

Basic Points

June Reflections: Summer's Storms and Norms

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Don Coxe

THE COXE STRATEGY JOURNAL

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Author: Don Coxe 312-461-5365
DC@CoxeAdvisors.com

Editor: Angela Trudeau 604-929-8791
AT@CoxeAdvisors.com

Coxe Advisors LLP.
190 South LaSalle Street, 4th Floor
Chicago, Illinois USA 60603

www.CoxeAdvisors.com

June Reflections: Summer's Storms and Norms

OVERVIEW

Our summertime offering reflects this season's contrasts—violent storms and idyllic days.

As this is written, banks across Europe are being lashed by storms spawned in the Mediterranean.

Meanwhile, from across the globe, world leaders and their advisors are preparing to come to Toronto to discuss policies for extending the economic recovery from the damage of the hurricanes, tornados and earthquakes of the Summer of 2008. Thanks to the unfolding revelations of the financial crises facing a collection of Eurozone under-achieving over-promisers, the widespread confidence about the economic outlook as of late winter is dwindling rapidly.

This issue is therefore in two parts: today's eurocrisis ("Financial Trichinosis"), and a more leisurely discussion of long-term investing in two stores of value—the Canadian dollar and gold.

The Canadian dollar had been drawing serious investor interest since 2005 as the G-7 currency best attuned to a global commodity boom, but more recently has been gaining respect for Canada's relatively strong economic and financial performance under crisis conditions. We hope our analysis of the historical background to Canada's recent impressive performance will be especially helpful to visitors. The gold story has been around for millennia, but it is now attracting serious investment interest for thoroughly modern reasons.

We revised our Recommended Asset Mix in April, reflecting our confidence that the global economic recovery was on track. We thought the European Union would not let Greece's problems derail Europe's fragile comeback. It now appears European banks are sliding on Greeced skids into a new PIIGS-borne epidemic, before the banking system had fully recovered from the Great CDO Plague that originated in Washington and Wall Street. Result: a weakened global economic outlook.

We are adjusting our Recommendations to reflect the risks of stronger summer storms.



June Reflections: Summer's Storms and Norms

I. FINANCIAL TRICHINOSIS

Humans can contract spiral trichinosis from tainted pork. If a sufferer gets prompt treatment, it is easily cured. If not, it can enter the central nervous system and produce agony and death.

What is spreading across the Eurozone financial system is a disease spawned in southern PIIGSties. Its potential lethality derives from the two major misunderstandings arising from the birth of the euro: (1) that published national financial statements showing adherence to Maastricht (read German) maximum debt levels would be of roughly equal honesty across the eurozone, and (2) that members with histories of profligacy, devaluations and defaults had been miraculously baptized into permanent financial sinlessness.

Even with good intentions, the countries most eager to qualify for admission to the club of issuers of a currency that would be at least as acceptable and strong as the dollar and yen—Portugal, Ireland, Italy, Greece and Spain—had marginal, uncompetitive economies compared to Germany, France and the Netherlands, (let alone the USA and China). However, in some cases they lied in their financial data to pass the Teutonic tests, and in all cases they broke the behavior rules thereafter. Moreover, they all gained access to almost unlimited funding at rates that were minimally (read ridiculously) close to Germany's. Sovereign credit bond buyers—particularly European banks—greedily and stupidly sought these bonds to catch those small premiums at a time of sustained low interest rates.

But those bankers were buying those dubious bonds to disguise their own misdeeds: their balance sheets were heavily over-levered and, as the subprime and LBO loan crises unfolded, their need for tangible capital escalated dramatically. The banks could borrow on their own credit and load up on PIIGS bonds without having to allocate capital against them. (This was a provision of the Basel Accords that governed banks that functioned internationally. It was there because bonds of an advanced industrial OECD nation were deemed the safest of all credits—better than loans to the mightiest of corporations.)

The more bonds benighted bankers bought, the more they convinced each other that the eurozone was the reliable roach motel of currencies: once in, there was no way for a nation to exit the zone in order to revert to its long-standing traditions of depreciating its currency to offset its lack of competitiveness and its ghastly finances. If any country got into some difficulty, then, as it had done for decades in all European Union burden-sharing, Germany would pick up the tab—directly, or through some other agreement or through the European Central Bank.

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What these PIIGS aficionados didn't notice was the huge growth in deficits in these underperforming and over-indebted economies—and how restive Germans were becoming after decades of sacrifice to bail out East Germany, while also picking up a growing share of the tab for a wide array of European Union expenditures.

Angela Merkel was denounced across Europe when she resisted giving Greece immediate aid. What was ominous was that she was attracting even greater resentment within Germany for capitulating to the demands of its partners. Her coalition suffered the worst defeat in its history in the largest of the *länder*—North Rhine-Westphalia, because voters smelled betrayal: they had been forced into the euro by her party under Helmut Kohl, and had been guaranteed this new currency would have the strength of the *Deutschemark*—the German institution in which, for decades, the people had taken the most pride.

As we discuss later, the euro is unique in the history of currencies because it isn't backed by any nation's government, taxation or army. It is backed by a newborn international central bank whose control is indistinct.

What makes this current crisis so severe is that it may have the same effect on the credibility of the euro that tearing down the curtain had on the Wizard of OZ: There's no nation or economy standing behind the paper currency—just an international committee of bureaucrats which can only enforce its decrees against its members with their consent. It is little more than the currency equivalent of the United Nations—a good idea, perhaps, but you might not want to bet your personal wealth or pension fund on it.

So all those banks holding PIIGSpaper at par, denominated in a dubious currency, watch their real capital and liquidity eroding even as Basel is putting the finishing touches on new rules that would (according to Barclay's) force European banks to raise \$2 trillion more in tangible capital. It will be recalled that Bernanke believed that deflation of banks' capital was *the* factor triggering the Depression.

We had watched this black comedy/tragedy unfolding since we published two months ago, but remained hesitant about responding with revised recommendations as long as the economic data remained favorable. Our thesis has been that there is a global industrial recovery, even though many economies remain weak. World trade was rising much more rapidly than world GDP—as evidenced by prices of industrial commodities and the muscular industrial activity in China and India.

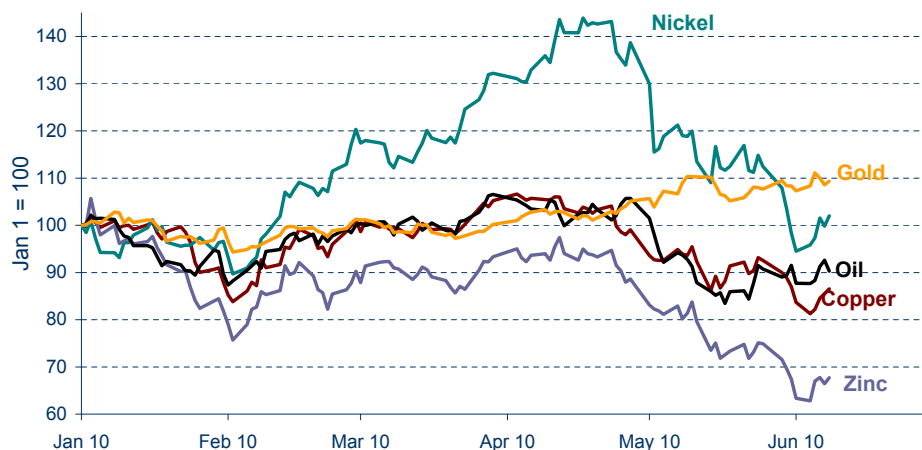
But we got a shock on June 1st that forced us to rethink our confidence. The *Journal of Commerce's* Smoothed Index of Industrial Raw Materials (the dull, down and dirty variety of inputs to the basic industries, of which Europe has proportionally more in its GDP than does the US) was announced: its year-over-year increase was announced as being down 57% from the previous month. (It was still climbing, but at a sharply lower rate: in April it was up 60% from 2009, but in May, just 26%. A client who challenged our bleak interpretation of the data notes that this is still a robust number. However, we have watched this index since we came into the portfolio management business but have rarely cited it because it is relatively obscure and rarely deviates strongly from the better-known indices, including the various Crude Goods components of the Producer Price Index. When its rate of annual change moves sharply, it has had a good record for picking peaks and bottoms in commodity cycles—and therefore in global industrial activity.

Milton Friedman flatly predicted the euro would never happen, because the economies and cultures were so diverse...

That index's behavior is confirmed by the recent fall in base metal prices, as cited by Bart Melek, BMO's Global Commodity Strategist:

Copper, Nickel, Zinc, Lead and Crude Oil

Jan. 1, 2010 to June 11, 2010



Source: Bart Melek, Global Commodity Strategist, BMO Capital Markets (Bloomberg and BMO Capital Markets)

It is also confirmed by a sharp downward reversal in the Baltic Dry Index and by weak US employment news.

As a *Fortune* columnist reported recently, Milton Friedman flatly predicted the euro would never happen, because the economies and cultures were so diverse and no central bank could set "wise" policies that would be good for all of them.

Assuming that the PIIGS will not be a herd of Gadarene Swine that plunge together over a precipice into the Mediterranean, investors should soon be able to revert to longer-term portfolio construction.

"Papering over a problem" has been Brussels' approach for years, when nations that had been at war with each other so often in recent centuries were having trouble agreeing on trade and economic issues. But when the paper you are using is the currency that is the real problem, you cannot hide it.

Conclusion: the euro may manage to muddle through, but its agonies are now blending into the fabric of Europe's overloaded and undercapitalized banks at a time when no PIIGS—or, for that matter, the UK—have competitive economies.

This means panicky global investors are rushing from euro-denominated debt into Treasuries, which is great news for Messrs. Obama and Geithner in their roles as the world's biggest issuers of new debt. But it's terrible news for them in their roles as managers of the economic recovery. The strongest component of this rather epicene recovery has been exports and that was fueled—until Athens took center stage—by the dollar's weakness.

As the TED Spread and other measures of bank confidence levels deteriorate, we are forced to contemplate the problem of a new banking crisis originating in Europe at a time US foreclosure rates and bank closures continue to increase. Persons in weakened conditions are more susceptible to death by trichinosis than robust people who ate the same tainted meal.

We have revised our Asset Recommendations accordingly.

Assuming that the PIIGS will not be a herd of Gadarene Swine that plunge together over a precipice into the Mediterranean, investors will eventually be able to revert to longer-term portfolio construction.

Greed based on unrealistic assumptions of future returns is being replaced with a new defensiveness: how can we protect the wealth we have, while still obtaining some level of real growth?

Those who now seek shelter and realism, rather than gigantic get-rich-quick scams are turning to stores of value. We suggest they focus on two: the pre-eminent store of value through all recorded history, and, for financial assets, on the relatively scarce paper currency that has the lowest endogenous risk.

