

Qwest for Returns

JUNE, 2010

ISSUE 10

Cam Hui, CFA

Board of Advisors

Qwest Investment Management Corp.

chui@qwestfunds.com

An antidote for market volatility

Just as the markets were rocketing back in a rip-roaring rally from the March 2009 lows and the prospect of a US economic recovery was at hand, the Greek crisis has just showed us how fragile the global financial system remains. In the space of a few weeks, investor sentiment has downshifted from greed to fear. They are right to be worried about the possibility of a global synchronized double-dip recession:

- The Greek Crisis may still spread to other European countries.
- China is experiencing a property bubble, which will not end well.

What's more, the financial unwinding of the Great Recession in the US may not be over:

- Another round of residential mortgage resets could plunge an already fragile financial system into a downturn.
- Commercial real estate is a disaster waiting to happen.
- Provincial, state and local government budgets are under serious pressure. These entities are on the brink of financial catastrophe and blow up the municipal bond market, leading to another round of cascading defaults.

Recovery or double-dip?

Investors facing these macro-economic risks are caught on the horns of a dilemma. If they remain exposed to risk with a fixed buy-and-hold asset mix, they risk getting blindsided again by the specter of a global recession, as they did in 2008 when most balanced funds were down 20% or more in that year. On the other hand, if they move to the safety of cash and default-free assets, they risk missing on a rally should the global economy recover.

A buy and hold strategy is not the solution.

During these current periods of economic instability and uncertainty, investors need to use trend following models that capture and profit from that instability. An example is the Inflation-Deflation Timer model, which is well-suited for an environment where market expectations oscillate between the equatorial heat of runaway inflation and the arctic deep freeze of recession deflation (see http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_november_2009.pdf).

Some important caveats are in order. Trend following models such as the Inflation-Deflation Timer model are designed to capitalize on intermediate term economic trends and do not spot exact tops or bottoms. Moreover, the intent of these class of models is to protect investors from large scale macro risks and panic episodes such as the Lehman crisis or the Russia crisis. They will leave investor exposed to the garden variety 10-20% corrections, which is part of the risk of investing.

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Europe catches the PIIGS flu

The market turmoil that engulfed Europe highlights a scary fact: the global financial system is highly unstable. As the chart below shows, The Dow Jones Euro STOXX 50 Index is down 7.1% in May and 13.2% from its high point in April.

"We need banks. They are like the arteries in our bodies; they keep the blood (money) flowing. And when our arteries get hard, we can be in danger of heart attacks."



The Greek Crisis resulted in a banking crisis for Eurozone banks. John Maudlin explains (see <http://www.ritholtz.com/blog/2010/03/what-does-greece-mean-to-you/>):

Why is Greece important? Because so much of their debt is on the books of European banks. Hundreds of billions of dollars worth. And just a few years ago this seemed like a good thing. The rating agencies made Greek debt AAA, and banks could use massive leverage (almost 40 times in some European banks) and buy these bonds and make good money in the process...

But those European banks? When that debt goes bad, and it will, they will react to each other just like they did in 2008. Trust will evaporate. Will taxpayers shoulder the burden? Maybe, maybe not. It will be a huge crisis. There are other countries in Europe, like Spain and Portugal that are almost as bad as Greece. Great Britain is not too far behind.

He went on [emphasis added]:

But the fact is, we need banks. They are like the arteries in our bodies; they keep the blood (money) flowing. And when our arteries get hard, we can be in danger of heart attacks.

