



# The Quarterly Letter

Published since 1992

## The Quarter in Review...

In the introduction to our first quarterly newsletter of 2006, we warned you not to extrapolate the excellent results obtained during the first quarter to the entire year. In fact, we were then in the process of significantly reducing the equity weighting in our portfolios, which seemed quite contrarian at the time.

One has to admit that our timing was quite good. Indeed, the bond and stock markets have both retreated during the second quarter of 2006. Our typical client experienced a drop of 3.5% in his/her portfolio during this period, despite our sale of stocks at the beginning of March. To date in 2006, our typical client's portfolio has increased by more than 1%, not

bad considering the circumstances. Our stocks are up 4.8% so far in 2006, much better than comparable indices.

The markets are presently experiencing their first correction since the significant increase that began at the end of 2002. The correction was due! The unremitting increase in interest rates, the slight increase in inflation and the expected slowdown in the growth rate of the world economy have been the catalysts for this drawback. However, discussions of recession or stagflation (combined inflation and recession) seem far-fetched to us.

In view of the significant decrease in the stock market, we have decided to use a portion of



our cash position to buy depreciated securities. We believe that the risk-return equilibrium is far from being as good as it was a few years ago and that a slight underweight position in equity is appropriate, but we remain rather optimistic for the next twelve months.

Enjoy a pleasant summer!



The Dalpé-Millette Group

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## Selected Statistics

Month	Interest Rates			Stock Exchanges			Currencies		
	Canada Short-Term	Canada Mid-Term	Canada Long-Term	CAN TSX/SPX	USA DJII	Intern. EAFE	USA\$	EURO	YEN
Dec. 2005	3.37	3.92	3.98	11272	10717	1680	0.8580	0.7245	101.13
Mar. 2006	3.86	4.16	4.26	12110	11109	1842	0.8568	0.7096	100.86
April 2006	4.04	4.31	4.47	12204	11367	1910	0.8956	0.7092	101.95
May 2006	4.18	4.35	4.45	11744	11168	1827	0.9076	0.7078	101.80
June 2006	4.30	4.47	4.58	11612	11150	1823	0.8931	0.7117	103.85

## The Bond Market



As was predicted by 70% of analysts, the Bank of Canada raised, for the seventh consecutive time, its overnight target rate by 25 basis points to 4.25% last May 24<sup>th</sup>. Monetary authorities based their decision on the vitality of Canadian domestic demand and the growth in the world economy. Monetary policy is currently close to a neutral stance, i.e. the level where leading interest rates are neither accommodating nor restrictive for the economy.

In the communiqué announcing its latest rate increase, the Bank of Canada indicated that the leading rate was now at a level that should maintain the Canadian economy close to its equilibrium, i.e. economic

growth of about 3%.

On the American monetary policy side, it seems that the U.S. Federal Reserve (Fed) governors are divided between the risk of inflation and the risk of an economic slowdown. Moreover, conflicting messages contained in speeches from various members of the monetary authority are undermining the credibility of the Fed. Under these conditions, the Fed increased yet again the target rate of its federal funds by 25 basis points to 5.25%. This is the 17<sup>th</sup> consecutive increase since the beginning of the current tightening cycle by the Fed in June 2004.

Within this context of uncer-

tainty with respect to the Fed and its policy, the bond market is looking for direction. It is also trapped between the fear of inflation and signs of a slowdown in American economic growth.

The Canadian bond market experienced a setback during the second quarter of 2006. Holders of the Government of Canada long-term bonds lost -3.2%, while the Scotia Capital Universe index, a benchmark for Canadian bonds as a whole, recorded a return of -1.0%. As for the JP Morgan index, it posted a return of -0.1% for the American bond market.

A seventh rate increase for the Bank of Canada.

## The Currency Market



The Canadian dollar pursued its appreciation during the second quarter, smashing new records once more.

The loonie climbed in excess of 90 cents US on May 4, a first since 1978. It has appreciated by 4.1% against the American greenback to date this year, following four consecutive annual gains. Moreover, the loonie soared by 4.8% last April, the strongest rise since February 1971.

The strength of our currency reflects economic growth that is benefiting from record-high prices for oil, natural gas and metals such as copper and

gold. The Alberta tar sands contain the largest crude oil reserves outside of the Near East and Canada is the world's second producer of nickel and zinc. Energy goods represented up to 80% of Canada's trade surplus last year. The commodities boom fuelled by the demand from India and China has helped the currency to rise from a low of 61.8 cents US set on January 2002.

