Waterhouse
Private Client Services

# The Monthly Advisory

January 2005

Private Investment Advice

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**Please see the final page of this report for important disclosure information.**

## 2005 Investment Outlook

Our theme for 2004 was "In like a lion and out like a lamb". We thought equity markets would start the year with strong positive momentum but would turn more negative as central banks hiked interest rates and earnings momentum fell. While these events did take place, it was China, commodities and currencies that instead, grabbed the headlines of 2004. What's in store for the year ahead? The theme, as you will read in the following pages, is for positive, but more muted, rates of return.

First, a quick recap. The global economy was very strong in 2004, growing 5% according to the International Monetary Fund, the highest rate in nearly 30 years. This led to strong demand, particularly from China, for commodities. Zinc prices shot up 50% from the 2002 lows, copper doubled, and nickel prices tripled. Oil prices were also strong as suppliers had trouble keeping up with demand. Finally gold benefited from a falling U.S. dollar and was traded above the US$450/oz mark for the first time since June 1988. Year to date, oil prices rose 36%, the CRB Metals Index rose 30%, the Canadian dollar rose 7%, the S&P 500 returned 8% (2% in Canadian dollars) and the commodity-rich TSX Index returned 11%. Bond investors were also happy as yields on the 10-year government bond fell to 4.22% from 4.66% in Canada, and to 4.08% from 4.25% in the United States.

Looking into 2005, growth should slow around the world. The tricky part will be to see if the world economy can achieve the proverbial "soft landing", where economic growth slows to a level that is consistent with its potential (i.e., a growth rate that is neither inflationary or deflationary). China is in the midst of trying to slow its once overheating economy to a more sustainable 7% per year. In the United States, the Federal Reserve is raising short-term interest rates to dampen growth from 4.4% to a level that is close to its sustainable growth rate of 3.25%. In Canada, growth is slowing due to a stronger Canadian dollar and rolling over commodity prices. In other regions around the globe, stronger domestic currencies and rising short-term interest rates also point to a slower pace of economic growth.

The benefits of moderating economies to more sustainable levels are many. First, inflation should remain under control. We have witnessed the disruptive effects that surging demand can have on the commodity markets (especially energy prices) and the trickle down effect on our pocketbooks. Moderating growth should remove the excesses in the system, keeping a lid on inflation. Low inflation should keep long-term interest rates low, due to the strong relationship between the two. This, in turn, will help keep equity market P/E ratios stable, as the effects of long-term interest rates on P/E levels are well documented.

This leads us to our outlook on equities. The primary drivers of the equity markets are earnings, interest rates and valuations. On the earnings front, slowing economic growth should lead to slowing earnings momentum. S&P 500 earnings should grow by 8% in 2005 versus the 18% in 2004. Interestingly enough, this is in line with long-term growth rates of the S&P 500. Consensus TSX earnings are forecasted to increase 12.3%. Interest rates should provide a stable backdrop for equities as TD Economics forecasts 10-year bond yields to increase only a quarter percent over the next year. Valuations remain favourable for equities. The S&P 500 is trading at 16.4 times forward earnings, below the Rule of 20 which suggests fair value is 20, minus the rate of inflation, or 17-18 times. The S&P/TSX Index is trading at 14.5 times forward earnings, below the 1 point average discount we historically trade versus the S&P 500. When equity valuations are compared to bond market via the so-called Fed model, equities looked to be about 30% undervalued on both sides of the border.

Of course there are many wild cards to this forecast. A depreciating U.S. dollar may cause U.S. interest rates to increase at a faster pace than expected, dampening economic growth and equity performance; China may not achieve the soft landing hoped for; and inflation may be unexpectedly strong. But overall, we expect more muted (single digit), but positive returns for 2005.

*John Bai, CFA*
*SVP, Research Marketing Group*

# Economic Outlook: 2005 Economic Perspective

The global economy is expected to experience moderate growth, low inflation and continued gains in corporate profits. Based upon our economic forecasts, we provide tempered return expectations for the major asset classes.

### Return on cash to rise only slightly

After raising rates in the second half of 2004, the Bank of Canada paused in its tightening cycle in December, as it decided to assess the economic fallout from the sharp appreciation of the Canadian dollar. Looking ahead, the Bank is likely to be highly reactive to upcoming economic data. If economic growth slows to below 3% or the Canadian dollar rises rapidly from current levels, the Bank would leave rates unchanged. However, it is unlikely to cut rates, as monetary policy is already highly stimulative. This suggests a floor on the return for cash at around 2.50%.

In contrast, if the Canadian economy once again copes well with the stronger Canadian dollar, just as it did in 2004, and the economy grows at faster than 3%, the Bank would resume its tightening cycle. However, the extent of the rate hikes would be limited, as inflation will remain subdued. As a result, the economic outlook implies that cash should deliver an average return of between 2.50 and 3.25% in the coming year.

