

## Hillsdale September 2006 Market Outlook

### Global View

After a broad based swoon during the April-June period, global equity markets have bounced back with great vigour. Over the past three months, many markets, including those in South America, Eastern Europe and the Far East have posted gains between 15% and 20%<sup>1</sup>. Amongst developed European markets, gains have averaged in the high single digits, while the US, UK and Canadian markets have experienced returns in the low single digits. The advances are notable not only for the level of returns but also for their breadth as, on a year to date basis, every major developed and emerging market, save Japan and South Korea, has posted gains.

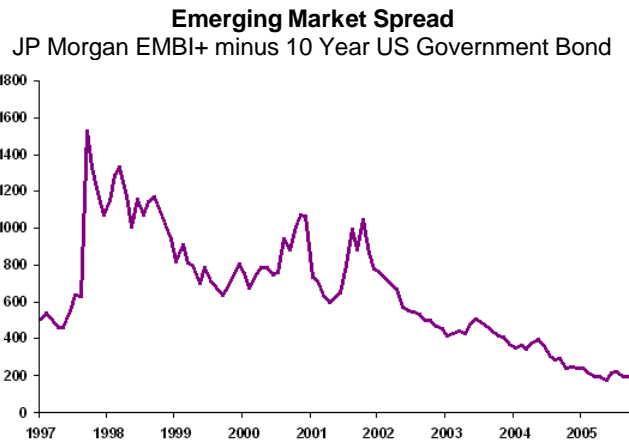
From a global perspective, the outlook remains very favourable. The IMF in its World Economic Outlook, released September 16th, increased its forecast for world growth for both 2006 and 2007 to 5.0% up from 4.6% and 4.7% respectively. It cited breadth of demand during the first half of the year, with most regions either meeting or

***"IMF increased it's forecast for world growth 2006 and 2007 [...] strongest 4 year expansion for the world since the 1970s."***

exceeding expectations. The IMF also noted that early indications suggested that the pace was being maintained in the third quarter. Despite slow downs in the US, EU and Japan, growth expectations were still raised because of steady growth in China and other developing countries. If correct, this would become the strongest 4 year expansion for the world since the 1970s. In contrast, those arguing for a slowdown in growth have been overly US centric in their perspective, focusing instead on the overextension of the US housing market, the US consumer and the US government as well as noting global fiscal imbalances.

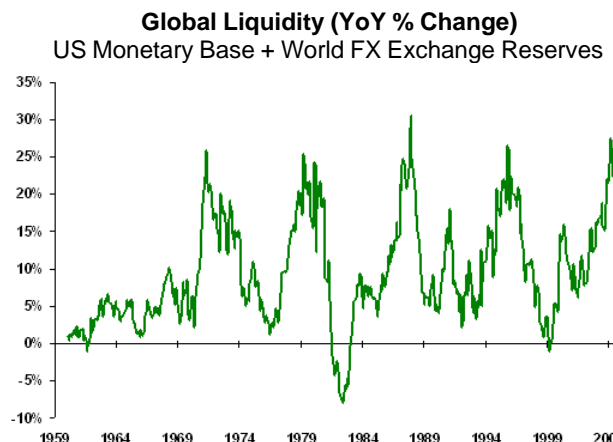
### Credit Spreads and Liquidity

Credit markets seem to agree more with the IMF view than the US centric view. Whereas emerging equity markets fell by more than 20% during the April-May period, credit spreads barely moved. As the graph below notes, emerging market credit spreads remain near 15 year lows. This means that sovereign and quasi-sovereign entities in countries such as Mexico, Brazil, Russia, the Philippines, Turkey and Venezuela can borrow funds in US dollars for rates that, on average, are only 2% more than the US government pays for its borrowings.



Source: JP Morgan

Also, while much has been made about the rate rises in the US and the end of quantitative easing in Japan, global liquidity still remains robust. As the graph below notes liquidity is hovering near its long term average and has in fact been trending up over the past few months.