The loonie's increase is also attributable to the weakness of the American dollar. Our currency is benefiting from the downward slide of the American greenback, which seems to have lost the favour of inves-

tors. Since January 1<sup>st</sup>, the American dollar has lost 5.6% against the euro, 1.2% against the yen, and 5.1% against the pound sterling. It is at its lowest level since the end of the 70s against the loonie. Among the factors explaining the pressures faced by the American dollar lies the ever-troubling issue of the current account deficit.

The loonie reaches a 28-year high.

## Canadian Stocks



Ghosts from the past came back to haunt investors when the Toronto Stock Exchange's main index, the S&P/TSX, gave them a fright by tumbling over 300 points in half a day last June. This correction, which began at the tail-end of the quarter, is fuelled by increased suspicions of an economic slowdown and rate increases both in the United States and in the industrialized world, all of this stoked by a pull-back in oil prices, the latter having a significant influence on the Toronto index. Thus, the gains reaped since the beginning of the year, and quite enviably with respect to other North American stock exchanges, have vanished completely as the index ends the year so far with a return of 3.0%. At its zenith on April 19, the TSX was up 11%.

The situation still remains unstable for the Toronto Stock Exchange's main index considering its strong dependence on speculative stocks such as oil and natural resources. These subsectors represent a portion of the Toronto index that is two to three times higher than those of other major stock indices in the industrialized world. No wonder that the S&P/TSX is so agitated when faced with the slightest indication of an eco-

nomical slowdown or of a decrease in the demand for raw materials. Fear of a collapse in the demand for a vast array of commodities is also pulling the S&P/TSX down. Even banks participated in the Canadian stock market's retreat since the increase in interest rates slows down loan activities. The relapse of financial stocks weighs heavily on the index since they represent 29% of the index's value. Without its stock market leaders, the Toronto index is witnessing its gains wilt.

Indeed, the index ended the quarter with a heavy loss of 4.1%, which is also reflected in the results of its subsectors since only the basic materials sector closed in positive territory. Curiously, this sector reported the best performance, posting, in spite of everything, a gain of 0.5%; the setback being felt particularly on the natural resources side. Since their peak set in mid-May, the prices of copper, aluminium, nickel and zinc have fallen by 27% each, while gold retreated by 26%. Securities of natural resources producers took the rap following speculation that Canada's major customers, such as China, will adopt measures to slow down their economy, which would have negative implications for Can-

ada. The worst subsector, that of information technology, recorded a disastrous performance of -21.5%.

In Canada, the economy remains robust, but foreign trade continues to weigh heavily on growth, the strong loonie being the main culprit. However, with growth in real GDP at 3.8% (at an annualized rate) in the first quarter, we are led to believe that the Canadian economy is currently evolving slightly above its full potential, thanks particularly to greater than expected productivity gains. For its part, the Canadian labour market is on a roll with the creation of 96,700 jobs in May, mostly full-time. The unemployment rate decreased by 0.3% to a level of 6.1%.

For its part, inflation has accelerated substantially to position itself at 2.8% in May from 2.4% in April, mainly due to the price of oil. These numbers, combined with the strong increase in employment, are keeping economists pensive and even ambivalent regarding the Bank of Canada's next decision with respect to its monetary policy.

Without its stock market leaders, the Toronto index sees its gains wilt.

## US Stocks

The second quarter of 2006 has been one of the most turbulent in many months. The Fed's dependence on economic statistics and investors' interpretation of the latter have rendered the markets very volatile. However, major American indices have weathered the storm much better than world indices.

Over the first four months of the year, America's leading stock index, the S&P 500, reported good progress with an increase of almost 5%. In May, however, American indices experienced their worst monthly performance since January 2004. The S&P 500 fell 3.1%, the Dow Jones lost 1.8% and Nasdaq declined by 6.1%. The S&P 500, the Dow Jones and Nasdaq ended the second quarter of 2006 with respective returns of -1.9%, 0.4% and -7.2% and a year-to-date performance of 1.8%, 4.0% and -1.5%.

Following a first quarter of 2006 where economic growth strongly accelerated in the United States, many signs are now foreshadowing a slowdown. Consumer confidence retreated for the third consecutive month in June in our neighbour to the south, disposable income is stagnating, employment creation is losing vigour, the unemployment rate dove to 4.6% in May, the trade deficit is deteriorating and indicators are pointing to a slowdown in the real estate market.

The expansion in the real estate sector has allowed consumers to sustain the American economy during the last few quarters. However, following its overheating, the sector has embarked on a downward trend. This slowdown in the real estate market combined with the increase in interest rates and in the price of oil are causing disappointing growth in

household spending. Indeed, in May, the manufacturer index declined to its lowest level since the summer of 2005, also signalling a deceleration in economic growth.

