OPTIMISTS, PESSIMISTS and REALISTS

January 2009

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." William Arthur Ward

"A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty." Winston Churchill

"It's better to be an optimist who is sometimes wrong than a pessimist who is always right"

"Optimism is the faith that leads to achievement. Nothing can be done without hope and confidence." Helen Keller

Sir John Templeton, shows that bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.

"Many of the truths we cling to depend on our point of view."

Yes, the news is awful. How much of the bad news has already been discounted by the market?

Question -- How could we possibly get a bull market signal when the US economy is unraveling?
Answer -- The stock market looks ahead often as far as six months to a year or more. 2009 will end up as a good year for those long equities and a bad one for those short equities. Our conclusion is that the terrible unemployment news and most of any upcoming bad news has been discounted. We are impressed by the fact that the current picture is materializing in the face of ugly economic news.

The early stages of a new bull market usually coincide with reports of weak profits and lackluster economic data. It is not uncommon for the bad news to continue for a year or more after the market reaches its lows, proving that equity investments do not always need good economic news to move higher. The current environment however does not have the characteristics of past recessions.

One instrument I've been watching with interest is the so-called Ted-Spread which has now dropped to almost 1%. Ordinarily, this indicates that default risk is diminishing, which should be bullish for stocks. Most bond-buyers and professionals watch the Ted Spread with intense interest.

During the latter stages of 2008, what we expected to be a mid-cycle slowdown became a severe financial and liquidity crisis.

Mounting job losses are expected to push the unemployment rate to a peak of 8.5%, and real GDP growth is expected to contract for another two quarters.

The depth of the financial wreckage caused by capital deficient credit default swaps (essentially insurance with no capital backing) was obviously not anticipated by us or by most others.
Neither the duration nor the extent of a primary movement can be predicted in advance.

Consumer confidence has declined to an all-time low. Yes, it can go lower, but sooner or later it will reverse itself.

While we remain optimistic about the future, we continue to believe that a cautious approach is necessary in these unprecedented times. Notably, the fear and global deleveraging that has resulted in indiscriminant selling of many quality investments may not be complete. There remains sufficient economic uncertainty and political unrest around the world to warrant a careful next step. At the same time, we are mindful that uncertain times have historically provided a fruitful investment environment for astute investors.

Commodities

The US financial system (and the dollar as a reserve currency) no longer finds itself on strong footing. Likewise, the US auto industry will never again be the engine of US economic growth it once was. The old mantra of “as goes GM, so goes the US” may be prophetic and is scary. However, one area where we have been (and remain) invested because of especially strong, long-term underlying fundamentals, is in commodity companies. While virtually every hard commodity has suffered a sharp decline in price over the past few months, the supply and inventory of many of these same commodities has declined significantly. We believe that long term, ongoing economic development in China, India and other countries will continue and the demand for commodities has a strong foundation for future growth and increased pricing.

While we remain hopeful that for commodities this is a pause (18 -24 months) within a secular spending cycle, getting the negative news priced in is an important process. This needs to occur before commodities can resume their pricing uptrend. We continue to believe in the secular growth story for the Chinas and Indias of the world and remain long term bulls on commodities in general and Canada in particular. Many in the emerging market economies have high savings, little debt and a growing desire to consume.

We are seeing hints of inflation -- recently the CRB Commodity Index was up, bonds appear to have topped out, and gold has been climbing ever since its October low. Worldwide Governments are trying to inflate their economies out of the current economic situation.

Energy

Similarly, ongoing economic growth in developing countries is destined to cause a profound positive impact on global demand for energy. Currently, the US economy uses approximately 20 million barrels of oil per day, or the equivalent of 24 barrels per person, per year. In contrast, the Chinese economy (where the population is four times that of the US) uses just eight million barrels of oil per day, or roughly 2.3 barrels per person, per year. The dramatic decline in oil from $147 to $35 in a span of 5 months is enormously stimulative for the US economy.

