Offence wins games, defense wins championships…
Time to be defensive!

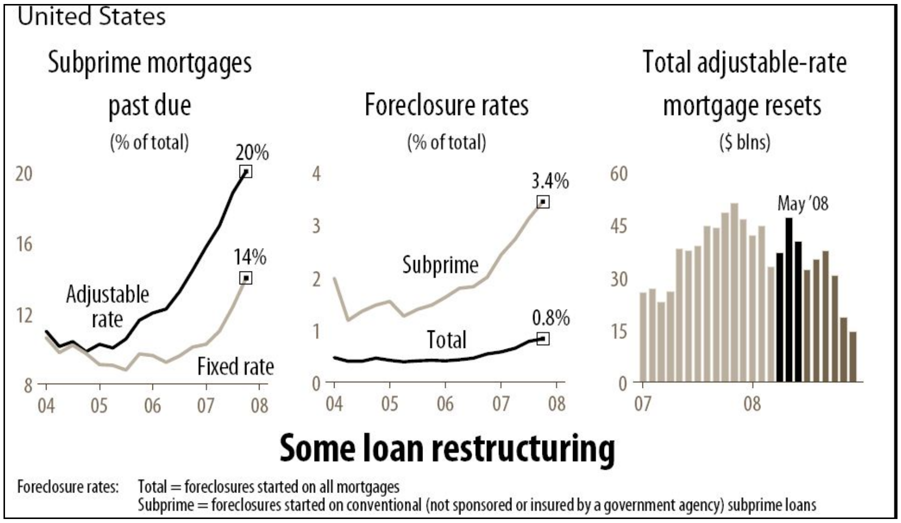
The last six months have been a nerve-racking rollercoaster ride. The financial crisis and its lack of transparency evolved further in the last quarter, raising uncertainty and investor anxiety. In our last newsletter, we tried to explain in laymen's terms how subprime loans worked and how they became the financial system's worse nightmare (you may refer to it if need be). In this newsletter we will highlight some "known" examples of the harsh reality that some institutions are facing today, but first we will explain how this "lending bubble" came to be and why financial institutions became addicted.

When the World Trade Center was attacked on September 11, 2001, America's response was to declare war on terrorism and show the world how financially strong America really was. With the intervention of the Central Bank, the U.S. kick-started the economy by slashing interest rates to their lowest level in 40 years and then kept them low for over 3 years. Easy money allowed consumers to spend and invest, some more wisely than others. It also attracted speculators, namely in the real estate market, where leverage is widely used and accepted. Bankers and mortgage lenders became excessively greedy as real estate values grew along with demand. The lack of regulation in mortgage lending in the U.S. pushed the competition to lend up to 105% of real estate market values, with mortgage rates at a discount to prime for one to two year duration, and no principal payments. These "pre-approved" methods of financing further stimulated speculators. As your house value increased, your friendly banker offered you yet additional capital against your mortgage, either to buy your dream car, boat, jewelry, etc. or to speculate in real estate to buy another property.

Osama bin Laden must have been impressed of how fast and how strong the economic recovery was for the next five years! I wonder if he was planning on America to self-destruct!?

This excessive use of leverage is now coming back to haunt us. Today we have speculators and overly indebted home owners that are being foreclosed in record numbers (see Graph #1).

