RIDING OUT THE STORM

As you know, we have for some time believed that the apparent ongoing bull market was really, since April 1998, a stealth bear market camouflaged by a few mega cap stocks making new highs and by the ridiculously overvalued tech stocks which comprise the NASDAQ Index. Most stocks have been in decline for 2 years and we believed that the insane, liquidity driven bubble would end, likely in an ugly fashion as fear replaces greed.

We suggested that this so-called "bull market" was like the Emperor who wore no clothes and, indeed, the action of the past few weeks has confirmed to us the Emperor was, indeed, in the buff. We believe it will become evident in the near future that the bull market has clearly ended. We believe that the coming bear market is likely to affect the real economy as North American consumers already spending all they earn will naturally cut back and that the bear market will spread globally to all the world's overvalued markets. The US economic engine will stall and any slowdown will spread to Asia, Latin America and, of course, to Canada where we are so dependent on exports to the US.

Even though tech stocks are the fastest growing area, they are not immune to cutbacks in consumer and capital spending. The new economy depends on the old economy too—50% of capital spending goes for information technology. Declining revenue and earnings growth will be a killer for technology companies trading at ridiculously high price to earnings ratios. Even though most tech stocks are off their highs, and most internet type stocks greatly so, much worse is to come. Most internet companies lose money and depend on Wall Street to finance those losses. When the bear market is here in earnest, that capital will not be forthcoming and many of these companies will be bust. Many others will lose up to 90% from their peak prices.

We confess to being somewhat ambivalent about the nature of the ensuing bear market in terms of its potential severity and duration. That this market is incredibly overvalued is not at issue. At its peak of 5048 the NASDAQ traded at 190x earnings. At ½ of its peak therefore, it would still, to us, be expensive. The technology leaders such as Nortel, Cisco, Oracle and Sun are overvalued and we are short some of them. Slowing top line growth at Microsoft, Intel and IBM may be the tip of the iceberg. The recent flight to old economy Dow Jones' type stocks should also prove to be an ill-fated reaction as many of these are overvalued, including GE (45x earnings), Disney (58x), Wal-Mart (41x) and most financials and brokers whose earnings we believe are cyclically set to decline. When this recent relief rally is soon exhausted, investors will continue to sell rallies until the point where the once profitable market is feared, loathed and thoroughly discredited as a place to make money. However, our extreme bearishness, as we have written before, has been tempered by the fact that most stocks have been declining for some considerable time, small caps for almost four years. So maybe, as our colleague Martin Braun thinks, we are already in the eighth inning and the decline of this last group of overvalued stocks could be fast and furious, maybe over in just a few months.

In any event, lots of exceedingly good value exists among the stocks that have underperformed for so long. Such groups include the retailers, the apparel manufacturers, the resource stocks, including the oils and gas (despite terrific commodity prices), the base metals and the golds.

We have been finding some good buys among them. In the retailing group, we bought and sold TJX for a quick 30% gain (and are looking to repurchase it on weakness) and have now recently bought Abercrombie & Fitch, a hot retailer which trades only at about 8x 2000 estimated earnings, grows its earnings at 30%, has no long-term debt and $160 million in cash which it has been using to buy back its depressed shares. In the oils, we bought and sold Anderson Oil and Ranger Oil at profits (the latter a little too early as it is now the subject of a takeover bid).

We are looking to add to our oil and gas weighting with a Canadian gas producer as we believe high gas prices will prevail for some time and that many profitable takeovers and mergers will occur in this area (à la Anderson's takeover of Ulster, Petrobank of Ranger and Alberta Energy of Westpoint). In the resource area, we have bought a little of copper producer, Aur Resources.

We just bought Bristol Myers when it cracked excessively on news it was withdrawing an important new experimental drug from its NDA filing with the FDA because of potential side effects. We think it will trade higher with the improving drug group when the realization settles in that the magnitude of the downside move was unwarranted.

If in this market we can buy **great** companies at **good** prices, we will. Bristol Myers is a great company selling at a good price. We have also been buying some IMAX Theatres which we think is an excellent growth story trading at a good price. And conversely for clients that allow it, we have been hedging by shortselling less than great companies at bad prices (E*trade, Ameritrade) and even great companies at bad prices (Oracle, Cisco, Nortel, Citigroup, Schwab).

At the bear market extremes we think are coming, we should be able to buy **great** companies trading at **great** prices and so we're husbanding cash for that purpose.

Our cash has been augmented by sales and certain special situations. In the quarter, SMK (Speedy Muffler King) paid an extraordinary dividend of $2.10 per share and its parent, Goldfarb, in turn is paying out $5.50 per share on April 28, 2000. We believe that Goldfarb, post dividend, should still be worth $13.00, a potential gain of over 100% in the 18 months we anticipate for the liquidation of Goldfarb, with little market risk.