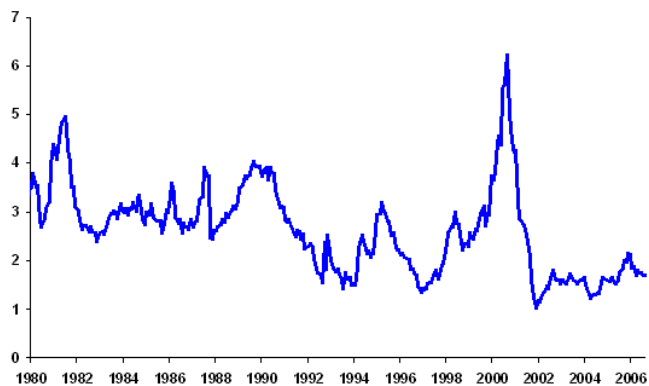
Source: US Federal Reserve, International Monetary Fund, Hillsdale Research

### Focus on Canada

Canadian fundamentals remain notably upbeat. The Bank of Canada, at its September meeting, left the bank rate unchanged at 4.25%. After seven consecutive increases, the Bank has now held rates steady for two consecutive meetings, with expectations that there will be room for potential rate reductions in the coming months. In its statement, the Bank noted that risks to the economy were neutral stating that growth in the second quarter was slightly

below expectations but that housing prices and consumer demand came in slightly above expectations. With cash rates now yielding less than 4.2% and stock yielding 2.6% (including Income Trusts), the risk premium continues to favour stocks over cash. As the graphs below notes, the risk premium continues to trend well below its long term average of 2.6%.

**Canadian Equity Risk Premium**  
90 Day T-Bill Yield Divided by TSX Dividend Yield



Source: CPMS, Bank of Canada, CIBC World Markets

Historically, a reading greater than three and a half has been associated with over valued markets. Prior to the recession in 1990 this ratio approached four, during the valuation blow offs in 1987 and 1998 it also approached four, whereas, prior to the tech crash it reached a record six times.

***"Energy and material stocks [...] now account for almost 80% of the volatility of the index [...] this is the most skewed the small cap index has been in the 20 years we have collected data on it."***

Risk premiums versus bonds are also favourable. The 10 year bond is yielding 4.2% and, with stocks yielding 2.6%, trades at a risk premium of 1.6x the dividend yield available from stocks. The long term average is around three times the stock yield and historically, a risk premium approaching four times has been adverse for stocks. To reach their long term average, bond yields would have to move towards 8%. As a result of cash and bond markets being sanguine about inflationary prospects and with each offering historic low real yields, both indicators continue to remain stock friendly.

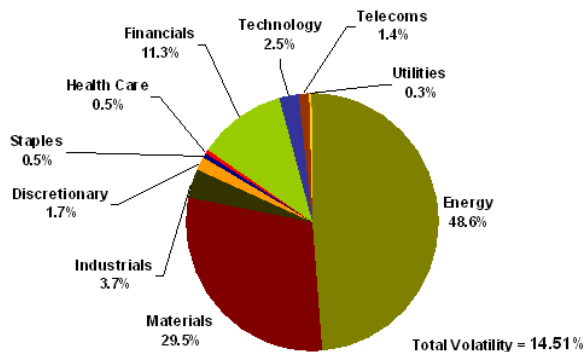
Of even greater significance to the Canadian market has been the continued ascent of energy and commodity prices, in particular the base and precious metals. In 2005 the TSX was led higher by the energy sector, however, this year the story has been mostly about metals. While only some of the major metals have regained their spring highs, each has managed to regain its uptrend and stay on or near its 40 week trend line. Year to date gains in copper (53%), uranium (50%), zinc (75%) and nickel (99%) have been heroic, while gains in silver (22%), platinum (20%) and gold (11%) have been solid<sup>1</sup>. By comparison, energy prices, as

measured by West Texas Intermediate crude, have fallen from a peak of \$77 towards the low \$60s and are up only 3% for the year.

Not surprisingly, metals firms have been the biggest beneficiaries of these dramatic moves. Of the 50 top gainers year-to-date in the TSX Composite, almost half are from this sector. The next biggest category of names has come from Consumer Discretionary followed by Energy. On the other hand, Financials, Consumer Staples, Telecom and Utilities are notable for their absence from this year's top winners list.

