QUARTERLY COMMENTARY

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Another War

I've been asked by several investors why haven't the markets moved down significantly since the devastating and shocking attack on Israel and their declaration of war and pending move on Hamas. They haven't dropped materially because as long as the fight remains limited between Hamas and Israel the net effect on international economies and corporate earnings is negligible. The caveat of course is that if it devolves into a wider regional conflict involving the evil puppet master Iran and/or its proxies, we'll see oil prices have a more substantial move upwards and a deeper correction due to the potential of a quick worsening of the situation and the inflationary pressure of higher energy prices. According to Bloomberg Economics an escalation of Israel's war with Hamas, drawing in Iran, could send crude oil to $150 a barrel and cut about $1 trillion off world economic output. (Mr. Market obviously doesn't think this is a strong possibility since Iran has already accomplished its primary goal of interrupting the peace process between Israel and the Saudis). While the S&P/TSX Capped Energy Index rose 2.8% in September for a fourth consecutive monthly increase, it pales in comparison to oil's 8.6% surge.

Besides, the market has already been in correction mode for a while. The S&P500 has been quietly correcting since the middle of the summer and the TSX has been essentially trading in a wide range but sideways for the last year and a half! In September alone the only sector

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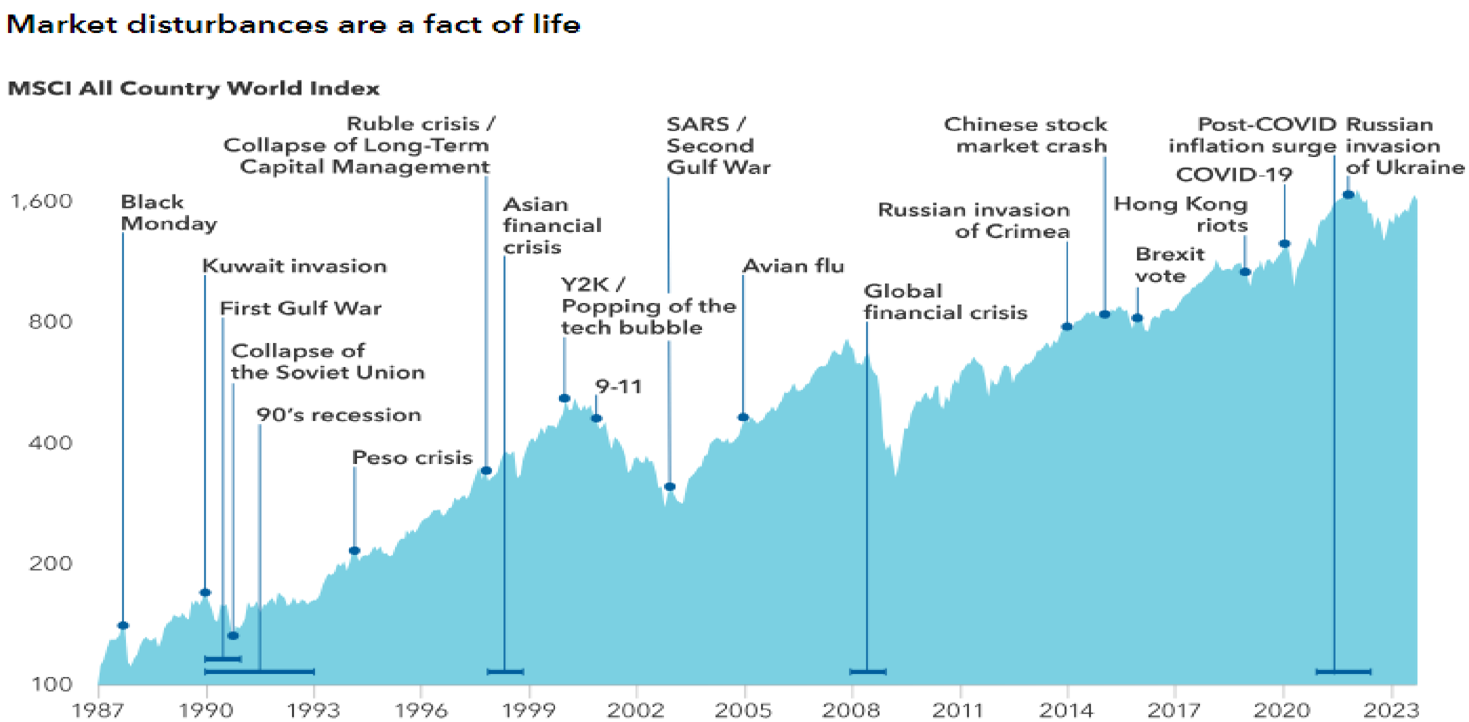
that was positive in Canada was the energy sector which I believe still has room to run. It remains as one of my favourite sectors in which to invest. The fight in the markets is basically between stocks and bonds – with fixed income just now winning this battle. In September government bond yields moved higher which is a primary reason stocks underperformed. Uncertainty surrounding where bond yields will level off has created greater near-term uncertainty, but I feel that we're close to a top in short term interest rates and that's why I've been adding to fixed income exposure for many clients. That's not to say that I feel