II. STORES OF VALUE

A store of value is an accepted measure of wealth and a reliable vehicle for wealth accumulation. It should retain its real value over time. Over the centuries, various attempts to create new stores of value through political printing presses (beginning in China in the First Millennium) failed.

Gold fulfilled that role through history, either alone or, since the Napoleonic Wars, as the backing for currencies that were freely convertible into bullion.

After World War II, gold never regained that status as the global store of value, even when Nixon's closure of the gold window unleashed a rally that became a mania that exhausted itself in 1980. Most central banks consistently unloaded their gold during its ensuing Triple Waterfall collapse that ended in 2001. Gold was monetarily obsolete, though still useful for wearing around female necks, and in dentistry—the caries trade.

When the millennium dawned, global investors had three currencies competing for pre-eminence as global stores of value—the dollar, the yen, and the newest challenger—the euro. As the decade unfolded, the yen succumbed to Japan's continuing Triple Waterfall decline and morphed into the currency of the carry trade. The dollar's value declined steadily against most tradable currencies. In particular, it lost half its value against the upstart euro between 2001 and 2007.

This month, we advance the thesis that *none* of the three major tradable currencies will regain its role as a prized store of value. Gold is moving from the shadows where economists and politicians had consigned it to center stage.

What makes a currency a store of value?

The British pound was the pre-eminent paper currency for nearly a century until World War I, and was prized among people who wanted liquid assets that would keep their value under stressful conditions—economic and geopolitical. Its prestige derived from (1) Britain's status as the only industrial power with a long history of democracy and the rule of law, (2) "The Navy of Nelson", which ruled the seas and protected the free trade which fed British prosperity by giving British industrialists and consumers reliable access to the world's raw materials and manufactured goods, and (3) The Bank of England's continuing pledge to accept pound notes against full payment in gold sovereigns or bullion. It did not displace gold as the recognized global store of value, but it offered flexibility for financial and commercial transactions that permitted economic expansion unconstrained by the obviously-restricted supplies of bullion.

Gold was monetarily obsolete, though still useful for wearing around female necks, and in dentistry—the caries trade.

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**The US was...
"the indispensable
nation"..**

World War I ended the sterling's era of global dominance. The dollar—backed, (in theory) by Fort Knox's gold and, more tangibly, by the free convertibility of the greenback into the nation's seemingly-inexhaustible supply of silver, and America's rank as the foremost global military and industrial power—took on that role, which was codified at Bretton Woods in 1944. Gold was pushed to the margins of the global economy after Roosevelt made it illegal for Americans to own it (except for jewelry, dentistry and industrial uses). The US guaranteed that it would exchange its gold to foreign governments for greenbacks, and did so until 1971, when Nixon closed the gold window. (The US stopped redeeming greenbacks with silver in 1963.)

The dollar fulfilled a core component of the requirements of The Liquid Global Store of Value by being disseminated continuously across the world through the nation's endless trade deficits. Global trade could keep expanding as nations recovered from the war, because greenbacks were always available and always accepted. The dollar was able to maintain its prestige and pre-eminence even as it declined in value against currencies of rising commercial and industrial economies because the US was, as Madeleine Albright later noted, "the indispensable nation" whose military prowess was the primary guardian of global peace during the Cold War and whose willingness to intervene in smaller conflagrations abroad where the nation had no direct interest—such as the Balkan implosions after the end of the Tito era—kept the world mostly peaceful.

US Dollar Index (DXY)

January 1, 1986 to June 15, 2010



The dollar's plunge in the past decade was partly driven by fears that the nation's military expenditures would undermine America's financial might, but mostly by the growing doubts about the longer-term competitiveness of American industry, and concerns about the nation's falling savings rate. Its recent rally is mostly because of the dramatic crisis in the eurozone at a time the economy of the other of the dollar's major alternatives—the yen—remains mired in its Triple Waterfall demographically-driven decline that began in 1990.

[The dollar's] recent rally is mostly because of the dramatic crisis in the eurozone.

China's renminbi is assuredly the strongest of the major currencies, but it has been too restricted and illiquid to be a universal store of value. It is quite possible that the renminbi could meet those requirements—and this could happen quite soon if China decides to demonstrate that it has become the real leader in the global economy by revaluing its currency upward as its primary means for restraining its domestic inflationary pressures. (Otherwise, it will have to tighten liquidity and bank lending, thereby slowing its growth at a time the industrial world is gasping for breath. The braying American yahoos who demand that China revalue the RMB to make unionized American factories with underfunded pension and welfare plans suddenly competitive are, we suspect, the major reason why China has not already made this move.)

Whilst there is no other Western currency that can displace the dollar's role in international transactions, there is, we believe, one that offers investors and savers a strong, sensible alternative to the dollar's status as the store of value...

Of the industrial world's currencies, only the Canadian dollar (known as "the loon" or "loonie") now boasts the qualities of endogenous strength and political reliability that could make global investors—particularly high net worth managers—prize it as a secure, tradable store of value from a long-term standpoint, and we believe it is on the road to that status. Its ascent has been slowed by the new financial crisis, which forces deleveraging in dollar-denominated debt: in recent years the greenback has only been a foul-weather friend—weak in good times and strong when financial markets totter and bad banks face disembowelment. The loonie's small scale and liquidity compared with the major currencies precludes it from being a major component of global forex reserves. It can be considered NAFTA's equivalent of the Swiss franc—and an appropriate wealth-conserving medium for high net worth investors.

Canada's proven wisdom in pension funding... the reliable handiwork of prudent Scottish-style actuaries compared with the withering works of European-style socialists and American-style handout-oriented politicians.

A. The Call of the Loon

We have been bullish on Canadian investments—particularly in comparison with US investments—since the new millennium arrived.

That enthusiasm derived from our view that Canada was completing its adjustments to the competitive challenges it faced from the Reagan renaissance.

We believed that a new commodity boom driven by the emergence of China as the driving force of a different kind of global economy would play to Canada's strengths in commodities. It was ready to be a good-news currency because its wrenching adjustments to North American Free Trade had laid the basis for economic progress.

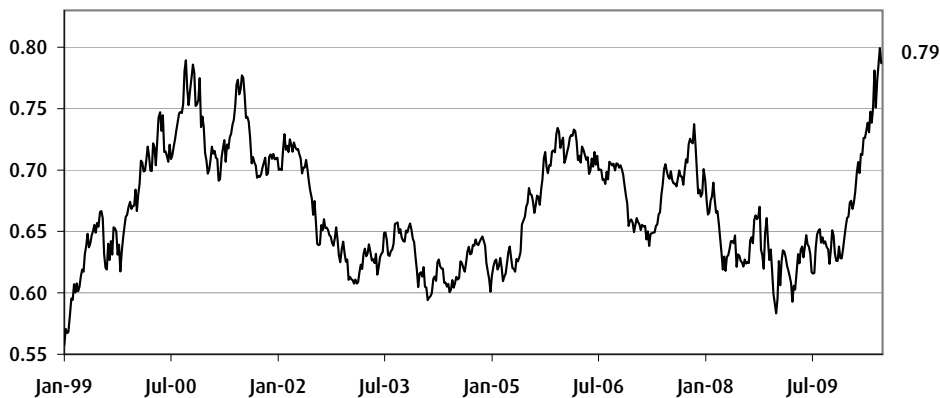
In particular, we were impressed with the nation's underlying financial strength from its new political realism, its strong banking system, and its relatively strong pension system—public, private, and the Canada Pension Plan. As demography deteriorated across the OECD, Canada's proven wisdom in pension funding would ultimately convince foreign analysts that its retirement income system would look more and more—in comparison with systems abroad—like the reliable handiwork of prudent Scottish-style actuaries compared with the withering works of European-style socialists and American-style handout-oriented politicians.

Canadian Dollar/US Dollar
January 1, 1996 to June 15, 2010



Canadian Dollar/Euro

January 1, 1999 to June 15, 2010



**So how did Canada
become the
cynosure of global
appraisers' eyes?**

Canada entered the 2008 recession after a decade of budget restraint, which had endowed it with a sound national balance sheet. That gave the nation's crisis managers great flexibility in concocting and executing ambitious stimulus packages, which have generally worked well.

According to the international publications that rate such things, Canada has the top-ranked central bank chief (Mark Carney), the top-ranked Finance Minister (Jim Flaherty) and, naturally, the top-ranked financial system in the G-7.

So how did Canada become the cynosure of global appraisers' eyes?

Having all that mineral wealth at a time of a global commodities boom really helped.

But Russia, Iran, South Africa and Argentina have also been big winners from the commodities boom without developing economies and financial systems that function well enough to evoke envy or respect.

Canada is in the sweet spot now because its governments in Ottawa over the past three decades have been mostly right about developing and implementing gutsy—and electorally unpopular—programs for the nation's biggest economic challenges. No other G-7 nation was lucky enough to be able to undergo major changes in leadership at the top without backsliding on painful—and utterly necessary—long-term restructuring strategies.

June Reflections: Summer's Storms and Norms

For the Tories, the political outcome of courage in doing the right things led to a renewed demonstration of the principle that no good deed goes unpunished.

With particular regard for the visitors to the G-20 meeting, we offer a summary of recent Canadian political-economic history. It is our thesis that successive Ottawa administrations did the difficult big things right—in the face of sometimes-vicious criticism and frequent rage.

In the Eighties, two major challenges faced the Tory government of Brian Mulroney:

First: How could the nation develop the economic vitality to stop the brain drain of its best and brightest, who were leaving in droves for the burgeoning opportunities across the border as the Reagan boom unfolded?

Second: How could it begin the process of preparing Canada for the coming crises for its pension and health care systems from its fast-deteriorating demography? (As early as 1978, the federal government had released a well-documented long-term demographic study entitled “One in Three” about the grim outlook for the nation’s social security programs in the next century when retirees would be one-third of the population.)

The first challenge was met when President Reagan proposed free trade with Canada, and Mulroney accepted the offer. The nation was convulsed along its internal fault lines. The Canadian Left, the stronghold of the nation’s anti-Americanism, launched a furious counter-attack against free trade, and managed to get the Liberal Party, which had historically been more pragmatic, to join it in full-throated opposition. Free trade barely made it through the approval process. Its advent forced much of the Canadian manufacturing base into a lengthy and painful process of consolidation and adaptation to the suddenly-fearsome competition from the South.

