CROFT FINANCIAL GROUP
INVESTMENT COUNSELLORS-PORTFOLIO MANAGERS

Economic Outlook and Market Forecast
Second Quarter 2008

On sentiment and clarity in the markets

The first quarter of the year – what we've termed "the quarter of crisis" – saw markets move entirely to sentiment-based trading, abandoning the clarity of fundamentals altogether. That was triggered by growing signs through the first quarter that a US recession was taking hold, that the subprime mortgage debacle (and related credit crunch) was about to swing into high gear, that the housing slump would intensify, and that the price of oil was headed to new highs.

Let's define what we mean by "sentiment" and "clarity." Sentiment drives investor decisions when there's generally a lot of angst over a macro event that's creating a distraction from the normal course of looking at things like GDP growth and earnings growth. Clarity becomes a market driver when investors start focusing on fundamentals. (Clarity typically asserts itself when sentiment wafts away, and that's what we like to see in equity markets.) And right now, we're dealing with a distraction that nobody really understands – the problems in the global credit markets.

The troubled first quarter of the year saw the US Federal Reserve Board, led by the new Chairman, Ben Bernanke, cut the target for the federal funds rate to 3.0% from 4.25%, in an emergency reaction to seriously deteriorating credit conditions. Bankers nervously wrung their hands about things called "collateralized debt obligations" and "credit default swaps," which it seemed no one was willing to buy at any price. Confidence in the financial system was badly shaken, as even the rate at which banks lend to each other climbed substantially over three-month US Treasury bill rates. Even now, the spread measured by the London Interbank Offered Rate (Libor) is over 80 basis points for US money, 75 basis points for European funds, and 99 basis points for U.K. funds. (It could be even wider, as some suspicion has been cast on the accuracy of the Libor rate recently.) The Libor spread is normally about 5 basis points. And this is a clear sign of the high level of risk still prevailing in credit markets.

In Canada, David Dodge's last act as outgoing Governor of the Bank of Canada in January was to preside of over a cut to the target overnight rate to 4%.

The Fed's Mr. Bernanke, however, is presiding over a US economy that's inexorably gearing down, while inflation is stubbornly gearing up. The US economy grew at a minuscule 0.6% annualized in the fourth quarter of 2007. But by February, the consumer price index was rising at an annualized rate of 4.0%, with expectations that the rising trend in inflation would continue through March. Meanwhile, the Canadian consumer price index came in at 1.8% year-over-year in February, with expectations of a slight decline, to around 1.4%, for March.

The Fed has signaled that it is likely to continue easing in coming months in an effort to cushion the economy. And that raises the spectre of "stagflation," a condition of stagnant growth combined with rising inflation.

Although Canada is in much better shape fiscally and economically than the US, the performance of our economy and markets is largely dependent on what happens in the US, our largest trading partner by far, taking about 75% of our trade. So although we may well avoid an out-and-out recession in Canada, as we did in 2000-02, our stock markets will still feel the US pain. One bright spot: Through the first quarter, the commodity surge eased some of that pain.

Still, the Bank of Canada wasn't about to take any chances. In a move characterized as "bold" by many media pundits, the BoC, led by incoming Governor Mark Carney, cut its target overnight rate by 50 basis points, to 3.5% from 4%, the biggest cut since the last crisis in 2001. And you don't do that unless you think things are really going off the rails. That's precisely what the Bank of Canada thinks – and it's taking steps now to cushion the blow.

The bank says, "there are clear signs that the US economy is likely to experience a deeper and more prolonged slowdown than had been projected in January." Beaten down by the collapsing housing market in the States, the US economy has ground to a halt, and "can be expected to have significant spillover effects on the global economy," as the BoC puts it. The downside risks to the Canadian economy – and the whole world – just got a lot worse through the first quarter.

Meanwhile, the troubles in the banking business are growing. As the subprime mortgage monster rips and tears at banks' loans and mortgage investment portfolios, regulators are applying increasing pressure on lending institutions to fortify balance sheets with more capital – capital that just isn't so easy to come by these days. That new reality was brought home graphically with the collapse and subsequent bailout of Bear Stearns Cos. as the first quarter drew to a close.

