

Investment

Review & Update



FEB 2008

Challenges & Solutions of Global Markets



A picture says more than a thousand words.

The world's economic fate seems to hinge on the timely actions or responses of this man, the world's most influential central banker, Federal Reserve (FED) Chairman, Ben Bernanke. So important is the US economy, there is a saying "[that] when United States sneezes, the rest of the world catches a cold". The latest sneeze is likely to take the form of a US economic recession. This economic slowdown is likely to spread to impact neighboring countries and spread to Europe, Asia and the emerging markets particularly to those dependent on the US as their main source of export and growth. The reality of globalization is that our economic fates become more intertwined with each other.

The CHALLENGE:

The root of the problem, first evidenced in the summer of 2007, is related to non-performing sub-prime mortgages that were impacted by declines in US real estate values. Billions of dollars worth of these mortgages were packaged as "credit derivatives" and sold off as AAA investments to US and global financial institutions with fancy names such as ABCP-Asset Backed Commercial Paper, MBS-Mortgage Backed Securities, and SIV-Structured Investment Vehicles.

While some of these instruments have been in use for many years by investment bankers for large commercial real estate projects, the extension of the "packaging" to cover much higher risk consumer based mortgages, credit card and auto loan financing has now exposed the greed and lack of oversight that exists. It is not well understood by the retail investor that most of these credit derivatives are based on NON- TRADITIONAL banking practices which in many cases are considered for financial reporting

purposes as "Off Balance Sheet Financing" falling outside of the oversight of regulators and central banks. This lack of understanding is compounded by the trust that these same investors draw from the ratings of these "instruments" by the credit rating agencies that are clearly in conflict of interest as they are paid for their credit opinion by the issuer.

Further compounding these problems is the fact that these derivatives are traded in the over-the-counter (OTC) market, which is an inter-bank system of wholesale banking, where the pricing mechanism depends on the willingness of other counterparties to quote a price. As a result, many of these derivatives lost their value, when the liquidity and marketability of these derivatives disappeared in the face of the downturn in US real estate. Unlike TRADITIONAL banking instruments the recourse and recovery from defaulting parties is complex and often dependent upon resolving prior claims. As a result, without liquidity or demand for these instruments, banks are being forced to hold these instruments and to account for the value of their declines within

DISCLAIMER: E&OE: Investment Fund values change frequently and past performance is not indicative of future performance. No guarantee is given or implied and there is risk of loss as well as the opportunity for gain when investing in mutual funds.

Integrated Tax Planning, Private Wealth Management & Family Business

STERLING
MUTUALS INC.
Independent Financial Network



Investaflex
Financial Group

Investaflex Financial Group / Sterling Mutuals Inc. © 2008

Challenges & Solutions of Global Markets

their financial statements. Therefore in future quarterly reporting, banks are expected to write off more of their assets that have experienced credit deterioration or have gone bankrupt. So far the total loss declared by all banks and other public financial institutions from around the world adds up to \$130 billions. Bill Gross, manager of the largest bond fund in the world, has estimated the final tally could be as high as \$250 billions, while a Japanese economic research team estimated the final damage could be as much as \$450 billions. The chairman of a major bank involved in this fiasco mentioned that they cannot quantify their future losses. As long as the credit crisis lingers, the reality is that nobody knows when and how this trillion dollar derivative market will eventually be resolved. Moreover, the continued reported weakness in the US housing market compounds this situation. This credit turmoil is also occurring at a time when the US personal saving rate is the lowest, and government spending and deficit are the highest in history

The RESPONSE:

1) The initial effect of the reported losses suffered by banks threatened to freeze the normal inter-bank lending (or money market) operation and the central banks in US and Europe quickly restored confidence by standing in to provide short term lending to any banks that had a hard time borrowing from other sources to fund their short term borrowings due to a credit crunch. They have basically opened their wallets to their banking institutions in order to keep the wholesale banking system operating smoothly.

2) The US Federal Reserve Board (FED) understands that financial

institutions are the backbone of the free market economy. If the banks become insolvent, the economy can potentially collapse, such as the Great Depression in the 1930s, when there was a run on the banks. The Bernanke Federal Reserve cannot afford to fail and will, if required, surpass the actions of predecessors to keep the economy working. So far they have cut their short term interest from 5.25% to current 3.00%, with the interim 0.75% emergency cut made last Tuesday (January 22nd, 2008) in response to deteriorating global stock prices, and a further 0.50% cut this week after their regular FOMC meeting. The purpose of these interest rate cuts is to allow banks time to improve their earnings quickly in order to save for the next write off. A second motive is to try to lower the 30-year mortgage rates to slow the real estate decline. We are hopeful that these aggressive interest rate cuts will help.