While the nation was still struggling with the restructuring necessitated by free trade, the Tories addressed the nation’s fiscal deterioration by cutting income taxes to compete with the attractiveness of the US under the Reagan tax cuts—but created a new national sales tax that would be folded into the various provincial sales taxes. Mulroney, and his Finance Minister, Michael Wilson, understood that there was no way the nation could keep its popular “free” health care without a tax on goods and services—the equivalent of the European VATs. For the Tories, the political outcome of courage in doing the right things led to a renewed demonstration of the principle that no good deed goes unpunished.

The ensuing election was really no contest. Led by Jean Chretien, the Liberals won in a landslide—on a platform of tearing up the Free Trade agreement and repealing the unpopular Goods and Services Tax.

What could have been a disastrous setback for Canada turned out to be a blessing. Instead of fulfilling those demagogic promises, the Liberals courageously expanded free trade to include Mexican participation in NAFTA, and actually beefed up those hated new “Tory” sales taxes. They also retrenched on many dubious spending programs, as the nation’s parlous fiscal condition raised fears that the IMF might be called in to bail Canada out. The Canadian dollar was already being derided as the “Peso of the North.”

The Canadian dollar was already being derided as the “Peso of the North.”

But under the leadership of respected Finance Minister Paul Martin, the Chretien government did what was right—and stayed the course. Only the center-Left Liberals could have managed to keep the nation moving forward during a period of prolonged spending restraint. Had the Tories somehow survived in office, the media would have waged sustained 24/7 campaigns against the “Americanization and de-humanization of Canada by Reaganite and Thatcherite Conservatives.”

Result: The deficits turned to surpluses. The manufacturing base slowly became competitive and the jobs came back. The “brain drain” disappeared from the media as a manifestation of the nation’s historic inferiority complex...

And then the prices of raw materials began to climb.

Although intra-party warfare ultimately forced Chretien’s resignation and the unexpected defeat of his successor, Paul Martin, Canada continued to benefit from sound, understated leadership.

The Tories, under Stephen Harper, a bright intellect but a dour campaigner, have managed to stay in power for four years and move the nation forward without once winning a Parliamentary majority—a record British Tory David Cameron could covet. Moreover, until after the Crash, the Tories resisted Opposition demands to boost spending.

Result: when Bear Stearns, IAG, Lehman, Fannie and Freddie collapsed and the commodity boom became a bust, Canada’s finances remained strong in comparison with the rest of the G-7.

...observers rank the CPP as one of the three best-funded public plans in the OECD.

Key reasons for that financial soundness:

1) The Canada Pension Plan (CPP)

The Liberals originally introduced the Canadian equivalent of Social Security in 1966. Fittingly, it was the Liberals who introduced its only major financial restructuring during the 1990s, when the investment policies of its huge reserves were switched from ownership of long-term provincial government bonds into open market investments managed by a highly-professional team in Toronto, the Canada Pension Plan Investment Board. Last year, the national plan earned 15% on its diversified portfolio—and would have earned far more except that its large exposure to US assets hurt its returns as the Canadian dollar soared. Outside observers rank the CPP as one of the three best-funded public plans in the OECD. (Quebec operates a parallel plan to the CPP—the Quebec Pension Plan—which has, from inception, invested in open market investments. Its funding level is not as robust as the CPP's, but, in comparison with Social Security, it is very strong.)

2) Government Employees' Pension Programs

The CPP's impressive financial strength compared with US Social Security is mirrored in the comparison between the relative funding of the two nations' retirement programs for government employees.

This journal is written in Illinois, which has the dubious distinction of being second only to California for having the most inadequate funding of its state and local employees' pensions.

Stanford economists recently costed out California's state and municipal employee programs, and they are underfunded by \$500 billion—far more than all the California General Obligation debt outstanding. The American public sector's cost burdens are of Grecian proportions: as David Einhorn of Greenlight Capital wrote in *The New York Times*, May 26, "In 2008, according to the Cato Institute, the average federal civilian salary with benefits was \$119,982, compared with \$59,909 for the average private sector worker.... Government employees are expensive and difficult to fire. Bloomberg News reported that from the last peak, businesses have let go 8.5 million people, or 7.4% of the work force, while local governments have cut only 141,000 workers, or less than 1%."

Most states' employee programs are pathetically underfunded. In contrast, Canadian provinces' plans are, by and large, actuarially sound, and pose no threats to the nation's financial stability. Having actuaries—rather than politicians—design and run public employee plans is a testimonial to Canadian good sense and American folly.

3) The Banking Oligopoly

Not one Canadian bank went broke during the Depression. And none was on the edge of bailout during this recession. (A few small start-up banks have failed in recent decades, but not one of the biggies has ever been rumored to be facing Lehmanitis.)

Canada today has five large and one medium-sized national bank, and fifteen smaller banks. "The Big Five" have dominated Canadian banking for many decades.

For those visiting Canada for the G-20 meetings who don't know the roster of the six national banks, they are, in order of market cap:

<i>Name</i>	<i>Market Cap (bns)</i>
Royal Bank of Canada	76.5
TD Bank	62.0
Bank of Nova Scotia	51.9
Bank of Montreal	34.5
Canadian Imperial Bank of Commerce	28.2
National Bank of Canada	9.4

Six banks? There are, (depending on how many failed over the weekend), roughly 8,000 in the USA—although only a handful of them have scale remotely comparable to the top Canadian banks—and almost none have their financial strength.

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If Canada's national banks were all taxed for this global fund, the headline might read "Six and the Citi."

Canadians love to grumble about their big, ubiquitous banks, but they also love to save with them and invest in them. They take for granted that the banks are financially sound.

Are the banks too clubby with their Ottawa regulators and the Bank of Canada? Both sides say no, but there is no question that the associations have been long and close. The Bank of Canada and the Department of Finance both feel entitled to claim much of the credit for the splendid comparative strength of Canada's banks, whereas the bankers like to claim they've just been smart and careful.

The reality is that all parties can puff themselves up a bit: the banks have been regulated by Ottawa since Confederation, and the process has clearly worked well.

That's one reason why Canadian bankers and the politicians united in rejecting the Obama-Brown call for heavy new taxes on global banks. "They created the mess: now let them pay back some of what the taxpayers gave them to keep going" was the justification for this proposed global grab.

Except that "justification" doesn't apply to Canada. Ottawa immediately vowed Canadian taxpayers wouldn't participate in propping up the malefactors of Wall Street and London.

A year ago, all members of Canada's banking Big Five had bigger market caps than Citigroup, the multi-strategy hedge fund masquerading as a bank that was saved from death by elephantiasis with more than \$50 billion of US taxpayers' money. (For a brief period of time, Citi was costing the Treasury more than the Afghanistan and Iraq Wars combined. If Canada's national banks were all taxed for this global fund, the headline might read "Six and the Citi.")

We have heard from time-to-time that Canadian bankers aren't as smart or imaginative or aggressive as their American counterparts—and that's why they didn't get into trouble. In essence, goes this sneer, they were too mediocre to get into trouble. They don't deserve all the respect they're getting.

However, the basic business of banking should be somewhat dull and formulaic, and rooted in a visceral skepticism about complex new products that offer big bosses big paydays.

Canadian bankers have done well by not trying to do too well for themselves. They would collectively evoke the respect of Walter Bagehot (founder of *The Economist*). In contrast, many of the biggest names at the biggest banks who will have representatives in Toronto for the G-20 would draw Bagehot's contempt.

4) Canada's Natural Resources

You were, perhaps, wondering why it took us so long to get to the most obvious part of the Canadian success story—its oil, gas, and mineral resources?

Answer: because almost everybody knows this, whereas Canada's comparative civic, political and banking virtues are less well understood.

Canada is the #1 supplier of crude oil to the US, and, as the Alberta oil sands continue to expand, it will increase its share of the US market. (All US polls show that Americans still believe Saudi Arabia is the top supplier, but Canada sends nearly twice as much oil to the US as the Saudis.)

Canada has substantial offshore oil and gas, and it remains a major producer of copper, nickel, iron ore, aluminum and gold. It has long been a major producer and exporter of wheat, oats, barley and canola—but rains on the plains will constrain production this year. (Experts claim Canada's biggest crop export to the US is actually cannabis, but statistics on the revenues are even less reliable than a US budget forecast.)

But Canada's mining and oil wealth is not just minerals dug from the ground. It is the managements, geologists, engineers, drillers, workers and investment bankers who staff companies headquartered in Canada that operate across the world. They are collectively the main reason why the Toronto-Montreal Stock Exchange is such a big factor in global commodity stock capitalization.

...Americans still believe Saudi Arabia is the top supplier, but Canada sends nearly twice as much oil to the US as the Saudis.

[Canadians] have collectively managed to close what has always been the yawning gap between household debt levels in Canada and the US...

Caveat

After all those commendations to Canadian politicians and businesspeople, what can go wrong for the Canadian success story?

They are threefold: the first is the disconnect between the prudence, far-sightedness and caution of those successive Canadian governments and the personal financial behavior of much of the Canadian populace today; the others are the possible unpleasant side effects from a global reappraisal of Canada's investment attractions.

1. A Real Estate Bubble *Now?* Loonacy.

As individuals, Canadians frequently seem to want to mimic the worst in American excesses, while collectively disparaging Americans for their alleged bragging and greed. Quietly, however, they have collectively managed to close what has always been the yawning gap between household debt levels in Canada and the US, as measured by consumer debt to after-tax income. It is now 1.47 times in both countries, from the creation of a new housing bubble.

The OECD noted this alarming coincidence last month when it issued a warning that Canadian consumers' debt levels are now at seriously worrisome levels. Near-Zero interest rates and a relatively strong economy have pushed vast numbers of households into a financial danger zone.

The Bank of Canada broke ranks with the rest of the G-7 last month when it raised its target rate from .25% to .5%. Like most other observers, we believed this would be only the first of several boosts, since the Bank was publicly worried about the fast growth in consumer borrowing, particularly for housing. However, Governor Carney announced that the Bank might not be able to continue its tightening because of the bad news from Europe. (This was, we believe, the first time since World War II that Canadian monetary policy has been tied to conditions in Europe.)

Most Canadians' mortgage rates are tied to short or medium-term rates. The thirty-year fixed-rate mortgages that apply to most American homes have not been available in Canada.

Expect a pricking of the real estate bubble, but don't expect an American-style crash and recession. The banks have always been able to sell high loan-to-value mortgages to a government agency, Canada Mortgage and Housing Corporation. In addition, any mortgages with loan-to-values above 80% must be insured—by that same agency. So all those personal pains will not lead to problems for the financial system, although they will have deleterious effects on Ottawa's balance sheet.

2. Dutch Disease

The Economist coined this term in 1977 to describe what happened to Holland after the discovery of huge deposits of natural gas in the Dutch area of the North Sea in 1959. Exxon set up a partnership with the Dutch government in 1963 to develop those fields.