### Bond yields to edge only modestly higher

The prospects for Canadian bonds are tied to several factors, including the extent of central bank rate hikes, the future path of inflation, the prospective new issuance of bonds and the performance of U.S. Treasuries.

As discussed above, the outlook for the Bank of Canada is dependent upon upcoming economic data. Our base case forecast is for the Bank to leave rates on hold through the first half of next year, but lift the overnight rate by 50 basis points in the second half of next year.

Meanwhile, the pace of core inflation (excluding volatile food and energy prices) is likely to rise, but only towards 2 per cent. This should not unduly worry markets, as inflation expectations already appear anchored at close to that level.

U.S. bond yields are likely to trend higher, reflecting rate hikes by the U.S. Federal Reserve, additional supply of Treasuries necessitated by the record U.S. fiscal deficit, and in reaction to a further weakening in the U.S. dollar. Since Canadian bonds are traded on international markets as an alternative to U.S. bonds, rising yields Stateside may put some upward pressure on Canadian yields. However, Canadian bonds are likely to outperform their U.S. counterparts, with the implication that Canadian bond yields are expected to drop well below that of their U.S. counterparts next year.

Overall, the increase in Canadian bond yields is likely to be quite modest. A well diversified basket similar to the benchmark Scotia Capital Market (SCM) Bond Index, currently delivers a coupon return of around 4.10%. That return would be reduced in a rising rate environment. However, the scope for higher yields is limited, suggesting that bonds should deliver 2.00 to 4.50%, with a distinct bias toward the top end of that range at the moment.

### Corporate profit growth should be supportive to equities

Our research suggests that there is a strong positive correlation between equity valuations and the growth in corporate profits. It must be stressed that the relationship may not hold in each and every year, but equities and profits do generally follow a similar trend over time. So, what is the outlook for corporate profits in 2005?

The U.S. economy is expected to grow by about 3.5 %, which should support corporate profit growth of around 5 % – roughly the pace of nominal GDP growth. In Canada, economic growth is forecast to be marginally slower than in the United States, but corporate profits are anticipated to deliver a much weaker performance. The main reason is that energy and non-energy commodity prices are expected to experience a pullback. Expectations for a drop in oil prices to below US$40 a barrel, a pullback in natural gas prices, and a close to 5 % decline in non-energy commodity prices (such as lumber and base metals) in 2005 imply that aggregate Canadian corporate profits will rise by a more modest 3% next year. And, the fallout from the recent appreciation in the Canadian dollar suggests that profits of Canadian export-oriented sectors are likely to lag the rest of the economy. Adding on the expected return from dividends, this macro outlook suggests that Canadian and U.S. equities, on a fundamental basis, should deliver a total return of 5% to 7%.

The benchmark for international equities is the MSCI Europe, Australia and Far East (EAFE) index, which includes the equities of major industrialized economies. Collectively, corporate profits in the EAFE index countries are likely to rise at a moderate pace in the coming year. Including dividends, a total return of around 6.5% on the EAFE could be achievable. And, there is an upside risk to this forecast, as price-to-earnings ratios are low and multiple expansion is possible.

While the fundamentals point to mid single digit returns by equities, as always there are risks. First, the U.S. dollar has recently come under considerable downward pressure, and it remains to be seen whether the correction will continue at an orderly pace – a particular concern in Canada, where the full impact from the past rally in the Canadian dollar is uncertain. Second, the geopolitical situation remains unstable. Third, although crude oil prices have dropped from their record levels in October, the world is still in the midst of an oil price shock. Fourth, China's central government is attempting to moderate the pace of domestic economic growth, and the results of its efforts could reverberate around the world. Fifth, next year will be the first year in a new presidential term in the United States, which is often a hurdle for the performance of equities, as the four-year election cycle usually encourages any major tightening in fiscal policy to be conducted during an Administration's first two years. Sixth, the U.S. Federal Reserve has signaled that additional rate hikes are in the pipeline and markets may start to fret about the impact of higher borrowing costs in the world's largest economy. Equities are expected to show tentative gains in 2005.

*Beata Caranci*
*Economist*
*TD Bank Financial Group*

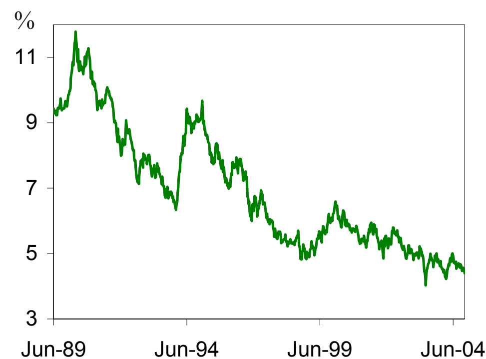
# Fixed Income Outlook: Why Play the Waiting Game?

