September 2009

Our first quarterly letter comes at a most interesting time. We are in the midst of a very weak economy, short term interest rates are near zero, and investors are taking on risk again.

Stock markets have rallied off their lows as investors focus on the "green shoots" that seem to indicate an end to the recession. Stimulus spending, coupled with central bank intervention, has had the desired effect in the short term as the worst case scenario has been avoided. That said, sifting through the economic data reveals an underlying economy that remains structurally weak.

For the developed world, the key economic driver is consumer spending. The U.S. consumer is by far the most significant, accounting for nearly 70% of U.S. GDP and 16% of global GDP. Although this number is somewhat inflated by healthcare, it is still significant.

However, after years of overspending, consumers are now retrenching. We are in the midst of a significant deleveraging process, whereby banks are rebuilding their capital and consumers are reducing their debt. The chart below illustrates the decline in consumer debt since September 2008.

CONSUMER CREDIT OUTSTANDING
Seasonally adjusted

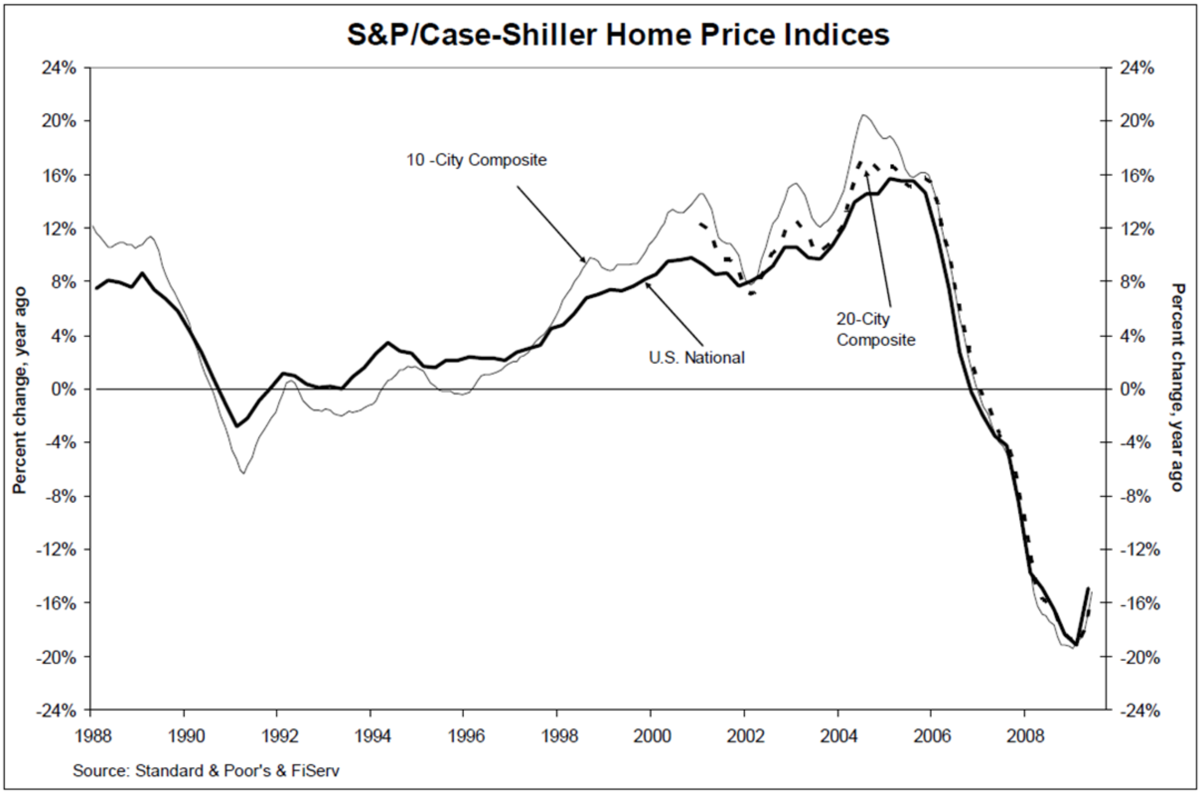
						2008			2009				
	2004	2005	2006	2007	2008	Q2	Q3	Q4	Q1	Q2r	Junr	Julr	Augp
Amount: billions of dollars Total	2,191.5	2,291.0	2,384.8	2,519.5	2,559.1	2,574.3	2,578.3	2,559.1	2,535.3	2,493.7	2,493.7	2,474.7	2,462.7

r: real p: projected

Source: Federal Reserve Board

Consumers have cut their debt by over $110 billion (not including mortgages) over the past year after forty years of almost continuous increase. In addition to weak loan demand, lenders have become far more cautious, given the rate of job loss and the rise in defaults. For example, U.S. credit card defaults rose to a record 11.5% in August, up from 10.5% in July. Given the weakening employment picture we expect this trend to continue, which does not bode well for a strong recovery scenario.