The result was a boom in revenues for the Dutch economy, before European Monetary Union agreements began to fix relative currency values on the Continent. The Dutch guilder, long the symbol of reliable, stolid burgherdom, rather suddenly became a hot “commodity currency.”

The problems of petro-prosperity unfolded quite quickly. Relatively few Dutch jobs were created by the gas boom, because the Dutch had so few petroleum engineers, roustabouts and other trained personnel for developing and harvesting the gas that underlay the frequently challenging North Sea. (Recall the famous *Times* headline: “Fog in North Sea; Continent isolated.”) Dutch consumers (and Holland’s air) benefited from the displacement of coal in home heating, and some Dutch manufacturers—particularly chemical companies—also benefited from ready and reliable gas.

However, the soaring guilder was bad news for the competitive position of traditional Dutch goods, such as machine tools and dairy products. Not only was Dutch cheese being priced out of traditional foreign markets, but foreign cheese and other dairy products for the first time became strongly competitive in Holland. Although there is disagreement among economists as to the extent of damage to overall GDP growth, there is little doubt that a natural resource with a relative short lifespan proved to be very disruptive to important, long-established sectors of the Dutch economy.

Dutch Disease is a relatively mild case of a well-documented malady: “The Curse of Oil.” Why did oil-rich states such as Saudi Arabia, Venezuela, and Nigeria fail to develop diversified, vibrant economies compared with oil-poor neighbors, such as Israel and Chile? Answer: a numerically small sector of the workforce and business community earns outsized incomes and may be prone to spending its riches in economically deleterious ways. If, in addition, the nation’s currency becomes a haven for global hot money, it will challenge the income base for traditional local industries.

Even within Canada, a mild form of Dutch Disease has shown itself. Alberta has tried, gamely, to diversify its economy away from oil and gas.

Dutch Disease is a relatively mild case of a well-documented malady: “The Curse of Oil.”

Commodity-exporting countries' currencies... are therefore attractive parking places for investors who are leery of financial strains across most of the OECD.

But with the development of the oil sands, wage rates for manual and skilled labor skyrocketed. A Calgary friend told us three years ago that he served on the boards of two hospitals which were raising funds for much-needed expansions. Because of the huge construction wage rates being paid in Fort McMurray, the costs of both expansions were up by at least half—and he was seriously worried about being able to complete the projects. (He got help from an unlikely source: the Crash.)

A half-century ago, currency trading was constrained, and was generally limited to corporate and tourist needs. There were no huge electronically-endowed currency trading rooms, no liquid currency futures markets, and governments imposed barriers on currency speculation and trading. (As recently as 1979, a German investor or corporation wishing to trade Deutschemarks for other currencies had to make filings with the Bundesbank on any exchange exceeding 10,000 Deutschemarks.)

Now, not only can investors and speculators trade millions of dollars' worth of almost any major currency with a keystroke, but currency swaps are a multi-trillion-dollar asset class. For example, the brief boom in Canadian "Maple Bonds" at a time of a weak Canadian dollar drew new issues for Canadian investors from foreign corporations, but the proceeds were nearly always swapped into American dollars.

The currencies of Canada, Australia, New Zealand and Brazil are seen by global investors as the best ways to play a global economy in which raw materials prices increase more rapidly than the prices of most other goods and services. That fundamental change in the terms of trade means that a group of countries whose combined GDPs are relatively modest in global terms are benefiting on their trade accounts relative to countries whose exports are heavily oriented to services and manufactured goods. Commodity-exporting countries' currencies have been strong against the currencies of commodity-importing nations, and are therefore attractive parking places for investors who are leery of financial strains across most of the OECD. (Mark Steele, BMO's top-ranked Technical and Quantitative Analyst, has shown that this year the Loonie has actually traded as a petrocurrency, moving closely with the price of oil.)

When Canadians think of the value of their currency, they almost always think of it relative to the greenback, because trade with the US is such a huge component of Canada's GDP, and the two nations have—by far—the biggest cross-border trade in the world.

All attempts by governments over many decades to diversify Canadian trade away from the US failed, and Canada entered free trade with the US. For the first decade after those agreements came into force, the Canadian dollar was mostly weak, because the Commodity Triple Waterfall Crash drove the value of key Canadian exports down, and because the lowering of traded barriers exposed the competitive weakness of so much of Canadian industry. Until then, Canadian “branch plants” were collectively a large percentage of Canadian manufacturing. Small, uncompetitive Canadian branch plants owned by US corporations closed. But the free trade in autos became a bonanza for Canada, as US and foreign car and truck manufacturers invested heavily in opening and expanding Canadian plants—mostly in the Ontario corridor from Windsor to Oshawa tied by Highway 401.

Canada now could face a potentially painful attack of Dutch Disease as important sectors of its economy become uncompetitive because of Canada’s powerful trade balance in key commodities such as oil, metals, and metallurgical coal.

Despite repeated warnings from the Bank of Canada and some Canadian politicians, most Canadian-owned manufacturers did not improve their productivity as rapidly as manufacturers in the US and Europe—let alone Japan and the Asian tigers. They felt they were permanently sheltered by the low value of the loon, which seemed destined to be a diving bird forever.

Another beneficiary of the low loon was the Canadian tourism and hospitality industry. As American tourists flooded into Canada for its wide range of natural attractions, its attractive, safe cities, and such magnets as the Shaw and Shakespeare festivals, a widening proportion of the Canadian economy became dependent on a low loon.

The soaring loon has already hit tourism and some manufacturing sectors. But, from our conversations with Canadians in those industries, there is a conviction that the loon could trade frequently at par—which would be tough—but it would inevitably slide back to more congenial levels.

We believe that complacency is misplaced.

We participated recently in a discussion on Canadian television in which the CEO of a leading tourism company outlined the ways in which currency changes influenced travel flows. We were most interested in her analysis that when the loon climbs, not only does tourism from the US and Europe decline, but many Canadians switch their vacation plans away from Canadian destinations to the US and Europe. That means Canadian hotels and ancillary hospitality industries are hit with a double whammy.

They felt they were permanently sheltered by the low value of the loon, which seemed destined to be a diving bird forever.

A new metallurgical coal mine creates large export revenues and strengthens the currency, but it creates few jobs compared to the employment levels at even a few convention hotels.

These industries are labor-intensive, and a sustained, currency-driven slowdown would have big impact on Canadian unemployment statistics. A new metallurgical coal mine creates large export revenues and strengthens the currency, but it creates few jobs compared to the employment levels at even a few convention hotels.

If Canada's Dutch Disease moves from nuisance to chronic condition—which could happen if oil moves to triple digits and mineral exports expand in response to soaring Asian demand—the longer-range impact on several important sectors of the Canadian economy could be painful.

At a minimum, the disease would affect the profits and market values of many Canadian stocks in service and basic industries.

Canadian investors should be looking at their Canadian equity portfolios. Most foreign investors need not worry about Dutch Disease when they buy Canadian stocks because the earnings of the banks and resource industries that are their major Canadian equity holdings would be relatively unaffected. Most Canadian mining companies operate globally, and, although a lofty loon would be a nuisance to Canadian oil and gas companies, strong global hydrocarbon prices should more than offset any cost disadvantages—and there is no politically-safe global alternative to the oil sands.

There is another potential problem as a result of Canada's success:

3. "Helvetanemia"

We coined this term for the challenge Switzerland faced in the late 1970s. (Because Switzerland has four official languages—it has, for convenience, long styled itself with the name the Romans gave it—*Helvetia*.)

As inflation accelerated during the 1970s—even amid recessions—wealthy investors sought to preserve their assets. The Swiss franc had the highest percentage of gold backing of any major currency, and Swiss banks had one unvarying rule for all private wealth accounts: at least 10% of each account had to be in gold.

Those policies gave Switzerland another unique advantage in attracting major private wealth accounts—apart from the famous secrecy and the nation's adamant refusal to enforce other nations' tax policies. Gold wasn't even a legal investment for US citizens until the Republicans forced approval during the Nixon era, and there were few investment management organizations with any experience in managing portfolios of gold and/or gold mining stocks.

Result: the Swiss franc became, in the eyes of both the lawfully and unlawfully rich, as good as gold. Stupendous amounts of money flowed in. By 1978, the franc's appreciation threatened the existence of some Swiss industries, most notably the watchmakers. "Do something to save us!," they cried.

And they were heard in Berne.

The government imposed a hefty capital tax on new deposits in Swiss banks from non-residents. There were also threats of even greater punitive tactics to come.

They weren't needed. The inflation-driven commodity mania peaked out with gold at \$825 and silver at \$38 and a powerful dollar rally ensued. The Swiss franc lost its luster and the watchmakers were headed for the most profitable decades in their long history.

However, three decades later, Helvetanemia is returning. Amid the shock of the Greek crisis and the ensuing plunge in the value of the euro, the Swiss National Bank (SNB) has emerged as the most-determined buyer of euros, in exchange for Swiss francs.

Its President, Philipp Hildebrand, has been frantically selling francs in exchange for euros, trying to hold the franc's exchange rate in the 1.4 euro range. Last week, the SNB announced that it had increased its foreign currency reserves by more than 50% *in one month*. Despite his efforts, the franc has strengthened 6% against the euro in recent months, and this has Swiss industries and politicians alarmed. In April alone, the SNB added the euro equivalent of \$24.6 billion to its currency reserves. This could turn out to be the highest-risk Swiss rescue operation since William Tell shot his arrow.

Forex traders abroad have used Hildebrand's eruption to swap their euros for francs. It is unclear how long the SNB can maintain this buying: its total holdings, according to Bloomberg, "are about three times larger than the European Central Bank's foreign currency reserves."

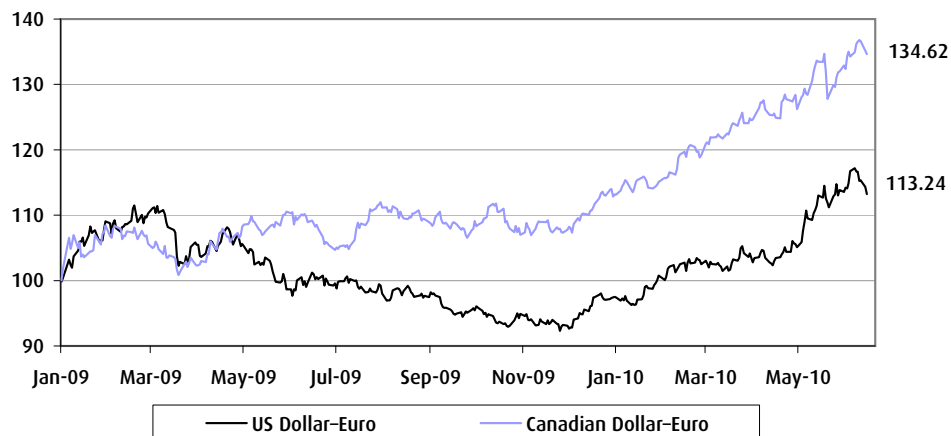
This could turn out to be the highest-risk Swiss rescue operation since William Tell shot his arrow.