With each dawn of a new investment year, investors are drawn toward annual prognostications in order to help make their investment decisions. However, attempts to time the market do not work for most investors because the crowd, of which every investor is a part of, cannot hope to outwit itself in the end. Financial markets themselves are derivative of the biases and preferences people bring to decision-making. Still, there is comfort to be found with fitting in and conforming to popular culture – it is only human nature. However interesting these shorter-term investment forecasts may be, most individual fixed income investors would be better served to give them only a passing glance, and stick to their longer-term strategies that are tailored to their longer-term goals.

## The Cost of Waiting – the Investment Year in Review

A year ago, the investment theme for 2004 was rising interest rates, and indeed, both the Federal Reserve in the U.S. and the Bank of Canada did embark on a new cycle of interest rate hikes this year. From June 30 to the end of December, the U.S. central bank has raised its administered Federal Funds rate by 1.00% to 2.25%. On the same path, the Bank of Canada has lifted its target overnight rate by 0.50% beginning on September 8. So, have investors been better off by waiting in cash, and waiting for bond yields to rise before making their purchases?

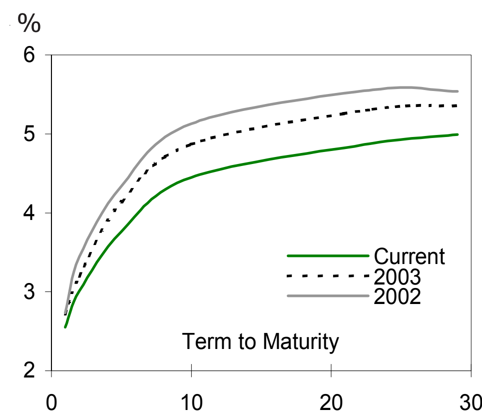
## Canada 10-Year Bond Yield History




Source: TD Waterhouse Canada, Bloomberg as of December 1, 2004

The answer for many investors is, surprisingly, NO. But we like to preface our analysis by saying that every investment portfolio should have a cushion of cash to meet emergencies – the minimum guideline is enough to meet at least three months' worth of expenses. However, having too much cash means missing out on better returns elsewhere. A year ago, the return on cash was 2.72% (represented by the three-month Canada Treasury-bill yield) while the yield on a 10-year Government of Canada was 4.87%.

## Canadian Yield Curve




Source: TD Waterhouse Canada, Bloomberg as of December 1, 2004

Today, the return for cash is only 2.40% (the three-month Canada T-bill yield fell to a low of 1.92% in April before rising in September), while the Canada 10-year yield is also lower at 4.32%. By waiting, investors run the risk that rates will fall, and they will lose the opportunity to lock-in current levels; or that rates do rise, but not high enough (or soon enough) to offset potential income sacrificed during the waiting period. An investor today would have to purchase the 10-year bond at a yield of 5.11% in order to break even with the investment opportunity that he could have locked-in the year previously. Worst still, the cost of waiting goes up the longer the wait. For example, an investor that has stayed in cash for two years (yielding 2.71%) waiting for the 10-year bond yield to rise (available at a yield of 5.13% two years ago) would need to buy that 10-year bond at 5.74% today simply to make up the income sacrificed during the waiting period. Individual investors can easily do their own cost of waiting analysis for various maturity terms and waiting periods by using the calculator found at http://www.costofwaiting.com.

## Just Out of Curiosity – The Year Ahead

TD Economics predicts that 2005 may prove to be a challenging year for investors, requiring the need to maintain well-diversified portfolios. After a short-lived monetary tightening cycle this year of only 50 bps, the Bank of Canada took a pause in December, and will likely remained sidelined for the first half of 2005 in order to gauge the economic impact of the Canadian dollar's sharp appreciation. In short, the investment outlook for 2005 is for low to mid single digit gains for all asset classes (with all asset classes underperforming against their long-term average projections), and any performance better than that should be viewed as an accomplishment. The 10 year projections for the average annual returns for the major financial asset classes are: cash at 4.6%, bonds at 5.75%, Canadian equities at 7.75%, international equities at 8% and U.S. equities at 8.75%. Over the next 10 years, the average annual return for most portfolios is anticipated to fall in a range of 6 to 8%.

## Last Thoughts

The decision to put off a bond investment today in the hopes of getting a better yield later by waiting is a marketing-timing or trading strategy. For most fixed-income investors, this strays away from their longer-term investment strategy – which is to maximize income. The bond portion of an overall portfolio should have the least amount of risk and is not normally a place to conduct market-trading strategies. In a low interest rate environment, fixed income investors must be mindful that costs eat up returns. Most bond investors should find bond-laddering to be among the most simple (but effective) and cost-efficient strategies for their fixed income investments.

*Sheldon Dong, CFA*
*Fixed Income Strategy*

# U.S. Equities: The Year Ahead

As we celebrate the year that was and look into 2005, we expect three themes to dominate U.S. equities in 2005, these being: China, corporate profits and the U.S. dollar.

