THE TAMRIS REVIEW
The Global Bubble Economy
A Canadian Portfolio Perspective
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This review focuses on a number of key risks to the Canadian economy and by virtue of this, risks to Canadian Investors.

For as long as anyone can remember Canada has benefited from being close to the US economy and, most portfolios have been closely aligned to the US and Canadian debt and equity markets.

But, this strategy may or may not be the most appropriate strategy going forward, depending of course on how you view the main risks to the Canadian and American economies and their combined asset markets.

While every manager will have a different view, it is important that their views are substantiated and detailed and cognisant of the risks that are discussed below.

Canadians cannot afford to ignore the very real risks that could affect their financial security if their portfolios' asset allocations do not reflect the real risk and return relationships in markets and economies.

Is your money being managed properly? Is your manager aware of the risks? Can your manager manage these risks and, if so, how?

Introduction

The Canadian economy is small and reliant on a strong and vibrant US economy. It is also an economy with a fairly large and important manufacturing sector and a large and very important commodity and resource industry.

80% of Canada's exports go to the US market and a good portion of its manufacturing industry is reliant on international companies. With the exception of its surplus in energy and commodity exports to the US, Canada would be operating a trade deficit and, is operating significant trade deficits with every one of its other important trading partners, including the strongly developing countries in Asia.

Canada has benefited from its close proximity to the US over the last century, but new threats are encroaching on its ability to continue to compete and are compounding long term competitive weaknesses.

- Intense global manufacturing competition, a strong currency and the continued growth and development of Asia.

- An imbalanced US economy with historically high levels of consumer debt, historically low savings rates and an historically high trade deficit. It is not just the Canadian economy but the global economy that is reliant on US domestic demand

These all represent threats to the Canadian economy and the Canadian investor. Indeed, there are many who believe that the current risks in the market place are elevated beyond risks considered "normally extreme" for the current stage of the economic and stock market cycles.

The TAMRIS Consultancy
8 Algo Court, Willowdale, Ontario, Canada, M2M 3P1
Telephone 416 730 8103, E mail atamris@sympatico.ca
http://moneymanagedproperly.com

Global manufacturing competition

Intense global manufacturing competition has been felt by Canada for some time, but the pressure has increased over the last few years. Not only is there the pressure on all developed global economies to outsource to cheaper developing markets (this reduces the number of companies willing to produce in Canada) but the level of investment in manufacturing capacity and the relative price of goods produced by these lower cost economies is placing tremendous competitive pressures on Canadian manufacturing companies.

To make matters worse, the Canadian currency has moved back to levels that have previously caused significant competitive pressures and damage to Canadian industry. A collapse in US consumer demand and the continued competitive advantage enjoyed by overseas producers of both goods and services would see a collapse in the Canadian manufacturing sector.

The rise in its currency and its reliance on the US is of concern given its historical manufacturing problems. In a 2000 report[1], the CME (Canadian Manufacturing & Exporters association) stated the following.

> …when benchmarked against industrial performance in other leading economies, Canada's manufacturing sector is falling behind. A significant excellence gap has opened up between world-class practice and the average performance of Canadian industry….Canada's manufacturing sector performs on average 62% as well as the best of the G7….Canadian manufacturers are relatively competitive when it comes to production and export growth, but less so in terms of productivity, profitability and investment. And there is a significant gap with respect to innovation, including training, research, development, and the commercialization of new products. There has, in other words, been less of a tendency in Canada to compete on the basis of new products, new processes, and new skills, and greater reliance on other factors such as the low Canadian dollar, slower growth in labour costs and….strong U.S. market demand.

By 2003, the competitiveness of the Canadian manufacturing sector had made a marked improvement, but the Canadian dollar had also fallen significantly and US consumer demand had continued to expand. Despite this, the 2003 CME report[2] made more or less similar comments (word for word in fact).

