GORODN PAPE US INCOME LETTER January 2, 2008

Gordon asked me the write a few thoughts on the major investment themes for 2008 for the initial issue of the US Income Investor (?). In investment, it's a good rule of thumb that whatever has been happening will continue to happen until something major occurs that changes the direction of events. Thus, once central banks such as the US Federal reserve (the Fed) the Bank of Canada and the Bank of England begin reducing or increasing interest rates, the process will continue for a long time and move a long way. With the Fed having reduced the rate at which it will lend to its member banks (the Fed Funds rate) three times by 1% to 4.25% since August, 2007 and the Bank of Canada and Bank of England having begun the process by reducing interest rates once by 0.25% (to 4.25% and 5.5% respectively), it is safe to assume that 2008 will see further interest rate cuts.

Of course, how far the process will go is unknown at this stage, but one should never underestimate how low and how long they can go. I don't recall many commentators in 2001, when Alan Greenspan started cutting rates on January 2nd from 6.5% to 6% that forecast that Fed funds would finish at 1% in mid 2003, 5.5% and two and a half years later. Similarly today, not many analysts are forecasting more than a fall to 3% by the end of 2008, another 1.25% from the present level, although one or two of the more bearish are looking at negative real interest rates (interest rates minus inflation) which implies Fed funds at below 2.5%.

The situation is not as clear cut in Canada, where the retiring Governor of the Bank of Canada, David Dodge, was raising rates by 0.25% to 4.5% as recently as August last year, worried by the booming western Canadian resource based economy, as house prices in provinces like Alberta, British Columbia and Saskatchewan shot up more than 25% p.a. in both 2006 and 2007, leading the Bank to worry about inflationary pressures. However, Mr Dodge has a track record of raising interest rates in response to inflation concerns, as he did in 2003, before reversing himself shortly afterwards. The reason, in both instances, was that raising interest rates in Canada while its major trading partner, the US, is cutting them (75% of Canada's exports go to the US), only leads to one result.

The Canadian dollar, popularly known as the "loonie" after the picture of a Canadian loon (a type of waterbird) on the C$1 coin, rose more than 20% in 2003 the first time that Mr Dodge chose to go in the opposite direction to the Fed, and by almost 20% last year, as short term investment money chases after a more attractive interest rate than they can obtain in U$ deposits. This, in turn, has the effect of acting in the same fashion as an increase in interest rates, thus slowing down the economy as Canadian exports to the US become less competitive and manufacturing, especially autos and forestry, suffer accordingly. The stronger loonie also reduces the inflationary pressures that led the bank of Canada to raise rates in the first place, as imported goods such as technology and capital equipment, let alone energy and raw materials that are priced in U$, all become cheaper. Residents of states bordering Canada will probably have noticed the large number of Canadian number plates at shopping malls near the border this fall, as parity between the loonie and the greenback for the first time since the 1970s brought waves of shoppers over the border in search of bargains.

For a US investor, this has resulted in Canadian stocks being one of the best performing investments over the last 6 years, as the loonie has appreciated by almost two thirds (from U$0.63=C$1 in February, 2002 to U$1.02=C$1 in January 2008) while the S&P/TSX Composite Index has doubled over the same period in C$ terms, making the total return to US investors more than double the 67% that S&P500 has delivered over the same period. The intention of this publication is to look at some of the Canadian investments that are easily available to US based investors, and while it is highly unlikely that the next few years will see the same type of move in the currency to add to U$ based returns, the superior fundamentals of Canada against the US, where the resource boom has led to the federal government and most provinces running budget surpluses to accompany the trade and current account surpluses that Canada has traditionally enjoyed means that the loonie will likely continue to at least maintain its present levels against the U$ for the next few years.

As I remarked at the beginning of the article, trends in investment, once begun, tend to continue for longer than most observers expect, and given the dampening effect of the housing slowdown on US consumer spending and government revenues, it is difficult to see US interest rates not being substantially lower by the end of 2008. In Canada, on the other hand, while the new Governor of the Bank of Canada, ex Goldman Sachs alumni Mark Carney, may reduce interest rates a couple of times to avoid the loonie rising back to U$1.10=C$1 as happened briefly in November, is still enjoying the benefits of the resource boom and will not need or want to cur interest rates as far as the US. Therefore, it is reasonable to expect the loonie to remain near or a little higher than its present level and those Canadian companies not exposed to the domestic US economy to continue to do well. Elsewhere in this issue, Gordon has updated details of the first recommendation I made to Canadian investors almost 3years ago, Canadian oil sands, the purest play on the massive oil-sands reserves in northern Alberta, which have helped to make Canada the largest supplier of oil and gas to the US for the last decade.