## China

We believe China will be a key theme in 2005. Chinese city dwellers earn about three times as much farm peasants, providing plenty of incentive for a long-tailed metamorphosis, from an agrain society into a manufacturing hub. Each year, almost 20 million Chinese migrate to cities for work. The ripple from China's investment-led boom has become understood by markets, but the emergence of Chinese consumers is under estimated. By 2014, CSFB estimates Chinese consumption will represent 37% of U.S. and 11% of global consumption. By 2014, CSFB's demographic analysis projects 151 million Chinese urban households earning more than U.S. $10,000 per annum versus 4 million at year-end 2003. We believe this theme is under exploited and off the radar screen of most investors. At present, China is trying to engineer an economic soft landing in 2005. CSFB forecasts real GDP growth in China of 6.9% in 2005, with reacceleration in 2006. CSFB's emerging market strategist expects the following U.S. based companies to benefit from the emergence of a Chinese consumer society: AIG (AIG), Altria (MD), Archer Daniels Midland (ADM), Coca-Cola (KO), Colgate Palmolive (CL), Dell (DELL), McDonalds (MCD), Procter and Gamble (PG) and Walmart (WMT)to name a few.

## Profits

Corporate balance sheets are in excellent shape, with plenty of cash and very modest debt loads. S&P 500 companies have close to $600 billion in cash and equivalents, compared with $260 billion at year-end 1999. This suggests a good environment for capital spending, employment and consumption. Acquisitions, dividends and share buybacks should also increase materially. However, even as corporate spending picks up, profits are expected to decelerate from a 20% clip in 2004 to something closer to 8%. Historically, when earnings growth has decelerated, high quality stocks have outperformed low quality. Sectors that normally perform well when earnings growth decelerates include: consumer staples, health care and telecommunications. We believe consumer staples and telecom should prove rewarding in 2005 while health care is a more bifurcated sector. Health care cost containment stories such as HMOs and generics should perform well, while pharmaceutical drug stocks, which are historically cheap, face patent expirations and slower growth that have the group probing for a bottom. Industrials should continue to perform as corporate spending continues at a double digit pace. As earnings growth decelerates in the general marketplace, companies that post earnings growth should command a scarcity premium. Restructuring stories, which accelerate profits, will become prized in the year ahead. We note high quality ideas such as Avon Products (AVP), Dell Inc. (DELL), casino operator Harrah's Entertainment (HET), IBM, Ingersoll Rand (IR), drug retailer Walgreen (WAG), and telecom service provider Verizon (VZ).

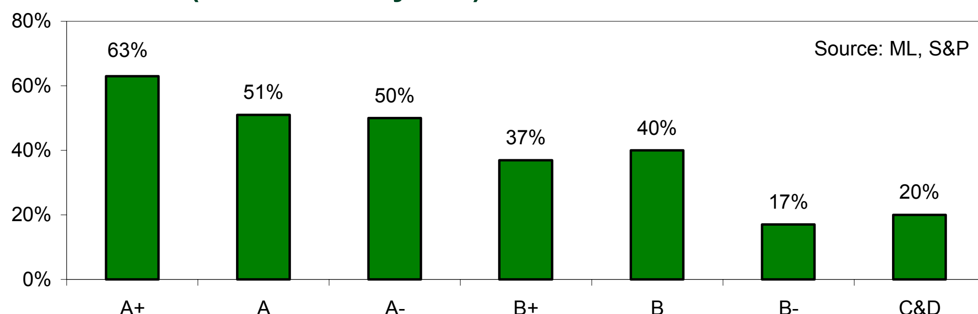
## U.S. Dollar

This writer continues to view the U.S. dollar as a safety valve to "twin deficits" - namely, the fact that U.S. exports are roughly half of imports, and President G. W. Bush, for now appears content to let the budget deficit grow. Since its peak in 2002, a trade-weighted U.S. dollar has declined over 30%. The next major shift in the U.S. dollar adjustment lies with Asian currencies. This writer, along with most market observers, expect China's fixed foreign exchange rate, to be adjusted. The fact that China is trying to engineer a soft landing and help develop consumer spending suggests revaluation is palatable. While the U.S. dollar is clearly in a bear market, a number of factors suggest a temporary bear market rally. We are now at a point where U.S. dollar weakness is creating economic repercussions in Canada and Europe, and being felt in U.S. interest rates. With the euro about 25% overvalued on a Purchasing Power Parity (PPP) basis, and given the U.S. dollar peaked at 30% overvalued on a PPP basis, we see limited near term appreciation potential for the euro. Currencies typically are trending beasts and a reflection of relative prices, trade balance, yield differentials, relative productivity, trade balance and net investment income. TD economics forecasts the euro at 1.39 by year-end, but that is also close to the tipping point where Europeans take their expensive currency and buy U.S. assets. Ultimately the U.S. needs to increase savings in order to remain "master of its own domain". TD economics forecasts the U.S. dollar to depreciate by 10% in 2005 against its trade weighted index. With respect to the loonie, TD economics sees the Canadian dollar appreciating over the next 12 months, in a trading range of 82 to 86. Given purchasing power parity on the Canadian dollar is estimated at 84 to 85 cents, the upside could be considerable in a currency overshoot. Our experience looking at private client portfolios is that they are underinvested internationally. The recent strength in the loonie provides an opportunity to increase foreign exposure at the best level in years, although it could get even better.