> Canada, in fact, turns in one of the lowest performance ratings of any of the world's major industrial economies when all benchmarks are taken into account.
>
> Canadian manufacturers and exporters are relatively competitive when it comes to production and export growth, but less so in terms of productivity, profitability, and investment. And, there is a significant gap with respect to innovation, including training, research, development, and the commercialization of new products. There has, in other words, been less of a tendency in Canada to compete on the basis of new products, new processes, and new skills, and greater reliance on other factors such as the low Canadian dollar, slower growth in labour costs, and until recently strong U.S. market demand.

THE CME reports echoed those produced by the Rotman Business School in 1991 and 2000[3]. Much of Canada's improvement in competitiveness occurred during periods of significant currency weakness. As of the time of writing the Canadian dollar stood at 87 cents to the US dollar, a rate that has precipitated concerns in the past.

The problem is that at previous historical inflection points the US economy upon which Canada depends was not so imbalanced and the rest of the developing world not as organized, not as competitive and not as pervasive in the products and services it could compete in.

[1] Canada's Excellence Gap; http://www.cme-mec.ca/national/documents/Excellence_Gap.pdf

[2] Striving for Excellence; http://www.cme-mec.ca/national/documents/Striving_for_Excellence.pdf

[3] Canadian Competitiveness: Nine Years after the Crossroads; http://www.mgmt.utoronto.ca/research/competitive.htm

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An imbalanced US economy

Stephen Roach, Chief Economist at Morgan Stanley, calls the US economy a "shoestring economy".

Paul Volker[4], a retired Federal Reserve Chairman, has said "there are disturbing trends: huge imbalances, disequilibria, risks….. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot……As a nation we are consuming and investing about 6 percent more than we are producing……What holds it all together is a massive and growing flow of capital from abroad, running to more than $2 billion every working day, and growing. The United States is absorbing about 80 percent of the net flow of international capital….at some point, both central banks and private institutions will have their fill of dollars"

Consumer debt

For the first time since the depression of the 1930s, the savings rate of US consumers has fallen into negative territory and the economy's net national savings rate (government, corporate and consumer combined) has fallen to 1.5% compared to a 40 year average between 1960 and 2000 of 7.5%. Likewise, growth in employment earnings over the last five years has been at historically low levels, and according to Morgan Stanley real earnings growth in the year to September 2005 stood at 25 year lows.

So, consumer demand has not come from earnings growth, or in reality employment growth which has also been weak and concentrated amongst poorer paying jobs. The US consumer has been borrowing from their homes to fund their expenditure. According to the US Federal Reserve, home equity extraction in the US in 2004 was some $600bn, or close to 7% of personal disposable income[5].

It is important to note that the US economy has been on a roll since the early 1990s when the longest US economic expansion on record began and ended, followed by one of the shortest contractions on record. The reason the last recession was short and shallow was because US interest were lowered to historically low levels in 2001 and kept there till 2004. This supported the economy, the stock market and most importantly of all, fostered a real estate boom providing consumers with low cost access to capital gains on their properties.

Some feel, that it was this boom and this boom alone that has kept the US economy above water. Indeed, the debt that consumers had built up during the previous economic cycle has been added to in the current. The ratio of interest payments to personal disposable income has risen further to historic highs (currently 19%) as has practically every other measure of debt.

A good report on US consumer debt, "Greenspan's Legacy of Debt" can be found at the Northern Trust website and was written by their Chief Economist, Paul Kasriel[6]. I would refer you to page 8 and chart number 13 which shows net home equity extraction for the last 50 years. Focus in particular on the last 5 years and you will get the picture.

If the housing market were to slow down (as it now appears to be) or worse to decline, the drop in consumer demand could be significant enough to cause a domestic economic recession. The Japanese economy in the late 1980s and early 1990s was also at the peak of a similar period of economic excess.