Graph #1



Source: BMO Capital Markets Economic Research, March 2008

Currently an estimated one-in-ten (or eight million) households owe more than their house is worth, making it harder to refinance. This is the exact vicious circle that we highlighted to you in Newsletter # 32 (pg. 2 and 3); an increasing amount of foreclosures negatively affects the real estate market values, which in turn causes more foreclosures. Perhaps what we underestimated was the strength of the imagination of this new breed of “PHD financial engineers” that redefined the word “leverage” and created a whole new set of acronyms that basically allowed a financial institution to “re-structure” and to “re-finance” distressed mortgage portfolios generating an additional fee (i.e. larger profit for the firm). Of course, the rating agencies (S&P, Moody’s) would get a piece of the pie as they are not government-controlled, or regulated, for that matter. So from the original problems that occurred in some RMBS (residential mortgage-backed securities) came the CDO’s (collateralized debt obligations) to the rescue. The growing default rate on CDO’s in 2007 brought about a new string of acronyms, on and off bank balance sheets, such as SIVs (structured investment vehicles) and VIEs (variable interest equities) and ABCP (asset backed commercial paper). It seems that our new breed of financial engineers has created a monster with nine heads which grows two new heads to replace one lost in battle.

These new investment vehicles are found today in most financial institutions, and the flight of investors to quality (government bonds) has killed their liquidity and consequently their value. Those financial institutions caught holding the bag (i.e. a worthless mortgage-backed portfolio) could find themselves in trouble if they cannot meet the minimum capital requirements imposed by law. It is important here to remind you that Canada has one of the most restrictive bank Acts in the world and one of the most stringent capital requirement policies. Although some Canadian banks are more affected by this crisis than others, they all remain on very solid financial grounds.

One of the recent casualties that resulted from the extensive use of these leveraged products is a European mortgage lending company called the Carlyle Capital Corp. After it became public in July 2007 at $19/share, it used its $670 million in equity and lent some $21.7 billion dollars in mortgages (or 32 times its equity) through loans from Merrill Lynch, Bank of America and Citigroup. Obviously, when times got tough, the banks kept pouring good money after bad to try to save the company, but in vain. Bad loans of this nature are uncovered regularly and losses are piling up everywhere. Those U.S. banks mentioned above did not assume 100% of these loans. They re-packaged them and sold them with higher yields to other banks worldwide, which explains the contagion. This example also shows the extent at which some collateral was re-used several times in order to spread the risk, but in hindsight, spread the contagion. Would anyone lend you 10 million dollars on your $300,000 mortgage-free house? No wonder that in today's circumstances banks no longer want to lend to one another! There is simply no trust left between them. As a result, despite the Fed's actions of cutting interest rates in order to facilitate credit and provide needed liquidity, the London Interbank Offered Rate (LIBOR), which represents the rate used by the banks to lend to one another, was actually higher than the Fed's fund rate. In response to this logjam, the Fed had to become creative. In conjunction with the European Central Bank (ECB), the Bank of Canada, the Bank of England and the Swiss National Bank, the Fed introduced a new measure called the Term Auction Facility (TAF) in the U.S., that ensures the availability of funds at the Fed Fund Rate in exchange for a wide variety of collateral including "toxic" mortgage debt paper. This intervention allowed LIBOR to be realigned with the Fed Fund Rate which means that real rate relief was getting to borrowers.

Although the Fed's actions brought temporary relief to markets, it was facing yet another crisis. Bear Stearns, one of the world's largest investment houses, was caught "bare naked". Its sudden liquidity crunch forced the Fed to intervene once again. The Central Bank's role is to lend to chartered banks and act as the Bank of banks. It is not meant to bail out financially distressed companies unless its intervention is deemed to be essential to maintain an orderly and stable financial system. J.P. Morgan Chase, Bear Stearns' banker, was used by the Fed to flow through money to Bear Stearns to bail them out. This kind of intervention by the Fed has to be approved by a special committee before it can proceed. The last time the Fed used this last resort clause was during the great depression to avoid bank "runs" and to provide financial stability. The failure of Bear Stearns brought an opportunity to J.P. Morgan Chase to acquire all or part of Bear Stearns for next to nothing. The cleansing in the financial services sector will continue for a while and opportunities will arise as we move on.

