

Tough Love

It has been a long week back from the long weekend. The TSX has been plunging, down approximately 9% since the beginning of the week. Energy and basic material equities have fared the worst, following the underlying commodity prices down. The commodity bulls have been quiet, and one bull in particular has been silenced permanently. Ospraie Management announced Wednesday that they were shutting the doors on their multi-billion dollar commodity fund after being down 27% in August. We expect more announcements of this nature as the impact from high volatility and declining asset values takes their toll.

Within the commodities space we have been watching copper closely. It is used in so many industrious applications that it is often referred to as "the metal with a PhD in Economics". Copper prices have declined close to 25% from highs reached earlier in the year and appear to be trading in a pattern of lower lows and lower highs. Copper's technical price action confirms a few things for us. First of all, it confirms that we are in the midst of a global economic slowdown. The world has not decoupled from the US and the issues that impact the US economy are grinding away at other economies as well. We are starting to witness copper inventory builds in Asian warehouses. Not coincidentally, China, which is now the second largest auto market after the United States, has seen auto sales slow for five consecutive months.

Recent weakness in commodity and equity markets reaffirms the notion that markets are self correcting mechanisms. We do not need government to step in every time there is an asset bubble to reduce speculation. Over time, the market will take care of overly leveraged and overly wrong speculators. Speculators can be beneficial. Benefits occur when speculation causes elevated pricing which in turn accelerates investment to solve supply shortages. The speculative unwind also tends to uncover mismanagement and dishonest behaviour. It is not a coincidence that the Worldcom and Enron scandals were uncovered during the unwinding of a speculative bubble. Without speculation and the ensuing fall outs, more scandals may go unnoticed and undisturbed.

We aren't suggesting that regulation isn't necessary. For capitalism to be effective, decisions have to be made ethically. Sometimes this requires strict regulation and enforcement. Ethical decision-

making creates trust. Trust is the grease in the wheels of capitalism. The debacle surrounding Fannie Mae and Freddy Mac (the government sponsored enterprises who own or guarantee about half of the US's \$12 trillion mortgage market and are responsible for approximately eighty percent of mortgages being made in 2008) is a clear breaking of the trust required that makes capitalism work. It will take considerable time and effort to recover from this. Government regulation has failed miserably here and may be the ultimate example of capitalism gone wrong. Evidence of mismanagement at these entities has been apparent for some time.

During the early part of the decade Fannie was headed by Franklin Raines, who was high up in the government ranks as the Director of the US Office of Management and Budget during the Clinton Administration. While at Fannie, Mr. Raines received enormous compensation. In 2003 alone, he was paid over \$20 million. In 2006, the Office of Federal Housing Enterprise Oversight announced a suit against him in order to recover some or all of approximately \$50 million in payments made to him based on overstated earnings. In 2008 a settlement was reached where Raines and two other executives agreed to pay fines totalling \$3 million, which were to be paid by Fannie's insurance policy. The Fannie debacle is disturbing and is weighing in on markets. Change is needed and the market in its self corrective mechanism is working hard to make this happen through a dose of tough love. As Fannie & Freddie plummet, the alarm bell is ringing louder than ever and efforts to regain trust are underway.

As this plays out, markets will continue to be volatile. Deposit costs at banks are elevated and will remain elevated until trust is restored. This could take weeks, months or years. We lean towards the latter. This will make economic activity sluggish for some time. Don't be fooled by quick fix solutions like tax rebate checks or ineffective rate cuts. The rot needs to rot. Don't be too pessimistic either. Enterprise and honest capitalism will continue to move forward. Innovation will continue and ideas will develop. We attempt to protect against the downside risks by investing in high quality businesses run by honest, capable and candid management with their own skin in the game. Times like these provide opportunity to add these businesses to the portfolio at attractive valuations. Not all businesses should be painted with the same brush that Fannie and Freddie deserve.