



# The Quarterly Letter

## The Quarter in Review...

The third quarter of 2006 witnessed a significant rebound in the value of our portfolios, following the downturn that hit the second quarter. As of the end of September, the value of our portfolios was at its highest level for the year.

If the trend continues (and it rarely does!), our typical client should obtain a return of approximately 7.5% in 2006. This is more or less in line with what we predicted at the end of 2005 and typical of a year of economic transition, as we believe is the case this year.

Our portfolios are currently underweight in equity and are awash in liquidity. We are rather confident that, in spite of a likely slowdown in growth, the economy should fare rather well during the next few years.

On the other hand, we are puzzled with respect to the short-term volatility in stock markets, which could tend to exaggerate the negative impact of a slightly underperforming economy. More cyclical securities and the emerging markets could suffer more than others.

This explains our patience in



reinvesting the cash amassed from the sale of some of our equity holdings in 2006. We believe that the risk of major opportunity losses during the next few months is not significant. We continue to be on the lookout.



The Dalpé-Millette Group

Published since 1992

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## Selected Statistics (source: Desjardins Securities And StarQuote)

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
<b>Dec. 2005</b>	3.37	3.92	3.98	11272	10717	1680	0.8580	0.7245	101.13
<b>June 2006</b>	4.30	4.47	4.58	11612	11150	1823	0.8931	0.7117	103.85
<b>July 2006</b>	4.15	4.19	4.31	11831	11185	1840	0.8840	0.6929	101.36
<b>Aug. 2006</b>	4.12	4.01	4.11	12073	11381	1885	0.9025	0.7035	105.54
<b>Sept. 2006</b>	4.16	3.90	4.00	11787	11670	1885	0.8979	0.7078	105.89

## The Bond Market



As many expected, the Bank of Canada announced last September 6 that it was maintaining its overnight lending rate unchanged at 4.25%. It is the second consecutive time that the Bank leaves its key lending rate unchanged since the beginning of the credit tightening cycle in September 2005. Seven consecutive increases of 25 basis points each followed one after the other from September 2005 until May 2006.

The Bank of Canada indicated that after seven consecutive hikes since September 2005, interest rates were sufficiently high to maintain inflation at its target rate of 2%. In general, the Bank of Canada seems to be keeping essentially the same

forecasts with respect to Canadian economic growth and price evolution.

The American Fed announced, during its last meeting on September 22, that it was maintaining its target benchmark interest rate for federal funds at 5.25%. It is the second pause since the beginning of the Fed's current tightening cycle in June 2004. In addition, in spite of the expected slowdown in the American economy, the Fed is concerned by the high level of risk with respect to inflation. In its communiqué, the Fed is clear: some strengthening of monetary policy might still be required due to inflation risks.

In this context, the return on

10-year Canadian federal bonds went from a high of 4.64 % at the end of June to 4.11% in mid-September. Also, the rate of 10-year US treasuries retreated from 5.25% to 4.80%.

Indeed, investors who bought long-term bonds obtained higher returns. For the quarter, the Scotia McLeod index for long-term Canadian bonds posted a return of 8.2% and the Scotia McLeod Universe index obtained a return of 4.8%. In the United States, the J.P. Morgan bond index posted a return of 3.8% for the same period.

The Bank of Canada and the Fed keep rates unchanged.

## The Currency Market



The Canadian dollar has followed a remarkable course these last years, primarily swept along by a worldwide infatuation for raw materials that has fed the demand for Canadian dollars. The loonie soared from 62 cents US in January 2002 to 91 cents US at the beginning of the summer, before retreating a little during the last few months. It is currently trading around 89 cents US.

During the last few months, the world economy has been faced with several setbacks. In spite of these upheavals, the loonie has been able to hold its head high. Since last May, the Cana-

dian dollar has hovered on average at around 89.20 cents US. Its endurance was all the more impressive considering the backdrop of lacklustre economic statistics. First in line among the culprits was the decline, as of May, in the price of several raw materials: petroleum (-17%), natural gas (-20%), gold (-6%) and lumber (-9%).

In spite of its endurance, the loonie is facing headwinds. In addition to the impact of decreasing raw material prices, other factors have come to the forefront such as the erosion of the Canadian trade surplus indicating difficulties with

foreign trade, the uncertain prospects of the world economy and also, the gap between Canadian and American interest rates, which has widened over time. In this context, the loonie is about to undergo a significant stress test.

The loonie is facing headwinds.

