

INVESTMENT REVIEW AND OUTLOOK

Perfect Storm Hits World Markets

World equities had their worst quarter in more than five years in the first quarter of 2008. Soaring energy prices, massive write-downs in the banking sector and a liquidity crisis that culminated in the demise of Bear Stearns together created a perfect storm in the global markets. The end result was a flight to quality and a tidal wave of risk aversion that spread across virtually all asset classes and geographies in the first quarter. Ironically, despite the U.S centric nature of the credit storm, the S&P 500 held up better than many other markets around the globe in the period. The following chart is illustrative:

World Stock Market Scoreboard 1st Q 2008 (in local currency)

U.S. / S&P 500	-9.4
U.K.	-11.7
France	-16.2
Germany	-18.9
Japan	-18.2
Australia	-15.5
India	-22.9
China	-34.0

As the chart clearly shows, stocks were not the place to be in the first quarter. ***Correlations tend to rise in times of crisis, but the uniformity of negative returns in the most recent quarter was highly unusual and reminiscent of the global meltdown that occurred in 1998 around the Long Term Capital episode.*** Asset classes producing a positive return for the first three months of this year were few and far between. They included high quality bonds, commodities and gold. Among U.S. industry sectors, the best performers in the first quarter were consumer staples, materials and energy and the worst were financials and technology. There was little differentiation in the quarter from an equity style perspective.

On an encouraging note, since quarter end there have been some early signs of stabilization in the equity markets, if not yet in the credit markets. Stocks have rallied in April and begun to show resilience in the face of an ongoing stream of negative news. With the collapse of Bear Stearns the market may have experienced the kind of catharsis that has punctuated financial crises throughout history. Of course, even if the eye of the storm has passed, the seas may remain rough for some time.

Wall Street Avoids Armageddon

Faced with one of the worst credit crises in financial market history, the Federal Reserve took unprecedented- some would say- *desperate* measures to stabilize the system. Not only did the central bank aggressively slash interest rates and open up the discount window to investment banks for the first time since the 1930s, it was also a key player in the eleventh hour rescue of Bear Stearns. ***The Fed's actions were as alarming as they were reassuring.*** And while it is too early in this crisis to pass final judgment on the new Fed chairman's crisis management skills, by preventing a sudden bankruptcy filing by Bear Stearns he succeeded in taking the Armageddon scenario off the table. The domino effect of a sudden Bear Stearns collapse would have been devastating on Wall Street, if not Main Street.

While the worst of the credit contagion may be behind us, the healing process will take some time. The reversal of a credit bubble that was decades in the making will not be quick and those expecting a "V" shaped recovery are likely to be disappointed. The suppressed appetite for risk on the part of both borrowers and lenders that accompanies a deleveraging cycle will be a persistent headwind for the economy. Meanwhile, as news flow from the financial sector begins to lose its shock value, the focus may shift to the health of the overall economy, particularly the non financial segments of it. ***There is little question that a recession has begun. As David Rosenberg of Merrill Lynch has said, the key question now is whether it will be "short and shallow or deep and prolonged."*** The outcome will hinge on how quickly the Fed can "fix" the credit markets. If credit market dysfunction is protracted, there is an increased risk that financial sector problems will begin to undermine the still healthy parts of the economy. One of the key areas we will be watching for signs of credit market stabilization are spreads between higher risk and lower risk assets. There are tentative signs of improvement/narrowing in credit spreads at this point, but overall conditions are still worrisome.

Portfolio Strategy

In our January letter we were quite defensive, emphasizing higher than normal cash reserves, global large cap stocks, energy and gold. Our current strategy is little changed. There is a great deal of uncertainty to the outlook, whether one looks at the financial markets, the real economy or the political landscape. ***However, investing has always been about the probabilities and it would be a mistake to get too bearish in the face of record setting stimulus efforts,***

healthy global economic conditions and reasonably valued equities. The “don’t fight the Fed” axiom may be too simplistic for the times, but we still think the odds are that the unprecedented reflationary efforts of the Fed will be successful. Unfortunately, a central bank can only do one thing at a time. In fighting the debt bubble deflation battle, the Federal Reserve has taken its eye off the inflation ball at a time when inflationary pressures are already building around the globe. Since this is an election year, the Fed may want to avoid any dramatic shift in its policy bias until after November, possibly putting it further behind the inflation curve. This has potentially profound implications for the U.S dollar, P/E ratios and, ultimately, stock selection.

Over the next several months the economic news is likely to worsen, but the period of greatest stress for the financial markets may already be behind us. Nevertheless, as we enter a prolonged deleveraging cycle and the first consumer led recession since 1991, the investment environment will remain tricky. Importantly, the winners and losers will be different than those of the last business cycle. Indeed, with a period of rising global inflation upon us, the ingredients for success will be different than many of today’s investment professionals have seen in their entire career. Interest rates and inflation rates have been falling steadily since the early 1980s creating a good deal of complacency about inflation. Global demand pressures, inflationary monetary and fiscal policies and a weaker dollar all point to upward pressure on inflation. Should protectionist policies gain political traction, this would only exacerbate the situation. **Accordingly, we continue to have a significant focus in our portfolios on inflation hedges and inflation beneficiaries, including energy, commodities and gold.** In addition, the bull market in large cap, globally exposed industrials and infrastructure plays is ongoing and our portfolios have major exposure to these important long term growth themes. Against the backdrop of a long deleveraging cycle and inevitable consumer retrenchment, we remain underweight the domestic financial and consumer discretionary sectors. **The consumer enters this recession burdened by levels of food and energy inflation not seen since the 1970s.** There will be many rallies in the consumer and financial areas in the coming months as well as select opportunities to purchase enduring franchises at cheap prices. However, just as it was a mistake to try to pick a bottom in technology shares earlier this decade, it could also be a mistake to bottom pick in financial and consumer related issues today.

The bottom line is that global stocks appear to be in a bottoming process. Credit market conditions remain a concern, as does the state of the U.S. economy, but massive monetary stimulus and reasonable valuations should put a floor under the market. The flight to safety has left a mountain of cash on the sidelines earning very low nominal and *negative* real returns. The storm clouds would only need to part slightly to bring investors back to equities.

As always, we welcome your comments and questions.