The icing on the cake – and the attendant message to markets about the Fed's resolve to head off financial collapse – was a further 75-basis-point cut in the federal funds rate on March 18 (following another 25-basis-point cut to the discount rate), to 2.25%. The Fed also signaled that more cuts were in the offing, because financial markets are still "under considerable stress."

We predicted in our *2008 Economic Update* that the Fed would cut rates by 200 basis points, possibly before the end of the first quarter, and that's precisely what occurred.

Despite the brief respite from financial crisis that came in the wake of the Fed's move, we don't believe this particular show has played out just yet. The reason is that the arcane credit problems that sparked the March storm still prevail in the financial system. Bad debts still hang over the markets like rock teetering on a broom handle. And there's little hope that the US will skirt a recession.

Commodity prices reacted quickly to a barrage of bad news, as oil, gold, wheat, base metals, and a host of other commodities retreated from a record highs.

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In our *2008 Economic Outlook* we also predicted that gold would "hit US$1,000 an ounce sooner than later." It did, touching US$1,034 per ounce on March 17, but by the final week of the quarter had retreated to around US$920. We also predicted that oil would trade within a range of US$85 to US$100 per barrel. By the end of March, a barrel of crude oil had dropped to about US$101 from a record high of US$110.

Combined with slowing demand (at least temporarily) and a selloff by investors raising cash to meet margin calls as the credit market tightens up, commodities took a slide in March, and the TSX felt the pain, as did the loonie, which fell 2.19 cents against the greenback on March 19, its steepest single-day drop in 46 years. Stock markets generally are skittish and volatile. And analysts and pundits are deeply divided on the nature of what's going on, how long it will last, and how deep it will be.

Clearly, a number of complex, interrelated factors are at work here, and in this quarter's *Economic Outlook*, we want to explore some of these and see how they are likely to influence our portfolio decisions in the coming months.

US economy stumbling

We said in our *2008 Annual Outlook and Market Forecast* that there is no question that the US is slowing, and trading activity at the end of last year was reflecting investor views about the US economy six to nine months down the road – about the length of time a normal slowdown/recession would take to work its way through the economy.

US gross domestic product grew at a meagre 0.6% in the fourth quarter of 2007, for a full-year growth rate of 2.2%. That's a pretty dismal handoff to the first quarter of this year, and so far, the economic data just don't look that encouraging for a first-quarter recovery.

Take corporate profits – the bottom line that, after all, is the alpha and omega of the stock market. US fourth-quarter corporate profit fell 3.3%, confounding expectations of a 0.l% drop. Full-year profits rose 2.6% compared with a 12.2% advance in 2006.

Then, some really crummy news on spending fired up investors' urge to sell even more. The US Commerce Department said that consumer spending grew just 0.1% in February, the most sluggish showing since September 2006. In addition, it was the third consecutive month of nearly flat consumer spending growth. Why is this important? Simple: Since the bottom of the last recession in 2002, consumer spending, fuelled by low interest rates and a booming housing market, has been the engine of US economic growth, accounting for some 70% of economic activity. It follows that, more than anything else, a slowdown in consumer spending will put the brakes on GDP.

Then there was the unexpected decline in February durable goods orders – refrigerators, washing machines, and the like – and indication that spending is on the decline. And in a sign that the US housing market bubble has well and truly burst, new home sales plunged to a 13-year low.

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As consumers increasingly feel the effects of job cuts, the collapsing real estate market (which for so many years fuelled the spending binge), and spiking energy costs, investors busily reevaluate the outlook for corporate earnings and weigh valuations in light of the worsening economic news. However, with the S&P 500 Composite still trading around 16 times trailing 12-month earnings, pretty close to its long-term average, we can't really argue that stocks are "cheap" – yet. Which puts a little damper on some of the more bullish market pronouncements we've been hearing lately, and augurs for more downside volatility in store for the months ahead.

In Canada, the economic picture is somewhat brighter, even though fourth-quarter GDP grew only 0.8%. For all of 2007, Canadian real GDP expanded 2.7%. However, that somewhat middling top-line picture doesn't tell the whole story. Final domestic demand grew 6.9% in the fourth quarter, the third straight quarter of growth above 5%, with surging household consumption and double-digit growth in business inventory investment. In addition, the Canadian housing market remains healthy, not having been subjected to the strains of system-wide defaults and foreclosures brought on by resets in subprime variable rate mortgages that occurred south of the border.

