

## MARKET COMMENTARY

Tetrem Capital Partners, January, 2005

Just prior to the Holidays, Tetrem moved to new offices in a building just across the street in downtown Winnipeg. We are very happy with our new surroundings and the advanced technology we have installed.

No move can be complete without a little office clean up. While going through some storage, I came across a copy of an interview that I did with the

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Globe & Mail dated the 18<sup>th</sup> of October, 2002. This was a period of massive pessimism, during which the NASDAQ hit its low point, a 78% decline from the March 2000 peak. I usually try to avoid making market calls in interviews with the media (or at any time), but the headline quote of the article leaped out at me with “best buying opportunity in eight years.” Maybe it was optimism brought on by the birth of my son Spencer a couple of weeks earlier that led to my statement. It was a controversial comment at the time. After the interview appeared I got some criticism about the “market call.” However, in my mind I was not making a call, but just stating a fact. From a valuation perspective, share prices had retreated to their cheapest levels since the Mexican Peso crisis of 1994. While I was firm in my view

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regarding the buying opportunity the markets presented, I actually had no idea what direction the stock market was heading towards in the near term. If anything, my inclination was

that there was still some more downside for stock prices.

It turned out that there wasn't much downside left as October 2002 marked the bear market lows for most major equity indices. There has been a tremendous rally in equity prices since that time. The S&P 500 and the TSX/S&P Composite indices have returned 62.3% and 69.3% since their lows of October 2002. Much of the fuel for the rally has been low interest rates. With leadership from the U.S. Federal Reserve, global central banks slashed interest rates in response to fears of a deflation-led recession in the aftermath of the bursting of the technology bubble in early 2000. Low interest rates spurred

*Low interest rates spurred consumers to consume more ...*

consumers to consume more and brought on asset inflation of financial assets, commodities and most importantly, housing prices. Houses are the biggest asset that most people own. When the value of their house increases, they feel wealthier and are more likely to go out and buy things. Lower interest rates have brought on this self-perpetuating cycle. One of the consequences of this cycle has been the consumer's willingness to take on a greater debt burden.

The dynamic of this cycle has been especially strong in the United States where interest rates were kept at 1% for 12 months in a row and individuals could quite easily “cash out” the appreciation in the value of their homes through home-equity financing. On top of this, tax cuts and government spending in the United States have added fuel to the heated consumption of the past four years.

All of this works very well until interest rates go up. The Fed began to increase interest rates with five incremental increases of ¼% each during 2004. They seem intent to continue the stimulus reduction of very low rates as 2005 progresses.

Even after the 2004 rate increases are taken into account, the absolute level of interest rates (currently a 2.25% Fed Funds Rate) remains very low by historical standards. There is an old adage in the stock market of “don't fight the Fed.” Investors who followed this adage have

been rewarded handsomely since October of 2002. The question is whether we should continue to “not fight the Fed” now that the massive amounts of monetary stimulus injected into the economic system are gradually being reversed. At the same time, tax cuts and government spending are due for a pause as George Bush has promised to work hard to reduce the deficit, further reducing the potential for continued sources of stimulus.

Back in October of 2002 we should have taken our own advice and gotten even more aggressive in buying beaten up stocks. While our performance has been respectable, it could have been that much better. What held us back then was our concern over economic imbalances. We continue to be concerned by the imbalances created by a highly indebted U.S. government and consumer. This indebtedness has led to a huge U.S. trade imbalance.

One of our hedges against the future risks of economic imbalances has been our position in the shares of gold mining companies. Hedges work great when the risks you are hedging against come to fruition. While the U.S. dollar has been in a bear market in reaction to economic imbalances, U.S. equity markets have continued to rally strongly. Up until now, the “insurance policy”

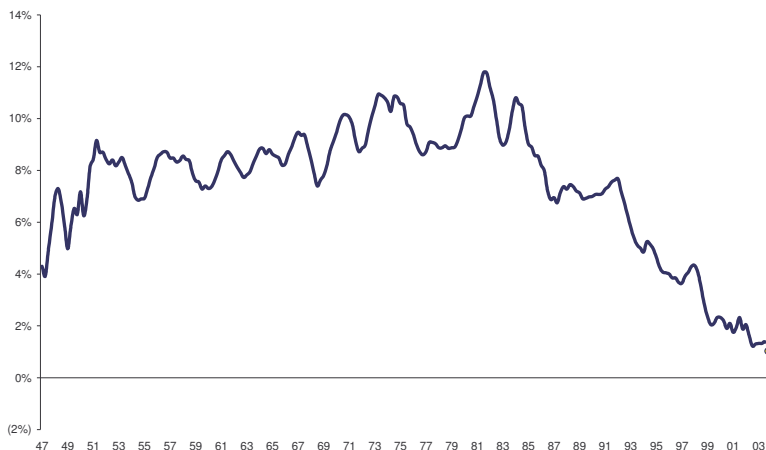
*The U.S. is now sourcing over 70% of the world's savings to feed its consumers' appetite.*

of owning gold mining stocks has been a drag on the overall investment performance of accounts managed by Tetrem. Fortunately we were not left behind in the performance race as we have had a number of individual stock positions that have rallied strongly and our over weight of energy companies has benefited our portfolios extremely well.

Where does this leave us today? We remain concerned about the continued growth of economic imbalances in both absolute and relative terms over the past two years. A fundamental problem for the U.S. is its low savings rate. As the chart below shows, the U.S. personal savings rate is now approaching zero. To finance the purchase of all of those cheap goods coming from China, the U.S. has to import capital. The U.S. is now sourcing over 70% of the world's savings to feed its consumers' appetite. While foreign countries, led by Japan, have been happy to purchase U.S. Treasury Bonds to support the dollar and keep their exports going, they can only do so for so long. Low savings are at the centre of the economic imbalances. Eventually U.S. savings will have to increase or the U.S. dollar will remain under pressure. An increase in the U.S. savings rate will trigger a recession as consumption is reduced. The US consumer is the core of the U.S. economy driving over two thirds of the U.S. Gross National Product.

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U.S. Personal Savings As a Share of Disposable Income  
4 Quarter Moving Average - 1947 to Q3 2004



Imbalances can grow for many years without being corrected. This is how we got to where we are today. The harsh reality is that the global imbalances created by the savings starved, yet consumption hungry, U.S. consumer might not reverse until there is a tough economic recession. In a consumer led recessionary scenario, the consumer will be forced to retrench, thereby creating the groundwork for a return to balance. Granted, it is a chicken and egg scenario of what comes first, the retrenchment or the recession, but either

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cannot be avoided. The only question is timing. The unwinding process may have already begun or it may be years away.

Given our concerns with economic imbalances, we believe that it remains prudent to protect portfolios from losses of capital by maintaining exposure to gold mining companies. As equity valuations have risen and individual opportunities are getting harder to find, the cost of this insurance (in terms of investment opportunity cost) has actually declined.

*... a consumer led recession... (and) the ensuing retreat in equity prices will create the buying opportunity of the decade.*

Many market pundits will react to a consumer led recession by espousing an Armageddon scenario for the equity markets. However, the ensuing retreat in equity prices will create the buying opportunity of the decade. We'll be ready.



Danny Bubis, CFA

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