

After a strong recovery in April and May, the bear market resumed in June basically taking indices down to levels reached at the end of the first quarter. The one exception, again, was the TSX which has continued to gain ground because of its approximate 50% weighting in energy, mining and materials. Aided by these resources, the portfolios had positive returns for the quarter. Because of the different risk profiles of our clients, securities mentioned will not necessarily be included in all the portfolios.

## \$150 Oil ?

The impact of the credit crisis has started to diminish, replaced by the cost of energy as the key influence on investors' sentiment and the state of the economy. Other sectors of the market will not likely respond positively until energy prices stabilize. An observation is that the price of a barrel of oil at U\$145 is about 100 times the price of a litre of gasoline. Refiners can typically extract about 75 litres of gasoline from a barrel of oil. The remaining portion of the barrel is used for distillates such as heating oil, jet fuel, and diesel.

A tug-of-war between inflation and stagflation is also giving investors indigestion. Food and energy inflation are impacting consumer spending, diverting funds for discretionary expenditures to consumer staples such as food and driving to work. This reduces the profits, and thus, stock prices for discretionary sectors of the economy such as autos, appliances, and clothing. Stagflation is the combination of inflation plus a slowing economy. It is an undesirable situation that we last encountered back in the 1970s. The central banks have the challenge of mitigating inflation by raising interest rates and, simultaneously, trying to stimulate growth, usually by decreasing interest rates. Obviously, something has to give; the US Fed has stopped lowering interest rates while the rest of the world, Europe, China and India have raised interest rates in an effort to control inflation.

The table below summarizes recent market performance, presented in Canadian dollars.

| Market Indices (\$C)    | Year 2007 | 2008 YTD | Q2 2008 |
|-------------------------|-----------|----------|---------|
| TSX (Canadian market)   | 7 %       | 4.6%     | 8 %     |
| S&P 500 (US market)     | -11 %     | -11 %    | -5 %    |
| Nasdaq (mainly tech.)   | -6 %      | -11 %    | -1 %    |
| MSCI World              | -6 %      | -10 %    | -4 %    |
| MSCI EAFE (Int'l)       | -5 %      | -11 %    | -5 %    |
| DEX Mid-term Bond Index | 3 %       | 3 %      | -1 %    |
| US\$ relative to Cdn\$  | -15 %     | 3 %      | -1 %    |

## Portfolio Activity

As the emerging countries raise their standard of living they increase the world demand for meat and higher quality food. To participate in this agriculture boom **Agrium (AGU: TSX)** and **Hanfeng (HF: TSX)** were added to portfolios. Agrium produces potash, nitrogen and sulphur based fertilizers and distributes them through their recently purchased retail operation, UAP Holdings. Hanfeng who manufactures slow release fertilizer in China recently signed a 50/50 joint venture with Shandong Mingshui Great Chemical Group, one of a few top professional nitrogen companies in China. Shandong will supply 100,000 tonnes per annum of raw nitrogen and production facilities while Hanfeng provides their proprietary slow release technology. A second joint venture between Hanfeng 34%, Matahari Kahuripan Indonesia 33% and Sumber Agrindo Sejahtera 33% represents Hanfeng's first slow release fertilizer production facility outside of China in Indonesia.

Early in the quarter **Talisman (TLM)**, an oil and natural gas producer was purchased. Talisman has recently started to focus their efforts on natural gas extracted from shale in Quebec and Western Canada, oil from the UK North Sea and Southeast Asian reservoirs. Later in the quarter when oil and energy prices climbed rapidly, Talisman and **PetroCanada** were trimmed back in portfolios that have larger energy holdings.

Given the high cost of energy, **Canadian Hydro Developers (KHD: TSX)** was purchased for more risk tolerant accounts. KHD currently has 11 hydro generation stations, 9 wind farms and 1 biomass facility with additional hydro and wind farm facilities under development. Also in the green energy space, **GE** who manufactures wind turbines was added to some accounts. GE serves the infrastructure needs of the emerging economies by supplying power generating turbines, water supply and treatment equipment and jet engines. The company's large finance business was a drag on its earnings in the first quarter but they are in the process of selling the non-profitable portions of this division.