But the cheery domestic demand picture was darkened considerably by an 8.5% drop in fourth-quarter exports, as manufacturers and exporters continued to wage a – thus far losing – battle with a soaring Canadian dollar and a weakening US economy (where, incidentally, most of our exports still go).

Weakness to persist

The weak fourth-quarter GDP growth is likely to continue into the first quarter of 2008, despite a boost from surging commodity prices. The Canadian stock market is dominated by the financial sector, which is still staggering under the burden of weak earnings and revelations of exposure to risky investments, going beyond US subprime mortgage-related debt. In late March, for example, CIBC confirmed that it has some $25 billion of investments tied to monoline insurers – those companies that insure bond principal and interest against default. Some of that investment is at risk, and we could see further writedowns from CIBC on top of the $4.2 billion it has already written down. In sum, the financial sector will continue to weigh heavily on the Canadian market for some months to come.

Yet the S&P/TSX Composite Index outperformed its major US counterparts in the first quarter. So what brought the Canadian market back? In a word: commodities. The Canadian market found a renewed source of energy in, well, energy. And metals, mostly gold. Oil and gold both cracked record prices in the first quarter. We said in our January report that we did not expect to see gold at much over US$1,000 per ounce – and it in fact touched US$1,034 before retreating down to the recent US$900 per ounce. We expected oil to trade in a range of US$85 to US$100 per barrel. That, too, has come to pass, though as the upside of the range recently expanded to nearly US$115 per barrel for oil futures.

So why isn't the stock market sliding more rapidly? Although markets have experienced the kind of volatility I don't think anyone of this generation has witnessed before, they have arguably not convincingly entered bear market territory – that is, a sustained slide of more than 20% from a market top.

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From last year's record highs, the major stock market indexes certainly "corrected," as the S&P/TSX Composite Index dropped 18% from last year's high to its low this past January. Ditto for the Dow Jones Industrial Average, which posted a high-low spread of 18% to March. By March, the S&P 500 Composite actually had eroded 20% from its high-water mark last year but has since rallied off that bottom. So no bear, at least not officially.

A major indicator of stock market volatility, the Chicago Board Options Exchange's volatility index, known as the VIX after its symbol, climbed briefly over 30 in March. But recently it has fallen back to a level in the low 20s. The VIX, which measures implied volatility and moves inversely to stock prices, is often called the "fear gauge," falling as stock markets become more confident and rising as stock market anxiety ratchets up. The VIX is down from the 32.24 high reached in March, but up from the single-digit level of early 2007. So there is no extreme pessimism in sight.

Right now, the market seems to be telling us that stocks are priced more or less fairly, that the earnings outlook, while darkened by the slowdown in the US economy, is not really all that bad, and that there's likely to be a significant rally in the second half of the year.

Sentiment-driven markets

However, despite the slide in implied volatility – and the implication of reduced anxiety among investors – we don't believe that the market is focusing on the fundamentals fully at this stage. And we will not see a sustained rally until later in the year, because we don't think market has regained that element of clarity that we mentioned earlier.

In fact, the market is still being driven to a large degree by sentiment, and we can see that in the day-to-day volatility still prevailing in the big stock indexes. Take a look at the chart for the S&P/TSX Composite Index since the beginning of this year. Observe the tremendous swings in range between 1,400 and 1,250 through the period.

We need see that choppy action settle down before we see sustained rally from this point. And what will resolve that choppiness back into a definable uptrend? It's clear that any change has to be driven by the financial sector, because that would tell us the economy has settled and that things have started to right themselves. At this point the Canadian market, while rangebound, is still in positive territory because of gold and oil, as well as commodity products. The major oil and gold companies are what's important to the Canadian economy at this stage, and this is being reflected in share pricing. Take a look at the chart of the S&P/TSX Capped Energy Index since its January bottom. Compare it with the S&P/TSX Capped Financial Index immediately following, and you'll get a feel for what we mean.