> According to the Economist [7] "Japan provides a nasty warning of what can happen when boom turns to bust. Japanese property prices have dropped for 14 years in a row, by 40% from their peak in 1991. Yet the rise in prices in Japan during the decade before 1991 was less than the increase over the past ten years in most of the countries that have experienced housing booms. And it is surely no coincidence that Japan and Germany, the two countries where house prices have fallen for most of the past decade, have had the weakest growth in consumer spending of all developed

[4] An Economy on Thin Ice, Washintonpost.com Sunday April 10th 2005. http://www.washingtonpost.com/wp-dyn/articles/A38725-2005Apr8.html

[5] Federal Reserve Board, remarks by Alan Greenspan, September 26 2005, to the American Bankers Association Annual Convention. http://www.federalreserve.gov/boarddocs/speeches/2005/200509262/default.htm

[6] Greenspan's Legacy of Debt, Northern Trust, http://www.northerntrust.com/library/econ_research/weekly/us/

[7] In Come the Waves, The Economist June 16 2005; http://www.economist.com/finance/displaystory.cfm?story_id=4079027

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> economies over that period. Americans who believe that house prices can only go up and pose no risk to their economy would be well advised to look overseas.

It is important to note that many argue that the US consumer is in good shape, because paradoxically US household wealth has also never been higher; due rising property prices and the recovery in the US stock market. What wealth managers have to assess is what impact on consumer demand, the mainstay of the US and global economy, a declining housing market would have.

Current Account Deficit

The surge in consumer demand fuelled by housing wealth has also added to a further long standing problem, the US current account deficit. Indeed, if it were not for the ability of both the developed and the developing world to supply the goods that US consumers demanded, interest rates would have risen much earlier and much higher. So imbalances in the US economy have been allowed to develop further.

The US current account deficit is now equivalent to 7% of gross domestic product and, it is a deficit on which it depends on the rest of the world to finance.

If foreign investors stopped buying US securities, the US dollar would fall, capital would leave the US, the US government would not be able to fund its own deficit, interest rates would need to rise and US consumers would have to rein in their own expenditure and start saving. Indeed, for most this is the biggest risk to the US economy. According to Northern Trust, foreign ownership of US capital stock stood at 8.8% in 1987, as of 2004 it stood at 26% and on rapidly upward rising trend. For those who want to find out more, please see chart 16, page 10 of the Northern Trust report of the Greenspan Legacy of Debt.

There are innumerable reasons as to why the US trade deficit is unsustainable. For those who want to read further about this area please note the Morgan Stanley Global Economic forum archives at http://www.morganstanley.com/GEFdata/digests/digests.html for Stephen Roach's excellent and regular commentary on these issues. The Financial Times, the Economist as well as the Wall Street Journal also write regularly on this topic.

But, the US consumer splurge has also created a global imbalance. In the US economy, consumer demand now accounts for 71% of gross domestic product, well above Europe's 58%, Japan's 55% and China's 42%. While European and Japanese domestic economies have been mired in slow growth, their economies have benefited from US demand. Additionally, the significant growth differential achieved by Asian economies, in particular China has also depended on US consumer demand. There are concerns that there has been significant over investment in Chinese productive capacity and that the Chinese economy is one of the most exposed to a collapse in US consumer demand.

US Impact on Canadians

There is no economy more reliant on the US than the Canadian economy and no economy more exposed to a downturn in the US economy.

Only a 1/3rd of Chinese exports went to the US in 2004 compared to 80% of Canada's. Beyond the US, Japan was the next largest export market for Canada, yet even here American exports dwarfed Japanese exports 38 times.

A recent Economist Article put Canada's resource based exports at 50% of the total. If it were not for Canada's energy and natural resource sector Canada would have a trade deficit. Outside of the trade deficit with the US, Canadian trade deficits with other countries are actually deepening. Most notable of these other counties is China; Canada imported 4 times as much from China as it exported in 2004.