June Reflections: Summer's Storms and Norms

**The Left's loss is
the loon's gain.**

Canadian Dollar–Euro and US Dollar–Euro

January 1, 2009 to June 15, 2010



SNB Policies for the Bank of Canada?

The Bank of Canada's Mark Carney must be feeling great sympathy for Mr. Hildebrand in this unequal struggle. Mr. Carney routinely makes it clear he's unhappy about a loon trading "at par"—let alone above. But he well understands the problems for Canada as the small economy next to the giant if his currency becomes, like the Swiss franc, a recognized store of value. Its intrinsic worth comes from the nation's stable banking and financial systems, its comparative fiscal virtue, and its center-right government, which respects capital and entrepreneurship. The demagogic denunciations of corporations that are daily fare in a Congress whose banking committees are headed by Messrs. Dodd and Frank—who were Fannie & Freddie's most passionate defenders—are heard only rarely and briefly in Ottawa, and mostly from the gaseous Left, which struggles to find relevancy. Why, they whine, are we not being voted into power after the worst recession since the Thirties was caused by capitalists? Their stupid greed should be our ticket to Ottawa!

The Left's loss is the loon's gain. Result: the loon is the symbol and storehouse of the most financially stable and capital-friendly nation in the G-7.

But, even if Canada were to experience a house price decline, its banking and financial system would be largely unscathed.

And Canadian government debt would continue to be treated with enthusiasm by sovereign credit buyers seeking safe sovereign stuff as more and more governments go deeper and deeper in debt.

The Grecocollapse Boosts the Greenback and Hits the Loon

When the Obaman excesses were producing a flight from the dollar, the first and most obvious refuge was the euro. Central banks who were overstuffed with dollars, and faced a rising torrent of Treasurys from endless deficits realized they couldn't unload their dollars but they could—and did—move into the euro or the yen.

Euro (US Dollars)
June 15, 2009 to June 15, 2010



Then the Greeks were forced to start telling the truth about their real financial condition, and investors began wishing they'd all go jump into the wine-dark sea.

But the yen's basic deflationary problems reasserted themselves.

Then the Greeks were forced to start telling the truth about their real financial condition, and investors began wishing they'd all go jump into the wine-dark sea.

Beware of Greeks baring facts.

The Greek labor force has spent years proving that it lacks the ability or energy to move the country forward, but it is now demonstrating that it has the power to shut the country down. Greece's root problems— are its lack of real industrial and commercial competitiveness and, more importantly, the recognition by global banks and investors of the nation's politically powerful public sector whose pay scales, pensions and health care could be financed only by gods.

June Reflections: Summer's Storms and Norms

**Hemlock,
Mr. Papandreou?**

Even the Fates seem to have it in for Greece these days. Its leaders tried to justify their pleas for financial support by citing the glory that was Greece, as if its intellectual and cultural excellence 24 centuries ago should excuse its collective incompetence and dishonesty today. Regrettably, as investors responded to these Greek gripes by thinking back to the 5th C. BC and mused about Socrates, they realized that he's now Prime Minister of Portugal.

Hemlock, Mr. Papandreou?

Contagion

As bad as the Greek crisis has been for the credibility of the euro, investors soon sensed that its real meaning was that Hellas was just the first of the worst, and a form of Financial Trichinosis had been unleashed among the rest of the PIIGS.

Thus the sudden rush into the dollar, as central banks, foreign exchange funds and sovereign wealth funds across the world looked in horror at their exposure to a currency that was being exposed as the product of a grand theory and a formula—not the unit of trading of a nation, backed by its government and central bank.

That flight interrupted the loon's upward flight—but only for a few weeks.

Canadian Dollar

April 18, 2010 to June 15, 2010



When the euro completes its adjustment to the new reality—that the euro is the shared vision of a set of politicians—now mostly dead—who met long ago—then the loon will resume its upward climb against the greenback and most other currencies.

The move into the loonie may have just begun. If the global economy gets back on the growth track of late 2009, led by Chinese willingness to let its GDP growth move back above 10% with an upwardly-revised renminbi valuation, the Loon could be driven to the US\$1.10–1.15 range and keep it there for a long time.

The ultimate altitude reached by the loon will be defined by the interaction between the good news in Canada about what matters and the bad news across Europe, the US and Japan about those same topics.

To restate a jazz classic:

*Somewhere there's music,
How faint the tune?
Somewhere there's haven,
How high the Loon?*

For those with wealth, Canada may not be Heaven, but it may be the best haven on offer.

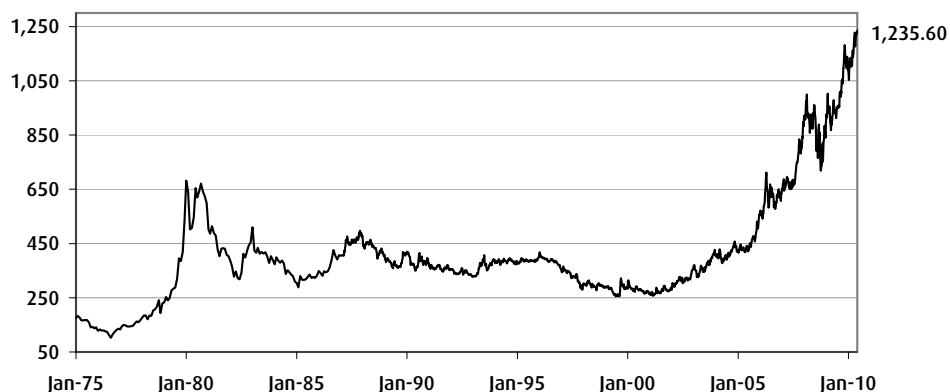
***Somewhere there's haven,
How high the Loon?***

B. The Oldest-Established Store of Value Moves to Center Stage

...why gold?
Isn't it irrelevant?

Gold

January 1, 1975 to June 15, 2010



Gold

June 15, 2009 to June 15, 2010



Who needs gold?

Over the decade that we have been advocating exposure to gold and gold mining stocks, we have been routinely subjected to basic skepticism: why gold? Isn't it irrelevant?

If the dollar doesn't look good, I can buy the yen.

If the yen looks bad, I can buy the euro.

Besides, what good is gold? Other commodities are useful and, in most cases, absolutely necessary.

But gold hasn't been needed for central banking for nearly a century, and, apart from jewelry or for providing Mafiosi with a convenient vehicle for storing their wealth, it doesn't fulfill any purpose that sound paper money can't do better. (This, of course, assumes the availability of *sound* paper money.)

**This, of course, assumes
the availability of
sound paper money.**

In answering a question about gold's rather dramatic return to store of value status with the portfolio managers of one of Canada's largest public sector pension plans, we took a new tack:

"The longest-established text-based religion in the West is about the God of Jacob—His works and His worship. For roughly five thousand years, a believer summed up his credo by saying, 'I believe in God.'

"But when this credo arrived, it had to share space with an alternative belief system that was around for thousands of years before the Judaeo-Christian era began. A believer in this system summed it up, 'I believe in Gold.'"

Two systems—similar professions of faith. Neither could prove to a skeptical rationalist why its tenet was valid.

As we have thought about this space-sharing and competition between spiritual and temporal beliefs, we have mused that large-scale skepticism about both of them occurred only recently. Darwinism, paleontology, and astrophysics combined to drive the Old Testament explanation of history out of the temples of scientific learning. Keynesianism came along to drive gold from the temples of the central bank money-changers in favor of the printed paper promises of politicians.

Why is gold back among serious, respectable investors?

Why is it now available through ATMs in the gold market of Abu Dhabi?

Is it a return of inflation?

How could that be, when, as the wise David Rosenberg routinely scoffs, "What inflation?"

...the Fed's response to the Crash was the greatest goosing of its asset base in history, raising fears among the putatively paranoid that a new Weimar was being born...

Indeed, Canada reported its first negative CPI in 44 years, the US, its biggest decline in 18 months, and across the OECD there is, (at least for now), more fear of deflation than inflation. Despite astonishingly high housing subsidies that are swelling the already-bloated US national debt, US home prices remain soft, and foreclosure is not only no longer a disgrace—it threatens to become almost chic. (A recent poll of homeowners disclosed that 55% of those with mortgaged homes believed their house was worth less than their mortgage.) Not all the news is bad: The cost of TARP has turned out to be far less than feared: the cost of saving the US from house price collapses on a scale that would unleash a Depression—including the mind-boggling costs for keeping Fannie, Freddie and the Federal Home Loan Bank alive and lending, and the various cash subsidies to buyers—is many orders of magnitude above the Wall Street bailouts.

If the only thing keeping house prices from collapse is a boost in the national debt bigger than the total cost of all the US's foreign wars since World War II, then how can inflation be a threat?

Yes, some industrial and food commodity prices have shown some inflationary tendencies, but, with the exception of coffee, cocoa, iron ore and metallurgical coal, prices have been sagging recently—although remaining far above Lehman lows.

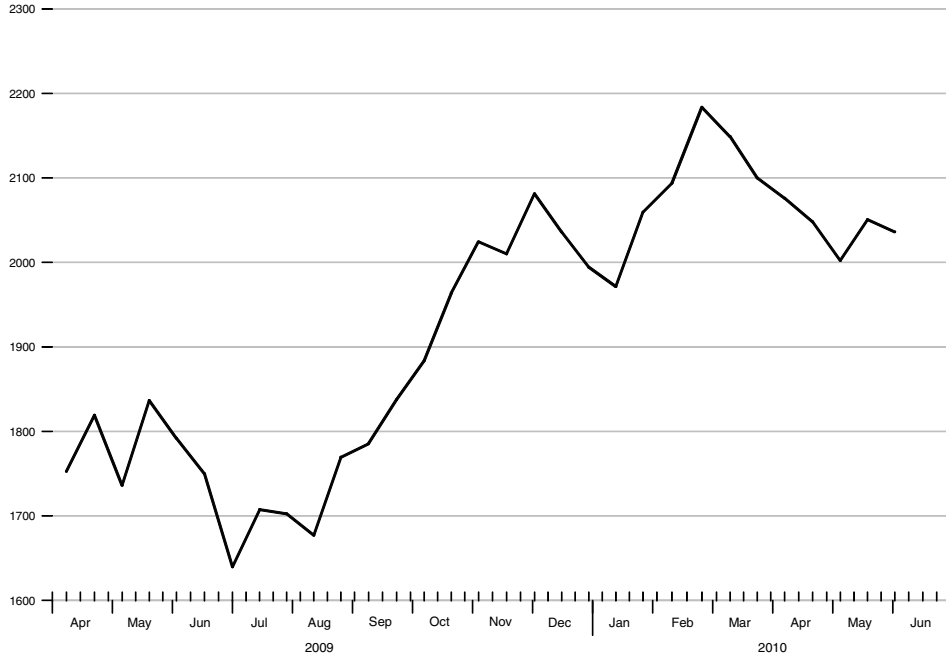
Interest rates remain in the zero range, which would be a sure sign of inflation on the horizon if there were projected increases for anything significant other than wages and benefits for government employees.