The Fed also said it would lend U.S. treasuries for a 28-day period through a new "term securities lending facility" – yet another facility where the

Fed would accept as collateral AAA rated mortgage securities sold by mortgage lenders (such as Fannie Mae and Freddie Mac) and of course by banks, as they have become illiquid. The creation of this new “facility” had the Dow rally 417 points on March 11, 2008. A few well-known and respected money managers and economists (Dennis Gartman, among others) pronounced their belief that the worse of the financial crisis was now behind us. It is their view that the Fed was creative enough in providing all kinds of facilities to temper the financial crisis and restore investors confidence. Although the financial crisis seems to be under control, the economic outlook might suffer some consequences. Let’s hope that further crisis management by the Fed will not be necessary.

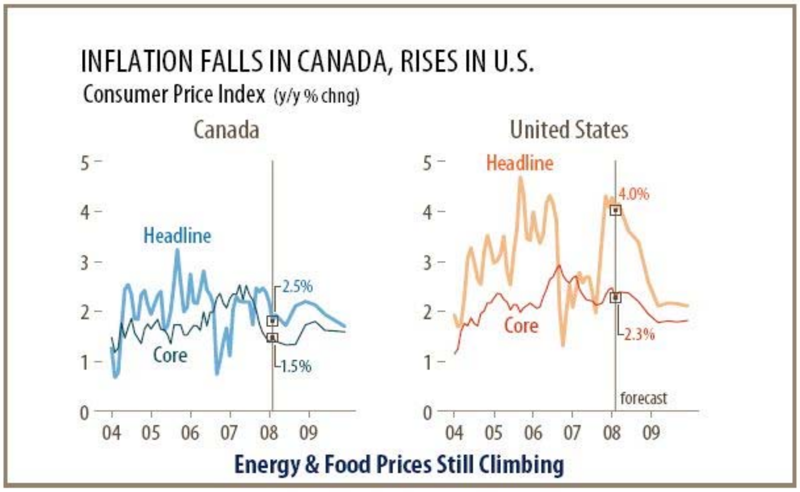
The Bush administration’s fiscal stimulus of $170 billion will reach 130 million American households in May of this year. Although this may not be the last government intervention, it will be the last for President Bush as he leaves office later in November. We believe that the combination of the monetary and fiscal stimulus could get the job done…but at what cost?

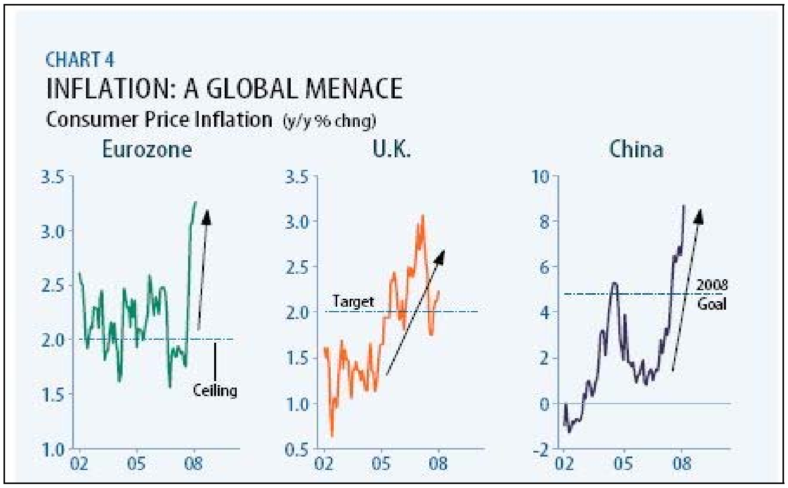
Attached to these “parachutes” come “huge money printing machines”. The U.S. dollar is getting diluted at warp speed. The depreciating US currency has a direct impact on all commodity prices (as they are priced in US dollars) and imported goods (nearly 70% of American consumption is imported goods). As covered in the last newsletter, inflation may be a lesser evil than a lasting depression. But once the financial system is stabilized, the fight against inflation will be at the forefront. Meanwhile, interest rates have fallen to a level so low that bonds and other fixed income instruments provide a negative “real” return to investors (net of inflation) for the first time in decades. Although it may seem secure to reduce exposure to stocks in favor of bonds in reaction to the current financial crisis, be aware that your purchasing power is eroding. So inflation complicates investing.