3) The US Bush government has also recently announced a one-time stimulus package of US \$150 billions to put more money into taxpayers' hands, hoping they will spend it quickly to create a money multiplier effect to stimulate the economy. This may just be the first of many fiscal stimulus packages aimed at re-priming the economic engine.

4) The US Government has also helped those mortgagors who are on the verge of mortgage default or would otherwise default on their loans because of higher interest rate resets on variable interest rate loans obtained at the time of buying their homes by declaring an interest rate freeze. This is another step to slow down mortgage defaults in light of higher interest resets and declining asset values of real estate.

5) Central banks around the world that have so far stayed on the sidelines are likely to join the FED soon in their effort to stop this financial rout. For example, Canada has eased their short term interest rate recently and UK is likely to follow suit. The rest of the countries in Europe are likely to respond in due course. While central banks focus on the monetary policy of their own countries and will generally avoid acting in concert, if confidence is not restored by the current round of initiatives, we may yet witness a synchronized response to mitigate the impact on currencies.

6) Fortunately, some major banks such as CITIBANK, MERRILL LYNCH, UBS and CIBC have received fresh capital injections of liquidity from a variety of sources including sovereign wealth funds (GIC, CITIC, ABU DHABI-central banks), pension's funds, corporations and wealthy individuals to rebuild their capital base. Banks have also embarked on rebuilding capital and investor confidence by cutting dividends, costs, jobs, and firing the CEO's responsible. However, some smaller banks which are unable to get new and fresh capital are likely to be merged or acquired privately and/or sold off commercially during this process of de-leveraging. In the worst case scenario, governments will step in to nationalize troubled banks, a case in point is the recently collapsed mortgage bank - Northern Rock in UK and in such cases, public and tax payers' money will be used to fund this bailout.

7) At the moment, every tool from a macro-economic standpoint has been triggered by the FED and the US Government to avoid a replay of the 1930s recession. Demanding times require fresh solutions, and the

DISCLAIMER: E&OE: Investment Fund values change frequently and past performance is not indicative of future performance. No guarantee is given or implied and there is risk of loss as well as the opportunity for gain when investing in mutual funds.

Challenges & Solutions of Global Markets

willingness of the central banks and governments to take prompt and decisive action we hope will prevent a global meltdown. But we must also remember that every action has both a short term, and a long term effect and the long term effect of pumping liquidity into the economy is inflation, and over the next few years investors will want the investment growth from the markets to beat a rising cost of living.

The IMPLICATIONS:

Topsy-Turvy

market conditions continue to prevail as sentiments in the equity market oscillate widely as investors ponder the largest financial challenge since the depression and the US effort to mount a rescue. Although we think the global financial sector and equity markets are not yet out of the woods, we remain optimistic that as markets come to fully understand the commitment of central banks to ensure liquidity there is likely to be a sharp rebound from the bottom. What should be the correct response of our clients, understanding that there may yet be a further decline in markets before they bounce back?

The ACTION:

Buy? Sell? Or Panic? Or is it time to head for the hills?

As we focus on the current situation, it is evident that clear headed thinking is required. The correct response to the market depends entirely on your risk tolerance based upon your appetite, ability and need to assume risk. Each client family has a portfolio that considers these elements. For those who are more speculative and have a long time horizon, this may be the time to start adding to the portfolio equities weighting. For most clients who hold balanced portfolios, sticking to your strategic asset allocation with a mix of equities, bonds, cash, high quality marketable securities and gold should be able to ride through these volatile times. For those in retirement, reducing equities and adding cash may be a more comforting position. It is important to structure the cash flows in such a way to minimize the impacts of market volatility or what is now referred to as "Drawdown Risk". Adding Life pay and term certain prescribed annuities and/or high-yield cash accounts to create this predictable cash flow will aid

the perception of stability and create more comfort.

As your advisor team we monitor the markets daily to understand why the markets are behaving the way they are, then we consider how best to tackle the problems before we share our views with you. We empathize with the emotional rollercoaster our clients are experiencing as our personal portfolios are made up of the same investments, with the outcome of our recommendations impacting our personal financial position in the same way it impacts our clients. We will continue to update you on the latest changes but at the meantime, if there is any concerns or questions, please call Victor Whang at 604-331-2524 or Malcolm Ross at 604-331-2521.

Best regards,



Victor Whang
604.331.2524



Malcolm Ross
604.331.2521

308-938 Howe Street Vancouver BC V6Z 1N9
T: 604.331.2520 | F: 604.331.2540
info@investaflex.com | www.investaflex.com

DISCLAIMER: E&OE: Investment Fund values change frequently and past performance is not indicative of future performance. No guarantee is given or implied and there is risk of loss as well as the opportunity for gain when investing in mutual funds.

Integrated Tax Planning, Private Wealth Management & Family Business

STERLING
MUTUALS INC.
Independent Financial Network



Investaflex
Financial Group

Investaflex Financial Group / Sterling Mutuals Inc. © 2008