The financials are off their lows but still don't have the sustained momentum behind them that would lead to a convincing market rally. For that to happen, the market has to turn away from sentiment.

Current sentiment is being shaped by fear and uncertainty in financial system. What does this mean? In March, the US Federal Reserve Board bailed out the failing investment bank Bear Stearns Cos. and prevented it from failing. Basically, the Fed bought up $30 billion of Bear's less liquid debt and then brokered (some say strong-armed) a deal where JP Morgan Chase would buy the tattered remnants of Bear Stearns. (An initial share swap deal at $2 per share was hastily put together to allow the companies

to do due diligence. That diligence – and some fairly serious grumbling from shareholders who started feeling oppressed – soon brought a better price of $10 per share).

But at the height of the Bear Stearns flap, the Fed also cut its discount rate (the rate at which it lends to banks) and – significantly – opened discount window to investment banks, something it hasn't done since 1930s. And here's where everything changed. The Fed has suddenly becomes the lender of last resort for questionable debt in marketplace.

Giant step into moral hazard

It's a giant step the Fed has taken into the minefield of moral hazard. In order to understand how this evolved, we have to try to determine what motivates Ben Bernanke, the current Chairman of the Fed. The record shows that as a Fed governor, Bernanke showed a gritty, stick-to-it approach. Focused, purposeful, and goal directed, he takes a tack and then lets it run to the full limit – a characteristic that he has brought to his job as Chairman of the world's most influential central bank. In that sense, his approach is diametrically opposite to former Fed Chairman Alan Greenspan's, whose opaque policy utterances carefully camouflaged a highly pragmatic policymaker.

Much is made of Mr. Bernanke's earlier academic research into the causes and results of the Great Depression of the 1930s. And, indeed, his understanding of that great failure of monetary, fiscal, and political policy may well be behind the Fed's actions in March. However, this is not the 1930s. And we can assume that Mr. Bernanke and the other Fed governors are aware that they have a great many more subtle and powerful tools at hand than their dustbowl counterparts so many years ago.

Indeed, the Fed has so many levers and is juggling so many balls that it has created a very interesting environment, but one fraught with a great deal of risk. We have to understand where the Fed can go next if it has to.

If the Fed becomes lender of last resort, the theory goes that it will provide the financial system with enough liquidity to settle down and focus on some of the fundamental issues. Will it work? Look at spread between 30-year mortgage rates and long-term government bonds. The Fed's rate cuts were made with intention of lowering long-term mortgage rates. But if you look at what happened, you see that long-term mortgages haven't come down that much. The rate on government bonds dropped, but the spread did not contract much and in some cases expanded. So the putative benefit of short-term cuts on long-term rates, which is really what the Fed wanted to see happen, was short-lived. Any further rate cuts will be like pushing on a string – a case of diminishing returns.

In that light, we will not see any real advantage in interest rate cuts unless there is a coordinated rate cut with every other central bank in the world. If the US continues to cut rates in a draconian fashion without the rest of world playing the game, the US dollar would devalue even further against the basket of world currencies. And that in turn implies rising prices for oil, which trades in US dollars. The price of gold would follow suit, rising on the sentiment from the lower dollar and higher oil.

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The fact that gold hasn't gone up further at this stage means the Fed got a primary directive to support the US dollar. And that means further rate cuts are unlikely unless there's a coordinated effort among the world's big central banks. That too seems unlikely, given April's meetings among senior financial officials of the G-7. Although the G-7 endorsed an enhanced regulatory regime that, against all historical evidence to the contrary, they hope will prevent future crises, they avoided any mention of joint action, leaving each country to deal with the crisis in its own way.

Which brings us back to the Fed. It has already set itself up as the *de facto* lender of last resort. The last arrow in the Fed's quiver is basically becoming the buyer of last resort. What has to happen there is that the Fed does more widely what it did with Bear Stearns – that is, buy bad debt and put it on backs of taxpayers. What the Fed is doing now is saying they'll swap Treasuries for that debt. Those are short-term swaps that are in effect creating liquidity. The inventory of the major banks is thus government bonds, which are liquid. The inventory on Fed's balance sheet becomes bad debt, which has no liquidity. The Fed is swapping good liquidity for bad liquidity.

