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Second Quarter 2009 – "A Sprint of a Rally"

Continue to race or drop the baton?

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As Markets Pull Ahead, Will Prices Follow?

The S&P/TSX Composite Index gained 18.97% during the second quarter of 2009. Few sectors performed poorly this quarter with the Telecom and Materials sectors lagging with returns of -1.3% and +4.1%, respectively. The Financials and Information Technology sectors outperformed the other sectors during the quarter, gaining 33.8% and 23.5%, respectively. Investors bought sectors that had been sold off in previous quarters and avoided past market leaders like the Materials sector. Canadian indices outperformed their U.S. peers as oil prices recovered from multi-year lows pushing the Energy sector higher.

Last quarter we wrote there were signs that the freefall in economic activity were abating. This trend has continued as the U.S. ISM Manufacturing Index and many of its international equivalents moved from showing "contraction" to "expansion" signals over the past three months. In addition, Consumer and Investor Confidence have bounced off their lows. New and existing home sales have been rising with help from government incentives and low mortgage rates. Employment numbers have also signaled ***slowing*** economic decline. Although the rate at which jobs are lost has declined, unemployment rates in Canada and the United States rose from 8% and 8.5% to 8.6% and 9.5%, respectively. What does all this data mean? It means the economy is showing mixed signals and will remain fairly sluggish until all indicators signal recovery.

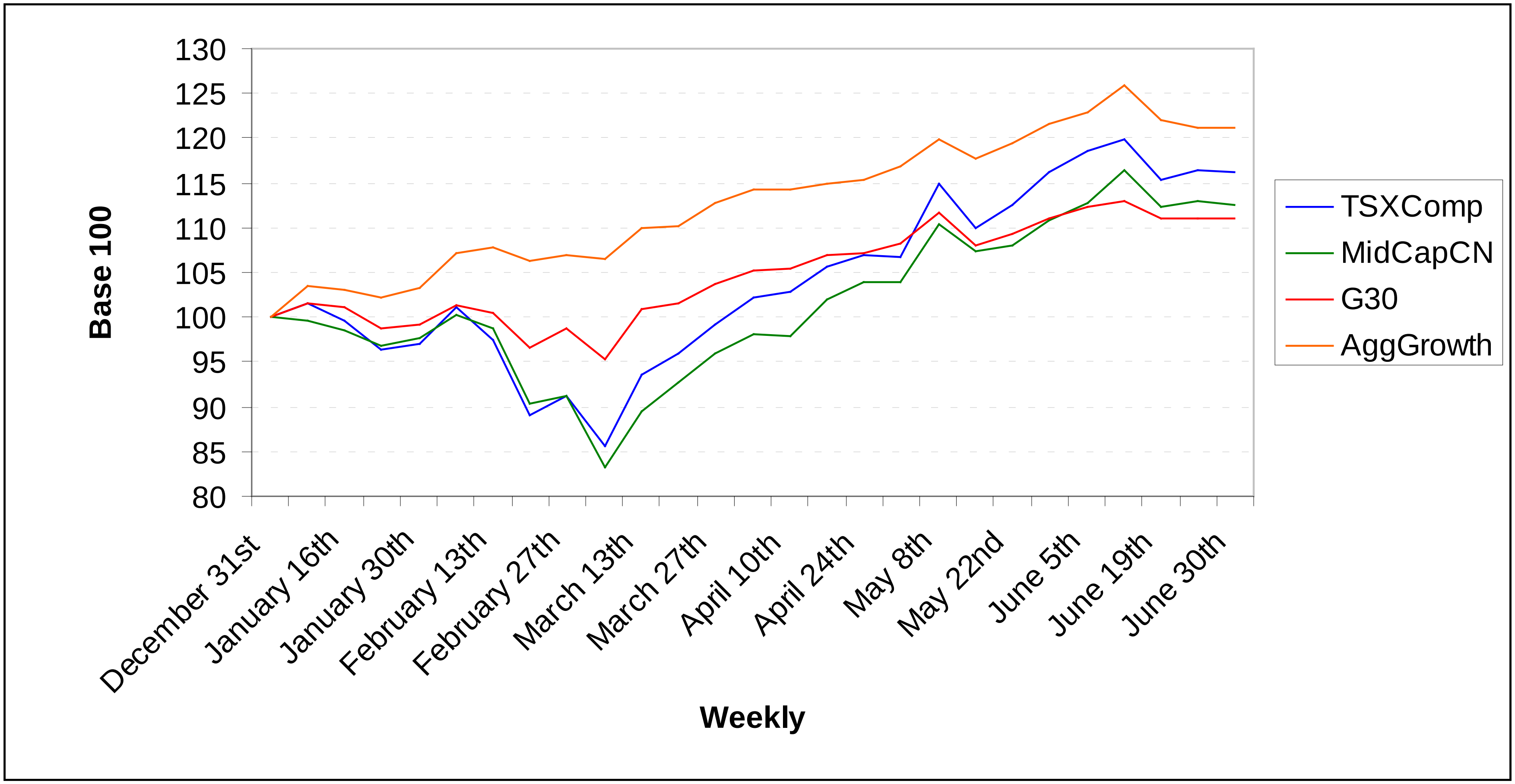
The rebounds in equity markets and investor and consumer confidence have shifted the focus to inflation and inflation alone. This is because the mega-stimulus packages conjured by governments around the world bring the expectation that money supply will increase in the near future. Classical economic theory tells us that growth in the money supply stimulates inflation producing economic activity. Uncontrollable inflation can hinder economic growth and this creates an incentive for governments to restrain access to capital and to decrease the effective money supply through raising interest rates. Will we see runaway inflation?