Looking at past history, equities have always shown an ability to generate positive real returns, due to the ability of corporations to pass on at least some of the increases in input costs to selling prices. However, equities too have a much more difficult time in periods of inflation. Underleveraged and debt-free companies tend to outperform their counterparts through those difficult times.

Inflation is now appearing in most countries. Europe’s inflation has reached a 14-year high at 3.2% while Australia is at a 16- year high at 3.8%. The headline inflation in the U.S. is also approaching a 16-year high at 4.3%. Singapore reached a 26-year high at 6.6% and China, an 11-year high at 7.1%. Meanwhile, Canada has been spared a sharp hike in inflation to date, as the strength of the loonie offset higher cost of imports in U.S. dollars (see Graph #2). But with the Canadian and U.S. dollar now at parity, the disinflationary effect of the rising loonie will dissipate.

Graph #2





Source: BMO Capital Markets, Focus March 14, 2008

Hard commodities such as energy, base metals, gold, etc., have a tendency to adjust rapidly to U.S. dollar changes, especially if capacity is tight and demand is strong. What we are witnessing today is a surge in world demand as emerging markets expand, after a prolonged period of oversupply that lasted 20 years and that resulted in a series of closures and a wave of consolidation. Soft commodities (grains, corn, milk, etc.) however remained in oversupply until the new Chinese middleclass increased their demand for meat, and the Americans increased their ethanol content in car fuels in order to reduce their dependency on foreign oil (see Newsletter #37). The combination of those two factors depleted the excess supplies of many basic food commodities and is now at the forefront of new inflationary pressures. The use of food for fuel could not have come at a worse possible time. Fortunately, North American farmers (the largest supplies of grains and seeds in the world) have benefited of 18 years of crops without a significant drought. Now that supply is being squeezed by demand and that inventories have reached historical lows, we will not be able to ship any excess food supplies in the event of a world catastrophe (tsunami, earthquake, etc.) See Table #1

Table#1

World Supply & Utilization of Major Crops, Livestock, & Products

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
						Million units			
Wheat									
Area (hectares)	215.4	217.6	214.7	214.6	209.6	217.2	218.5	212.3	217.5
Production (metric tons)	585.8	581.5	581.2	568.4	553.5	625.1	621.5	593.2	605.0
Exports (metric tons) [1]	113.4	101.5	105.7	105.6	108.4	110.7	116.2	110.7	106.9
Consumption (metric tons) [2]	585.1	584.2	585.4	603.7	587.5	606.9	624.4	615.8	619.6
Ending stocks (metric tons) [3]	208.5	205.8	201.6	166.3	132.4	150.6	147.6	125.1	110.4
Coarse grains									
Area (hectares)	299.7	296.8	301.5	293.3	306.4	299.8	300.8	303.7	315.0
Production (metric tons)	877.7	862.5	894.1	875.4	916.1	1,015.8	977.3	979.7	1,056.2
Exports (metric tons) [1]	104.9	104.1	102.0	102.1	103.2	100.9	107.1	116.5	120.2
Consumption (metric tons) [2]	882.3	884.2	906.9	903.0	945.8	978.2	991.5	1,008.6	1,063.3
Ending stocks (metric tons) [3]	232.8	211.2	198.3	170.7	141.0	178.6	164.4	135.5	128.4
Rice, milled									
Area (hectares)	155.3	151.7	150.6	146.0	148.3	150.6	152.6	153.0	153.6
Production (metric tons)	408.9	398.7	399.3	377.8	391.6	400.5	417.6	418.2	422.9
Exports (metric tons) [1]	22.8	24.1	26.9	28.7	27.4	28.5	30.2	30.9	29.4
Consumption (metric tons) [2]	399.7	395.1	413.1	407.6	413.0	408.1	415.6	420.0	422.5
Ending stocks (metric tons) [3]	143.5	147.2	133.4	103.6	82.1	74.5	76.5	74.8	75.2
Total grains									
Area (hectares)	670.4	666.0	666.8	653.9	664.3	667.6	671.9	669.1	686.1
Production (metric tons)	1,872.4	1,842.7	1,874.6	1,821.6	1,861.2	2,041.4	2,016.4	1,991.1	2,084.1
Exports (metric tons) [1]	241.1	229.7	234.6	236.4	239.0	240.0	253.5	258.0	256.5
Consumption (metric tons) [2]	1,867.2	1,863.5	1,905.4	1,914.3	1,946.3	1,993.3	2,031.5	2,044.3	2,105.4
Ending stocks (metric tons) [3]	584.9	564.1	533.3	440.6	355.5	403.7	388.6	335.3	314.0