Now, the Fed might argue that if it holds onto the bad debt long enough it might be okay, and it might be able to unload it at some future date. That's debatable. The fact is that the risk is pushed right onto backs of US taxpayers.

At this point, the Fed is still making a swap. It's creating a counterparty, and providing resources in the form of loans to be able to finance that. If the Fed becomes buyer of last resort, it is a tough smell test to pass. When you do that, you create a moral hazard.

It's all well and good to talk about "moral hazard" in the abstract, as the academics who created the concept do. But what does it really mean in concrete terms? Writing in the April 21 issue of *Maclean's* magazine, journalist Steve Maich defined it as well as anyone I've read in recent months. He writes that saving foolish homeowners and greedy bankers from the trauma of foreclosure might bolster consumer confidence and avoid the possibility of a nasty collapse. "But what message does that send to the guy who, five years ago, looked at the numbers and realized he couldn't afford that four-bedroom mansion. He read the fine print and saw those toxic mortgages for what they were. He bought a smaller house, lived within his means, and will still have to pay his mortgage, *even while the US government uses his tax money to bail out his neighbor who gets to keep the big house he can't really afford*." [Emphasis added.]

President Bush, Ben Bernanke, and analysts not involved in bad debt have acknowledged this problem. Most investment banks are involved – up to their proverbial eyebrows -- in this dodgy debt, so they are naturally reluctant to talk about moral hazard. They want to see rescue package – for themselves.

The Fed's pot of gold

The moral hazard is that Fed becomes pot of gold at end of speculative rainbow. It becomes the put option on the financial markets, which means Wall Street can feel free to take even greater liberties with risk, knowing that the Fed will buy off that risk, backstopped by US taxpayer. Remember? That's the guy who now in effect pays off two mortgages instead of one – his own and the one the Fed has handed him.

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Using the Fed as the buyer of last resort "just this once" creates huge moral hazard, when somewhere down the road, someone again cries wolf, as they surely will. But then there won't be the wherewithal to provide the bailouts. In effect, the problem will have been compounded because the Fed is now only applying a band-aid to a gushing bleeder.

However, even knowing this doesn't mean the Fed and the current Administration won't take this step. But if they do, they will have to manage the politics around it and sell the moral hazard as a one-time event in an election year. And they have to do it quickly before Democrats and Republicans gear up for the presidential election campaign. They will want to make sure that the next president, whoever it is, will not be saddled with the responsibility of this moral hazard.

How are they likely to frame it for taxpayers, who are very quick to spot "moral hazard" (think of that guy with the two mortgages)? First, they are going to give more authority to the institutions that take on this moral hazard – more authority to regulate and to decide on what are good and bad practices. This is essentially what Treasury Secretary Paulsen's proposal is all about. And the reason he was able to release it so quickly is that the Administration knew a crisis was brewing last June, foresaw the calamity, and began preparing the regulation package in anticipation of the political storm.

Second, we're likely to see the political spin stepped up, with news stories suggesting that a large part of the blame must go to the government itself, which encouraged looser lending standards and greater competition in the mortgage lending business in an effort to attract more first-time homebuyers – and therefore grateful voters.

The upshot is that most of Paulsen's recommendations probably couldn't be implemented for another 8 to 10 years. There are huge processes involved. That means nothing would happen until the next presidential cycle. In fact, it may not ever get done, as it drifts out of minds of taxpayers over time.

How does this play out in marketplace? Most of subprime debt has already been already written off. We're now seeing reasonable-quality paper that's bumped up against the liquidity crisis. That' what's happened in Canada with the frozen-up asset-backed commercial paper (ABCP). The paper may not be terrible, but there's no market for it. So liquidity is a key issue. And it's a long-term issue. Liquidity allows creditworthy customers access to capital that supports the US consumer. And that's the Fed's motivation.

The merger and acquisition business has dried up to a trickle of what it was even a year ago. Now you see deals being done that involve essentially creditworthy borrowers. Deals you can look at now – including Clearchannel in the US and BCE Inc. in Canada – may make the case that the Fed doesn't have to be buyer of last resort, because liquidity has started to come back into the system. But that's a big assumption. Clearchannel had to drag lenders into court to fulfill financing obligations. And the BCE takeover hasn't closed yet. It's going to be awhile yet before enough confidence is restored that credit risk is repriced back to more normal levels.