Growth in money supply does not always succeed in combating deflation as we learned from Japan's Lost Decade, where money supply increased more than 300%, yet equity and home prices plummeted and are still down more than 75% from their 1990 high. So even with massive stimulus, you may still experience an arguably worse scenario than runaway inflation – enduring deflation. Some of the more significant deflationary arguments are as follows: 1) government programs to stem foreclosures are preventing organic credit expansion as the mortgage values today do not reflect the values should the government programs be removed, effectively delaying loss realization and economic recovery, 2) unemployment is expected to rise for at least the next year, putting pressure on all mortgages, even those with renegotiated terms, 3) rising unemployment will cause loan and credit card delinquency rates to rise, squeezing bank balance sheets and reducing banks' propensity to lend to individuals, 4) low corporate profits and high vacancy rates will put downward pressure on commercial real estate prices and put further strain on banks' balance sheets, reducing banks' propensity to lend to corporations, and 5) prices of essential consumer goods are rising and wages are steady and unlikely to rise resulting in less discretionary income to spend on non-essential goods and lower demand for all products.

Inflation is difficult to imagine when demand from consumers and businesses is the weakest it's been in decades and the unemployment rate is expected to worsen. Inflationists have touted that the shift from negative to positive consumer savings rates will be the tinder that will set the economy and inflation on fire when consumers begin to spend again. That said, it is unclear whether banks will be able or willing to provide sufficient capital to allow consumers to live beyond their means and reinflate the economy.

What we do know is that the bulk of the increase in the consumer savings rate is a result of record low mortgage and loan rates, suggesting that any boost in demand will be temporary and unsustainable without ongoing monetary stimulus.

S&P/TSX Composite & Completion Indices vs the G30 & Aggressive Growth Portfolios: 2009 YTD



Aggressive Growth Portfolio: Gained 8.97% during the quarter.

