

# Investing forecast 2006

■ BY JIM MIDDLEMISS

As the Canadian stock market rides the Santa Clause rally into the end of 2005, fuelled by high energy and commodity prices and the Liberal government's pronouncement that it will lower taxes on dividends and leave income trusts alone, investors should prepare to be defensive in 2006.

That's because experts expect tepid stock markets and more volatility heading into next year, fuelled by rising interest rates, concerns about high energy prices, potential inflation, the U.S. deficit, a new chairman of the U.S. Federal Reserve Board and the ability of consumers to continue spending.

"I think the big thing is that global growth is slowing down and you have a rising interest rate environment to stave off inflation," says Adam Pion, a director in the private client group at UBS Bank Canada, in Vancouver.

"It's important for investors to keep focused on sectors and individual security selection rather than timing the market," says Don Ogden, a market analyst at brokerage firm Raymond James in Vancouver.

## Global markets up, U.S. market flat

Making money in the markets in 2005 was like shooting fish in a barrel. In Canada, all you had to do was buy a few income trusts, energy stocks and a bank or two, and chances are you made out like a bandit. If you invested in Europe or Japan, you also did well.

As of November 24, the TSX Composite Index was up 19.78 percent. The U.S. markets, on the other hand, were flat, with the Dow Jones up 1.23 percent, the NASDAQ up 3.98 percent and the S&P 500 up 4.07 percent.

So what's in the mix for 2006? Likely not the double-digit gains that some investors racked up in 2005. Analysts are most concerned with rising interest rates and the impact they will have on global economies and the ability of consumers to continue spending, particularly in North America, where consumer spending, not corporate spending, has driven the economy the past few years.

## So much depends on the Fed

According to Paul Taylor, chief investment officer at BMO Harris Private Banking, in Toronto, the tightening policy of the U.S. Federal Reserve Board will have a major impact on investments. Rates south of the border have risen from one percent to four percent in the past couple of years. "We expect that it will go higher to between 4.5 percent and 5 percent before the Fed moves to the sidelines," says Taylor.

"The same general environment exists in Canada, where the Bank of Canada is raising interest rates, and we will have a modest economic deceleration in 2006 versus 2005. Our sense is that the Canadian and U.S. economies will slow to a growth rate of 2.5 percent."

Ogden says one wild card is how new Federal Reserve chairman Benjamin Bernanke will perform. He is "more likely to focus on growth and supporting economic growth than former chairman Alan Greenspan, who was focused almost exclusively on the risk of inflation," he says.

Wilfred Hahn, of Hahn Investment Stewards & Company expects the Fed to stop raising rates in 2006, which will have an immediate impact on currency. The Canadian and U.S. dollars have been strong lately, relative to other world currencies. Part of the reason is a rise in energy prices and interest rates, which attracts investors. Once rates stop rising, he expects the U.S. dollar to "have another major leg down."

## Other indicators

Pion says the United States continues to be a good long-term growth story, but some bumps in the road lie ahead. "You've got the housing sector flattening out," which is a concern because rising house prices have prompted U.S. consumers to refinance and spend on goods. "The North American housing bubble has peaked. You're going to see an impact on consumer spending," agrees Hahn.

As for specific sectors of the market, Pion says he's concerned about industrials and materials. "I think valuations are particularly stretched," he says. Energy prices will also weigh heavily on the U.S. economy, causing consumers and

businesses to pay more, as much as US \$1,500 to US \$2,000 more per household, says Taylor. Rising energy prices are a "significant headwind U.S. consumers have to face," he says.

## Investing at home

In terms of Canada, analysts suggest it's time to take some money off the table. Taylor recently moved to being slightly underweight in Canadian holdings. However, he still believes that "we're in a long-term secular bull market in commodities and oil."

The challenge for Canada is the lack of diversification in different economic sectors and how heavily the country relies on energy, materials (including mining companies) and financial services. "If you took away (returns in) materials and energy from the index in Canada (in 2005), you wouldn't have much growth," says Pion.

Ogden says that is why it's a stock-picker's market. For example, he likes the business intelligence software markets and oil sands. He says 2006 will be the year that growth in the global oil production curve will stop, but demand will continue to be high and that will support higher energy prices, which is positive for Canada's energy sector.

## Investing abroad

Pion says Europe has had rising valuations, but "there is some concern over the elections going on." Nonetheless, he continues to invest there. Hahn adds that "Europe is surprisingly strong and consumer sentiment is pretty good." Continental Europe, he notes, actually has a trade surplus, unlike the United States, and interest rates will likely start to rise.

Pion is cautious on Japan, saying the valuations "are pretty stretched," However, Taylor is bullish because, for the first time in 15 years, Japanese economic growth shows signs of stability. He says emerging markets such as China and India are slowing, though their growth rates are still high, at 8 percent or 9 percent, compared to 2 percent or 3 percent in North America.

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