According to a recent Economist Survey on Canada "The bulk of Canada's manufacturing output is traded, not consumed domestically, and the bulk of it heads south. The just-in-time factories of Ontario and Quebec are joined at the hip with their American suppliers and markets"

There are also few economies in the modern world as exposed to currency appreciation as Canada. There is no doubt that the Canadian economy has both benefited from and is paying for the rise in oil, gas and other commodity prices over the last five years.

The question is what price will Canadians pay for the rise in a currency that is at least indirectly if not directly associated with its commodity or "petro currency" status?

If international firms, in particular US firms, decide to shut their plants and produce elsewhere, Canada is at risk. Likewise, Canadian manufacturing does not appear capable of competing effectively at current exchange rates with other global economies; just look at the trade deficits with Europe, Japan and Asia in 2004 before the appreciation in its currency.

It is also likely that the long term demand for natural resources will continue to expand as China, Asia and Eastern Europe grow and develop. Canada's resource stocks may therefore continue to have merit, but what of the heavy long term allocations to the broader Canadian market that most Canadians currently have?

Aside from the underlying weakness of the Canadian economy in response to an expensive currency, the US economic risks pose the greatest risk to Canada and to Canadian investors. Given the relationship between Canada and the US and its reliance on US demand, Canada is effectively part of the US economy, but with additional currency risk.

Portfolio construction & asset allocation

The ability of a portfolio to meet an individual's future financial needs depends strongly on the ability of a portfolio to manage the risks that will affect the ability of assets to meet those financial needs over time.

The issues discussed in this document do not cover all those that a firm charged with constructing, planning and managing the ability of your assets to meet your financial needs should consider. For example this document does not consider all the structural risks within the Canadian economy, nor has it addressed global structural issues affecting specific economies. It has not addressed inflation, or global money supply or the risks that economic cycles and their risks pose to stock market valuations and returns.

What it has done is addressed a key issue which portfolio construction, planning and management, from a Canadian perspective, needs to be able to manage.

Portfolio structure needs to be able to manage risks to return as well return. A structure that is not able to manage the external risks to the Canadian economy and hence, the risks to an individual Canadian's financial security is not a proper portfolio structure.

The risks discussed in this document may never impact on the Canadian economy even though the risks are indeed high to extreme. Canadians have lived with the US economy at their door for the last 100 years and more and have rarely experienced as big a threat as they do now.

> Portfolios with heavy Canadian and US exposure have done just fine, but will they do just fine from this point on?

There is no one way to manage a portfolio, but all portfolio managers need to be aware of and understand the risks to the ability of assets to meet future returns.

> How does your portfolio cope with these risks and what is your advisors strategy regarding these risks?

If your advisor does not have a view and cannot communicate how their structure manages these risks, you may have a problem.

Conclusion

Canada is a small resource based economy. The world is growing as is the importance of international trade. The US economy on which Canada depends is at an important juncture. Its current account deficit poses risks, its unbalanced economy with the precariously over extended consumer poses risks, but what also poses a risk is its need to access the cheapest and most competitive source of goods for its economy.

There is no doubting the fact that Canada has benefited from being a close neighbour of the US for the last 50 years and that much of its standard of living can be directly attributed to this proximity. There is also no doubting that the US economy is the most efficient and competitive in the world and cannot be counted out.

However, if the US economy were to undergo a period of much slower growth, if developing economies continued to assert greater dominance on the global economic scene and commodity prices were to remain at high levels, there is a big risk that outside of the resource sector, the relative strength of the Canadian economy will deteriorate.

- Just what should the Canadian investor do given that most Canadians weight almost exclusively to the Canadian and the US stock and debt markets?

- What are the risks to Canadian financial security of such a strategy and what should advisors be looking at to mitigate these risks?

- Are Canadian wealth managers fully assessing the risks and fully informing the Canadian investor of these risks and most importantly are they offering to manage these risks?

The above are all questions your advisors need to be able to answer, irrespective of whether their assessment of the risks comes to the same conclusion.

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