

REVIEW & COMMENTARY

1ST QUARTER 2004

Scandals of Mass Destruction

It is hard to imagine capital markets operating in an environment of relative calm. Mind you, what is relative, especially these days?

For the past several weeks, equity markets have corrected. After roughly three quarters of rising equity prices, a pullback was overdue. Nonetheless, this correction should remind investors of the perils of financial complacency; markets never go in a straight line. Little has changed economically; interest rates are low, the economy is growing, job growth has been disappointing (but should improve), and Canada and the U.S. are facing federal elections. And though the U.S. dollar appears to have slowed its recent descent, there is nothing that the present administration is doing to reverse the dollar's decline. These factors are all market positive.

Should we expect the correction to continue? We are not market timers, particularly in the short term, but we remain positive. Certainly, the threat of terrorism is as great as it ever has been. North American equity markets have recovered nicely since 9/11 and over the long term, equities should continue to outperform bonds and cash. Given the political landscape, there should be little to unsettle the markets in terms of fiscal reform, at least until the elections are complete. China continues to consume inordinate amounts of raw materials in order to feed a level of growth that has dwarfed any other industrialized nation and single-handedly led a global economic recovery. Further, with interest rates so low and U.S. deficits mounting, long term bonds are riskier than they have been in the past 25 years, making equities relatively more attractive.

Indeed the biggest worries we see are not the falling U.S. dollar (or rising Canadian dollar), political elections, deficits or rising interest rates. Beyond further terrorism, which might rear its head closer to the U.S. Presidential Election, we see two potential problems that could plague the market's climb, China and Scandals. China could present a problem if the ruling party does not take the necessary steps to mend their ailing financial system. According to the Economist, the cost of settling the banking system's bad debts and setting up an appropriate pension and welfare system would exceed 60% of

China's Gross Domestic Product. These are conservative estimates, some estimates are considerably higher. If the financial system in China is allowed to deteriorate further, the subsequent chaos could bring a halt, albeit temporarily, to their appetite for global goods and services. This, in turn, could spiral through the financial markets sending equity prices lower. Moreover, China doesn't have the infrastructure to support its ravenous growth; most cities and companies suffer rolling black outs due to electricity shortages. Further, China has become the second largest consumer of oil in the world (wedged between the U.S. and Japan) and high oil prices pose an indirect but no less punitive tax on the economies of industrialized countries.

Another issue that concerns us is the ongoing corporate and political scandals. On a relative basis, the scandals remain relatively small but they garner, and rightly so, a lot of attention. A significant risk to the market in our opinion, in addition to the simple threat of additional crimes, is if these perpetrators are not brought to justice. In a recent poll on credibility, politicians rank closely to used car-salespeople, and that may be quite unfair to used-car salespeople, since at least you know you are buying a used car. CEO's have also dropped several notches. If those leaders of our society who breach ethical, moral or legal standards are allowed through either privilege or wealth to skirt due punishment, it may lead to a significant setback. To date we have had two mistrials, Quattrone and Kozlowski, and nothing may be more disruptive to investor confidence than technicalities getting in the way of justice.

Though one verdict does not make a trend, engineered innocence could undermine market integrity that has slowly restored its foundations on the expectation that those who break the law will be justly punished. Certainly the decision regarding Martha Stewart must have sent a chill down the spine of many defendants. There are many pending high profile trials that will do a lot to restore market buoyancy if proper justice is served. And if China can manage its financial matters sensibly, we should enjoy better markets ahead.

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