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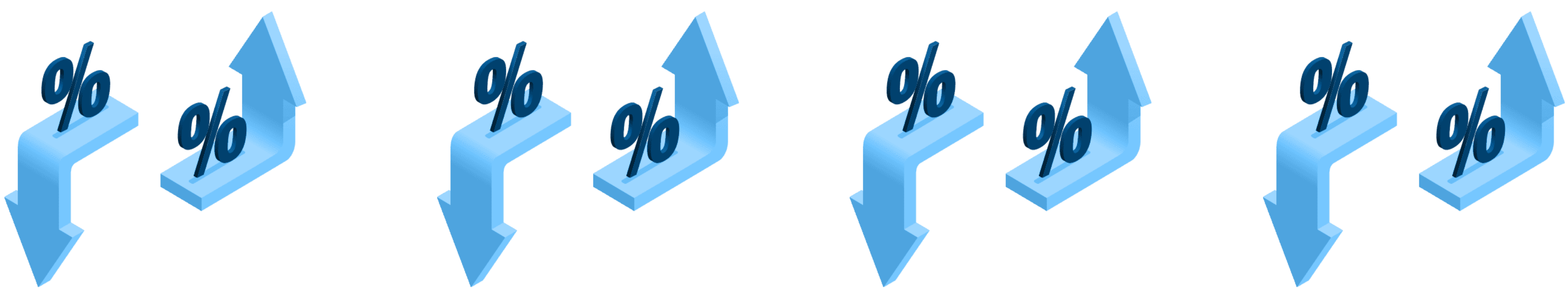
rates are going to drop any time soon – the longer maturity GICs and bonds look a little expensive to me. By that I mean the interest rate you receive from these aren't enough to warrant owning longer maturities. They are acting like rates are going to come down quite a bit in the next few years – maybe they will but if they don't then you're stuck with fixed income that doesn't provide a decent return over the inflation rate.

Most economists continue to expect BoC to remain on hold, though upcoming data could sway the decision. In September the Fed's economists predicted slower but still positive growth, roughly flat unemployment, and a drop in inflation to about 2% over the next three years. That would be a so-called Goldilocks scenario for the US economy. At the next meeting in November Chairman Powell is expected to walk a fine line between signaling a willingness to wait and not raise rates, but also saying that if the labor and inflation data does not cool, the FOMC would be prepared to raise rates at their December meeting if appropriate. Speaking at the IMF meeting recently, BoC Governor Macklem noted there are clearer signs that rate hikes are cooling the economy. The good news with short to medium term bonds and GICs is that while we wait to find out whether a recession occurs or corporate earnings deteriorate, the risk/reward balance of fixed income looks more and more compelling.



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American billionaire hedge fund manager Bill Ackman *says "What has worked for me as a portfolio manager is the collaboration with our analysts — to get a sense of intrinsic value. And then I can do my own thing trying to decide where the market is wrong, over or underestimating fundamental values, and then invest accordingly, while doing my best to remain patient and focus on long-term results …. it enables me to look beyond crises because the crises seem like such a constant. So yes, this too shall pass. And I'll be relatively fully invested, most of the time."*

The stock market tends to put in a bottom sometime in October or early November (typically late October) and historically the most volatile month of the year is October. But with volatility comes opportunity. As well, November and December are among the strongest months of the year for equities so even with all the turmoil in the Middle East it's very possible that a year-end rally ensues.

Regards,

Richard

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