

Mutual Success

Your Fund of Information



June 2008

Geo-Politics and the "Real" Economy

As our investment team continues to review the macro-economic picture in order to develop our top-down asset allocation strategy for the next six to twelve months, we are consistently brought back to the reality that economic models draw correlations between variables when "assuming all other variables remain unchanged". However, we are clearly living in a time where many of these variables are changing concurrently and the impact is starting to play out in ways people have not foreseen. To cite but one example the UN Food and Agriculture Organization (UNFAO), has just finished hosting world leaders in Rome where the poorest nations were appealing for assistance due to the dramatic rise in food prices, much of which is driven by the demand for bio-fuels. Governments have failed to recognize that, in promoting ethanol based fuels from corn, and bio-diesel from soy, the demand for these would impact food prices. As oil rises, Organization of Petroleum

Exporting Countries (OPEC) has indicated that it does not see a need to increase supply, and as a result Indonesia, a major oil producer, withdrew its membership from OPEC so that it can increase its own supply to subsidize grain products for its people. Grains feed not only people, but also the animals from which many derive their meat and protein, and prices for these have also gone up sharply. In response, there have been marches and strikes over rising basic food costs across the globe. We are facing global inflation!

Since the Second World War the United States Dollar (USD) has been the major measure for global commodity prices including oil. Many attributed the rise in oil and commodity prices as a response to a weakening USD, which was weaker due to a decline in the US economy on the back of the credit crisis. However this is not the whole picture. The declining USD combined with rising oil and commodity prices is causing inflation to increase in the

US. This inflation is fuelled by the reducing interest rates and billions of dollars being pumped into the credit market by central banks to avoid a recession. While it may have been appealing to the US to have a weak dollar in order to reduce their "real global indebtedness" the slide is probably more than expected, and with fear of recession still real, raising interest rates is not likely the best solution. It is for this reason we predict that at an upcoming meeting of G8 Central Bankers the US will attempt to rally their colleagues and advocate for a strong USD policy and act in concert to buy USD in an attempt to bring down commodity prices for a period. If successful, we believe there will be drawback in the market in late June and July which will afford us an opportunity to buy in at lower levels than the current heady highs, with modest returns expected over the next couple of years. If it is not successful we can expect to see inflation making a charge through the next couple of years with wild market volatility fueled by short term speculation.

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Of course this may be “true” if, as our economist friends might suggest, “all other things remain equal!” However there are a number of factors that may come into play. Let us look at just three of them. Iran and Korea have been advancing their nuclear aspirations. While there has been much rhetoric about the “Axis of Evil”, Korea has recently made some concessions about the monitoring of its activities. Iran, by contrast has not, and some might question the need for nuclear energy when it holds the world’s largest reserves of oil? Israel certainly will not sit idly by as Iran, who advocates for its destruction, develops nuclear weapons. With or without US support, it is likely a matter of time before Israel launches a pre-emptive strike on Iran’s nuclear facilities, at which point oil prices will rise sharply, and dependent upon the outcome, will likely remain at even higher levels.

The psychological barrier of \$4 per gallon for gasoline has started to manifest itself in changes in automobile purchasing patterns. Sales of recreational Trucks and SUVs have fallen sharply like their gas guzzling predecessors of the 80’s. Ford and GM both are facing escalating losses and plant closures. More gas efficient compacts and fuel cell vehicles are gaining popularity, but the contraction of housing values has meant less home equity to parlay into automobiles and “toys”. The job losses will have a ripple effect in the economy.

South Africa has been the world’s largest gold producer for the last 100 years, since the gold fever of the 1880s started to attract miners into the Transvaal away from the diamond mines in Kimberly. The deepest mines over a kilometer deep chase the rich veins of the Marensky Basin from the Witwatersrand to the Eastern Transvaal. For 7 days in March the entire mining industry including gold, platinum (the new resource which abounds), diamonds, chrome, iron, and coal was brought to a halt in South Africa because of a lack of power. Eskom the national power authority has underestimated the growth in demand for electricity, and culpably failed to service and upgrade their existing supply services over the last 10 years. The country now survives by rolling blackouts where sections of the country are turned off during the day and other peak hours to ensure the supply for essential economic sectors. Electricity supplies to delinquent neighbours like Zimbabwe have been terminated, and imports from Mozambique and the large Caboro Basa project on the Zambesi River are supplementing the shortages stemming from mismanagement. SA’s response to financing the upgrades needed, is to authorize a 50% price increase in electricity price. These fuel and electricity costs and the bio-fuels discussions earlier are having a huge impact on inflation in SA. Political unrest in SA has also risen with the flow of illegal refugees both political and economic from neighboring countries including Zimbabwe, with xenophobic attacks perpetrated against these refugees by SA peoples

