REVIEW & COMMENTARY

3^{RD} QUARTER 2004

Crouching Tiger…

Few things are more topical than $50 a barrel oil these days. Sure, the U.S. election is getting some headlines but there is nothing that creates more indifference than a neck & neck election race- at least until the final stretch.

To date 2004 has been volatile. Starting on the back of a positive 2003, equities started well, but gave back considerable gains mid-year. U.S. equity markets bottomed in the past quarter with the prospect of higher interest rates and a slowing economy at home. While the U.S. economic picture grew cloudy, Canadian markets and the Loonie shone brightly even more so after the second interest rate hike by the U.S. Federal Reserve failed to move the bond market in the expected downward direction.

Higher oil prices will eventually take a toll. Corporate earnings projections are already growing cautious and they haven't had time to fully reflect the full effect of higher fuel costs. In fact, with a slowing global economy, a U.S. Federal Reserve that may continue to raise interest rates, lowered corporate earnings projections, a $50+ oil price, we should have a recipe for financial concern- the ***Hidden Dragon***.

China can be blamed and thanked for all the aforementioned. First, China's incessant demand for almost everything has been one reason why the global economy continues to improve. According to the *Economist*, China has been responsible for almost 40% of global demand since 2000; thank goodness because that was just about the time the tech market bubble started to leak. A strong reason behind the prices of steel, copper, coal and oil and many others is China. Four out of five of us, those that live outside of China, should be thankful since without this demand the world economy would not be on such solid footing. Not only do many of us benefit from higher commodity prices (the Loonie certainly has), in some part, the relatively low interest rates we enjoy today are partly thanks to China as well. China's enormous trade surplus with which they continue to buy billions of U.S. Treasury bonds, is keeping U.S. interest rates lower than they should be. This is another reason why equity prices remain buoyant. Furthermore, due to China's low labour costs many consumer goods such as shoes and clothes, are cheaper than

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they have ever been before. Due to low interest rates and more disposable income (cheaper goods combined with lower taxes), consumers have had more money to spend on other things. No wonder housing prices continue to rise. This in turn has increased the confidence of many homeowners/ consumers who continue to spend and drive the economy upward.

Thus the world is becoming caught in a quandary. The more the Tiger eats, the more costly it becomes for the rest of us. The bigger the Tiger becomes, the more dependent the rest of the world will become. Higher raw material costs have already hurt many economies. Many countries already subsidize oil prices by lowering or foregoing taxes. Some simply sell below market levels. Second, if China's economy were to slow (which means it might slow to mid to high single digit growth rather than its present level somewhere in the mid to high teens), it may have a dramatic dampening effect on the global economy. If China's economy cools, raw material prices will most likely fall helping many industrialized countries who have suffered under the stress of high prices. But demand for many products may fall too. The present interest rate environment may change dramatically too, with interest rates moving up. This might happen if the Chinese government stopped being an unrelenting purchaser of U.S. Treasuries. Slowing economies and rising interest rates are not a good combination.

It may not be long before the U.S. economy will stop enjoying the status of being the most influential economy in the world. At present rates of growth, according to the International Monetary Fund, and after adjusting for purchase power parity, China's economy will become the largest in the world somewhere around 2020 as measured by GDP. The big difference will be that they will still have substantially more people so there productivity will lag- but they will be even more influential than they are now.

Can China's pace be sustained? History suggests it can. South Korea and Taiwan grew at 8% + for over 4 decades. Japan grew for decades as well with a significantly bigger economy than the other two. So China can grow for an extended period of time but it may not be without interruption.

Thus, with the uncertainties of the future, it remains prudent to be balanced in your approach to investing. It will help fortify you against the potential volatilities in the global marketplace. If we are right about China, the difference may be that when China catches a cold in the future, the rest of us may get pneumonia.

Stodgell Investment Management