We wish all our readers a new year full of peace, joy, good health and prosperity.

*Bill Swan, CFA*
*VP & U.S. Portfolio Manager*

### Average Performance by Quality When the Profits Cycle Decelerated (Last Three Cycles)



# Canadian Equities: Rules of Thumb for 2005

The year 2004 was definitely a good one for Canadian stocks. Year to date, the S&P/TSX is up 9.6%, financials are up 13.7%, and energy stocks have posted an impressive 23.2% gain. The question we are faced with now, however, is whether or not Canadian stocks are capable of posting similar share price gains in 2005. We believe the simple answer is, No. With commodity prices rolling over (zinc, copper are already down 5% and 11%, respectively, from their October highs, oil is off 28% from its October highs), and with the Canadian dollar expected to remain strong versus the U.S. dollar for most of 2005, we believe that many Canadian companies are going to be hard-pressed next year to post the impressive earnings growth we saw in 2004. This will, we believe, result in muted share price performance for many TSX stocks.

We do believe, however, that there will be some stocks in 2005 that will buck the overall trend and instead, reward investors with good results, and ultimately higher share prices. In order to find these stocks, as a general rule of thumb, we believe that investors should stick to companies that:

1. exhibit growing trailing earnings momentum,
2. have higher than average dividend yields (as we believe that the market will continue to rely on income to supplement the lower growth potential of share prices),
3. have less than average U.S. dollar exposure, and
4. exhibit more defensive characteristics (as we believe that many cyclical stocks have peaked).

Below we highlight a number of the S&P/TSX sub-sectors and our outlook for each of them for 2005. In addition (keeping in mind the above-mentioned rules of thumb) we provide a few of TD Newcrest's top picks in each of the sectors mentioned.

## Energy

Energy was definitely one of the favourite sectors for Canadian investors this year. Oil had an impressive run, and, while off over $15 from its $56-plus peak in October, we are expecting crude to remain at higher than average levels in 2005 (TD Newcrest is looking for $41 average WTI in 2005). As many of the Canadian producers and integrated oil & gas companies share prices have already factored in these higher than average prices, we believe that the best way to play this sector in 2005 will be through the auxiliary energy players, in particular, the pipelines and the oilfield service companies. We believe pipelines, for instance, will benefit from the increased activity in the oil sands; the drillers (who are entering their seasonally strong trading period) are likely to continue to benefit from the above-average drilling activity by the producers as oil prices remain high. TD Newcrest's picks: Precision Drilling (PD-T; BUY, Target $90.00) and Enbridge Inc. (ENB-T; BUY, Target $62.20)

## Materials

In 2005, we recommend being underweight the Materials sector, with a slight bias to gold stocks. Many base metal commodities have peaked and are beginning to roll over, and (in the base metal space) we would prefer to be exposed to the later cycle commodities going into the new year (i.e., aluminum). TD Newcrest's pick is Alcan (AL-T; BUY, Target US$57.00). Gold has recently seen a pullback from recent highs. As the price of gold tends to be inversely correlated with the direction of the U.S. dollar, which we forecast will remain weak over 2005, we would expect the gold price to remain elevated for at least the first half of next year. For retail investors looking to gain exposure to gold but do not necessarily want the company specific risk associated with individual stocks, we would suggest purchasing the gold exchange traded fund (GLD-N). TD Newcrest's picks: Eldorado (ELD-T; BUY, Target US$4.15), Goldcorp (G-T; BUY, Target US$17.70).

## Financials

We recommend that investors stay market weight the Financials going into 2005. The overall sector had an impressive run in 2005, with the banks up 9% and life insurers up 25%. Recently, however, we have seen a pull back in many of these stocks on concerns of slower earnings growth (for the banks) and U.S. dollar exposure (for the insurers, in particular). While we continue to believe that these factors may continue to put pressure on these stocks going into 2005, we believe that much of it is already factored into the share prices. For the Canadian banks, we would stick with stocks that will have the ability to generate decent year-over-year growth over the next year, and for the Canadian insurers, we would stick to those names that have less exposure to the U.S. dollar. TD Newcrest's picks: National Bank (NA-T; BUY; Target $53.00), Sun Life Financial (SLF-T; BUY, Target $43.50).

