REVIEW & COMMENTARY
4TH QUARTER 2004

Happy New Year

A review of our past four *Review & Commentary* suggests that we had a reasonably accurate year of predictions. While qualifying most forecasts, we had predicted that interest rates would likely not move up (*Up, Up and Away*). Likewise, we considered that North American economies would continue to improve despite the jobless recovery evident at that time and to some degree today. We also believed that equity markets would continue to improve throughout the year, which they did in North America.

Of course some of the predictions were not as successful. For example, we had not anticipated the dramatic increase in oil prices but had suggested that the relatively high prices in the "low to mid 30's" would dampen the economic possibilities in North America and other developed oil consuming countries. We continue to believe that the U.S. economy would be considerably stronger if oil prices were lower. And while we had expected the US dollar to weaken, we hadn't expected such rapid appreciation of the Canadian dollar.

In our Q1'04 commentary, titled *Scandals of Mass Destruction*, we had considered the ongoing misdeeds by corporate leadership to undermine capital market confidence. Thankfully, evidence of financial misconduct has reduced significantly except the accounting problems of Krispy Kreme. While the affect of this on the capital markets is difficult to quantify, the ongoing inability of Nortel to meet their self imposed deadlines to inform investors of their financial restatement does a lot to remind many of the misfortunes of the past few years. As we write this, Nortel is releasing the results and if nothing else, may finally put some of the lingering concerns of questionable corporate integrity to rest.

We are no longer confident interest rates will stay at current levels. While inflation concerns have been rekindled, much of the recent jump in statistical evidence can be referenced back to the dramatic increase in oil prices. Since we have had no luck predicting oil prices (in fact we probably would be an excellent contrary indicator), inflationary pressures will increase if oil prices remain in the mid 40's. On the other hand, China has provided some inflationary relief by driving down manufacturing costs in so many goods.

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Our concern over interest rates extends beyond oil prices (unless they head substantially higher). The U.S. deficits are of particular concern. If they continue to grow, then the U.S. government may have to increase interest rates to attract foreign lenders. Because of this, and the influence the U.S. interest rates, we would be surprised if fixed income returns exceeded their coupons (which in bond talk means that bond prices, at best, will stay flat or fall). Higher interest rates may have some effect on equities but unless they move up dramatically, it should be moderate. To counterbalance higher rates, corporations now have exceptionally strong balance sheets and increasing confidence in the economy which should lead to higher earnings and dividends. With the lower U.S. dollar, many of the high profile international U.S. conglomerates may for the first time have a foreign exchange benefit on their income statements. Unfortunately some Canadian conglomerates may experience the opposite.

We also expect that China will continue to surprise observers. Though they are attempting to slow their pace of economic growth, we are not sure they will slow it measurably. We continue to believe, as we stated in our last commentary titled *Crouching Tiger…*, that the Chinese economy will become even more influential in the years ahead. Though their appetite for many raw materials will remain, there are some fundamental structural changes in the Chinese economy that will become very significant; for example, it won't be long before they will be a net exporter of steel. More importantly, their increasing budget surpluses will play a very important role in the world's capital markets. They may become the world's biggest lender and as many of us know, lenders have considerable power.

One thing that we will echo from last year is that the returns will be moderate. We had predicted that 2004 returns would not be close to 2003's. We had predicted reasonably accurately an 8-12% increase in the equity markets, but in 2005 we don't anticipate capital markets will keep pace with 2004. In fact, this year we would welcome high single digits. While this may appear to be an inappropriate concession for a money manager, we feel comfortable that our style of a balanced portfolio stressing income bearing investments and total overall return will continue to find favour. At least we hope so. After all, we always hope to outperform in bad markets and participate in, to a healthy degree, the good ones.

Happy New Year and thank you for your patronage in 2005.

Stodgell Investment Management Ltd.