Although the Fed's response to the Crash was the greatest goosing of its asset base in history, raising fears among the putatively paranoid that a new Weimar was being born, in recent months the Fed seems dedicated to proving that its previous promises of piety were sincere. Based solely on the numbers, Bernanke almost seems to be willing to risk outright deflation:

US Adjusted Monetary Base April 1, 2009 to June 10, 2010

Averages of Daily Figures, Seasonally Adjusted

Billions of dollars



Adjusted Monetary Base

To the average of two maintenance periods ending:	Compounded annual rates of change, average of two maintenance periods ending:								
	06/03/09	08/26/09	11/04/09	12/02/09	12/30/09	01/27/10	03/10/10	04/07/10	
11/04/09	25.0								
12/02/09	27.2	89.1							
12/30/09	20.0	57.2	7.1						
01/27/10	17.5	44.8	4.8	-9.2					
03/10/10	25.9	53.0	27.1	23.7	45.7				
04/07/10	18.1	36.6	11.5	6.1	14.1	20.2			
05/05/10	12.7	26.3	3.2	-2.3	1.4	1.8	-35.5		
06/02/10	12.6	24.8	4.3	-0.2	3.3	4.1	-22.4	-13.1	

Source: US Financial Data; Federal Reserve Bank of St. Louis

June Reflections: Summer's Storms and Norms

...gold once again became a store of value when the dollar began soaring in response to the stench of seared Greece...

So what makes gold so attractive now?

And who is buying it?

According to the World Gold Council, industrial and jewelry demand have come back sharply (after collapsing in 2009), but the big new buying is for bar hoarding. Banks are running out of vault space and are building new above-ground facilities. (At the bottom of Gold's Triple Waterfall Crash, banks were moaning that their vaults were nearly empty and were costly to maintain.) In last year's First Quarter, there was net selling of 28.1 tonnes in bars. This year investors bought 89.7 tonnes. Record amounts of coins are being minted.

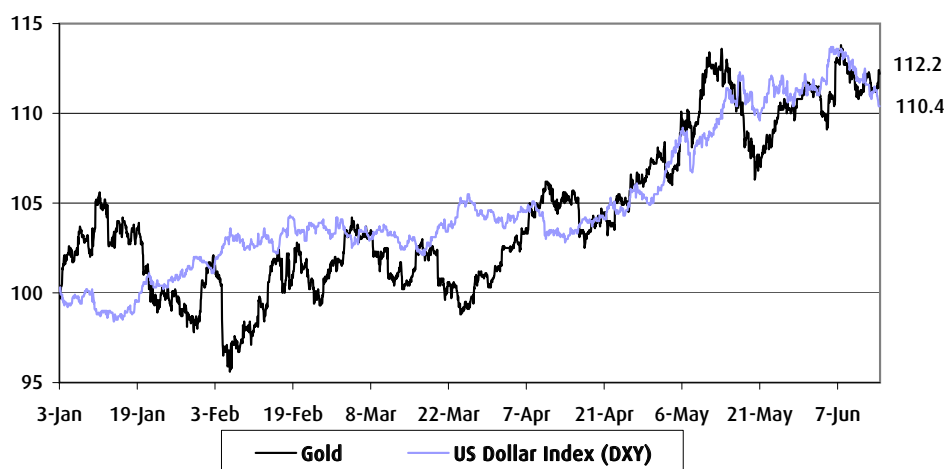
China and Russia have bought some gold for their foreign exchange reserves, but these purchases have been mostly from their own nations' mines.

The SPDR Gold ETF's holdings keep setting records. If it were a central bank, its hoard would put it in the top four.

We think that future historians may well report that the moment when gold once again became a store of value was when the dollar began soaring in response to the stench of seared Greece—and gold climbed right along with it. The asset classes that have been inversely correlated since Keynes's time suddenly united.

Gold versus US Dollar Index (DXY)

January 1, 2010 to June 15, 2010



When we first noticed this, we headlined it in a Conference Call, which we titled “The Odd Couple.”

That gold and the dollar are fundamentally inversely correlated to each other is obvious. One bets on gold because one is deeply skeptical that governments will fulfill their promises.

So why are they both in a mini-bull market?

We believe this is driven by the squeeze on the European banking system from the drachmadrama:

This forces the weaker banks to borrow in Eurodollars, thereby driving up the value of the greenback. International corporations also collectively rush to adjust their exposures, switching cash holdings from euros into dollars.

**One bets on gold
because one is
deeply skeptical that
governments will
fulfill their promises.**

Gold relative to Euro

January 1, 2010 to June 15, 2010



But this may be just Act Two in a Three-Act play.

Paper Prophets?

Milton Friedman famously said, “Inflation is always and everywhere a monetary phenomenon.”

He won the Nobel Prize in Economics in 1976 for his work documenting that dictum. It helped to explain stagflation—rising inflation during recessions. The Keynesians who dominated global economic thinking after WWII believed inflation was caused when wage increases outstripped productivity gains on a sustained basis. President Kennedy’s famed confrontation with the steel industry came when he convinced the Steelworkers to agree to a modest pay boost at a time of rising inflationary pressures. When Big Steel then boosted its prices above the percentage increase in wages, Kennedy declared war on Steel and the industry capitulated.

June Reflections: Summer's Storms and Norms

"I'll bring monetarism to Britain to smash the power of the unions!"

In the 1970s, a new collective bargaining pattern emerged, as the big unions successfully negotiated COLA clauses in all their contracts—wage boosts plus cost-of-living increases tied to CPI. As inflation surged, the companies and their unions were widely blamed for causing price increases across the economy even as unemployment was rising and most of the OECD was struggling with recessions.

When Margaret Thatcher became Britain's Prime Minister in 1979, she dedicated herself to imposing monetarism on Britain as the way to control inflationary wage demands from the big British unions.

As she told me in a private meeting in Toronto in 1978, she had had a meeting with Germany's Chancellor Helmut Schmidt shortly after becoming Tory leader.

She asked him, "Why don't your German unions make inflationary wage demands like our British unions?"

He replied, "Each year, we have a meeting with the eight German unions."

In explaining her surprise at this statement, she pointed out to us that there were 36 unions at the Ford Dagenham plant alone.

"What happens when you meet with the eight unions?"

"They tell us what their wage requests will be and we tell them what the economy can afford."

"And what if the unions demand more than you believe the economy can afford?"

"Then, madam, I tell them that the Bundesbank will not print the money to ratify those demands."

As she recounted this event, she said, with rising emotion, "Imagine that! He's a Socialist and he understands monetarism. I'll bring monetarism to Britain to smash the power of the unions! The coal miners will go out on strike and we'll just leave them there. Within two or three years, inflation will start to collapse, along with interest rates, and Britain will be on its way back to being an industrial power."

She went on, "In 1980, Ronald Reagan will win the Republican nomination and he will defeat President Carter and he will use monetarism to end the inflation era in America."

What actually happened was that President Carter was forced, because of soaring inflation, to install Paul Volcker as Fed Chairman and *he* introduced monetarism. He kept raising rates after Reagan was elected, but despite screams from the business community that his tight money was killing the economy, Reagan backed him. The deep recession in 1981-82 with sky-high interest rates arising from strict adherence to monetarism nearly aborted the Reagan recovery.

The most important economic number for portfolio managers in 1980–1984 was the weekly Fed statement showing conditions in the Monetary Base, M-1 and M-2.

We used those numbers to trade bonds, which became our asset class of choice when we dumped commodity stocks once we saw that Reagan would be elected. We moved our portfolio into very long Treasury zero-coupon issues when it looked as if money supply was being brought under control and the Fed could begin to ease.

That was then.

So why didn't inflation come roaring back when Bernanke doubled the Monetary Base and M-2 was climbing at double-digit rates?

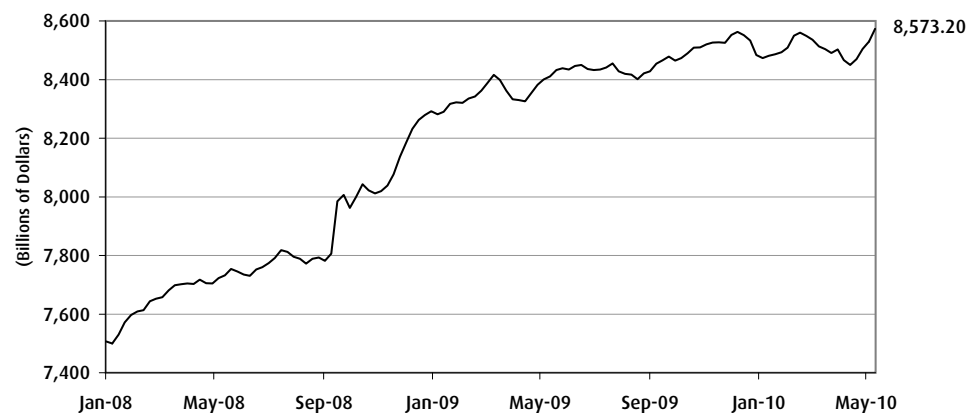
And why didn't inflation come back when central banks across the OECD were growing their monetary bases and money supplies were climbing?

And why did gold take off to record levels when money supply growth began to dwindle and actually turn negative?

...why did gold take off to record levels when money supply growth began to dwindle and actually turn negative?

US M2 Money Stock

November 2008 to June 2010



Source: Economic Data (FRED); Federal Reserve Bank of St. Louis; and Board of Governors of the US Federal Reserve System

[Gold] can be a haven for investors seeking to protect themselves against an implosion of majestic proportions.

We believe that Gold's recent rise began when investors sought a classic inflation hedge, but its real run came when deflation risks were far more obvious than any evidence of inflation.

As we have written in these pages, gold is the classic store of value. It should retain its value under both inflationary and deflationary conditions.

That means a great time to buy gold to make capital gains is when inflation is rising.