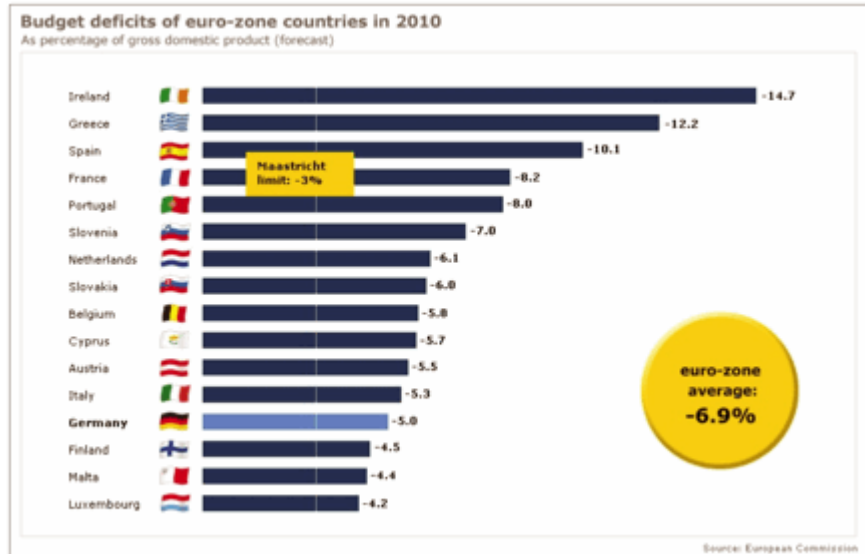
The European policy response has been characterized as Shock and Awe by Martin Wolf of the FT:

First, European governments have committed €500bn (€440bn in loan guarantees to eurozone members in difficulties, and a €60bn increase in a balance of payments facility). Second, the International Monetary Fund will, it appears, put up an additional €250bn (\$320bn, £215bn). Third, the European Central Bank has, to the chagrin of Axel Weber, president of the Bundesbank, decided to purchase the bonds of members under attack. Finally, the US Federal Reserve has reopened swap lines, to provide foreign banks with access to dollar funding. This is a panic-driven response to market panic. It reminds us of the autumn of 2008.

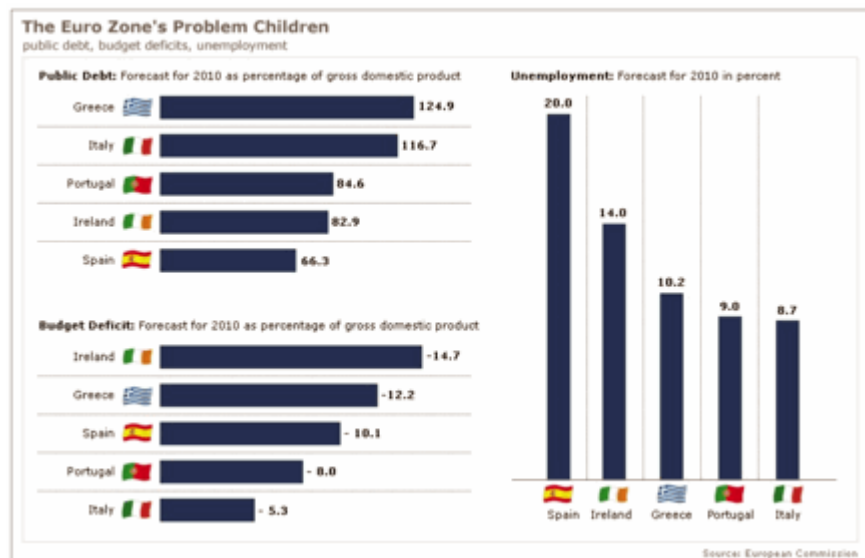
The average projected deficits for Eurozone countries are an astounding 6.9% of GDP.

European deficits are overwhelming

Why the panic? The reason is that the Greek contagion may spread to the other PIIGS (Portugal, Italy, Ireland, Greece, and Spain) countries. Within the Eurozone, deficits are already out of control. The average projected budget deficit for Euro zone countries is an astounding 6.9% of GDP:



The picture is worse for the PIIGS. Greek and Italy already sport a debt to GDP ratio of over 100%, the magic level at which many countries get into trouble. Ireland, Greece and Italy have projected deficits of over 10% of GDP. What's more, PIIGS unemployment is sky high, with Spanish unemployment already over 20%.



Greece, by itself, is a relatively small country. However, if confidence cracks and the contagion spreads to the other PIIGS countries, then the banks (which are mainly European) that lent money to these countries will have to take massive haircuts on their loan portfolios. It would render many European banks insolvent and start a banking conflagration that would spread worldwide.

To emphasize the point and as Maudlin aptly put it, "[W]e need banks. They are like the arteries in our bodies; they keep the blood (money) flowing. And when our arteries get hard, we can be in danger of heart attacks."

