

A Spring in the Market's Step

Not being believers in a world running out of oil, but being believers in sensible valuations, we held no energy stocks in the Global Equity Fund last year. We benefited as oil and share prices tumbled. At the beginning of 2009, we contemplated investing in Petrobras the Brazilian oil producer, listed on the New York exchange. We were keen, as the share price had fallen from the mid-70 dollar level to about \$20. We reasoned at that price PBR made sense relative to its underlying value, and as it had found reserves offshore Brazil, it would enjoy gains to future production. However, before we could get a report to print, \$20 quickly turned to \$30 then to \$40 and more. So swiftly did share prices move this year, we are sorry to say, we missed the opportunity to buy at the right price. We still have no oil companies in the Global Equity Fund. However, our Small Cap and Canadian Equity portfolios benefited from the run in energy shares.

For three months, from the March lows, stock markets, commodity markets, and the Canadian dollar have put in rallies of 20% to 40%. Moves of 100% or more in small companies, distressed resource, and bank issues were common thus partly reversing last year's collapses. Ian Cooke, QV's unrelenting small cap manager, ranked the recent performance of the shares in the BMO Small Cap Index relative to their profitability. As you might expect in a speculative market companies with no profits appreciated the most.

In the mind of the market, puny interest rates and lavish fiscal deficits reignited the re-inflation trade. After all, if your return on Treasury Bills was 40 basis points in interest then a 300 basis point, or three percent dividend yield on Canadian stocks looked to be a good deal. Cheap money drove hoarded cash into gold, commodities, stocks, and corporate bonds. It put a risky spring in the market's step.

While QV's unit values advanced from March as shown on the table, top right, we did not grow at the rate of the indices. Nor last year, did our unit values collapse to the same extent as the markets. The weakness in the price of the units of the Global Fund is a result of the 20% appreciation in the Canadian dollar. As the GEF holds most of its assets in US dollars, their conversion into our dollar depreciates our unit values. That is about to change and that is the thesis of this letter.

No Arbitrary Measures

We can think market action is arbitrary. It is not, not always. The world's leaders knew as the American mortgage crisis triggered chain reactions through other sectors and other economies that they needed their

Pooled Fund – Month End Unit Values[^]

Unit Values	Dec-08 [*]	Mar-09 [*]	May-09
Cdn Income Fund CI D	10.42	10.52	10.59
Cdn Balanced CI A	12.27	11.97	12.60
Cdn Equity Fund CI A	8.22	7.56	8.24
Cdn Small Cap CI A	15.92	14.30	16.58
Global Equity Fund CI A	7.95	7.32	7.22

[^] Fund NAVs reflect "full-fee" class * Post distribution

banking systems to reduce and write off their assets (loans), or in the new parlance to "de-lever." Leaders needed their highly borrowed publics and corporations, to re-finance longer term, to get out of the banks. The Group of 20 flushed the global financial system, drove short rates to nearly nothing, and accelerated government spending to stabilize markets by offsetting the deflationary run to savings by consumers and the plunge in capital investment by corporations.

Jim Grant observed, "Suppressing interest rates, central banks can't help but distort the market in interest-bearing securities." They distort the market in everything. With short rates near zero, the new money rallied the markets. In Q2, we have seen broad and beneficial re-financings. We have seen an extreme swing in sentiment from gloom to indiscriminate hope, from expectations of deflation to renewed inflation. We have seen sharp runs in commodities and speculative stocks, rationalized by the apparent indifference of Washington to the value of its dollar.

What Was, Is Not What Will Be

America is no longer self-financing. The US federal deficit has accelerated to nearly eight percent of GDP. The appearance of the Treasury Secretary Tim Geithner in Beijing this week, the co-incident warning of excessive spending by the Chairman of the Federal Reserve Board Bernanke and the address to the Arab world by President Obama suggests Washington is hardly indifferent either to the value of its currency or to the confidence of its creditors. As the world's largest debtor, the US can ill afford to ignore its bankers. Unlike the past, America's creditors have reason to insist the US sustain its currency and to this end, Russia and China have spoken publicly about the status of the US dollar.

Now, having faced the crisis, cashed up the biggest banks, having made the general public believers in economic "green shoots" and having engendered confidence and a bull market, we should ask, "What's next in this drama? What will be the big trends influencing asset values?"