Many of our stocks performed well in the last quarter. We took profits on Cryptologic all the way up to near its high of $68.00 and with it trading at less than half of that now will add to it again around $25 because it will again be very cheap at that level. We reduced our weightings significantly at higher prices in Lorus Therapeutics (which is just raising $40 million to add to its $14 million cash on hand) and in Advantex which is also now well financed, and in both of which companies we still have great confidence for the future and may also add to at lower prices. We purchased and have been selling Architel Systems, an undervalued fast growing company which provides solutions to telephone carriers allowing their customers quicker access and cost reductions, and it is now being acquired by Nortel for shares, which we believe to be overvalued and are accordingly shortselling in advance.

We will look to acquire other fast growing technology companies at good prices as the markets decline and which could be takeover targets. Indeed, we believe that Cryptologic, Lorus and Advantex may all be in that category.

It is ironic that, bearish as we are, this last quarter was so strong for us, that, as they say, "we shot the lights out." But now that the lights are out, we believe we need to be ultra careful in the dark.

We believe corporate earnings for this cycle are peaking and that the red hot economy will indeed soon show evidence of slowing. The bulls can't win because the Fed won't let them by continuing to raise interest rates and reduce the supply of money. So liquidity, the lifeblood of financial assets, is being reined in. Unless the market crashes, interest rates are sure to continue to rise until there is evidence that the economy is slowing and inflation is no threat. Looming inflation remains a serious problem affected by high oil prices, rising food, housing, and raw materials prices and a very tight labour market (the jobless claims rate in the US the lowest in 26 years). Purchasing manager surveys indicate pricing power not seen in some considerable time. And there is some indication that the productivity improvements in the latter half of 1999 have been overstated by extraordinary computer purchases relating to Y2K and that a negative surprise may occur with the first quarter US productivity numbers to be released on May 4th.

With record trade deficits and maybe, going forward, declining budget surpluses (from the slowing and inflating economy), the US dollar is at risk. If it declines, so will domestic stock markets as foreigners repatriate their investment funds and, then, as the market declines, so in turn should the dollar. A classic vicious circle. We don't think it is that the dollar has been strong, but that other currencies, especially the Euro, have been weak. Rising interest rates in Europe to support their currencies will make their markets and economies precarious too. Watch for a reversal or even a flight from **all** currencies to gold as investors seek the ultimate safe haven. History shows gold tends to do better at the end of financial asset inflations. And we've just had the mother of all financial asset inflations.

Rising interest rates, rising inflation, an overvalued dollar and peaking earnings and growth rates are not healthy for a grossly overvalued market. The warning signs are there.

Some further gratuitous thoughts. We suspect that the next few years or even months could indicate some shifts in the political climate, especially if the world economy slows. There could even be some turmoil. With the incredible wealth being so quickly created in the stock market and glorified in the press, the disparity between haves and have nots is becoming accentuated and can be politicized. Problems in health care and affordable education are becoming greater concerns. The industrialized world may tend to move increasingly left and government spending may again supersede debt reduction and even tax reduction as desirable political goals, with negative outcomes for government budgets and the business environment.

International risks may also increase from, say, China over Taiwan, tensions between India and Pakistan, instability in Africa, Asia and Latin America, terrorist activities from Afghanistan, problems in the European Union, financial and banking crises from the huge unregulated financial derivatives and Eurodollar markets and, Lord knows, from whatever else. Scary populist demagogues such as Heider in Austria or even Buchanan in the US and political turnovers, such as recently in Italy, will become more prevalent. So will labour unrest. Free trade may become less free. Beggar thy neighbour currency devaluations might be the vogue. Slowing economies and higher inflation will stimulate these shifts. Chretien may be well advised to get out while the going's good. So should investment guru Abbey Joseph Cohen and internet gurus Henry Blodgett and Mary Meeker who we suspect will go the way of former extinct species like Joe Granville, Henry Kaufman and dodo birds. What did Andy Warhol have to say about fleeting fame?

But, all in all, this can't be good for a market which is priced too high for negative surprises, whether they be economic, financial or political. We don't like surprises so we're getting ready. On the other hand, we believe in the long-term potential for equities and hope that we're sufficiently alert to take advantage of the good buys as they occur.

In the meantime, our main goal is to preserve capital and so we will hold some cash, some stocks unrelated to the direction of the overall market (e.g., Goldfarb, Mirage Resorts being taken over for $21 per share by MGM Grand), some cheap stocks that have had their bear markets, (Abercrombie & Fitch, Talisman, Ocelot, Triumph), gold stocks which typically move inversely with the market and income producing securities (Gulf Preferred, Residential Real Estate Income Trust). For accounts that allow it, we will hedge with some shortsellings. And we will continue to pick up quality companies, like Bristol Myers, as they meet our value criteria. Hopefully, the storm is over quickly because the real money will be made when the clouds clear.

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