace and creating workplaces with spirit and balance. Anne's newsletter has a readership of 250,000 people worldwide. Don't miss it!

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Deficits, Dollars and Markets

This newsletter is a series of short takes on questions that seem to be on many clients' minds these days. Let me know what you think and if you have other questions.

Consumer Debt

The alarm over consumer debt levels is exaggerated. The ability of the consumer to pay back debt is nearly as good as its ever been in our lifetimes, because interest rates are so low. We forget that 10 years ago, prime interest in Canada was 10%, down from 14% in 1989, versus only 5% today.

Interest Rates

Canadians, heavily influenced by the US media, seem to be transposing media hype of the US economy's problems onto our own, namely the threat of higher interest rates. However, Canada is much more on its own economic course now than in the past. T he big difference is the strength of the C$. Canada is the only country in the G7 to have a government budget surplus, and we are still a big exporter of resource commodities. As a result, our currency is in demand. This strength of the C$ allows the Bank of Canada room to actually *lower* short-term interest rates. A strong C$ allows interest rates in Canada to stay low, which is very good for the Canadian economy, plus it will keep the cost of Canadian imports low (more on this below). This is good news.

Inflation

Is inflation coming back? Inflation would drive interest rates higher. The answer, given by the bond market, is 'not any time soon'. Bond investors look out 10 or 20 years and they *hate* inflation. Long bond yields in Canada and Europe have declined in the last year and also more recently in the US. So the word is no inflation on the horizon. With inflation nowhere in sight in Canada, the prospect is for interest rates in Canada to stay lower than we expect. More good news.

US Government Deficit

The US government deficit, while impressive (or worrisome) in dollar terms, is not nearly so scary when expressed as a percentage of the economy, or GDP. In fact, US Federal Reserve data show the US government deficit has been greater as a percentage of GDP than it is today almost continuously for 20 years from 1975 to 1995. Not only that, but low interest rates make the total debt quite serviceable. So while of course deficits can't continue forever, the Americans have been there before and it isn't something they can't fix again.

Currency

A strong C$ reduces the cost of imports to Canada. For example, a stronger C$ reduces the cost of machinery and equipment imported by Canadian companies, which has a very important positive effect on our quality and productivity. It also reduces the cost of many other important things like Hondas and all the food we buy from California in the winter.

(Remember that the media were bleating about how bad the *decline* of the C$ was. Well, the effects are

equal and opposite on the way back up, so if it was bad back then, it has to be pretty good now. The thing is that a fluctuating currency may pinch some people, but it is great for others – you just won't hear the good news in the newspapers)

US Trade Deficit

Just as the weak US$ pinches the US consumer because the cost of a Mercedes goes up, a weak greenback is good for US exporters. This means that the strength in the US economy will tend to shift from the consumer to the corporate sector. For example, Caterpillar is a worldwide leader in engines and heavy equipment, so a lower US$ means that the price of a Caterpillar bulldozer goes down for the Chilean gold miner who buys it. Caterpillar sells more bulldozers, and the Chilean gold miner's costs are reduced. This is good news, folks.

This decline of the US$ is simply part of the natural rebalancing that has to occur between US imports and exports. The media are screaming about twin deficits (although nobody in the newsroom can explain why a trade deficit isn't a debt). Economics 100 teaches us that when a country imports more than it exports, it tends to exert downward pressure on its currency (because you sell your currency to import something).

When the US$ declines, imports become more expensive, so people import less and export more, and things come into balance again. The currency adjusts over time to compensate for trade levels and capital flows. It is all part of the wonderfully complex system of international activity that is our global village.

Will the US$ decline more? The greenback has already declined more than 30% against a basket of major currencies. The last time the US$ was this low, the trade deficit was not a problem, so the decline of the US$ may be closer to its end than its beginning.

Market Outlook

Unlike 2000, this year there are no big bubbles to burst, and fewer undervalued sectors. The remaining overvaluations in the markets created by the growth stock bubble are gradually being corrected. For example, 4 of the 20 largest companies in the US (by market value) had share price *declines* averaging more than 22% in 2004 – even as their earnings are increasing. Their stock prices were just too high and are coming down to earth.

Moreover, the valuations of the overall stock markets in Canada and the US are only slightly higher than long-term historical levels. And when these valuations are viewed in the context of low inflation and low interest rates, the markets appear quite reasonable priced.

As a result, the big discrepancy between the growth and value styles of investment management will be less important than in the last 5 years. In my opinion, the story of the next few years will be the ability of investment managers to invest in individual companies that have good growth prospects and that sell at reasonable prices. Good research will be key.

The days of just blindly 'buying the index' are gone. In my opinion the markets as a whole may well remain within what we call a 'trading range' – a few hundred points up, then back down – for years. We are highly likely to have what is known as a 'stock picker's market'. It will pay to keep in mind an old adage: 'it's not a stock market, it's a market of stocks'.

These market conditions, by the way, call for the skills, the experience, and the judgment of the managers that you already have looking after your investments now.

The Big Surprise

We humans seem to love to have something to fret about. The news media have conditioned us (or maybe it's our genetic programming) to worry about some kind of disaster or problem regardless of its real relevance to us. Unfortunately, the thing that will upset the apple cart is probably a surprise of some sort. Only problem is, we don't know what it is – since it hasn't happened yet. That's why we call it a surprise. So it doesn't do us any good to worry about it!

The good news is that we have designed your portfolio with surprises in mind: most clients have bonds in their portfolios, all clients are prepared for their portfolios to fluctuate in price, as they have in the past, and nobody has all of his or her eggs in one basket. If you have specific risks in your life we have talked about them and built a remedy into your plan. (If you have a risk we haven't talked about, you had better call me.)

The risks in the world today (that we know about) are no greater or worse than any time I've been thinking about this stuff, which is 22 years. So stop worrying and get out and enjoy life. An asteroid could hit any day now.

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