## Consumer Staples

We would recommend investors stay overweight this sector for 2005. The Consumer Staples sector is one of the most defensive on the TSX. We believe that this sector will be a beneficiary of the money that becomes available as investors lighten up on their cyclical stocks. In addition, we like many Consumer Staples stocks for their less than average foreign exchange rate exposure. In this space, we like the grocers (many are trading at multiples that are lower than their historical averages) and the drug stores (a little more expensive from a multiple perspective, but generating positive earnings momentum). TD Newcrest's pick: Metro (MRU.SV-T; BUY; Target $26.00)

## Telecom

An investment in the Telecom sector is a good way to gain exposure to higher yielding stocks. Although many of the stocks in the sector are experiencing slower growth (although not negative growth), a number have higher than average dividend yields due to the strong free cash flow generating ability. In addition, many of these stocks have lower exposure to the U.S. dollar. TD Newcrest's top pick: BCE Inc (BCE-T; HOLD, Target $32.00)

*Erin O'Neill, CFA*
*Canadian Equities Specialist*

# Income Trusts: Profiting From the Vicious Circle

TD Newcrest REIT analyst Sam Damiani best summarizes our thoughts and concerns for 2005, “We believe that the aging population’s desire for income is nowhere near abating, and that this group’s modest growth expectations will result in very little chance of broad disappointment that could cause negative funds flows.” Demographics and a rock bottom yield environment drive the demand for yield, which manifests itself as fund flows. The lack of liquidity in the trust market aids the volatility that investors have profited from in recent years and were hurt by in April. In the past two months, $1.4 billion has been raised for closed-end funds dedicated to income trusts. Another $400 million is currently being marketed; $1.8 billion dollars is tremendous support for an investable universe of roughly $75 billion.

TD Economics yield forecast, which is congruent with the bond futures market, implies that overnight rates will anchor down the yield curve for at least the next six months. In contrast, U.S. markets are pricing in three quarter point hikes by April. GDP, consumer spending and employment growth is still healthy in our biggest trading partner. While recent trade related economic numbers have been milquetoast for Canada, we have decade high capacity utilization of 85.7% and strong employment. It should not take much for inflation to tick up with a little help from our neighbour. The first intimations of inflation have begun to appear in America. Expectations are for a 2.2% increase in the core rate for November. We view the base case scenario for Canadian bond yields to be positive. However, the bullish Canadian yield expectations and concurrent trust valuations cause the balance of risks to be steadily tilting negative.

TD Newcrest’s REIT forecast return of 10% is reflective of the current yield expectations. The history of the S&P/TSX REIT index (31 December 1997) has had a statistically significant regression co-efficient ($R^2$) of nearly 75% to the 2-Year GOC (75% of the price action in the REIT index can be explained by the two-year bond). Using the historically relationship, and captured in the over/under valuation charts, the REIT index is currently overvalued by 7.5%. We also looked at the 10-year bond, while regression co-efficients are a much poorer 50%, it has been a much better explanatory variable in the past year. This painted a similar picture, showing an implied 4% overvaluation. Favourite plays include INNvest (INN.UN), Canadian Apartment Properties (CAR.UN), Calloway (CWT.UN) and RioCan (REI.UN).

The total return for the power trusts in the TD Newcrest universe is a meager 1.9%. The TD Newcrest valuation methodology employs a spread over the 10-year GOC. The target prices were based on a consensus 10-year bond yield of 5.4%, clearly consensus has moved lower. Using TD Economics Q4/05 estimate for the 10-year bond of 4.7% and TD Newcrest expected power trust yield spread of 3.2%, it would imply 2.5% capital growth on top of the 8%+ yield of the index. A look at the historical relationship between the index (1-July-1998) and various GOC yields shows an 83% $R^2$ for the two-year and 63% for the ten-year. In the current environment the power trusts are fairly priced in the context of the ten-year yield and 3% over valued to the two-year. The high leverage to an acquisition makes Macquarie Power (MPT.UN) our favourite in the space.

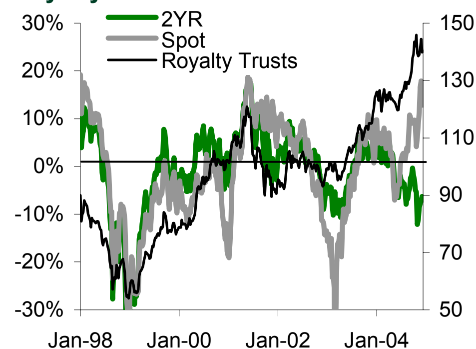
TD Newcrest implied total return for the pipelines is 7%. Its 2005 price/cash flow multiple of 12 times compares favourably to the REITs (11 times) and power trusts (12.7 times). We like the pipelines as a defensive back door play into energy investment. Fort Chicago (FCE.UN) and Inter Pipeline (IPL.UN) have exposure to the cyclical chemicals markets, which is a source of cash flow growth.