Unfortunately, the long run in energy prices and this year's extreme love of all things metal has forced a notably skew into the Canadian marketplace. Given the high levels of volatility associated with both energy and metals stocks, the price movement of these two sectors is now dominating the movement of the entire index. While these two sectors make up 50% of the dollar weighted exposure in the index, they now account for almost 80% of it's volatility. The story is worse for small caps stocks, where the two sectors now account for almost 90% of the volatility of that universe. In comparison, during the last commodity run in the late 80s, the small cap index was only 40% exposed to the two sectors and, at the peak of the tech boom in August 2000, the technology sector was responsible for just over 80% of the volatility in the composite index. For the 20 years that we have data, this is the most skewed that the small cap index has ever been.

**TSX Composite Contribution to Volatility**  
August 2006



Source: Hillsdale Research

To make matters worse, while the long term global growth story is largely a valid one, the valuation metrics being applied to many Canadian material names, especially those that are small to mid cap names, are simply not. During previous commodity runs, firms were able to achieve earnings growth and profitability in tandem with the commodity cycle. As the graph below notes, this cycle has been notably different. In the late 1980s, the median firm earned a peak return on equity of 15% and during the mini commodity run in the mid-1990s, this figure was only 12%. In comparison, the level of the return on equity during this current run only managed to reach 2%. This means that while many firms may own valuable properties that contain large deposits they have not been able to extract them

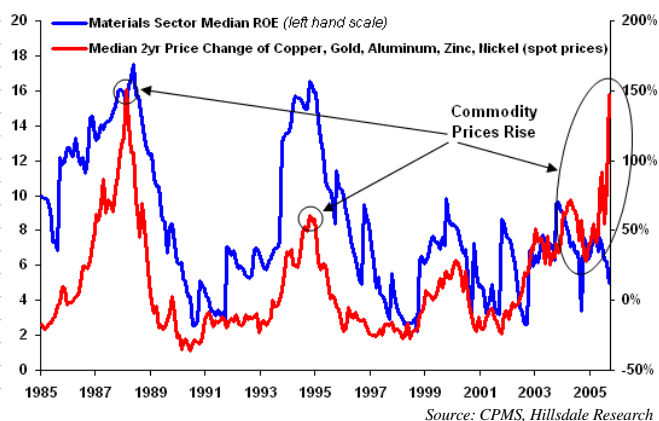
**Hillsdale Investment Management**

100 Wellington Street West, Suite 2100 · TD Centre, P.O. Box 228 · Toronto ON M5K 1J3

Tel: (416) 913-3900 · www.hillsdaleinv.com

profitably and/or the extraction has not yet occurred and still requires further investment or development.

### Materials Sector Profitability vs. Metals Prices

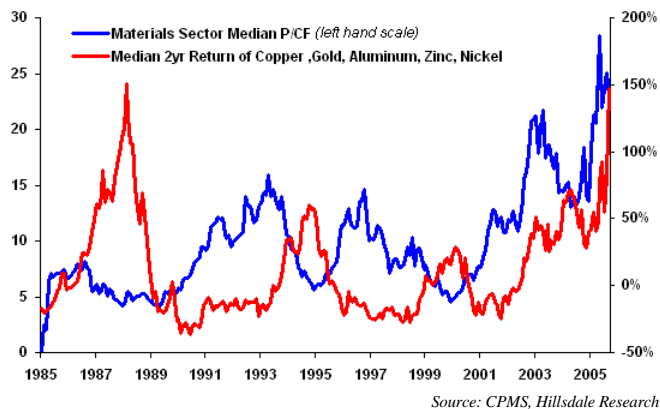


Nonetheless, during this cycle, investors have paid up in anticipation of future potential cash flow streams. As noted in the graph below, in the late 80s, the median firm traded at price to cash flow multiple in the low to mid single digits,

*"Many material stocks are now geared more closely with their commodity prices than underlying fundamentals."*

during the mid 90s, the median firm traded in the mid teens, whereas today, the median firm is trading in the mid 20s. Never have commodity investors paid so dearly for so little in anticipation of so much. This is similar to the environment with tech stocks in the late 90s when investors extrapolated cash flows far into the future and paid up in advance of any sign of profitability.