It also means a great time to buy gold to conserve existing wealth is when (1) prospective risk-adjusted returns on bonds and stocks look unattractive because the economic outlook is for slow growth with (2) a risk of a renewed downturn that would hammer the value of stocks—particularly financial stocks—and real estate anew, and (3) bond yields are too low given the endogenous risks in the currencies in which they are issued and (4) the range of future fiscal deficit forecasts is from grim to ghastly.

What we believe is unfolding is a rush into gold by individual investors who look at the astronomic growth in financial derivatives—particularly collateralized debt swaps—and government deficits at a time when the effects of demographic collapse are finally being understood.

According to some guesstimates we have heard, the supply of outstanding financial derivatives may be in the \$70 trillion range, dwarfing the combined value of money supplies and debts. The total value of gold is so minuscule in comparison to the supply of these software-spawned instruments that it cannot be any real help in stabilizing global finances—but it can be a haven for investors seeking to protect themselves against an implosion of majestic proportions.

That is why gold and the dollar can—if only for a brief time—rise together, as investors see that the only major currency alternatives to the dollar—the yen and the euro—are backed by rising national debts, rising numbers of pensioners, falling working-age populations, falling real estate prices, and a falling OECD share of global GDP.

There is no constraint on the ability—or, apparently the willingness—of governments and central banks to create new financial liabilities which can only be serviced if GDP growth rises—on a sustained basis—to higher levels than most OECD nations have seen since the Baby and Reagan-era booms.

Given the average fertility rates across the OECD of 1.3 to 1.5 babies per female, return to the economic growth rates of those eras is really out of the

question. Each new generation is roughly two-thirds the size of its predecessor, so construction of new homes, schools, and commercial buildings and filling them with workers—an important component of past periods of rapid GDP growth—has to be at lower rates in each cycle. The alternative—to pretend that the number of first-time homebuyers will reach or exceed the numbers in earlier cycles and, with government stimulus, build them on grand scale in the hope that they will come—can lead only to financial disaster.

In the current financial environment in which risk measures such as the TED Spread and VIX are leaping back toward post-Crash peaks, a momentous shift in investor appraisal of endogenous risks within asset classes is unfolding: sovereign credits are no longer being automatically accorded low-risk appraisals, and banks are being downgraded on the basis of their high exposures to sovereign credits—not, as in previous financial downturns, to dodgy corporate debts or putrid mortgage products.

This re-rating of debt instruments is a sign of the fundamental fragility in financial valuations since the end of those halcyon, bygone days when Moody's was a homely, plain-Jane stock which lived modestly, mostly off municipal bonds. Its puritanically lofty standards for Triple-A ratings could be met by only a handful of corporations and a select few governments and their agencies. Then Moody's suddenly blossomed into a sexy growth stock fattened in all the right places by fabulous fees for analyzing collateralized mortgage instruments and giving them the Good House-Financing Triple-A Seal of Approval. Too late did we learn that Moody's "experts" never really understood what the underwriters and math PhDs were confecting. Only the aggregators of the underlying mortgages knew about the deadbeat and dead mortgagors, and the systematic home overvaluations—and the only one of them who has been publicly pilloried is Paulson. (No, not *that* Paulson.)

*The world has gone mad today
And good's bad today,
And black's white today
And day's night today...*

This week, Moody's finally got around to lowering Greece's bond rating to near-junk. They seem to be cleaning up their act—probably in response to some pressure from Warren Buffett.

...Moody's suddenly blossomed into a sexy growth stock fattened in all the right places by fabulous fees...

Because of the contangos—particularly oil—these vehicles are even worse strategies than putting all the funds into Las Vegas slots—because your odds are better with the one-armed bandits.

So...as a store of value for future generations,

If you can no longer believe in residential real estate,
and you can no longer believe in bank deposits,
and you can no longer believe in the dollar,
and you can no longer believe in the yen,
and you can no longer believe in the euro...

What can you believe in?

How about gold?

It's so old, it's new again.

It can't be synthesized.

It's been despised by every liberal economist since Keynes.

Among the arguments routinely adduced against it is that it pays no interest—but with interest rates in the zero range, the opportunity cost is minimal.

Treasury bonds? Why bet your future on a ten-year piece of paper that pays 3.2% in a currency that's been in a bear market for most of the time in recent decades, knowing that the new supplies of bonds will be endlessly growing, in good times and bad, because the issuer's own forecasts say so (and most independent forecasters say the issuer's numbers are absurdly optimistic)?

Stocks?

The S&P currently trades at its level of March 1998—when Gold was trading at \$302.

Industrial and Agricultural Commodities?

To our sustained disbelief, major pension funds continue to hold more than \$150 billion in passive commodity funds like the GSCI. This is the investment equivalent of Einstein's dictum that one proof of insanity is trying the same experiment over and over, hoping for a different result. Because of the contangos—particularly oil—these vehicles are even worse strategies than putting all the funds into Las Vegas slots—because your odds are better with the one-armed bandits.

Gold is the recently-awakened Sleeping Beauty, who always was beautiful but was overlooked. She is ready to take the throne among stores of value that was long occupied by sovereign credits.

The handsomest courtier in her realm wears the crest of a long-necked water bird.

Conclusion

Until very recently, the case for gold was almost always presented as a hedge against inflation.

That case remains valid, because if the US and European economies revive, then the pressure on the Fed and ECB to raise rates will become intense, even though unemployment will still be at historically high levels and politicians will be screaming that any rate increases will punish the poor to reward the rich.

If the major central banks do not raise rates, investors worldwide will begin to bet heavily on a return of inflation.

However, those monetary Rubicons seem off in the distance, given modest US growth, and barely-perceptible recoveries or renewed downturns within the eurozone.

We believe gold should be a significant component in most high net worth wealth preservation programs, and in most endowment and pension funds.

For the first time since 1980, Germans and other Europeans with long memories are pouring into gold dealerships to exchange euros for coins and small gold bars. Germans have watched as twice in the past century their currency was utterly destroyed. They were strong-armed into believing Ludwig Erhard that their nation could have a currency that was as good as gold, and that revived faith was the underpinning of the German Miracle.

That faith is now eroding, and individual savers are protecting themselves. Long-suppressed atavistic attitudes that suddenly coalesce into fear-driven behavior can have momentous consequences.

Summing Up

Browning said it (In *Rabbi Ben Ezra*), "Leave the fire ashes. What survives is gold."

Gold is the recently-awakened Sleeping Beauty, who always was beautiful but was overlooked.

INVESTMENT ENVIRONMENT

To us, he is the oil equivalent of Lehman's Richard Fuld—a disgrace to his industry and an unmitigated disaster.

1. The BP Disaster

Since John Browne became BP's CEO, its North American operations have experienced the industry's worst and biggest "accidents"—the Alaska pipeline leak due to failure to "pig" the line, the Texas City refinery explosion caused by a series of acts of negligence—some criminal—and now Macondo. Browne even gave up using the name "British Petroleum" and said the company's logo meant "Beyond Petroleum," swanning around about going green and diverting money from oil and gas operations to those that would evoke praise from Al Gore and Greenpeace. With his words and the company's money for funding leftist causes, he became the first oil CEO to become a darling of the Left. To us, he is the oil equivalent of Lehman's Richard Fuld—a disgrace to his industry and an unmitigated disaster.

Macondo isn't on Browne's watch: his successor, Tony Hayward, has to assume responsibility—at least for what his company's lawyers cannot ascribe to Transocean, Halliburton, and Cameron International. But he inherited a company whose risk culture was seriously flawed.

It is still too soon to predict the ultimate consequences of this catastrophe. US public opinion has swung sharply away from endorsing offshore drilling by a landslide to only a small majority, and believers in man-caused global warming have increased sharply. The more damage is done to wildlife, beaches, and fisheries, the less willing the public will be to believe Big Oil and to believe the Hard Left.

From our perspective, apart from the splendid Admiral Allen, the person whose behavior in the first month after the blowout was most exemplary was President Obama. Although attacked unfairly by Republicans, Fox News and even James Carville, he demonstrated that he is what he said he was—a cool intellectual who remains cool under pressure, and a respecter of technology who understands its fallibilities. He chose neither to panic nor grandstand, and he quietly stood by BP during their early attempts to control the well, knowing that the federal government lacked both the manpower and expertise for the operations.

Sadly, he has been forced to abandon coolness and embrace populism. The temper tantrums he has more recently displayed are, perhaps, justified by BP's failings and by its attempts to lay blame on its partners.

Nevertheless, the President's first four weeks were impressive—and his standing actually rose modestly in the polls despite—or because of—the attacks against him from extremists and loudmouths on all sides. Once again, the voters were wiser than the pundits and politicians.

2. Correction or Eurobear?

As this is written, most global stock markets are rallying modestly but have broken their 200-day moving averages on the downside.

We have been predicting a correction since last September, so we can hardly say, "We told you so." The S&P has been pricing in sustained 3.5% - 4% US GDP growth for nine months, and that confidence is eroding:

- The strongest component of US activity has been exports, and the sudden eruption in the dollar is good news for America's European competitors and bad news for American manufacturers.
- Despite the buyer-friendly/taxpayer-unfriendly homebuyer subsidies, US home prices continue to wilt.
- Mass industrial layoffs have surged back after a lengthy period of shrinkage.
- The inventory rebuild has been a big contributor to GDP growth, and it should be near completion.
- The sudden surge in the VIX and TED Spread have reminded the unwary that all those months of zero-cost money have done little to move the piles of putrescent products from bank balance sheets. Banks collectively remain heavily over-levered, because the supply of suckers to succour the sick balance sheets remains inadequate. When the three biggest banks managed to earn trading profits *every single day* in the First Quarter, one has to wonder whether sustained punishment of savers and taxpayers to propitiate ingrate bankers should continue. The biggest bankers continue to reject the blame for the Crash, and continue to display no shame. (Perhaps BP should merge with one of the big banks?)
- The good news is that both the BKX and KRE have been outperforming the S&P since yearend, albeit less enthusiastically than earlier, so the sudden return of Fear is a potentially healthy development.
- Although the euro is unlikely to survive, it will not die suddenly. It was constructed according to Teutonic theories of rigid rules that will supposedly never be broken—a process that goes back to Hegel. We agree with those who think Marx and Schopenhauer both—in their own ways—exposed the flaws in Hegel's elegant reasoning. Germany should never be in a position in which it makes the rules for Europe based on a belief that everyone will adopt Germanic discipline—or else.

**The sudden surge
in the VIX and TED
Spread have reminded
the unwary...**

June Reflections: Summer's Storms and Norms

...we may be in uncharted waters—without Poseidon to protect us in storms. He backed Troy in the war and he may not have forgiven Greece yet.

