

## Q1 Review

*Problem we have is, a lot of folks aren't responding to over a million letters sent out to offer them assistance and mortgage counselling. You know, these mortgages can be pretty frightening to people. I mean, there's a lot of small print.*

President George W. Bush, speech to the New York Financial Community, March 14, 2008

*American authorities, especially Federal Reserve officials, harbour the mistaken belief that swift action can forestall a Japan-like collapse. The greater imperative is to avoid toxic asset bubbles in the first place. Steeped in denial and engulfed by election-year myopia, Washington remains oblivious of the dangers ahead.*

Stephen S. Roach, Chairman, Morgan Stanley Asia, March 6, 2008, International Herald Tribune

All right, who didn't read the small print? It would appear the answer is just about everyone. The real answer is they didn't care. At the end of the quarter, Washington announced the overhaul of the rules governing its financial system. Stephen Roach, the former Morgan Stanley Strategist, so prescient over the last few years, now might allow that Washington, in surveying the greatest global train wreck in the history of credit, is oblivious no more.

Since the world now suggests it may be the beginning of the end financially, we're seeing some opportunity. Just to quantify what coming to an end is, the following are the quarterly rates of change for a few of the world's stock markets: Canada off 2.8%, New York off 6.9% (S&P 500), London off 9.4%, India off 22.1% and China off 29.4% (Shanghai Index) to name a few. (Co-incidentally, two astronomers Klaus-Peter Schroeder of the University of Guanajuato in Mexico and Robert Cannon Smith of the University of Sussex in England have predicted that "if nature is left to its own devices, about 7.59 billion years from now, Earth will be dragged from its orbit by an engorged red Sun and spiral to a rapid vaporous death.") Knowing that, we thought you would feel better about the current market crisis. Wait there's hope. Canada may survive the end of the earth's demise as well as it has the stock market malaise.

QV will not belabour the tribulations of a five month equity bear market and the worst quarter in six years or a world scale banking crunch or the consumer and commodity de-levering flop that is just about to begin. We've done enough of that. Well, in light of the proposed mess fixing, we cannot help comment that the folks bringing you the "most sweeping regulatory overhaul since the Depression" are the same folks who created "the worst banking crisis in 30 years". We also note in an effort to support market prices the authorities have allowed the acquisition of questionable paper by the Federal Reserve Board and an increase in leverage by

Fannie Mae and Freddie Mac, thus eroding the quality of the institutions granted financial oversight. The consequence - borrowing costs in the US will likely rise with Government risk.

Our past hand-wringing about the consequences of our neighbour's monetary and fiscal policies are now well inked in the press. While our fretting has slowed, we predict business and market corrections have not. While May will see some respite from tax rebate cheques in the US, the housing crisis has spilled beyond financial institutions to consumer confidence and spending, profits, employment, and capital spending. These economic impacts will continue to take time to repair but we wouldn't be surprised to see stock markets rally in anticipation of the fix. It is interesting to note that when they do rally it is often the consumer or financial related shares which surge ahead, we treat these surges with caution.

On April's first day, and in some exultation over the start of a fresh quarter, over two major bank re-financings and over the newly proposed oversight of financial institutions, the Dow rose nearly 400 points or three percent. The down quarter is followed by an enormous up. The rally is one of many triggered by intervention. The New York market has seen the greatest volatility in the past five years with 12 sessions of two percent changes or more, very typical of bear markets. Nothing has as yet to stick beyond exuberant short covering rallies. This does not mean we won't put money to work in good investments over time. Picking market bottoms is not our forte and frankly for those who tell you it's theirs ask them how many times they've called the bottom before it actually is!!

Equity Support - Money has moved into quality bonds and has taken prices to high levels and yields down to a quarter of the long run return on corporate equity. That is a support. Dividend yields on many companies exceed bill and bond yields. That is a support. Bonds have provided security in a bear market for equities. The recession in the US will depress tax revenues and the bail out schemes will require financing. Debt issuance from the Treasury and security issuance from the banks will be high and likely put upward pressure on rates.

We had recently mentioned that this has been a difficult quarter for the Fund. Looking at preliminary numbers we are down roughly 5.5%-6.5%, slightly worse than the small cap benchmark return, which is down nearly 5%. A more significant exposure to the commodity sectors would have helped with performance but we think that is short sighted. We found many of the commodity stocks taking on a speculative zeal as a safe-haven in the midst of the market turmoil. The small cap market is now into the third year of underperformance relative to the large caps. As with all cycles this too will change.