

# Investment Outlook

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## Your Mid-Year Portfolio Checkup

**N**ow that the first half of 2005 is behind us, it is time to review what happened and the impact on your portfolio. Specifically, let's compare what was forecast in our January issue to what has actually transpired so far this year, how the anticipated dominant investment themes have played out and what may lie ahead in the second half of 2005.

### First Half Recap

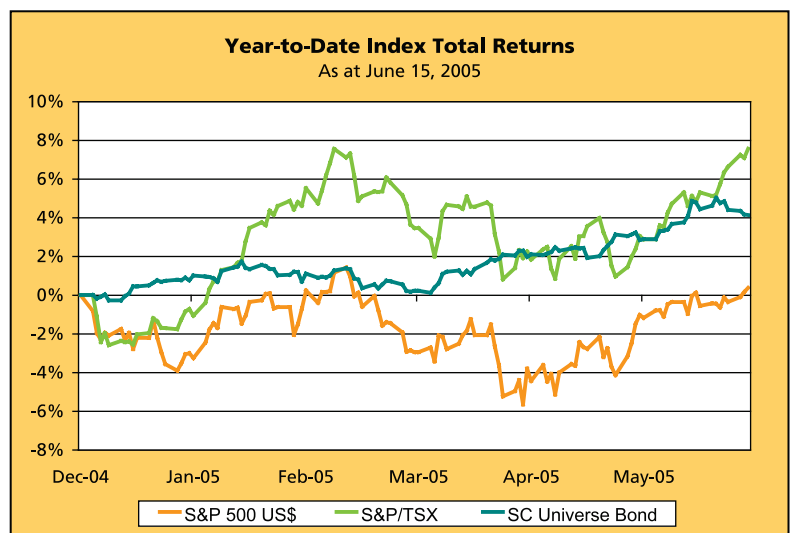
The initial six months of 2005 were characterized by wide swings in investor sentiment. This reflected volatile energy prices plus shifting expectations for both U.S. interest rates and the North American economy.

No topic has captured investors' attention more than the price of oil, which has remained persistently high. The price per barrel fluctuated within a band of \$46 - \$57 U.S. from January to June, moving on shifting sentiment regarding OPEC production, demand for energy in the emerging markets of China and India plus crude oil inventory levels. Despite rising crude inventories in the U.S., which reached the highest levels seen in five years, energy prices remained at levels above those anticipated by most analysts.

**The result was that the energy sector, to which your portfolios have very good exposure, remained the best performer in the Canadian stock market. A second consequence was that the Canadian equity market continued to outperform its American counterpart, since**

**the energy sector is a much larger component of the Canadian market than the U.S. and because the U.S. economy is adversely affected by rising energy prices. This is not the case in Canada, where higher oil and natural gas prices are, overall, mildly positive for the economy as a whole. All this generally worked to your advantage as your portfolios are typically overweighted in Canada.**

Almost as popular among investors as gauging oil prices on a daily basis was "Fed Watching", trying to anticipate the future path of U.S. interest rates established by the U.S. Federal Reserve and its iconic Chairman, Alan Greenspan. In brief, the central questions were whether U.S. economic growth and inflation would necessitate higher interest rates and to what extent and when. The answer was that the Fed continued to raise short-term interest rates, as we had expected, at what it characterized as a "measured pace".

*(Continued on page 2)*


# Your Mid-Year Portfolio Checkup

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The net effect was that the S&P/TSX Composite Index rose 7.6%, as of the time of writing, in the year's first half, while SC Universe Bond was up 4.2%. The S&P 500 recorded a slight gain of 0.4% in U.S. Dollar terms.

## Investment Themes Re-Visited

The first theme cited in the January edition of *Investment Outlook* was that we would likely avoid the negative returns in the stock market that often characterize the first year of the U.S. presidential term. Instead, we felt that the stock markets, and in turn your portfolio, would track corporate earnings growth in the mid-single digits for the year. As indicated above, the Canadian stock market has achieved much of that objective already, although the American S&P 500 is slightly below breakeven for the year to date. Overall, market returns have been in line with forecast.

As stated in our January column, we expect North American corporate earnings growth will decelerate as 2005 wears on. This, in combination with the effect of higher U.S. interest rates and less liquidity in the financial system will likely mean modest returns for stocks over the balance of the year, consistent with our forecast.

Since much of what we have perceived to be the upside in the stock market for the year has already been achieved, we have recently trimmed your equity positions where client mandates permit. Specifically, we took advantage of market strength over the past several months to reduce our overweight position in stocks by five percent, reflecting the factors cited above and in prior editions of *Investment Outlook*.