### Materials Sector Valuations vs. Metals Prices



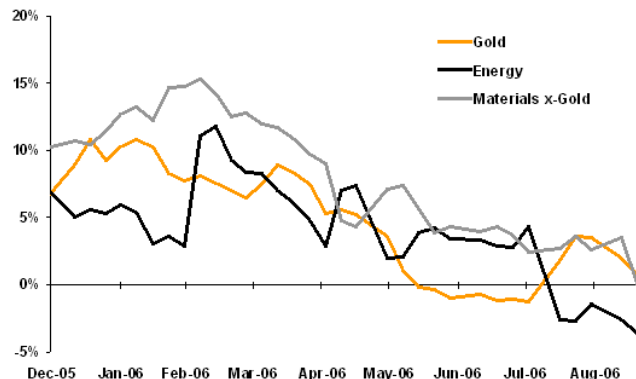
As the graph shows, the expansion of the multiple in the material sector this year has been driven largely by the rise in the corresponding commodity price. Many stocks are now geared more closely with their commodity prices than they are to their underlying fundamentals.

Since the level of volatility in the underlying commodities is two to three times higher than the historic volatility of

stocks, these stocks are now significantly more volatile than they were when the year started.

Largely as a result of this increasing risk, we began to reduce our exposure to materials and energy names starting in early March of this year.

### Hillsdale Canadian Long/Short \$ Exposure Rolling Sector Exposure



This caused our Canadian Long/Short and Performance funds to under perform, as both our long and short stock picking went unrewarded. Our longs struggled to keep pace and worse, our shorts, with their weaker fundamentals and higher commodity correlations, moved against us and generally outpaced our longs.

We now see the Canadian market at a cross roads, the underlying commodity names are well above their long term volatility levels, their multiples are extended, they have significant betas (correlations) to their underlying commodity and commodity prices, now in the fourth year of their run, look extended. Even though the economic environment is strong, the risk/reward ratio for commodity and energy stocks in the near term is very low. Given their relative size and levels of volatility, their downside risk is likely to have a disproportionate affect on the index.

Given this environment, we see tremendous opportunity on the short side as we expect that these names will have trouble exceeding their expectations. Also, when commodity prices conclude their ascent, we expect investors will gravitate towards other sectors such as industrials, consumer discretionary and financials which today offer superior profitability at a fraction of the risk. At this time, the current sector weightings within our Canadian Long/Short fund, are net short energy, neutral to materials and net long financials and industrials. Our Canadian Performance fund is significantly underweight energy and overweight financials, industrials and technology.

### Focus on the US

Throughout this cycle, the US market has been largely neglected by investors with its returns lagging behind many developed and most emerging markets. Unlike Canada, it

has no energy or commodity bias and the index is not skewed to any particular sector. The US market has remained very rational and has, in fact, continued to see a multiple compression. After peaking at 30 in March, 2000, price earnings ratios are now at 16 times. While this is slightly above average levels, it is important to note that levels of profitability for companies in the S&P 500 remain at all time highs. The combination of profitability at 17% and price earnings multiples at 16 times is identical to the environment in 1995, a point in time preceding a robust multiple expansion in the US and also, similar to now, a point in time that proceeded the end of a Fed rate-raising cycle.

Given the divergence in market structure and characteristics between Canada and the US and the differences in underlying volatility, the benefits from diversifying across the countries has risen notably over this past year. Our US long/short fund, which has outpaced both US and Canadian markets this year, has been completely immune from the speculative nature of the Canadian markets and offers a very valid complement to investors wishing to reduce their Canadian exposure. As of September 1, 2006, the fund is also available in a Canadian currency option that is hedged against movements in the US/Canada exchange rate. Its current weighting is net long technology, financials, telecom and health care, no weight in materials and net short consumer staples and utilities.

## Conclusion

From an investor perspective, please note that there are many ways that these events could play out in Canada. Given the dichotomy between the US and Canadian markets, the global nature of the commodity run and the related rises in emerging markets, it could be accomplished by a general rotation of assets. This scenario would most likely be played out over a longer time frame. Alternatively, some of the excesses may unwind in a manner similar to what we witnessed during the April-May period, when emerging markets, developed markets and commodities all moved down together. Or the valuations may persist for a few months more before noticeable adjustments are made as investors wait for the upcoming earnings season before reassessing. Regardless of the scenario, we expect it be accompanied by a higher level of volatility than we saw during the earlier years of this cycle. In response, we suggest that investors determine what their true underlying risk exposure to commodities is across all of their managers and then decide if the level is the most prudent and appropriate for their particular objectives.

Regards,  
Chris Guthrie and Arun Kaul

September 25, 2006

© Copyright 2006, Hillsdale Investment Management