The business trusts are a mix between cyclical companies and more stable, interest sensitive ones. The TD Newcrest implied return is 6%. Our thesis has not changed since last year. We value liquidity and growth. The best growth story in our mind continues to be Energy Saving’s Corp (SIF.UN), where besides several new markets stands to increase their market by 4 million residences when Ontario uncaps electricity prices.

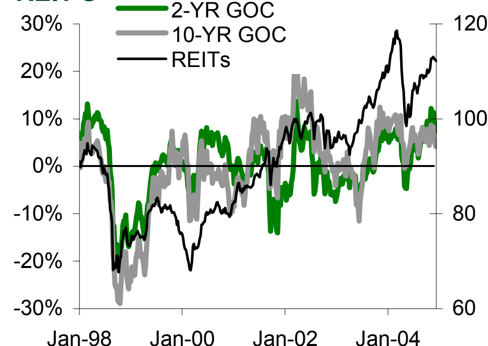
TD Newcrest implied total return for royalty trusts is 6%. Their forecast is for US$41 oil and US$6.25 gas in 2005. We have seen an incredible $R^2$ of 88% to the royalty trust index and a 50/50 oil/natural gas 2-year futures price index. An interesting pricing anomaly has presented itself. The trust index is currently 7% undervalued to the implied price of the 50/50 2-year futures index but 12% overvalued versus the spot price ($R^2$ 76%). A clear driver in the breakdown of historical correlations is the incredible recent volatility in crude in prices. The royalty trusts' current valuation and a still strong energy environment give us comfort that investors may be able to enjoy another year of positive, if not muted, returns. Favourites gas plays are Focus (FET.UN) and Shiningbank (SHN.UN), oilier plays ARC (AET.UN) and Peyto (PEY.UN).

## Implied Over (Under) Valuation

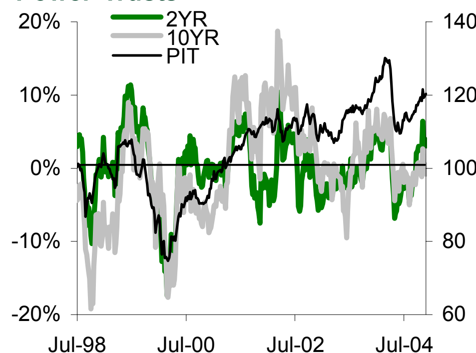
**Royalty Trusts**




**REIT'S**




**Power Trusts**




*Allan Vlah, CFA*
*Equity Income Specialist*

# Mutual Funds:
# Fighting Econocentrism - Opportunities for Return and Diversification Abroad

The meteoric rise of the Canadian dollar versus its U.S. counterpart, over the last two and a half years, has had a profound effect on the investment returns experienced by Canadian investors who hold U.S. and Global equity mutual funds.

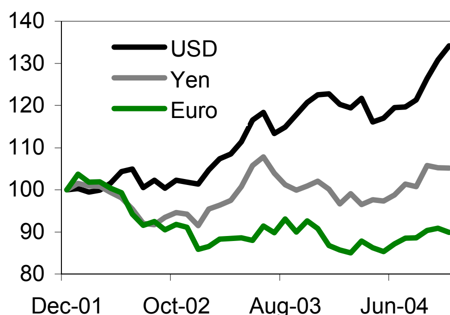
The goal of this article is to provide investors with a convincing argument on why to invest in global markets in the year ahead and combat the overwhelming under-use of foreign content in both taxable accounts and registered plans.

### Currency Provides An Opportunity

In the early 1990s the Canadian dollar traded at nearly US$0.90 in global currency markets. The dollar's 10-year slide from 1992 to 2002 would provide a wind at the back of investors in U.S. assets as the weakening currency added nearly 30% (or 2.49% compounded per year) of return to those invested in U.S.-denominated assets.

Since the bottoming of the Canadian dollar in February 2002, the mighty Canadian buck has reversed 10 years worth of decline in only a little over two and a half years. This 30% reversal has stung investors by reducing their annualized return rate by 11% on US assets.

## C$ vs. Major Currency




Source: Bloomberg

The consensus is for the Canadian dollar to remain strong in the coming years, although its meteoric rise is expected to flatten out into a much more palatable trading range. TD Economics' estimate of this range is for the Canadian dollar to trade at U.S.$0.82-0.86 – a level, this writer believes, provides an opportunity for Canadians to make global investments on better terms.

### Canada HAS outperformed, but what next?

The Canadian market has provided domestic investors with strong returns, powered by export-led growth derived from Chinese commodity demand and strong performance from Canadian financial institutions.