The second theme was that, after years of out-performance, small companies' shares, the so-called "small caps", would under-perform their larger counterparts in 2005. This forecast was based on the premise that small caps would see their share prices react to a less hospitable environment characterized by rising

interest rates and slowing profit growth. To date, this has certainly been the case as the Russell 2000 Index of American small caps has sharply underperformed the S&P 500 while the S&P/TSX Small Cap Index has similarly fallen well short of the S&P/TSX Composite Index of larger companies. This trend should persist throughout the balance of 2005.

## Your Portfolio:

- Modest overweight in equities.
- Slight underweight in bonds. Bond holdings have a slightly shorter term than benchmarks.
- Among bond holdings, overweight high quality corporate issues
- Overweight Asia in international equities.

## Stocks Outperform Bonds Overall

March 15, 2005 - June 15, 2005

SC* Universe Bond Index	3.6%
S&P/TSX Composite Index	2.1%
S&P 500 Index	3.9%
MSCI EAFE Index**	-3.3%

\* Scotia Capital

\*\* Morgan Stanley Capital International Europe, Australasia and Far East Index

Theme number three took up where number two left off. Just as we expected the small caps to under-perform, we anticipated a shift of leadership into the big, defensive companies' shares that exhibit stable sales, earnings and dividends. In the U.S. we cited the big pharmaceutical companies' shares, which have performed in line with the market in the year to date, along with consumer staple producers such as Colgate. Both the Consumer Staples Sub-index and Colgate have slightly out-performed the market year to date.

Closer to home, we recommended diversified financials – **Manulife, Sun Life and Power Financial** – as companies that would benefit from the same shift in leadership. All are up so far

in 2005 but have not out-performed the market to this point.

The fourth theme had to do with fixed income investments, for which we forecast a flattening of the yield curve, meaning that the gap between short and long-term bond yields would narrow. This has happened in the U.S., where short-term rates have risen and long-term rates have slipped. Flattening of the yield curve also took place in Canada but has been less pronounced as the Bank of Canada has not yet increased its benchmark Overnight Rate but will likely do so in the coming months. **The result is that the bonds in your portfolio had solid returns in the first half of 2005.**

Theme number five pertained to income trusts and the likelihood that lower caliber trusts would encounter difficulty meeting distribution targets while the higher quality trusts would fare well. We saw this dichotomy begin to emerge in the first half of 2005 and expect it to become more pronounced as the year wears on. **In the meantime, income trusts in your portfolio continued to generate solid income.**

The sixth and final theme was that the Japanese stock market would outperform U.S. equities in 2005. This has happened but to only a modest extent as the Nikkei Index has risen fractionally while the U.S. indices have declined slightly. Japan's lacklustre performance to date has been due principally to political tension between Japan and China, which has translated into market weakness. We expect this will change over the balance of 2005 to reflect strong growth in Japanese corporate profitability.

## The Road Ahead

Having already generated a good portion of the year's anticipated stock market returns, we have, where mandates permit, trimmed your portfolio's equity position and are now slightly overweight in equities. We expect continued modest progress throughout the second half of 2005.

**R.J. Gorman, CFA**  
**Vice President,**  
**Managed Investment Solutions**

# Risks in Canada's Housing Market Exaggerated

**A**lthough there is little evidence of a housing bubble in Canada, concern about the prospects for Canada's real estate market abounds. But in a topic paper entitled *Bursting Aspects of the Housing Bubble Myth*, TD economists show that four of these specific fears are largely exaggerated. "Canada's red-hot housing market is on a solid foundation because there is very little evidence of speculative activity," remarked Carl Gomez, economist with TD Bank Financial Group. "But while a modest cooling is in the cards this year and next, there are a number of misconceptions about the state of this housing market and where it's going."

## Rising interest rates manageable

A major misconception is that recent homeowners, lured into the market by low interest rates will be deeply hurt when rates rise. But the TD report indicates that despite the growing popularity of variable rate mortgages, longer term fixed rate mortgages remain the most frequently used financing option for most homeowners in Canada. As such, most homeowners are already insured to some extent against the risk of rising rates since their mortgage payments would remain fixed over the term of their mortgage.

And while most variable rate mortgage holders could simply lock into a fixed rate mortgage if rates headed higher, there is little incentive to do so immediately because payments on most variable rate mortgages would not change in the initial stages of a rising interest rate environment. Nevertheless, the TD report explains that the risk of a substantial increase in rates is not likely in the current economic environment. "Inflation is not the monster that it was in the late 1980's and that means that rates should only rise at a measured pace once the Bank of Canada begins its tightening cycle."

