



Meridian Global Investors Inc.

Market Pulse

Summer 2005

THE MARKET HARBOURS NOT ONE BUT MANY
“CONUNDRUMS”.

ALL THE MORE REASON TO BE EXTREMELY
CAUTIOUS

**MARKET ANALYSIS,
JUNE 2005**

Market Performance

	2nd. Quarter	Year to date
Meridian Composite	2.87%	4.17%
TSX 60	3.03%	7.09%
S&P 500	0.91%	-1.70%
SCM Universe	4.47%	5.61%
Canadian Dollar	-1.24%	-2.03%
FPX Balanced Index	3.78%	5.34%

Canadian markets have surprised investors with its strength over the first half of this year. This has largely been due to the strong move of the energy sector which has skyrocketed based on the oil price that now seems to be well established above US\$60 per barrel and may be on its way to \$80 or \$100.

The US equity market is struggling but has recovered some of its first quarter loss. However, it is the long end of the bond market that has created a “conundrum” for US Federal Reserve Chairman Alan Greenspan who is perplexed by the continued and persistent strength of long bonds in the face of short term administered rate hikes. Normally one would expect long bond yields to be rising in the face of the Fed’s relentless tightening, but the opposite is happening. Many theories have evolved to explain this phenomenon away and this shall be discussed later in this report.

The European equity markets are in good shape and many indices in the region are at three year highs, however the weakness of the EURO has offset any equity market gains, for Canadian investors.

Meridian has performed quite adequately through the first half of the year and our balanced portfolio has returned 4.17%. This has been achieved in spite of a conservative portfolio that has included a large component of cash and an underweight in equity (especially US equity), as we remain skeptical on the long term ability of these markets to continue rallying given the high valuations in stocks and the level of risk we view to be present in the current market.

Economic Environment

The global economy is perking along quite well and in spite of higher energy prices is above trend. The US consumer continues to drive the world economy and shows little sign of backing off. An increase in labour income is more than offsetting the cost of higher short term rates brought about by Fed rate increases. The much maligned Chinese economy is also chugging along at 9% growth levels and this together with Indian GNP

rising at 6% is helping to maintain solid Asian growth. The laggards are the major economies in Europe which are moribund and showing few signs of a strong recovery.

Inflation around the world is under control and for the moment the risk of major global deflation is more of a distant than immediate fear.

Where then are the economic triggers that keep us awake at night? Once again we go back to the trade imbalances that abound the global economy at the moment and the excessive government spending that we see in the US and parts of Europe. The main fear of government spending is that we are on the slippery slope of a demographic shift that is making a larger part of the population dependant on fewer workers than ever before. This is a long term structural problem that will get worse before it gets better. The trade imbalance problem is also somewhat endemic as the US consumer is importing a massive number of goods while the US has outsourced much of its production capacity to foreign countries and thus the huge balance-of-trade deficit which is exacerbated by the huge government deficit. This situation can be stretched further but when it ends it will end in tears and the repercussion to the global economy will be sharp and devastating.

Capital Market Drivers

Capital markets are ultimately driven by economic fundamentals but they are also driven by investor emotion and as a result can be extremely difficult to read, particularly in the short term. The US capital market complex seems to have become extremely complacent over the past three months. This is indicated by the low level of volatility in the equity options market as indicated by the all time lows currently being reported in the VIX index. In addition, the market vane has just seen bullish sentiment rise above 80% in US equities. This is very high and is normally associated with a sharp drop in the near term as most investors are bullish and heavily invested. The speed with which the global markets recovered from the London terrorist attack is another indication that investors are not paying attention to bad news; this can last awhile but it too will likely end in tears when the sentiment turns around.

Housing prices are still rising rapidly in North America and although they appear to have peaked in the UK and Australia they are definitely fuelling a “feel good” attitude amongst US consumers. This is creating some uncertainty amongst Federal Reserve officials who talk of a “long bond conundrum”. The Fed has consistently raised rates for 18 months and normally by now the bond market would have started tightening out along the curve. This time the long end of the market has in fact eased and rates have fallen beyond 10 years. As stated earlier, many reasons have been promulgated for this state of affairs; the story that makes most sense to us is that massive Central Bank ease, particularly from the Bank of Japan was required to try and reflate the global economy in the years 2002 to 2004. The Bank of Japan flushed the system with an increase in Japanese money supply of some three trillion yen (US\$350 billion). This excess cash was converted to dollars and invested in the US Treasury market: this served two purposes and may well have been done with the blessing of the Fed. Firstly the global deflation threat was halted and secondly the funds helped finance the twin deficits of the USA. However it also took

pressure off the domestic fixed income market which extended term and kept long rates very low for this point in the cycle, somewhat to the consternation of the Fed, who is now concerned that its low rate structure might be spawning a real estate bubble.