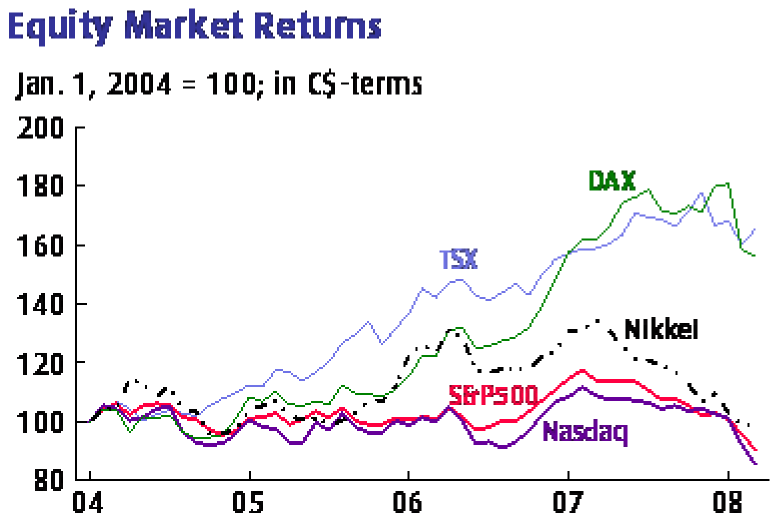
Source: USDA Economic Research Service, Agricultural Outlook: Statistical Indicators, March 2008: http://www.ers.usda.gov/Publications/AgOutlook/AOTables/

Can you imagine if 2008 turns out to be the year of the drought in North America? According to dendrochronologist studies (experts in analysis of tree ring growth patterns) droughts have occurred every 19 years on average in North America. It usually follows a year with a drought in the U.S. southeast, which we had last year (Lake Lanier, near Atlanta is 16 feet below normal level) and usually happens when the warm waters of the Pacific Ocean recede (i.e. La Niña), which should occur this year. The increasing probability of a drought is more than ever a cause for concern and should be taken into consideration in our investment strategy given the rock bottom inventory levels since decades.

The evolution of our investment strategy

In the past few years we have been raising many red flags in regard to the state of the U.S. economy and its vulnerability. Accordingly, we have raised the fixed income component in an orderly fashion from an average of 15% three years ago to 30% today (these weightings vary from client to client depending on individual investment profiles and risk tolerance levels). Furthermore, we have significantly increased our gold exposure in response to our lack of confidence in the U.S. currency and economy. Fortunately, we have also avoided the U.S. equity markets for the same reasons. In fact, we have kept most (in excess of 90%) of our investments right here at home, in Canada. The following graph provides you with the rate of return, in Canadian dollars, of other major world markets over the last five years.

Graph #3



Source: BMO Capital Markets Economic Research, March 2008

Canadians who have resisted investing in foreign countries during that time period, given all the publicity supporting the expansion of investment horizons in this new global economy, have been well compensated. Although this strategy is not a permanent one, it is one that provided Canadian investors the means to participate in the emerging markets expansion by minimizing currency risk. Canada is a large producer and exporter of energy and raw materials to China, India and other emerging countries.