## Condo development makes sense

Despite recent fears that the condo market in Toronto and Vancouver could

become overbuilt, the TD report notes that there are sound economic reasons supporting the development of this type of product. A popular argument is that condo living has become more appealing to potential homeowners given the growing trend towards smaller households. But the potentially bigger factor is that rising prices for highly accessible land in urban centres require more intense usage through higher residential densities to keep housing costs accessible.

## Many Risks In Canada's Housing Market Are Exaggerated, Say TD Economists

- Concerns about a housing bubble are overblown, as speculative buying is not behind today's strong market.
- Other fears including overly leveraged homeowners, excessive building in the condo market and a possible demographically inspired crash in home prices in the future are also exaggerated.
- As such, housing should still be considered a solid long-term investment

The TD report also notes that while condo developments can result in a volatile pattern of over and under building, the homebuilding industry has instituted a number of risk management techniques like pre-selling dwellings prior to construction.

## Baby boomers will support prices

As the leading edge of the large baby boom generation approaches retirement, a frequently heard myth is that home prices will collapse as this group increasingly unloads their family homes to a smaller pool of younger buyers. However the TD report counters that not all baby boomers will be retiring at the same time, "This demographic group currently spans in age from 60 all the way down to 39," Gomez pointed out. "So while older boomers may be pondering retirement, their

younger counterparts with growing families will still be looking to trade-up to larger homes. This should help to keep the housing market broadly in balance." But the TD report also notes that even as older boomers retire, they will not give up on homeownership just yet, "The fastest growing segment for homeownership are those above 65 and the boomers will certainly not reverse this trend given their high levels of wealth," said Gomez.

However, the TD report concedes that an aging population could be responsible for mild price declines in one small segment of the housing market over the next few years. "Smaller 'shoebox' condos recently sprouting up in parts of Canada as result of the current housing boom could face some difficulty when they come back up for sale on the existing home market," warned Gomez. "That's because these condos are designed mostly for young first time buyers whose numbers will make-up a smaller percentage of potential buyers in the future."

## Homeownership good investment

Given that there is no coming crash in real estate markets, only a modest cooling, housing should remain a sound investment. Assuming that the market remains fairly balanced and the economy grows moderately, the TD report expects home prices to grow at an average annual pace of about three per cent over the next decade. Though this does not seem like much, the report argues that the expected after-tax return is closer to six per cent given that there are no capital gain taxes on the sale of a principal residence. Furthermore, the growth of home prices tends to be more stable than other investments like stocks.

**For more information, please contact: Carl Gomez, Economist, 416-982-2557 or Craig Alexander, VP & Deputy Chief Economist, 416-982-8064**

*Bursting Aspects of the Housing Bubble Myth* is available in PDF format at: [www.td.com/economics](http://www.td.com/economics).

## Enhancing the Curb Appeal of Your Home

Landscaping your lawn can improve the aesthetic beauty of the property, as well as add to its resale value. But before you jump hoe first into the project, a little forethought and planning can save valuable time, effort and money.

The first step is to develop a landscaping plan. Draw a sketch of the property; include the physical boundaries, the position of the house, driveways, utilities and easements. There is software available that can aid you with planning your landscape, also.

Before you decide what type of trees and shrubs to plant, a careful consideration of the elements is in order. Climate, topography, land, soil, vegetation, house, utilities, views and the neighbourhood will all impact your decision.

You may want to ask yourself what it is your family needs. For example, if you have young children you may desire a play area or outdoor cooking and eating

areas. A golf enthusiast may consider a driving range. The sky is the limit, but once you are committed, there is no turning back.

The maintenance aspect may also pose some concerns. Will you be responsible for maintaining the property or will



you hire a gardener? Exotic plants and shrubs are best serviced by a gardener with experience in this area.

The location of your plants, trees and shrubs will be determined by your needs. Clearly, the objective is to blend your home and your property.

The following tips will help to create a good visual relationship between the two:

1. Try to position plants so that a natural scene is created as they mature.
2. An evergreen or cedar hedge will provide privacy and screen unsightly views. However, if privacy is a major concern you may want to build a fence. Consider the old adage "Good fences make good neighbours."
3. Buy your plants, trees and shrubs from a reputable nursery to ensure high quality.
4. A practical and aesthetically pleasing yard may include fruit and vegetable producing plants.
5. Choose construction materials such as wood and stone to complement your landscaping efforts, i.e. fieldstone walkways, wood decking etc.

Last, but not least, incorporate your plants, shrubs, trees, walkways, decking and patio into your plan. Once your plan is complete, it's full-speed ahead. The only question left to answer is "where is that shovel?"

Source: *Royal LePage*  
[www.royallepage.ca](http://www.royallepage.ca)



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