China: The Elephant in the room

In addition to the crisis in Europe, there is an elephant in the room of macro-economic forecasting: China. The world is experiencing a very fragile economic rebound and growth has been very unbalanced. If we were to examine this rebound from the bottom up, consider the recent financial results of heavy equipment supplier Caterpillar. How can this be a recovery with Caterpillar sales like this?

	Mar-10
Asia/Pacific	UP 11%
EAME*	DOWN 18%
Latin America	DOWN 15%
ROW†	DOWN 7%
North America	DOWN 21%
World	DOWN 11%

EAME = Europe, Australia, Middle East

ROW = Rest of World

Most of Caterpillar's sales growth came from the Asia Pacific region (read: China),

For the rest of the world, the risk is that China is currently blowing the Mother of All Financial Bubbles and that it may burst soon. Andy Xie reports that Chinese housemaids are now piling into the property market, which is a sure sign of a top for contrarians (see <http://www.businessweek.com/news/2010-04-25/i-ll-tell-you-when-chinese-bubble-is-about-to-burst-andy-xie.html>):

"My maid just asked for leave," a friend in Beijing told me recently. "She's rushing home to buy property. I suggested she borrow 70 percent, so she could cap the loss."

It wasn't the first time I had heard such a story in China. Some friends in Shanghai have told me similar ones. It seems all the housemaids are rushing into the market at the same time.

Moreover, Xie believes that investor expectations of a RMB revaluation is keeping funds in China, which serves to further inflate the bubble:

[T]he revaluation story has kept Chinese money inside the country. The dollar has always been the safe-haven asset for Chinese. This is why Chinese banks had a large dollar deposit base. Of course, anybody who was somebody had dollars offshore. Now all that money is back. More importantly, any income, legal or otherwise, now stays in China.

When all these excesses blow up is anyone's guess. When housemaids are scrambling to get into the property market, we are much closer to the end than the beginning. What's more, the Shanghai Composite looks like it's in freefall.



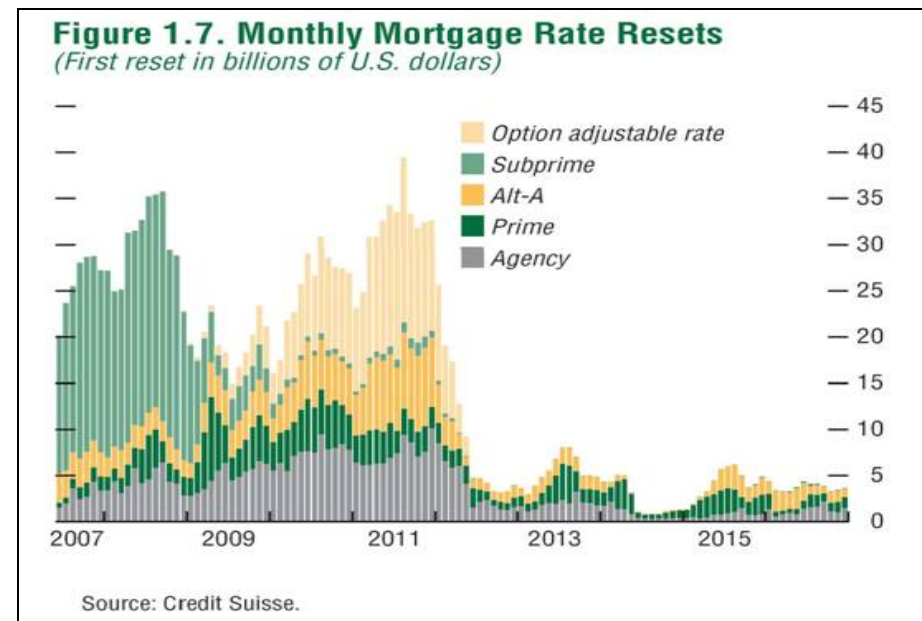
We have no idea when all this house of cards topples on us. Nevertheless, when this bubble pops, it won't be pretty, not only for China but for global financial markets as well.

If China goes down, then we all go down.