themselves struggling to find work, housing and food in the face of shortages and spiraling inflation. The current political unrest in Zimbabwe is for most unimaginable, pending the second round of the Presidential elections, with so called mediator President Mbeki from SA claiming that there is not a crisis in Zimbabwe. Diplomatic sources, human rights agencies, aid agencies, church leaders and SA observers all report that the potential for a free and fair election in Zimbabwe does not exist and Amnesty International has the country rated a 7 on its genocide watch scale of 8. The number of Zimbabweans illegally leaving the country is estimated at between two to three thousand per day, with about half being captured and returned to Zimbabwe, to try again tomorrow. There are now estimated to be over 3,000,000 living in South Africa the vast majority of whom are “illegal”, but who work in the mines and on farms. If the xenophobia continues to grow in proportion to the discontent at 45,000 new immigrants monthly who in their desperation often resort to criminal means to survive, the impact on mining and agriculture will be significant. In short major disruptions to the SA Gold production is highly plausible and as other factors point to gold as a good hedge in the face of inflation, the gold price may yet benefit from this geopolitical uncertainty.

Quo Vadis?

So where, in all of this, can we find good news and investment direction. Firstly, it is clear that

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energy and resources are still in demand as the so called emerging markets are now consuming more oil than the developed economies of the OECD where conservation and diversification strategies are being supported. Although slowing to single digits there is still real growth taking place in the emerging markets, and the demand for resources still remains strong. We believe that patience here will be rewarded, including in the Templeton Global Smaller Companies and Mackenzie Cundill Recovery funds.

There is no short term solution to issues facing agri-based commodities, so prices are likely to continue to remain high or go even higher. This auger well for Canadian energy, agriculture, commodities, and mining producers. We anticipate that gold prices will rise to reflect the issues associated with supply from South Africa, and demand from sovereign funds. This will continue to be a volatile sector, and for those uncomfortable with the volatility, only modest positions will be recommended but for investors who are more risk tolerant this should be a good hedge against both inflation and currency weakening. Our outlook on the global financial sector is still more negative than positive, as we see housing values in US and UK dropping, and the term “negative equity” being used more frequently, and US foreclosure numbers sharply up over last year. Although this has not yet hit the Canadian market except for some cities impacted by the job losses from plant and mill closures, we are watching for greater fallout and its impact on

the financial sector. After careful review and analysis we have decided to add funds managed by Front Street Capital with the well respected former Altamira lead managers, Frank Mersch and Norm Lamarche. They are active managers with strong track record and their Front Street Canadian Special Opportunities Fund focuses on commodities, resources and energy, and enable us to invest in Canada’s strengths without also getting into financials yet.

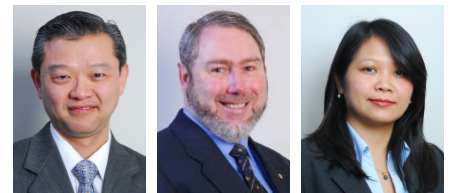
On the fixed income side after spending nearly a year reviewing both the original and revised product we consider that the Manulife Income Plus product is suitable annuity alternative for clients who want to create a secure, pension-like, permanent cash flow in their retirement with some upside market potential. For clients between the ages of 50 and 65 there are accrual advantages, and the product has some mortality guarantees for protection of beneficiaries. For those investors concerned about outliving their capital in retirement, this product is a good tool to complement their cash flow planning.

The Investaflex Team with Sterling Mutuals remains committed to ensuring that we are continually looking at the big picture, as well as the performance of the managers to whom you have entrusted your investments to manage, and we continue to look for ways we can add value and cost benefit advantages for our clients. With this in mind we have been interviewing a number of

Investment Counsel firms in order to assess how use of their services will be of value for our clients. Investment Counsel firms provide investment management services but generally do not provide integrated tax and financial planning advice, and through referral relationships with Sterling Mutuals we can help clients gain access to their services when appropriate. As with any recommendation of an investment manager we need to consider the manager track record, area of expertise, investment philosophy, management style and longevity. Minimum portfolio sizes will often limit the choices, but many managers offer Pooled Investment Funds or Mutual Funds for smaller portfolios or parts of a portfolio for which they are selected. As our assets under administration grow we want to be sensitive to the investment options for all family portfolio sizes.

If you have any questions on the information contained herein please do not hesitate to call one of the team. Here’s hoping for summer to eventually arrive!

Best Regards,



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