Small Cap Update

May 30th, 2008

Darren Dansereau, CFA

What inflation?

Mark Carney, the relatively new Bank of Canada governor, dropped interest rates 0.5% at the end of April. In their release, the Bank of Canada stated: “The Bank is now projecting a deeper and more protracted slowdown in the US economy. This has direct consequences for the Canadian economic outlook, with declining exports projected to exert a significant drag on growth in 2008.”

What are the inputs the Bank of Canada is using in their projections? We are inundated with references to a drop in US housing prices and global credit issues. The other issue gaining prominence is inflation.

According to a recent article by Bill Gross, inflation in the US is even higher than reported. Bill Gross is a bond guru at PIMCO, one of the largest bond managers in the world. He outlined three changes the US Bureau of Labor Statistics (BLS) has made to the US CPI calculation. These differ from most other countries.

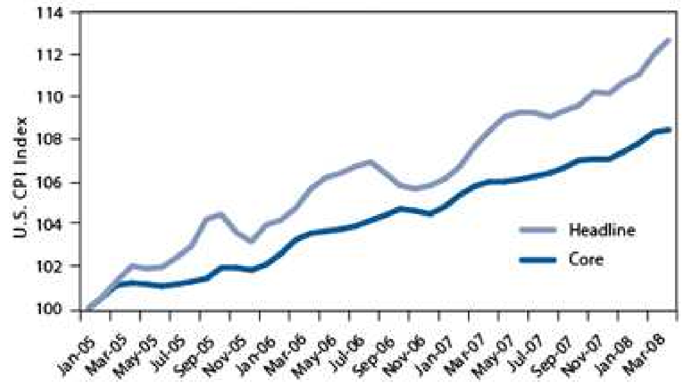
The first of these changes was made in 1983 to the housing calculation. The CPI calculation uses owner equivalent rent rather than house prices. This measures what an owner could get for renting out their house. The problem is the price of US housing has gone up by 3 times that of owner equivalent rents. The result: lower reported inflation.

The second is the substitution effect. The Bureau of Labor Statistics claimed more expensive goods would be substituted with lower costly alternatives when prices were rising. For example, if pork tenderloin is increasing in price, consumers will switch to Spam. Again, this would result in lower reported inflation.

The last is the most interesting; hedonic quality adjustments. This suggests that when the quality of a product such as a computer goes up, the price of the computer goes down. As an example, if the cost of a computer went up by 20%, but the speed doubled, the cost for the CPI calculated would actually **decline!**

In Canada and the US there are two types of reported inflation: headline and core. The core takes out the most volatile components, food and energy. The exclusion was to ensure the CPI numbers were not leaping up and down over time due to their volatile nature. We have seen a problem in both the US and Canada over the last few years. The headline inflation, which includes food and energy, is moving above the core level at and increasing pace. This is displayed in the chart on the right. The US government focuses on core inflation. Monetary policy based on this measure is not factoring the inflation experienced by American consumers and businesses.

Higher actual inflation in the US than what is reported creates problems. Social security and wage settlements are usually adjusted based on inflation. If these adjustments are lower than actual inflation, an employee will experience a reduction in their disposable income. Since US consumer spending makes up 70% of US GDP, this would slow the economy.



Source: PIMCO, Bloomberg, BLS

The tight consumer credit markets, the lowest consumer confidence in the US since 1973 and growing inflation result in Bank of Canada’s concerns.

The question is - how does an investment manager make money in this type of market? In his 1838 best-seller, *Theory of Natural Selection*, Charles Darwin made a statement which can help answer this. He stated “For survival, it is the ability to adapt to the changing environment that matters more than the environment itself.”

In terms of individuals, the globe and mail reported 44% of workers have changed their daily commuting habits. They have decided to car pool, telecommuting and even changing their schedules so they work 4 days rather than five. They have adapted.

In the corporate world we are seeing the same types of changes. For example, retailers have asked General Mills to reduce their packaging sizes. The result has been a reduction in paper costs and fuel costs as a truck can carry more boxes. Unfortunately, the cost of Cheerios will not go down, but it should go up less than if General Mills did not adapt to the environment changes.

We continue to invest in companies, who are in a better position to adapt to changing environments. Even if we do see a continued slowdown and growing inflation in the US and Canadian economies, our companies will continue doing what we expect them to do. We expect them to make capital decisions focused on a reasonable return for the risk taken. We also expect them to cut costs to fight the effects of cost inflation.