What happens if delinquencies begin to rise again and the market starts to discount the prospect of more stresses to an already weakened financial system?

More U.S. mortgage resets = Another Crisis?

There are indications that not all is well in the US, which remains the largest consumer market in the world. The chart below shows the schedule of projected residential mortgage rate resets in the US. Recall that the financial crisis of 2008 was sparked by defaults from subprime mortgages, which ultimately brought the financial system to the brink of disaster.



Today, we are seeing a repeat of the same pattern. Mortgage resets don't really start to rise until 3Q 2010 and the major peak not really occur until the second half of 2011.

While the US economy is currently showing a nascent and fragile rebound, we are now in the period when the zombie mortgage threat would be expected to appear again. What happens if delinquencies begin to rise and the market starts to discount the prospect of more stresses to an already weakened financial system?

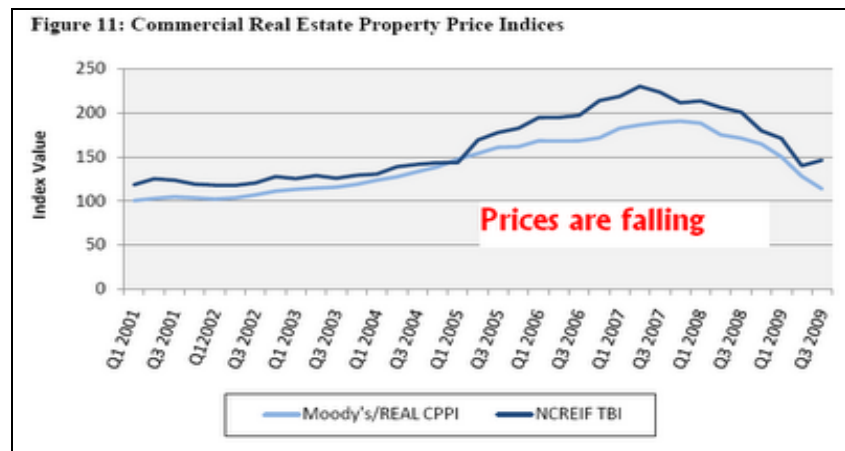
The US commercial real estate time bomb

The problems in the US residential real estate and the potential risks from another round of interest rate resets are relatively well known. What is less recognized is the potential disaster in the US commercial real estate market (CRE). Recently, Elizabeth Warren, chairperson of the TARP Congressional Oversight Panel, stated on CNBC that half of all CRE mortgages will be underwater by the end of 2010 (see <http://www.cnbc.com/id/36085517>):

“They are [mostly] concentrated in the mid-sized banks,” Warren told CNBC. “We now have 2,988 banks—mostly midsized, that have these dangerous concentrations in commercial real estate lending.”

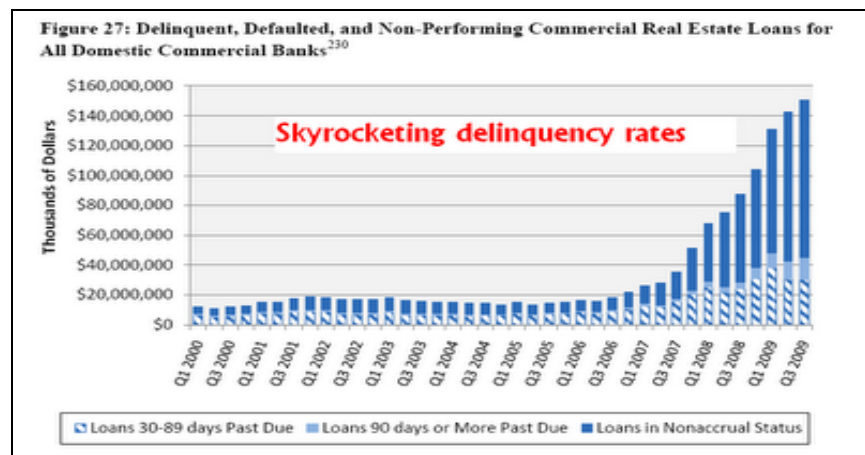
As a result, the economy will face another “very serious problem” that will have to be resolved over the next three years, she said, adding that things are unlikely to return to normalcy in 2010.