Recently, the Chinese government announced that it was considering a significant increase in its gold reserves from 600 metric tons to 4,000 metric tons.

We have been underweight financials in our portfolios for several years and continue to believe that this segment of the market will prove challenging for investors moving forward.

There is no economist, strategist or politician smart enough to predict tomorrow's headlines, so how can anyone say this bear market is closer to the beginning or to the end? Contrary to most experts, charts on the markets and their progress through most periods will give us a preview of tomorrow's news.

Markets need clarity and calm to entice cash from the sidelines, but the time of maximum pessimism is the optimum time to hunt for values and bargains.

While there are many who are projecting guarded optimism for a recovery by the second half of 2009, realists are looking at 2010 or perhaps later.

Money has been lost buying products which were never really understood by investors. Many now find themselves over-extended or in serious debt. It didn't take long for investors to point fingers in every direction except at the reflection in the mirror.

Infrastructure spending is at the heart of government plans. Highways and roads, railway and transportation systems along with power generating assets will all have money thrown at them in a desperate attempt to reverse the trend in unemployment growth.

What we may be witnessing is an epic change in the way people approach how they move around, how they allocate their budgets, especially with respect to discretionary spending, and their attitude towards debt.

Few indicators capture the scale of the global slowdown better than the Baltic Dry Index – a measure of bulk shipping rates – which plunged 94.0% between May and December. The services sector has not escaped untouched. With unemployment rising, property values collapsing, and personal wealth having been devastated by market selloffs, consumer confidence in western economies has plummeted and spending is retrenching. Deleveraging is now their key focus as the era of debt fueled consumption is coming to an end. The ramifications of this will be felt by the global economy.

Investments in key asset classes, whether equities, fixed income vehicles or real estate will continue to be challenging but market anomalies will offer long term opportunities. Deflation may now be perceived as the dominant risk but with the amount of stimulus that will be injected into the system there is a real threat of inflation becoming the problem that bedevils us. Under this scenario the U.S. dollar could weaken, benefiting precious metals, commodities and other hard assets.

Fears of shortages surround the energy sector, but food and agriculture will be clouded with the same concerns as the global population continues to grow. Over the next 10 years, projections call for **900 million people** to join the ranks of the middle class. This should establish a new army of consumers who will upgrade their diets as they focus more on protein. Infrastructure remains a key theme.

Obama has already said he wants to revive the economy through a job-creating public works program on a scale unseen since the building program of the interstate highway system in the 1950's. Steel, aggregates and aluminum will be required commodities and construction related stocks should get a lift.

Deflationary trends may be with us for some time, but we are confident that global stimulus plans along with monetary and fiscal policies will create serious inflationary pressures once the economy turns around.

Our forecast calls for a test of the November lows, followed by a slow stock market recovery in the second half of 2009. Be prepared for volatility though. Our outlook beyond 2009 is positive. The U.S. and other economies around the world will begin to recover. A new bull market will evolve before the economy starts its recovery. We will look back at this current debacle as the buying opportunity of a lifetime.

While the immediate visceral responses to losses is to want to hide in "the safety of cash" or to chase what has been working recently, the reality is that risk is likely highest in what is considered to be safe today (government bonds and cash). Investing is a marathon and in the end stock markets will properly reflect the relationship between corporate earnings and stock valuations. When this happens our patience and fortitude will be well rewarded.

Ben Franklin knew this rule, "I don't care how much or how little you earn, keep your living expenses BELOW your earnings. It's called saving. It's been a lost American art."

"Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

Berkshire Hathaway's Warren Buffett
New York Times
October 16, 2008

While much in the capital markets has changed, our view of investor capital as a precious, irreplaceable commodity has not been altered. As a result, our primary objective remains capital preservation and we thank you for entrusting us with this very important responsibility. We would like to thank our clients for their patience and understanding in these difficult times. We can only reiterate our commitment to work hard on your behalf and to be prepared when opportunities present themselves.

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