## Canadian Sector Performance

| Sector | 4 Year Return | 2.5 Yr Return | Index Weight |
|---|---|---|---|
| Financials | 103% | 19% | 33.1% |
| Energy | 163% | 68% | 18.1% |
| Materials | 65% | 25% | 16.8% |
| Information Technology | -86% | -15% | 7.6% |
| Consumer Discretionary | -9% | -4% | 6.3% |
| Industrials | -10% | -20% | 5.9% |
| Telecom Serivces | -41% | 2% | 5.0% |
| Consumer Staples | 133% | 18% | 4.5% |
| Health Care | -41% | -45% | 1.6% |
| Utilities | 92% | 31% | 1.4% |

Source: Baseline

While the performance has been strong relative to other developed countries, the TSX now counts on Financials, Energy and Materials as 68% of its capitalization. To continue to be propagates of the TSX in the years ahead, one must expect these areas to continue to deliver strong returns.

With analysts reducing earnings for banks, oil prices attempting to find a more stable and sustainable level around $40 a barrel, and some commodity prices near all time highs, we submit that the relative outperformance of the past four years is not likely repeatable, especially from the Canadian perspective, where currency will likely be less of a detractor for global investments.

### Overseas: Value of Diversification Increasing, Lower Valuations

Throughout the 1990s, increased globalization and economic synchronization between countries and regions of the world diminished the positive diversification effects of international investing. It appears, with correlations between major global markets declining, that international diversification will once again play a theme in portfolios in the years ahead.

Regions and countries are playing much more of a role in the disparity of investment returns as the decoupling of the world's economies seems to have begun. Movement in currencies, as well as disparities in economic growth signal that investors are beginning to take more notice of unique aspects of each country's domestic economy.

### Fund Picks

With the outlook for stability in the Canadian dollar and seemingly more attractive valuations and increased diversification benefits overseas, we are suggesting that clients should consider adding to their core exposure in Global mutual funds.

Our picks for global exposure continue to include Brandes Global Equity and Capital International - Global Equity, while we suggest investors look to add growth-oriented exposure through TD Global Select, managed by New York-based OppenheimerFunds.

One interesting opportunity that may not be on the radar screens of our readers, is the Bissett Multinational Growth Fund - a fund which has struggled of late.

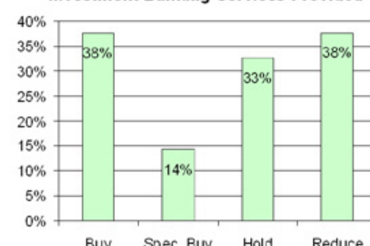
The fund focuses on U.S.-listed global companies (ADRs) that generate a large proportion of their revenues overseas. Since these companies report their earnings in U.S.-dollars, there is a positive effect on their earnings when foreign revenues are translated back to the firm's reporting currency. For Canadians, the opportunity presents itself to purchase leading global firms with their stronger Canadian dollars, while benefiting from the weakness that the U.S.-dollar is suffering. The companies owned in this portfolio exhibit reasonable valuations and strong financial positions and operating consistency, factors that play into the "quality" and "defensives" theme being touted by many market strategists.

The view from Canada, and the experience of investors domestically, varies greatly from our counterparts in the United States, Europe or Asia. We believe that an opportunity for global investment has presented itself to Canadian investors as our currency stabilizes, the outlook for Canadian markets is less compelling and the virtues of international diversification are re-discovered.

*Peter Shippen,CFA*
*Investment Fund Analyst*

## TD Newcrest Equity Research Disclosures

| | | |
|---|---|---|
| Alcan Inc. | AL-T; AL-N | 1, 2, 4, 13, 14 |
| ARC Energy Trust | AET.UN | 2, 4, 9 |
| BCE Inc. | BCE-T, BCE-N | 9, 13, 14 |
| Canadian Apartment Properties | CAR.UN-T | N/R |
| Eldorado Gold Corp | EGO-A, ELD-T | 2, 4 |
| Enbridge Inc. | ENB-T | 2, 4, 13, 14 |
| EnCana Corp. | ECA-T; ECA-N | 13, 14 |
| Energy Savings Corp. | SIF.UN-T | N/R |
| Fort Chicago Energy Partners | FCE.UN-T | 1, 2, 4, 14 |
| Focus Energy Trust | FET.UN-T | 2, 4 |
| Goldcorp Inc. | GG-N, GG-T | 13 |
| InnVest REIT | INN.UN-T | 2, 4 |
| Inter Pipeline Fund | IPL.UN-T | 1, 2, 4 |
| Macquarie Power Income Fund | MPT.UN-T | 1, 2, 4 |
| Metro Inc. | MRU.SV-T | 16 |
| National Bank of Canada | NA-T | 13, 14 |
| Peyto Energy Trust | PEY.UN-T | N/R |
| Precision Drilling Corp | PD-T, PDS-N | 1, 2, 4, 13 |
| RioCan REIT | REI.UN-T | N/R |
| Shiningbank Energy | SHN.UN-T | 2, 4 |
| Sun Life Financial Inc. | SLF-T; SLF-N | 9, 13, 14 |




* Percentage of subject companies within each of the four categories (Buy, Speculative Buy, Hold, Reduce) for which TD Securities Inc. has provided investment banking services within the last 12 months.

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