The performance of **Thomson Reuters** has been a disappointment as concerns mount about the downsizing of their financial sector customers. The company provides electronic information for businesses and professionals in the financial, legal, tax and accounting, scientific, healthcare, and media markets worldwide. Since the merger Thomson Reuters has traded at a 12 – 15% discount in London,

UK versus the North American exchanges. To take advantage of this arbitrage situation larger holdings were exchanged for the Thomson Reuters ADR trading in New York.

**Artis REIT, Canadian Tire, Manulife and EL Financial** were added to accounts. Canadian Tire has some defensive characteristics such as providing maintenance oriented products and selling auto parts to people who can't afford a new vehicle because of higher gas and food prices. A strong growth area is their financial division, a regulated bank that now offers mortgages as well as banking and credit card services.

In the defensive healthcare sector, **Stryker** was added to accounts. **Stryker** is a leading medical technology company that provides surgical equipment and support systems and orthopaedic implants such as knee and hip replacements.

In the technology sector, **Nuance** was sold for a profit and replaced by **Xerox**, a higher quality, dividend paying stock. Xerox has been in recovery mode for several years and has recently made strong enough progress to pay a dividend. Its core products are retail and commercial colour printing and document management.

In the fixed income area, we continued to add short-term, high quality corporate bonds and purchased Philips, Hager & North High-Yield Bond fund (series-F). Short-term bonds were purchased because of the risk of higher interest rates. When interest rates increase bond values decline, particularly, longer term/duration bonds. The PH&N High-Yield Bond fund consists of non-investment grade bonds that pay high yields. A fund was used for this portion of the portfolio because of the impact a bond default (company bankruptcy) would have on the portfolio. Series-F mutual funds can only be held in Financial Advisor managed accounts, pay no trailer fees and therefore have lower MERs (management expense ratios).

### Outlook

The North American economy continues to struggle with below normal growth of 0 – 1½ percent and Europe and the emerging markets will undoubtedly slow next. Markets will likely remain weak for the summer months with a potential improvement starting in the fourth quarter of this year. Never knowing exactly when the recovery will occur, we are 50 - 70% invested in areas that we believe will continue to perform or be first to move in an upturn.

Potential areas of interest are:

- Energy – continued energy exposure but at a slightly underweight level, selecting stocks with reasonable growth prospects that are cheap on a price to cash flow basis. Opportunities in alternative energy such as wind, hydro, solar and hybrid technologies look interesting. Boating and RVing are areas to avoid.
- Agricultural situations particularly where food can be grown more efficiently (i.e. slow release fertilizer, generically modified seeds, GPS guided planting).
- Consumer credit in the emerging markets such as the growth of credit card use.
- Home improvement – this sector has been decimated. There will be an opportunity upon a rebound.
- Infrastructure – technology that is being used to assist engineering and construction companies in designing and building infrastructure (i.e. engineering design software, project management tools, metal detectors)
- Internet applications and providers – the latest popular application is social networking, FaceBook could go public any day.

The portfolios have cash balances of 10 - 15%, which will be invested when we start to see some market recovery.

### Reminders

- The new **TFSA** (tax-free savings account) is a great way for investors to grow non-registered assets on a tax-sheltered basis. We will keep you posted on further developments as the accounts become available in early 2009.
- Proof of enrolment from post secondary institutions is required to withdraw funds from an **RESP**. This includes a receipt of payment letter or timetable on school letterhead with student name, address and enrolment confirmation for the 2008-2009 school year. We will prepare the EAP form for you to sign.
- Ensure you have **Will**. If you die intestate (without a Will) the government appoints an administrator for your estate, engages the Children's Lawyer for under-aged children and dictates which companies to use for services such as appraisals. This can be an expensive proposition and take a very long time.

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