In February 2010, the US Congressional Oversight Panel released a report entitled *Commercial Real Estate Losses and the Risk to Financial Stability*, which contained a number of disturbing data points. The report documents falling CRE prices (see <http://cop.senate.gov/documents/cop-021110-report.pdf>):



We remain concerned that the financial system could accumulate hundreds of billions in bad CRE loans in the coming months. These problems are not well recognized and therefore not discounted by the financial markets.

...and soaring delinquency rates:



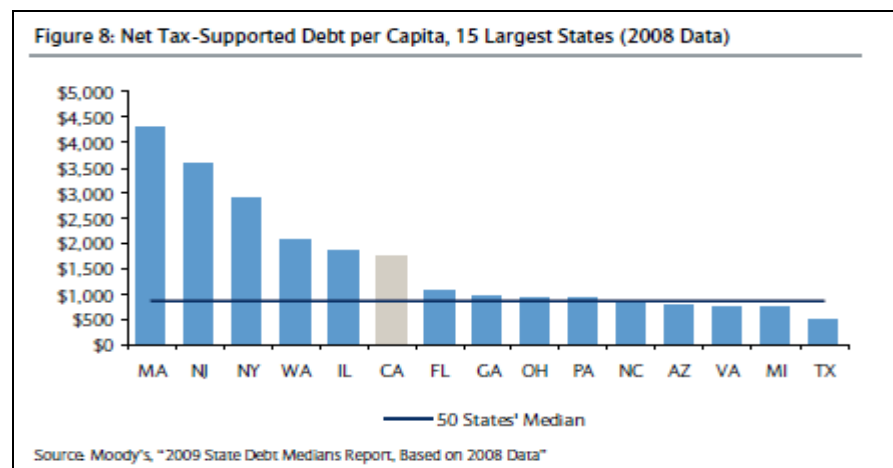
So we remain concerned that the US financial system could accumulate hundreds of billions in bad CRE loans in the coming months and that problems are generally not well recognized and therefore not discounted by the financial markets.

A looming municipal bond market calamity

Rick Bookstaber, who is a Senior Policy Adviser at the SEC and author of numerous textbooks on derivatives and risk management, recently suggested that the US municipal bond market is an accident waiting to happen:

1. It is leveraged and opaque.
2. It is very big and tied to the credit markets.
3. It is viewed by investors as being diversifiable by holding a geographically broad-based portfolio.
4. Investors have huge portfolios where assets and liabilities are apparently matched.
5. It has questionable analysis by rating agencies.
6. There are many entities, entities that may not approach default with business-like dispatch, and that have already mortgaged sources of revenue that are thought to support their liabilities.

The fiscal problems in California are well publicized so we will use it as a benchmark. The chart below shows the debt per capita of selected US states. While California's debt ratios are above the national average, they are nowhere near the highest.



How will the markets react to a Greece-like default crisis by Massachusetts, New Jersey, New York, Washington State, Illinois, California or Florida?

How will the markets react to an unexpected Greece-style crisis by Massachusetts, New Jersey, New York, Washington State, Illinois, California or Florida?

What's more, the state debt figures on the chart don't include unfunded liabilities, such as pension benefits for state employees. The Pew Center for Research on the States conservatively estimated the aggregate pension shortfall to be roughly \$1T (http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf). Barron's had a recent article indicating that the pension hole is closer to \$2T (<http://online.barrons.com/article/SB126843815871861303.html>).

Canadians should not by any means feel smug or complacent. The table below compares the budget deficit for California against Ontario. Both show similar levels of shortfalls, but California has a population that is larger than all of Canada's 33 million. In fact, the per capita deficit in Ontario is 3.4 times that of the Golden State.

State/Province	Population	Deficit	Per Capita Deficit
Ontario	11,410,046	\$21 Billion	\$1,840
California	36,961,664	\$20 Billion	\$ 541

The situation may not be that bad

Despite all these risks, a double-dip may not occur. A former colleague of ours once remarked that there is always “bad stuff” in the market otherwise stocks would be trading at 50 times earnings.

Are we overreacting? To be sure, there are some silver linings to the dark cloud of double dip recession that loom over us.