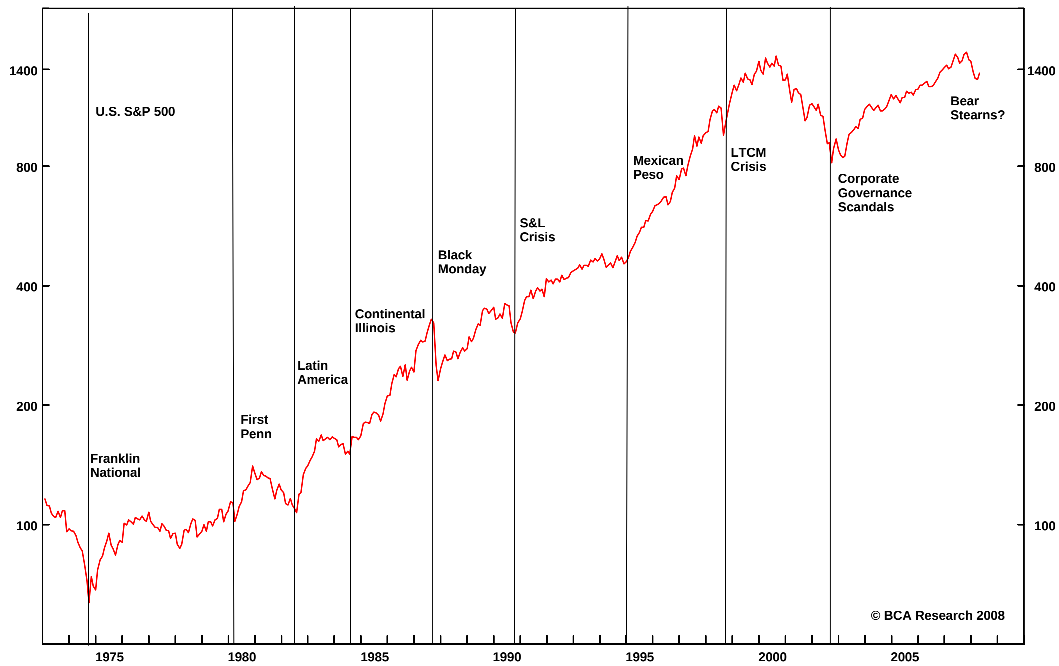
Although the TSX had a positive performance in 2007, it was the result of no more than seven companies out of 303. If you had missed out on all seven, chances are your performance would have been negative. In other words, the TSX as measured by the other 296 companies had a 0% performance in that year. It was the beginning of the current financial crisis that cause the uncertainty and hence the lack of confidence to drive the markets further.

This year to date was probably one of the most volatile in history. “March Madness” will no longer be attributed to basketball only; Equity traders, hedge fund managers and stock speculators had their own. Let’s hope it doesn’t become an annual event.

Conclusion:

Although there is a lot of uncertainty in the marketplace, there are situations that seem to be more predictable. The current financial crisis and inflation are causes for concern, but they also provide a direction on what sectors we should overweight and underweight. Fear and emotion should never determine your investment decisions. Table 2 demonstrates that historically financial crisis brought the best buying opportunities for long-term investors. Most of these crisis resulted in the bankruptcy of a major financial institution which signaled the beginning of a new bull market.

