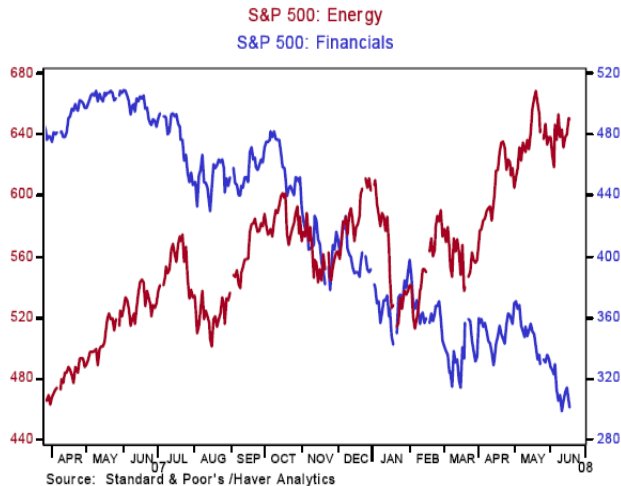


'Pete's Tax'

Chart 8: S&P 500: Energy vs financials

INFLATION IN ENERGY VERSUS DEFLATION IN FINANCIALS



Source: Standard & Poor's /Haver Analytics

Source: Haver Analytics, Merrill Lynch

The above is the 'one man's meat is another man's poison chart'. What is good for oilmen is not so good for bankers. Our proposition is, this is about to change and the shift will result in higher interest rates.

David Rosenberg of Merrill Lynch set out this S&P 500 energy/financial chart in a recent North American Market Memo. You might think the chart suggests the rise in energy stocks (red line) is sapping the bank stocks (blue line).

Well, it is. The exponential rise in petroleum prices is imposing a global tax on energy users. Rising prices of natural gas and oil directly offset the US Treasury's tax rebate to the US taxpayer and to the low interest rates provided commercial banks to restore their capital.

Concurrently, petroleum prices are reducing consumers' discretionary spending power. They are reducing the consumers' ability to pay their mortgage interest, and are raising raw material costs to corporations, and crimping their profit margins.

The falling bank index is indicative of the continuing and debilitating impact of 'Pete's Tax' on all of society. Therefore, bank loans are becoming riskier. At the same time, many international banks are holding loans far in excess of a prudent ratio to their shareholder capital. The obligation to reduce their loans, the act of de-levering, increases systematic demand for capital, hence rising rates.

The regulators now must be pondering the risks associated with allowing the price of energy to continue to rise on the back of low interest rates, and

continuing to allow the price of money, two to three per cent to be at a discount to anticipated inflation of four to six percent, or negative real interest rates.

After all, if as an investor or saver you suffer the loss of purchasing power for holding your money in bank savings accounts, in bonds or money market instruments, you will naturally buy the alternative assets that you anticipate will offer a promise of holding purchasing power. You will reduce your liquid assets again putting pressure on rates. In sum, the effort to save the commercial banks with low interest rates has given a massive push to global inflation. This, the regulators are starting to recognize.

Rising inflation, rising energy prices and diminished savings trends need to reverse. We think they will...and right now. The markets are getting a whiff of the possibilities of the reversal. After their winter surge, equity markets are falling. A reduction in petroleum prices and an increase in real administered rates is about to begin. Or, at the very least, the jawboning has begun.

Last week China joined the list of nations reducing petroleum subsidies. China's reduction in 'consumption incentives' caused some slippage in energy stocks, a dominant industry in the Toronto composite index. More important than diminished subsidies is the new tone of the central bankers.

The Globe and Mail reported last week that Bay Street's honeymoon with the new Governor of the Bank of Canada was over. He neglected to cut his lending rate by 25 basis points as predicted, and he had the temerity to do so without alerting 'the Street' of his change of mind.

Mark Carney knows that negative real interest rates serve to liquidate money and savings. In North America, we have effectively eliminated the incentive to hold savings. We think that is about to change. He also knows that very high real interest rates will serve to liquidate hard assets and a hint of a move to raise rates can serve to put a top on the commodity run. With North America's very low nominal and real interest rates, he knows that we run a risk of creating the conditions for hyperinflation. Now, Mr. Carney's change of heart is a sign we should expect short-term rates to remain as is or rise.

He joins the central bankers of Europe, Great Britain, and the US in that sentiment. India and Mexico have raised rates.

January's equity market lows are likely to be broken as rising rates conflict with already high, energy prices. Market gloom will be justified by falling share prices, an opportunity for well-positioned investors.