First of all, the Greek Crisis is highly reminiscent of the Bear Stearns/Lehman Crisis of 2008. European governments and central bankers have responded with their version of “Le TARP”, a rescue package that bails out the banks. While some may argue against the policy implications of the rescue, we saw the results of the wall of liquidity that rescued the US markets and sparked the nascent rebound that we observe today. The same may happen to Europe.

In addition, China may be able to engineer a soft landing. While Chinese authorities have taken steps to cool down the overheated property market, they have shown a tendency to restrain themselves when necessary. In past episodes of tightening, they have tended to stop at the edge of the abyss and step back before their economy has plunged into a full-blown slowdown.

In the US, the risks in real estate are well known and both Main Street and Wall Street are better prepared to deal with any eventualities that may impact mortgages, whether residential or commercial.

A buy and sell strategy is not the solution

In the faces of these risks, what does an investor do?

In an era of instability such as the one we face today, investors need to use models that capture and profit from that instability. An example is the Inflation-Deflation Timer model, which is well-suited for an environment where market expectations oscillate between the equatorial heat of runaway inflation and the arctic deep freeze of recession or deflation (see http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_november_2009.pdf).

Inflation-Deflation Timer Model

Return Summary (all figures in Canadian Dollars)					
	1Q10	1 yr	3 yrs	5 yrs	Inception (Dec 2000)
Inflation-deflation timer model	2.4%	42.2%	33.7%	22.4%	15.3%
60% stocks/40% bonds	2.1	24.0	3.3	7.4	4.9
S&P/TSX 60 (XIU)	2.8	37.6	0.5	8.1	4.6
DEX Bond Universe (XBB)	0.8	4.6	4.9	4.6	3.9
Reuters/Jeffries CRB Index	-3.4	24.2	-4.8	-2.7	2.5

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*People are our strength.
Creating value is our
goal.*

About the Author

Cam Hui has been involved in the equity markets since 1980, both on the buy side and the sell side. Most recently, Cam was a Relative Value and Technical Research Analyst with Merrill Lynch in New York. He is currently living in Vancouver, British Columbia with his family. He maintains his interests in the markets through his investment blog:

<http://humblestudentofthemarkets.blogspot.com>

Cam serves as a member of Qwest Investment Management Corp.'s Board of Advisors.

Contact Qwest:

Maurice Levesque
Managing Director , President
604-601-5802 or
mlevesque@qwestfunds.com

Website:
www.qwestfunds.com

Qwest Investment Management Corp.

Qwest Investment Management Corp. ("Qwest") is an investment management firm which specializes in identifying, structuring and managing investment products. Qwest is currently focused on investments in the natural resource sector.

Qwest's executive management team has over 100 years of combined experience in corporate and financial product structuring and investment management which provides the team with the skills required to evaluate and profitably manage the risk and rewards inherent in the capital market industry.

Qwest is the parent company of Qwest Investment Fund Management Ltd., a company which provides investment advisory, portfolio management services and fund management services, and Heritage Bancorp Ltd., a company which provides administrative services.

Interesting Facts About Qwest

- Specialists in investing Canadian capital in the natural resource sector;
- Throughout their careers, members of the Qwest management team have completed hundreds of financings and have raised and/or invested billions of dollars of capital in the natural resource sector;
- Resource company flow-through specialists;
- Recognized for our experience in Canadian oil and gas sector;
- Top quartile oil and gas-weighted flow-through portfolio performance.

Calgary-Based Portfolio Management

From our Calgary, Alberta office, Qwest's portfolio management team is strategically situated to conduct in-depth research and analysis of Canada's oil and gas companies. Our portfolio management team is led by Ms. Jennifer Stevenson who brings over 20 years of oil and gas industry experience and a strong track record in financing and investments in oil and gas companies.

The portfolio management team's additional strengths include:

- first-hand knowledge and insight into the oil and gas sector (i.e. situated in the heart of the Canada's oil patch)
- years of experience working with management teams to finance their oil and gas companies
- specialization in the research and analysis of Canadian mining companies
- considered to be leading experts in the oil and gas sector by Canada's most reputable media outlets

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