The Germans should never have believed that the Greeks would play by the rules: they would rather play. Period. *The Financial Times'* Gillian Tett is right that the euro is the monetary equivalent of a Collateralized Debt Obligation that lumps together BBB bonds to get AAA paper. If so, it has lost its claim to being a reliable store of value and central banks abroad will continue to reduce their exposure.

- Greek bonds currently yield 9%, and analysts are already discussing a pending haircut. We think the haircut should be to the neckline, but fret that markets will not rally once the headsman's axe has fallen, but will be rushing to find the next victim. Too bad there aren't just three little pigs.
- During the bad old 1970s, all currency crises were dollar crises. This time, it's the newest currency that is in trader's gunights.

Nobody knows which non-PIIGS banks are most at risk from sovereign bonds, bank-to-bank loans, mortgages and commercial loans in the most exposed countries—Greece, Portugal and Spain, but the amounts are in the trillions. And those calculations leave out Italy, whose publicly-traded government debt is the third largest in the world.

As for European financial stocks, we may be in uncharted waters—without Poseidon to protect us in storms. He backed Troy in the war and he may not have forgiven Greece yet. Gods' memories are long. But, as for dry land investments, it would appear to us that companies with unhedged reserves in the ground in politically-secure regions look even better as value propositions now that many sovereign credits and many more banks have become suspect.

The last bank-driven financial crisis was brutal for commodities and commodity stocks. However, the sell-off was accentuated by the \$65 billion in commodity-related risk investments held by Lehman clients which was ceremoniously unloaded after the bankruptcy. We wouldn't expect a repeat of that bank crisis—if only because the ECB would have no choice but to reliquify and North American economies are far stronger now than then.

China may be the key to averting a second global financial crisis. As the strongest of the major economies and a major funder of global bond markets, China has—at least potentially—a big role to play. Should it shock

the G-20 by announcing an upward revaluation of the RMB, it would thereby cease—for an extended period of time—draining dollars from the Chinese economy to send abroad in its currency management program—swelling the biggest savings fund in the world with more and more dubious paper. That would automatically reliquify the Chinese economy without requiring major loosening of monetary policy and would suppress inflation by lowering the costs of foods and fuels (which are dollar-denominated). This would increase the real wages of workers at a time when industrial unions are suddenly becoming troublesome. It might briefly slow the nation's growth to the 8-9% range, but would be a shot in the arm for many manufacturers across the OECD and Asia. US bond yields would rise modestly, but not enough to snuff the last of the life from the housing market. By removing the threat of major tightening from the Chinese financial system it would trigger stock and bond rallies—in China and abroad. One reason it could produce huge results is that the market isn't sniffing it at all. Should China not take this course within the next few months, we would probably become more bearish than we are currently. The recent work of Mark Steele, BMO's Technical and Quantitative Analyst, has disclosed alarming trends in global banking that could be beyond the abilities of the Fed and the ECB, and many Asian banking authorities. China could be a major contributor to an overall financial recovery if it revalues its currency and eases moderately.

Not all the recent news has been discouraging. The May nonfarm payroll numbers showed that Washington has finally delivered on its promise to create "Targeted and Temporary" stimulus. Of the 431,000 jobs gained in May, 411,000 were census takers. So three cheers for those great politicians—Hamilton, Madison and Jay—who wrote *The Federalist* that led to the Constitution with its directive for decennial censuses.

We are reducing our recommended equity exposure modestly for all pension funds, increasing cash by 5% in each, thereby emphasizing the exposure to commodity stocks in the total equity portfolio. We are also adjusting our commodity stock exposure to emphasize precious metals, moving them from 32% to 37%, thereby reducing endogenous portfolio risk from economically-sensitive commodity stocks in portfolios.

So three cheers for those great politicians—Hamilton, Madison and Jay—who wrote *The Federalist* that led to the Constitution with its directive for decennial censuses.

June Reflections: Summer's Storms and Norms

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation		
Capital Markets Investments		
US Pension Funds*		
	Allocations	Change
US Equities	17	unch
Foreign Equities		
European Equities	2	-2
Japanese and Korean Equities	2	unch
Canadian and Australian Equities	9	-2
Emerging Markets	12	-1
Commodities and Commodity Equities*	12	
Bonds		
US Bonds	12	unch
Canadian Bonds	8	unch
International Bonds	6	unch
Long-Term Inflation Hedged Bonds	10	unch
Cash	10	+5

* Please refer to Page 46

We have increased our durations as a hedge against a new economic slowdown.

Bond Durations		
	Years	Change
US	6.25	+1.0
Canada	6.50	+1.5
International	5.00	+0.5

Global Exposure to Commodity Equities		
		Change
Precious Metals	37%	+5
Agriculture	24%	-1
Energy	20%	-2
Base Metals & Steel	19%	-2

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

June Reflections: Summer's Storms and Norms

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation		
Capital Markets Investments		
Canadian Pension Funds*		
	Allocations	Change
Equities		
Canadian Equities	20	unch
US Equities	8	-2
European Equities	3	unch
Japanese, Korean & Australian Equities	2	-1
Emerging Markets	12	-2
Commodities and Commodity Equities*	10	unch
Bonds		
Canadian Bonds		
- Index-Related	18	unch
- Long-term RRBs	10	unch
International Bonds	7	unch
Cash	10	+5

* Please refer to Page 46

We have increased our durations as a hedge against a new economic slowdown.

Canadian investors should hedge their exposure to the US Dollar.

Bond Durations		
	Years	Change
US (Hedged)	6.25	+1.0
Canada	6.50	+1.5
International	5.00	+0.5

Global Exposure to Commodity Equities		
		Change
Precious Metals	37%	+5
Agriculture	24%	-1
Energy	20%	-2
Base Metals & Steel	19%	-2

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

June Reflections: Summer's Storms and Norms

RECOMMENDED ASSET ALLOCATION

Our New Category for Asset Allocation

(reproduced from Basic Points, April 2010)

In this issue, we have recommended that pension funds respond to the evidence of sustained global growth *without increasing their exposure to equities categorized by geography*—a typical way pension funds structure their portfolios.

Our Recommended Asset Allocation for US Pension Funds has always addressed capital market assets, and not real estate or the growing diversity of real asset investments. Together, globalization and technology have transformed the capital markets, and the traditional approach to classifying pension assets no longer fits our investment outlook.

This month marks a dramatic shift—some might say a sea change—in the capital markets. We needed a fresh approach to express the investment asset allocation—and opportunities.

We have added a new category “Commodities and Commodity Equities”.

Although commodities are regarded as “real assets” and commodity stocks as “financial assets”, they have inherent commonality: like equities, commodities are publicly traded; they are equity-equivalent investments in the same underlying asset: a resource.

Our new category brings these assets together to address an investment objective: investment in the industrialization of emerging markets: *the greatest efflorescence of human economic liberty in history*.

Our experience with managing the Coxe Commodity Strategy Fund, a global fund, is that investors can add it to their existing equity portfolios and increase their exposure to commodity-oriented stocks with a targeted approach, rather than merely increasing exposure to Canadian and Australian indices and adding commodity subset ETFs from some other markets.

We believe well-chosen commodity stocks will solidly outperform the traditional commodity funds—most importantly and obviously—as long as contangos are in force for key commodities such as oil. When one owns the shares of well-managed commodity producers with unhedged reserves in the ground in politically-secure areas of the world, one benefits more from a sustained commodity price increase than passive owners of that commodity.

We shall be discussing the implementation of this strategy in greater detail next month. For now, we are recommending that clients' portfolios be upgraded for greater global growth led by “Chindia” through this new category in the Asset Mix—rather than through simply allocating more money to regional stock markets that may or may not capture favorable commodity activity.

This month we are introducing a new portfolio for Canadian pension funds because we see the divergence between Canadian and US financial assets as a longer-term phenomenon.

June Reflections: Summer's Storms and Norms

INVESTMENT RECOMMENDATIONS

1. Canadian bonds, equities and bank deposits are excellent investments for investors based in other currencies. Canadians should take advantage of the Loonie's current weakness to borrow in greenbacks and otherwise hedge any risks they have to the outcome of a new global love affair with the Loon.
2. Resist the urge to buy the Macondo well-related stocks now that BP has somewhat capped the well. US trial lawyers cannot believe their luck: they will be able to sue, for treble-damages, everybody involved in the well in the infamous "hellhole" courts of Louisiana and Alabama, where the judges' electioneering costs are paid by plaintiffs' lawyers. BP's \$20 billion payment will prove to be just a down payment. This is, for these predators, the equivalent of getting advance advice of the winning numbers in a multi-billion-dollar lottery.
3. The oil sands producers don't benefit as heavily as the US trial lawyers from the BP disaster, but there are two ways their stockholders benefit: by reminding the public that the large-scale alternatives to oil sands petroleum involve much greater environmental risks, they will take some heat off the beleaguered companies; secondly, an offshore oil boom that might have followed from Obama's cautious reopening of offshore drilling has become a bust. That frees up investor capital allocated toward oil stocks to buy oil sands producers' shares as the least-costly way to acquire multi-billion-barrel North American exposures.
4. Remain heavily overweight oil compared with natgas. Gas prices have climbed because of the cutoff of expected production from the Gulf, but this should be only a temporary price boost. As Macondo has tragically demonstrated, finding big oil deposits is a high-cost, high-risk business. Finding gigantic natgas deposits is a low-cost, low-risk business. Natgas

risks becoming the hydrocarbon equivalent of political hot air: cheap, never-ending and ubiquitous.

5. Gold is more than the Bad News Bear's New Favorite. It is the completely inverse investment to paper money and complex financial derivatives, making it the multi-millennial belief system to which modern investors can return from the financial system's current excesses, misrepresentations, and bad politics. In a bull market for gold, the well-managed mines will outperform the bullion. A recommended alternative is the royalty companies.
6. Barring some war in the Korean Peninsula or the Mideast, or the collapse of some major European banks, this stock market pullback should continue to be a correction, not the first chapter in a new horror story. A new Crash at a time of Zero rates remains an unlikely outcome—but not as unlikely as it seemed two months ago before we found out about where all those trichinostic eurobonds were stashed.
7. Remain invested in companies which produce what China and India need. No matter what happens in the OECD, these economies will continue to grow faster than the US or Europe. Their public employees aren't paid more than their private sector earns, and they don't retire young. Their governments are not laden with debts that can only be serviced with economic growth at unachievable levels. In other words, they are doing the big things right—and the OECD collectively is doing them wrong. There is no reasonable doubt about which economies will grow most rapidly—with the lowest recession risk.

THE COXE STRATEGY JOURNAL

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