Inflation is accelerating in the United States and in the context of a slowdown in the American economy, this perspective has fuelled agitation in the financial markets. Indeed, many price indices reported stronger than anticipated increases mainly due to the increase in pump and housing prices. Nevertheless, the most recent data suggest that salary pressures, one of the most significant risks to inflation, are being curbed. Less significant increases in the cost of fringe benefits, high profit margins and a certain deceleration in the employment market are tempering this risk.



A more modest retreat in American markets when compared to the collapse of international markets.

## International Stock Exchanges

In spite of the significant downturn in world stock markets, the world economy is staying the course: the OECD leading indicator signals sustained growth in the economy. However, several elements of risk still remain, such as the persistently high oil prices, the price of raw materials and higher interest rates. European markets were hit harder than the American market during the second quarter with a setback of 4.9% in France, 4.8% in Germany and 4.3% in Italy. The same indices reported respective year-to-date returns of 5.5%, 5.1% and 2.8%.

In the Euro zone, the modest economic recovery continues and confidence indices are encouraging. Household spending, investment, government spending and

exports have all contributed to the growth of the past few months. The manufacturing index peaked at its highest level since August 2000. Furthermore, industrial growth has accelerated to a pace unequalled in over six years.

In the United Kingdom, the unemployment rate hit at a four-year record high, the increase in energy costs prompting companies to lay off staff. The British index is following the overall trend set this spring and has fallen 2.2% this quarter.

After taking off with a bang at the beginning of the year, with a gain of 5.8% for the first quarter, the Japanese stock market gave up 9.1% this quarter and posted a return of -3.8% for the first half

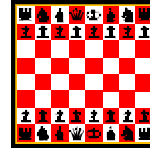
of 2006. The most recent results from Japan are positive, in spite of a slowdown in the pace of the Japanese economy. Consumer spending has increased and residential investment is up. However, public spending is down and exports are not following pace with imports.

In China, supported by increasing revenues, the retail business has experienced its strongest increase in over a year and a half in May. Industrial production has posted its strongest increase in two years. The Hong Kong index ended the quarter with a return of 2.9% and closed the first half of 2006 with a return of 9.4%.



Overseas stock markets were hard hit by the spring setback.

## Review of Portfolio Activities



We have carried out many portfolio transactions during the first quarter of the year: reducing the overall weight of equity, lowering the cyclical composition of our stocks and selling our very long-term income securities. All of these transactions have resulted in our portfolios being worth more today than if we had maintained the status quo.

Following a rather passive start to the quarter, we became more active in June:

- we sold 50% of our shares in Falconbridge, the cash compensation being higher than the then cash offers from Inco and Xstrata. We are waiting for events to decide on the balance of our stock, but we are tempted by the exchange of shares from Inco;

- we doubled our position in Alcan and increased our participation in India by 25% following the drop in prices

resulting from the stock market correction; and

- we extended the average length of our income securities a little, with the expectation of a decrease in interest rates in the long-term.

As we have mentioned many times in our Info Sabius, we believe that the current correction is a classic mid-cycle correction. It is rather difficult to predict when it will stop and at which level it will bring us. Our feeling is that most of the setback in prices is behind us and that the decline should not last longer than the summer. We are confident that the stock market in general will be significantly higher in twelve months than the current level — not 20% more, but enough to compensate for the risk and to beat the current return of some 4 to 4.5% for income securities.

The overall situation encour-

ages us to keep a defensive weighting in equity, i.e. below standard. For example, 43% of the portfolio of our typical customer is composed of stocks, compared to the neutral standard of 50% (and versus approximately 60% at the peak last February before our stock sales).

A very strong percentage of the appreciation in the stock markets during an economic cycle usually occurs at the beginning of the cycle. This is the time to be overweight in stocks, like at the end of 2002. The current period is not at this stage, which is why we are not using fully our abundant cash reserves in spite of the recent correction in prices. Our behaviour could change if the markets decrease even more than we anticipate. A situation we will be monitoring closely.

The decline of the stock market in the past few weeks gives us the opportunity to buy back securities at depressed prices, but we intend to remain prudent.



### THE DALPÉ-MILETTE GROUP IS GROWING ONCE MORE!

The Dalpé-Milette Group is pleased to announce that Annie Dagenais will give birth to her first child (a boy) next October. She will be leaving us in September for a one-year maternity leave.

To make up for the leave and considering the strong progress in our activities in the last year, we have hired Johanne Riel, who will be starting at the end of July. Johanne cumulates twenty years of experience in the financial sector with Desjardins, six of which were spent as an assistant-advisor with an experienced team at Desjardins Securities. In addition to her skills, her customers will appreciate her pleasant and emphatic personality. Johanne will be responsible for customer service.

Congratulations to Annie and Johanne!

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