## Canadian Stocks



The S&P/TSX experienced a comeback in July thanks to the record highs in the price of oil and of several metals, as well as to the better profits announced by the banks in their third quarter. However, the Toronto index gained only 1.3% this quarter in response to a relapse in the price of oil, gold, and copper following their respective peaks, leaving the index envious of the performance of its North American peers. We should not lose sight however that the share of the energy and raw material sectors within the context of total market capitalization is much more significant in Canada (45%), than in the United States (13%) or in the EAFE countries (16%), making the TSX a vehicle that is more sensitive to the decline in the prices of crude oil and raw materials, brought about by anxieties over economic growth in the U.S. If the American economy slows down, the entire world economy could be impacted. This would, in turn, considerably influence the resource sector, thus having disastrous repercussions on the leading Toronto index.

The quarter can thus be summarized as follows: the share price of oil and mining companies were strongly shaken, but technology stocks and companies producing consumer goods saved the day. As it were, over half of the TSX sub-sectors ended in positive territory.

At the forefront, the telecommunications sector recorded a strong hike of 24% during the last quarter. The telecommuni-

cations services companies and cable operators benefited from a stronger Canadian dollar, which allowed them to buy imported equipment at a better price. Furthermore, the sector put on a good show, influenced by Telus's announcement of its intention to transform itself into an income trust, and investors' hope that BCE will do likewise. In second place, the information technology sector lifted itself into positive territory for the year and ended the quarter with a considerable rise of 23%, motivated in good part by the semiconductor industry. Coming in third, we find the financial services sector, which regained all of the ground lost during the lean months of May and June. The end of a campaign of rising rates is generally good news for banks, which are sensitive to interest rate.

Among the losers, the health sector fell 11% during the last quarter, the worst return of all S&P/TSX sectors this year. However, its quarterly performance is surprisingly comparable to that of the energy sector, which ended for its part with a decline of 10%, making it the most impacted sector this quarter. It goes without saying that the energy sector took a nosedive at the same time as the price of a barrel of oil fell to its current position below the \$60 US mark. Finally, contrary to all expectations, the basic materials sector ended this quarter with a drop of 0.5%, not yet affecting its still significant annual return of 26%.

Recent statistics on the Canadian economy are signalling a deceleration in the second quarter. In general, exports gained some ground, but imports grew even faster, explaining the overall decrease in the trade surplus.

The global CPI increased by 0.2% in August, half of this rise attributable to a leap in the clothing and shoe component and a new strong increase in the owner-owned housing index. From one year to the other, global inflation fell to 2.1%, its lowest level in 9 months. The domestic economy remains sturdy, residential property forcing up inflationary pressure. It is important to note that inflation is a lagging indicator and that as long as real GDP growth stays at its normal trend level or lower, the Bank of Canada will be inclined to continue to tolerate a light increase in CPI. So, with a real GDP growth of only 2.0% in the second quarter, everything leads us to believe that the Canadian economy is currently evolving close to its full potential, giving Canadian monetary authorities a great deal of leeway in their management of monetary policy.

In spite of a comeback in July and August, the TSX posts a quarterly return of only 1.3%.

## US Stocks



A bullish sentiment in the summer has replaced the bearish feelings of the spring. In August, the S&P 500 leapt 2.1%, close to its best monthly performance in 2006 to date, at 2.5% set in January. In spite of the volatility in the stock markets, all of the major American indices ended the third quarter of 2006 higher with gains of 5.2% for the S&P 500, of 4.7% for the Dow Jones and of 4.0% for Nasdaq. These same indices rose by 7.0%, 9.0% and 2.4% respectively to date in 2006.

Expansion in the American economy is slowing down, but the possibility of a recession remains weak, according to most strategists. At the end of the quarter, household spend-

ing, notably those linked to the housing market are decelerating. Several signs of a downturn in the residential real estate market are manifesting themselves in the United States.

The trade deficit has set a new record this summer and this deterioration results from a decline in exports (strongest decline in 10 months) combined with an increase in imports (caused mainly by the rise in the price of oil in July).

The latest labour market results confirm the moderating trend of the last few months. The manufacturing index in August also demonstrates this timid growth of the economy. Figures for American productivity are on

the rise this quarter. However, unit labour costs increased faster than expected (5.0% over 12 months) following the upward revision of workers' wages.

After almost record high prices at the pump in July, oil prices have dropped almost continuously in September, falling to their lowest level in six months, giving some respite to consumers. American reserves are well above their seasonal average, and this has been one of the factors pulling prices down. In short, American markets, being less heavily weighted in natural resources, come out as big winners.