Table #2

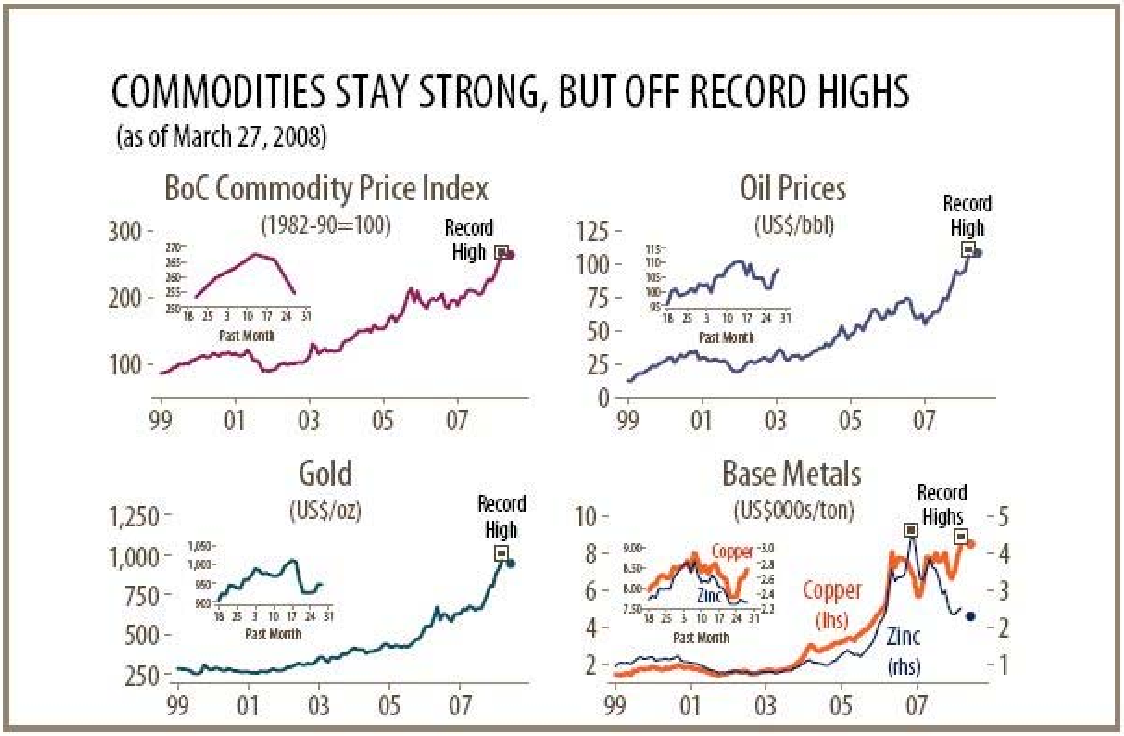


Source: BCA Research, Global Investment Strategy-Weekly Bulletin, March 20, 2008

The markets have rebounded from their March lows with the belief that the financial crisis was dissipating, but the eventual return of inflation might do the exact opposite in the quarters to come. In view of that risk, we believe it is wiser for an investor to prioritize “preservation” of capital over “growth” of capital until inflation is officially kept in check. This strategy is defined by an overweight position in fixed income (as a function of your personal risk tolerance), and inflation-sensitive stocks such as:

Gold ± 6% (Agnico Eagle, Barrick Gold, Goldcorp, Virginia Gold Mines)
Energy ± 10% (Suncor, Canadian Oil Sands, Petro Canada, Encana, Crescent Point Energy)
Agriculture ± 4% (Viterra, Market Vector Agribusiness ETF)
Base metals ± 5% (Tech, Sherritt Int'l, Quadra Mining)

Graph #4



Source: BMO Capital Markets Research, North American Outlook, March 28, 2008

Consumer staples (± 4%) and to a lesser degree, pipelines and electrical utilities (± 8%) should also provide stability and generate a good income flow. Stock selection should reflect very low debt levels as companies struggle to pass along their increasing production costs to consumers, let alone financing costs. In times of deflationary or disinflationary environment, the use of leverage can enhance profitability as interest rates usually fall. Adversely, inflation tends to push interest rates higher impacting financial and production costs.

Another sector that we believe should not be overlooked in the current commodity boom is water. Only 3% of the world's water supply is drinkable while demand has grown at twice the rate of the population according to the World Water Institute. Given the depletion of most agricultural commodities and the

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*Excerpts from the Canadian Equities Guided Portfolio, March 2008

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