The credit crisis started with the decline of home prices. This is illustrated in the chart below, which shows the year-over-year decline in U.S. home prices.



There has been some stabilization over the past few months, but both Moody's and Fiserv forecast that U.S. home prices will decline a further 11% by mid-2010, due in large part to the high foreclosure rate. Foreclosures rose to a record 937,000 in the September quarter, 23% higher than the same quarter last year (RealtyTrac). Weak home prices are impacting consumer spending, bank lending and jobs.

Federal Reserve Board Chairman Ben Bernanke recently stated that "from a technical perspective, the recession is very likely over" - not a very bullish statement! He went on to warn that unemployment is expected to surpass 10% this year. It is 9.8% today and fast approaching the post-World War II high of 10.8% reached in 1982. The U.S. economy has shed jobs for twenty-one consecutive months, the longest such streak on record (data was first collected in 1939). The recession may indeed be over, but growth in 2010 will be muted and this will remain a jobless recovery for some time. The International Monetary Fund anticipates global growth of 3% for 2010, well below the pre-recession level. This suggests that excess capacity will persist and inflation should remain a non-issue for at least the next year, allowing central banks to maintain a low interest rate policy.

Two pieces of legislation resulted in a boost to consumer spending this year - the "cash for clunkers" program aimed at boosting auto sales and the $8,000 first-time home buyer tax credit. Cash for clunkers, which offered a rebate on trade-ins for new vehicles, caused a sharp rise in vehicle sales for the month of August to an annualized rate of 14 million. However, after the program expired sales quickly shrank back to an annualized rate of 9.2 million in

September. The U.S. Congress is considering extending both programs on the basis that the economy may sink back into recession without further stimulus.

The outcome of recent government intervention (and possible new policies) is a fundamental issue we are grappling with. Will the stimulus be enough of a springboard for the economy to grow on its own, or will we slip back into a recessionary / slow growth environment and require more intervention? Governments must walk a fine line. Not enough stimulus and we risk a return to recession. Too much stimulus and we risk inflation and an enlarged government debt burden. Thus the risks to a sustained recovery are many, and include: the eventual withdrawal of government stimulus and reversal of an accommodative monetary policy; record high government deficits that may necessitate higher taxes and spending cuts; the potential for a weak U.S. dollar; and whether countries that are running large current account surpluses, such as China, are successful at encouraging increased domestic consumption to offset reduced consumer spending in the developed world.

With all of these issues, equity markets have risen sharply over the past six months. From our perspective there are three reasons for this. First, despite ongoing economic weakness, the rate of decline for sectors such as housing and autos has slowed, indicating that that the worst may be over. Second, despite the fact that corporate earnings declined over 20% in the first half of 2009, many CEO's have mastered the art of setting low profit expectations and then beating the earnings estimates through massive cost cutting. We note that this recession stands out as one where even hugely profitable companies such as Microsoft have been firing workers to maintain quarterly profits, but the cost cutting game will not drive earnings growth indefinitely. Going forward companies will need revenue growth in order to generate meaningful earnings improvement not an easy goal to achieve in a period of sub-par growth. Perhaps just as important, increasingly over the past few years companies have been encouraging investors and analysts to focus on "operating earnings" and ignore GAAP (generally accepted accounting principles) earnings, which often include material costs relating to restructuring and asset impairment charges. Finally, low interest rates are driving investors in search of yield to take on added risk. At a time of unsustainably low interest rates, we are seeing investors once again snap up long term bonds, including those issued by companies with questionable credit histories. This is not a new story and it usually ends badly - remember non-bank asset-backed commercial paper and subprime mortgages?

The S&P 500 is currently trading at a Price to Earnings ratio of about 27, based on "operating earnings". Using actual earnings, the P/E ratio is at a record high of 140! From these depressed levels it is reasonable to expect some earnings improvement in 2010, but even a 30% increase would leave the market P/E at 21 - still rather expensive. With this in mind, we have reduced our equity exposure. We have sold shares in Astral Media, Transcontinental and Illinois Tool Works. We are holding on to our shares in Canadian banks on the basis of their oligopoly-like characteristics and strong capital positions. It is difficult to find cheap stocks at present and we prefer to hold cash, in spite of a near zero return.

Capital preservation is always of paramount concern.

Sincerely,

Lorne Steinberg