The American economy slows its tempo.

## International Stock Exchanges



The European and Japanese stock markets posted gains this quarter due mainly to the good performance of indices in the month of August. The volatility of the stock markets in September was not in fact exclusive to North America.

French, German and Italian indices respectively gained 5.7%, 5.7% and 5.7% during the third quarter of 2006. The same indices reported respective year-to-date returns of 11.3%, 11.0% and 8.7%. As for the Japanese stock market, it posted a return of 4.0% over the last three months and 0.1% for the year.

Over the summer period, the economic recovery continued

in the euro zone. Germany, the top economic power of Europe, increased its industrial production this summer. The latest data on economic expansion demonstrate, on the other hand, a more modest trend. Moreover, the confidence of Europeans fell faster than expected in August. That of German investors, in particular, fell to its lowest level since 1999.

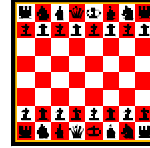
As mentioned in the second quarter, the economy in Japan is getting its breath back after strong growth. Consumer spending pursued its acceleration. Industrial production and net exports are however declining. Chinese growth still exceeds the objectives set. Ex-

ports jumped 32.8% in August, apparently not affected by the gradual re-evaluation of the yuan.

The International Monetary Fund raised its forecast for global economic growth in mid-September, but remains cautious about the potential repercussions of inflation, oil prices and the slowdown in the U.S. housing market.

Overseas stock markets end in positive territory overall this quarter.

## Review of Portfolio Activities



We have not carried out many portfolio transactions over the quarter. In August, we replaced the value of our investment in Falconbridge (the object of a takeover) by an equivalent value in Teck Cominco. We wish to retain our current weight in this industrial sector, convinced that in spite of the current temporary volatility, there are still several good years for basic materials producers.

In September, we also liquidated our investment in Groupe Jean Coutu, which has been part of our portfolio for a very long time. We believe that the sale of its United States operations was an excellent decision for the company, but that the challenge is considerable in order for it to generate significant

growth in its earnings over the next few years. At the current share price, the stock seems to be fully valued.

To date, the year 2006 is turning out to be a difficult one for a portfolio manager. As of September 30<sup>th</sup>, our typical customer (portfolio composed of 50% income securities and 50% equity) posted a return of 5.6% to date, an annual rate of 7.5%. This is rather in line with what we forecasted at the end of 2005. Again in 2006, we exceeded comparable indices for the various segments of our portfolio.

We consider 2006 as a pivotal year, one that is characterized by a slowdown in economic activity and a change of course for central banks (a pause in interest rate hikes or

even a decline). This occurs in every economic cycle and although it is not always easy in the short term to predict the degree of market volatility and how low the markets will go before resuming their upward progression, we are encouraged by the medium-term trend. Our current portfolios are underweight in equity - 42% versus a target of 50% for our typical customers, for example - and we plan to make some purchases soon, taking advantage of our abundant liquidity. A decline in the stock market would even be a good occasion to make some purchases, setting us up for portfolio growth in the next 2 to 3 years.

Few portfolio transactions over the quarter, but plenty of liquidity for us to benefit from eventual market declines.

### N.B.

A few months ago, we announced the departure of Annie Dagenais on a one-year maternity leave. After weeks of procrastination, we are happy to finally welcome to the group Mrs. Chantal Bouchard, who cumulates extensive pertinent experience in our field.

**Members of the Dalpé-Milette Group:**

2 Complexe Desjardins  
East Tower, 15th Floor  
Montreal, Quebec  
H5B 1J2

Fax: 514-987-1214

Marc Dalpé	514-281-8768	mdalpe@sabius.com
Jean-Marc Milette	514-281-8763	jmmilette@sabius.com
Chantal Beaulieu	514-281-8682	cbeaulieu@sabius.com
Chantal Bouchard	514-281-7401	cbouchard@sabius.com
Annie Dagenais (on leave)	514-281-8709	adagenais@sabius.com
Anna Gastaldi	514-281-8715	agastaldi@sabius.com

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# Info Sabius



For our clients who wish to obtain more information about financial markets as well as the views and thoughts which direct our portfolio management decisions, our Info Sabius meets these requirements. It is sent on a daily basis either by fax or by e-mail to our clients who wish to be kept abreast of their portfolios and the many issues which affect them. Please do not hesitate to contact us should you be interested in receiving it.

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