The IMF estimates that about two thirds of losses from US residential mortgages have been recognized by the banks. With the Fed providing a massive backstop (moral hazard be damned), some semblance of

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stability has returned to the financial sector, and balance sheets are being shored up again. Washington Mutual was the most recent beneficiary, with $7 billion of new capital. How other large institutions still at risk will fare is an open question. And lower-quality assets aren't yet finding a ready market. Until they do, we can't call the crisis "over."

Inflation

While these credit issues occupy the markets, something even more insidious has crept onto investors' radar screens: inflation. There's a growing realization that inflation is becoming a real threat, particularly in emerging markets, where the double whammy of food and energy inflation is wreaking havoc in the markets and on the streets.

The IMF forecast that consumer prices in both developing and emerging countries would rise another 7.4% this year. In the US headline consumer prices were up 4% in February. And in Saudi Arabia, inflation posted an 8.7% annual rate for February, the highest in 27 years. (Headline CPI includes the so-called "volatile" food and energy prices – but so what? Outside of housing and tax, those are where people spend most of their money!)

The debate centres on whether it's better to fight inflation or recession. And we got a good illustration of how this is playing out recently in Europe. In April, the Bank of England plumped for fighting recession, and dropped its key interest rate another 25 basis points, to 5.0%, citing the toll that the cooling housing market and tighter lending standards are taking on consumer spending. The European Central Bank (ECB) took a stand-pat approach, and kept its benchmark rate on hold at 4%, for the tenth straight month, pointing to solid investment growth, low unemployment, high capacity utilization, and medium-term upside inflation risks. (It did, however, acknowledge global downside risks to growth, suggesting the possibility of a rate cut in coming months.)

Even more significant, though, is the rise in the value of the Chinese yuan against the US dollar. The currency has moved to its highest level against the greenback in 10 years, a sign that Chinese monetary authorities see inflation arising from red-hot economic growth (estimated at 9.8% this year) as a bigger threat than a recession in the US.

The US dollar is under a lot of pressure, and that could lead to inflationary consequences. Current options on US$/J¥ trade with an implied volatility of 15%. Normally these options trade with implied volatility of 5%. This tells us that risk in the relationship between the greenback and the yen is much higher than it has been historically. An implied volatility of 15% is an enormous amount of risk in currency spread, and that tells us that there's a lot going on behind scenes to strengthen US dollar against some of these other currencies. Without that, you've got a real problem. Oil and everything else is priced in US dollars.

The best way to defend against inflation is to keep productivity high, employment high, and the US dollar strong. That means there's a need to enter markets, which is why there won't be more interest rate cuts unless there's a coordinated effort among world's central banks – and it doesn't look like that's going to happen.

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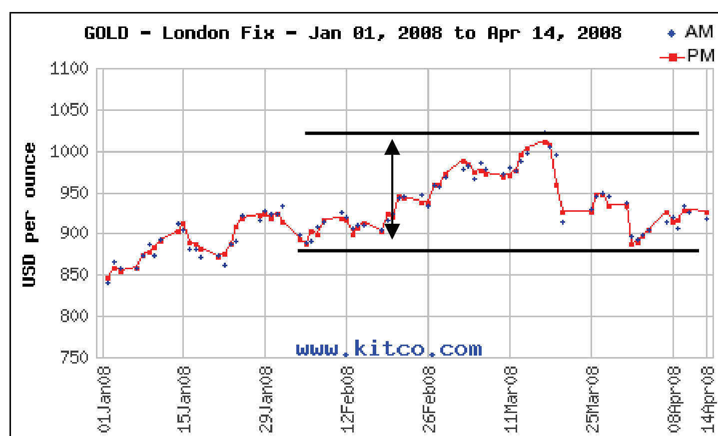
Oil and gold

With the anxiety in the market about credit problems, inflation, and the price of oil, the price of gold popped to new highs, crossing US$1,000 an ounce. That was a pure sentiment-driven advance. Gold performs best in a sentiment-driven market, because of its reputation as the ultimate store of value. When that sentiment-driven buying eased off, gold dropped 10%, to around US$900 an ounce.

