

Investment

Review & Update



May 2007

Global Asset Inflation

The purpose of this article is an attempt to provide a big picture (or Macro) view of what we see as a major trend in the global asset valuations. We will continue to monitor this trend in relation to our own investment strategy to see whether this will necessitate any re-allocation of client portfolios.

Since our update in Feb 2007 following the correction of the Chinese Equity market and its impact on global equities, the markets have stabilized. It was indeed a mild correction; hence non-action at that time was the best action. When a market declines sharply, there is always a fear that it could turn out to be more than a correction but is a major bear in disguise. Identifying the bear is usually a matter of hindsight. Over the past 80 years there has been more than 10 occasions where the market have declined by more than 20% from its peak (including the more recent year - 2000). The key lessons we have learned from the "bear" can be briefly summarized as follows:

- * The future is unknown
- * Change is certain
- * We plan for the long run but live in the short term
- * The pain of loss is more intense than the pleasure of gain
- * Well balanced investing incorporates personal risk as well as asset risk.
- * Successful investing is a matter of probability and risk reward ratios. If we make more correct than incorrect decisions, we should be ahead of the market.

In this issue, we would like to present and focus on a specific observation of our current global outlook. We think that the globalized world is currently experiencing an unprecedented period of high asset inflation, caused by the available liquidity (or high level of cash in the system) due to the low interest rate environment. A definition of inflation is "too much money chasing after too few goods" and is usually measured by Consumer Price Index (CPI)

(which could either include or exclude volatile energy prices). Although the official inflation in Canada has been at a range of 1-3% for the past few years, real inflation as experienced by consumers, (provided by anecdotal evidence) show that prices today are even higher. Prices of hard assets such as real estate have definitely appreciated more than 5% per year over the last few years. Gas prices continues to grow in the face of higher crude and refining cost and perhaps wider profit margins for the oil producers. In Canada, every investment asset class such as equities, bonds, real estate, commodities, currencies, gold, private equity have been booming for the last few years and continue to test new highs. In short, what we are experiencing is termed "asset inflation".

What is unprecedented is that unlike past boom cycles, which tend to be confined to a specific

country or region, the current boom is occurring globally. In other words, asset appreciation has been experienced worldwide. This makes the current asset inflation one of the strongest, largest and perhaps longest in the history and the impact would be huge if this trend reversed. Periods like this tend to favor or reward those who hold ownership position in hard assets (real estate, stocks, etc.) and is less rewarding for those who hold cash, GIC's, or bonds.

Here are some reasons to explain asset inflation:

1. A relatively benign interest rate environment

With the exception of the US short term interest rates which has risen more than 14 times. The availability of cheap money from countries such as Japan and other Asian countries continues to support more risk taking.

2. Synchronized world growth

Most countries are experiencing above par growth, especially Asia and Europe with the International Monetary Fund (IMF) predicting that average growth rate this year will be around 5%.

3. Increasing integration of global trade and finances

This has resulted in rapid flows of capital to the lowest cost producer. This has resulted in stimulation in economic activity in developing countries and cost efficient gains for the "importing" countries.

Our research which includes luminaries such as Global Bond manager Bill Gross leads us to conclude that we are in a secular bull cycle with its accompanying global asset inflation. Bill Gross is calling for this to last for another 3-5 years. We will look to position our portfolio guidelines to exploit this trend, but will be mindful of the personal risk/reward objectives for each client.

If you would like to discuss this further, please do not hesitate to call us.

Sincerely,



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