The best performers in this quarter were:

- Neo Materials Tech (Materials/Rare Earths) at +68.85%
- First Quantum Minerals (Materials/Copper&Gold) at +58.45%
- Quadra Mining (Materials/Copper&Gold) at +45.74%

The worst performers were:

- TMX Group (Diversified Financials) at -4.28%
- Bow Valley Energy (Oil&Gas Development/Exploration) at +1.01%
- Agrium Inc (Fertilizers & Farm Products) at +1.66%

During the quarter we bought:

- Bankers Petroleum: we accumulated a full position in Bankers as it was still trading at less than the value of its 2P (proven & probable) reserves; most comparable companies traded at a premium to their 2P reserve value.

During the quarter we sold:

- No Sales.

G30 Balanced Portfolio: Gained 8.28% during the quarter.

<u>The best performers in the quarter were:</u>

- Sherritt International (Diversified Materials) at +78.85%
- First Quantum Minerals (Materials/Copper&Gold) at +58.45%
- Quadra Mining (Materials/Copper&Gold) at +45.74%

<u>The worst performers in the quarter were:</u>

- Yamana Gold (Materials/Gold) at -6.00%
- BCE Inc (Telecommunications) at -2.93%
- TransCanada Corp (Utilities & Power Generation) at +0.34%

<u>During the quarter we bought:</u>

- TransCanada Corp: we purchased a full position following a bought deal which sent the stock down over 10%; as the cash from the equity offering is already allocated to an accretive project, we feel confident that the stock will recoup those losses very quickly.
- Yamana Gold: we purchased a gold equity to protect against long-term inflation and short-term uncertainty, both of which should put upward pressure on the price of gold; we chose Yamana as it should outperform the gold sector in the long-term with its strong organic growth profile and we believe it will hold its value amidst market turmoil due to its sizable current production and cash flow.

<u>During the quarter we sold:</u>

- No Sales.

Going Forward

As we have stated before, one's stance on inflation and deflation is most important in formulating one's tactical asset allocation. We believe there is a stronger argument for deflation but must continue to protect against both inflation and deflation.

It seems as though most central bankers share our thinking as rates have remained at record lows in many countries and as recently as the last week of June, the central bank of Sweden lowered interest rates and set their deposit rate at -0.25% (i.e. anyone depositing kronor with the central bank of Sweden will receive a negative return on their deposit). This goes to show you that those with the most information still fear deflation.

We believe central bankers will hold rates at rock-bottom for two reasons: 1) the volume of debt on government and commercial bank balance sheets has ballooned over the past 18 months, and should the world economy enter a deflationary spiral, it could lead to unpreventable bankruptcy of private businesses as well as governments and 2) high, but controllable inflation will effectively reduce the amount of debt on government and commercial bank balance sheets, easing credit supply concerns in the long-run.

If central bankers are willing to hold interest rates low until inflation is visible and undeniable, two possibilities arise: 1) stimulus is unsuccessful and we experience a depression, or 2) if money supply is not restricted once economic expansion is underway, a hyperinflationary scenario could arise. In such a scenario, effected economies and their respective currencies could be in jeopardy of collapse. Both scenarios are improbable yet possible and are impossible to predict before they are well underway. The best way to protect against both is to maintain a sizeable cash balance and hold stable, large cap equities and a small position in gold.

Where to go from here?

As at the end of the quarter, our G30 portfolio consisted of 46.7% cash, 4.3% fixed income and 49% in equities; our Aggressive Growth portfolio consisted of 57.1% cash and 42.9% equity. We were hesitant to buy into the rally's strength and bought equities that experienced pullbacks due to unique circumstances. Now that Canadian equity markets have run-up over 37% since their March 9th lows, we remain hesitant to buy equities in any event other than a significant pullback (over 10%) or a special situation involving an individual equity such as a bought deal or on baseless pessimism and a concurrent selloff.

We will continue to hold cash throughout these uncertain times. We are anticipating another major market selloff and will purchase equities at key price levels on the way down. We will focus on dividend-paying equities as we see limited potential for capital gains in the near-term.

Sincerely,

The Steele Wealth Management Group