Look Around

The stark global reality is that the US will not be able to cut interest rates more. The US cannot offset the growth in its \$51 trillion debt load with a spending program that results in an additional \$2 trillion deficit. Washington cannot counter the rise in consumer savings and anxiety driven by layoffs, with cheap money. Growth cannot be re-ignited as we revert from unbridled bank lending to increased bank constraint from re-regulation. Finally, China with a GDP of \$3 trillion cannot grow to offset the shrink in the US GDP of \$13 trillion.

The growth in debt over the last few decades gave rise to a phony prosperity. The size of the debt presents a systemic risk unable to be offset by low rates. Nor will US banks lend, despite their excess of cash reserves, when they face more erosion in their loan portfolios. Nor will the US sustain interest rates that do not pay their creditors. Nor will the markets be indifferent to the recent rise in interest rates co-incident with the rally in stocks and commodities.

That the economy south of the border is less bad, hence the spin on “green shoots,” we acknowledge. However, 75% of the world’s economies are in recession. The US economy is still contracting, not expanding. The constraints will not allow corporate America to earn the superior profits, or returns on equity, of the last few years. Companies enjoyed returns on equity of 20% in the US and Canada over the past few years. Twenty percent compares with long term averages of 13.4% and 10.0% respectively. Financial constraints suggest returns at half these historic averages. While the majority of companies beat analyst’s estimates in the first quarter, corporate revenues fell, and profits fell and the profit performance resulted from cutting employment. The correction is self-feeding.

In managing portfolios, we are particular about what we pay for the anticipated return. In time, the stock markets will reflect lower returns with lower prices. With the possible exception of Canadian small companies that trade at a discount to book value, the current levels of the Toronto or New York stock markets, well over book value do not correctly reflect the future profits.

The Consumer as the Wild Card

We have always enjoyed the musings of David Rosenberg, the former economic head of Merrill Lynch who now advises for an illustrious competitor, Gluskin Sheff. “I believe there is a lack of appreciation for what history tells us

about the after shocks that occur after a cycle that was dominated by a credit collapse and asset deflation...economic fragility, lingering deflationary pressure.” We might add strength in the reserve currency as the re-payment of debts in that currency force its purchase, despite a weak economy.

David points out that last week the story dismissed by the market was that the savings rate in the US hit a 15-year high of 5.7% and is “in a clear uptrend.” “This process is far from over as the 78 million baby boomer population whose median age is now 52, focuses on incremental retirement savings needs, which will be continuously absorbed out of increasingly scarce organic income. This will be a dead-weight drag on discretionary spending for years, not quarters...”

Because interest rates are rising, the central banks cannot cut more, and profits are falling, we expect a reversion to the trends of the earlier part of the year. We expect a reversal of the exciting trends of the last three months. We should see commodity prices decline in tandem with the Canadian dollar. We should see equity markets slip in concert with economic data.

We should see the shares of the relatively stable companies held in our portfolios hang in as commodities and financials retrace their gains. The action of the bond market will present a challenge to the expectations for economic and equity market revival. We think psychology is about to change and care and prudence will replace risk taking.

Total Return – Capital Gains plus Income (%)

To May 31 '09	1 Mo	3 Mo	1Yr	3 Yr	5 Yr	10 Yr
QV Pooled	%	%	%	%	%	%
Cdn. Income	0.1	1.5	6.1	5.7	5.3	5.3 [†]
Cdn. Balanced	2.1	6.8	-6.3	2.4	5.7	9.4
Cdn. Equity [†]	4.1	10.6	-20.3	-1.5	8.2	14.4
Cdn. Small Cap	4.1	16.5	-24.3	-5.6	6.9	13.7
Global Equity	-3.4	4.5	-12.8	-	-	-

[†] Historic equity returns from the Cdn. Balanced Fund [^]6 yr

Benchmarks:

DEX Bond Univ.	-0.1	1.7	5.5	5.6	5.6	6.2
Balanced Fund	4.5	13.0	-11.8	2.0	6.4	6.4
S&P/TSX Comp	11.5	28.9	-27.0	-1.3	6.9	6.4
BMO Small _{unwtd}	13.8	39.7	-30.1	-10.8	-0.4	4.6
MSCI World (\$CA)	-0.3	11.4	-29.9	-10.0	-5.6	-4.9

- Pooled fund returns are gross of management and custodial fees. Returns over one year are annualized.

- The Balanced Fund Index reflects the total rates of return earned by the DEX 91-Day T-Bill Index (5%), the DEX Bond Universe (45%), the S&P/TSX Composite Index (40%), and the MSCI World Index (CS) (10%)