Of particular interest to Canadian investors has been the energy market which has skyrocketed over the past quarter adding to an already solid first quarter. The oil price has risen to \$64 (from \$42) for a percentage increase of 52% over the past six months. The stocks on the TSX have kept pace with this blistering pace as the XEG (energy stocks ETF) has moved from \$50.25 to \$76.50 also for a return of 52%. Gold on the other hand has stayed in a narrow trading range from \$420 to \$450. The interesting aspect of the gold price has been that it has held firm in the face of the sharp increase in the value of the US Dollar against the Euro and the Yen, normally gold would have fallen in USD terms, the fact that it hasn't adds to our confidence that the gold price is on the verge of breaking out to the topside. We own positions in Canadian and US based Gold ETF's.

Fixed income markets remain in a rising formation although they have fallen into the middle of this trend over the past few weeks. They will likely stay strong given that the amount of global liquidity in the market is very high and the natural place for it to find a home is in the US Treasury market, which will in turn hold down Canadian long term rates. The Fed will continue to raise rates and the yield curve will continue to flatten.

Sovereign unrest

Since our last article there have been two series of terrorist events in the UK and King Faud of Saudi Arabia has finally succumbed after a long illness. The markets rallied after a swift drop on the first terror attack in London showing that global capital markets are becoming more complacent in the face of terror than they ever have been. The death of King Faud has shaken up the oil market a little, however nothing really has changed yet as his half-brother has simply been given the job he performed for the last few years. However, the new King Abdullah is also an old man and will not live long. This has given investors cause to wonder who, in the next generation, will inherit the kingdom and will this transfer of power be undertaken smoothly or will the hostile undercurrents present in the kingdom come into the open and result in insurrection or worse? We do not know the answer to this but any slight upheaval in this very volatile area will boost the risk premium in oil. Could we possibly see US\$100 oil before the end of the decade?

Outlook

We feel that the stock market is in the final stages of a bear market rally. This is a dangerous time to enter the market but it is also very difficult to predict with any certainty when these "fifth wave rallies" will end as they tend to be driven by emotion. Fundamentals have been totally forgotten in the exuberance of the rising market. The two sectors that are particularly overvalued and that are leading the market ever higher are energy and real estate. The fixed income markets are stable and look likely to remain that way but upside potential is limited.

Asset Mix Recommendations

Our Asset Mix Model is based on a neutral position of 60% Equities; 20% Fixed Income; 15% alternative asset classes; 5% Cash.

The equity components are further broken down into 20% for each of the Canadian, US and Non-North American markets. The Non-North American markets will include both developed and emerging markets.

The fixed income markets are split into domestic, foreign and inflation indexed positions. Only bonds with “A” credit ratings or superior will be included in portfolios. The real return bonds may include foreign pay issues.

The alternative asset class is made up of assets that have low correlations to the major equity markets of North America (i.e. S&P 500 and TSX/S&P 60). These may include commodities, funds of hedge funds, as well as ETF’s, closed end funds or other suitable instruments that give exposure to non-correlating asset classes (e.g. real estate, timber, metals, energy)

	Neutral		Current		Over/Under
Equities		60%		50%	-10%
Canadian	20%		20%		
US	20%		10%		-10%
International	20%		20%		
Fixed Income		20%		15%	-5%
Canadian	10%		5%		-5%
Foreign	5%		5%		
Real rate	5%		5%		
Alternatives		15%		20%	+5%
Absolute Return	5%		7%		+2%
Inflation Hedge	4%		10%		+6%
Real Assets	3%		3%		
Private equity	3%		0%		-3%
Cash		5%		15%	+10%

Our expectation is that even with the Fed continuing to tighten rates and the price of oil likely to remain above most economists’ average forecast the global economy will expand throughout the 3rd and 4th. Quarters. In spite of this we remain 10% underweight in equity as we believe the level of market risk to be high. We are also taking our 5% overweight in Canada off the table and placing the proceeds in European equities which have a lower risk profile.



We have reduced our fixed income component to 15% as we see little in the way of upside potential for this fully valued asset class and have invested the proceeds in Alternatives. We have re-classified our Alternatives into four sub-classes Absolute Return; Inflation Hedge; Real Assets; and Private Equity and in total are 5% overweight in these sectors.

We have a high cash weighting of 15% for a 10% overweight.

Our overweight allocation to alternatives and cash is based on a desire to be very conservative in what we consider to be a potentially volatile market.

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