The fact is that there is no strong fundamental case to be made for gold. There's jewelry demand, of course, much of it from India, but that tends to be fairly predictable. And gold has industrial uses as well, but not as much as, say, copper.

Primarily then, gold's biggest price moves are driven by market sentiment. And it looks very much like that sentiment is beginning to evaporate. The US dollar, whose weakness has largely influenced the price of gold, is not going to collapse.

Oil is also a key driver of the price of gold, and has typically had about a 10:1 correlation gold, and so it would seem to be a tad overpriced these days. The price of oil is driven more by the supply/demand equation than the price of gold, although there can be plenty of speculative, sentiment-driven movement in oil as well, something we've seen a lot of recently. As oil futures climbed to a recent US$114.95, gold futures for June delivery climbed to US$934.



Courtesy Kitco.com

At what price level will oil begin to have an impact on economic growth? No one knows precisely. But some analysts say it's already having an impact. We can see an example of that right here in Canada, where some economists have predicted that Ontario will be a "have-not" province by 2010, while Alberta basks in the glow of an oilsands-driven economic boom (that is, of course, if the Alberta government doesn't kill the whole thing off with punitive, politically-driven increased royalty demands). Ontario's troubles originate with the erosion of the manufacturing sector arising from the strength of the loonie, much of which can in turn be traced back to the surging profitability of the oilsands – which are surging precisely because the price of oil is so high. We can find another example of the impact of

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the price of oil in China, where rising food and energy costs are propelling inflation to worrisome levels. To some extent, oil is also having an in impact in the US, where combined with the erosion of housing values, rising energy prices are putting a damper on consumer spending, with consequences for everything from manufacturing to airlines (witness the recent proposed merger of Delta and Northwest Airlines).

As clarity begins to reassert in the markets, however, we look for gold – and possibly oil – once again to trade within a range. Oil is sentiment-driven at the moment, and could spike even higher over the next few months. We expect gold to fluctuate somewhere between about US$900 to US$1,000 per ounce. This suits us just fine, because we can apply our option-writing strategies to gold-mining companies. Our research has shown that stocks of gold mining companies tend to be range-bound, commanding high option premiums. We determined that an option writing strategy about doubled the return of a straight buy-and-hold strategy over time, and that's the tack we've taken for gold exposure.

Portfolio and market outlook

In our practice, we overweight Canadian equity more than anything else, because we believe at this point that Canadian equities have more potential. We have US exposure through US Treasury bonds, which are better investments than equities at the moment. The biggest US position in our pools is long-term US government bonds, while we also hold approximately 20% of our pool assets in cash as in Government of Canada Treasury bills, none of which are leveraged.

With cash on the sidelines, we are seeking opportunities to buy distressed debt of excellent quality, which we would be prepared to hold to maturity. We are simply not willing to make those commitments…yet.

Writing options against US T-bonds has returned 4% since beginning of year. As a strategy, we look at it as a better way to play the US market. We're satisfied with a positive 4% return on bonds rather than a negative 5% or 6% at the end of first quarter in US equities.

That doesn't mean we won't jump back in, of course. For the moment, though, we also have short positions in US equity. And we have written options against most of our equity positions, because we just don't think there's going to be a significant near-term move in the market. More likely, we'll see a trading range until we get a transition from sentiment to clarity, and we begin to see real interest in earnings.

We should start to see this shift developing by the third quarter of the year. But we may not start to see actual growth in economy until next year. Remember that equity markets react four to six months ahead of the economy. We are currently in a position to step up to the plate and judiciously buy when everyone else is selling.

We are positioned for steady upside with a defense against market pullbacks. That's likely to happen as we see a number of hedge funds fail in next little while – part of leverage problem in a market that's

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bumped up against a lack of liquidity. If that happens, the market will stumble, and we'll get sharp one-day declines. (We're not likely to see any further US rate cuts to cushion the blow.) If we get those sharp downturns, we want to have short positions we can take advantage of. So right now we're writing options against short positions too. The net effect is that we're pulling in capital month after month in what we think will be a trading-range environment for another few months yet.■

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