

Qwest for Returns

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The BIS publication paints a frightening outlook for the next 30 years for the citizens of most of the developed world. In short, all roads lead to inflation and none of the standard policy choices can avoid that inevitability.

A bumpy inflation road

Bank of International Settlements: All roads lead to inflation

The Bank for International Settlements (BIS) is an international organization of central banks which "fosters international monetary and financial cooperation and serves as a bank for central banks". In other words, it's a central bank of central banks.

Recently Stephen Cecchetti (Head of the BIS Monetary and Economic Department), M. S. Mohanty (Head of BIS Monetary and Economic Department) and Fabrizio Zampolli (Senior Economist) of BIS, authored a working paper entitled *The future of public debt: prospects and implications* (see: <http://www.bis.org/publ/work300.pdf?noframes=1>).

The publication paints a frightening outlook over the next 30 years for the citizens of most of the developed world. In short, all roads lead to inflation and none of the standard policy choices will avoid that inevitability.

Ubiquitous double-dip recession risks

Investors are right to be worried about the prospect of runaway inflation in the foreseeable future, as there are signs that the U.S. is at serious risk of a double-dip recession from:

- Residential mortgage resets
- Commercial real estate
- State and local government budgets
- China's economic growth

See "Double-Dip Recession Risks" on page 5 for full overview.

An inflation-deflation (or recession) timer

For investors, these scenarios create a problem. Investment hedges that perform well in an inflationary environment will do poorly in a recessionary period and vice versa. You can get the big picture right but get hurt in the interim.

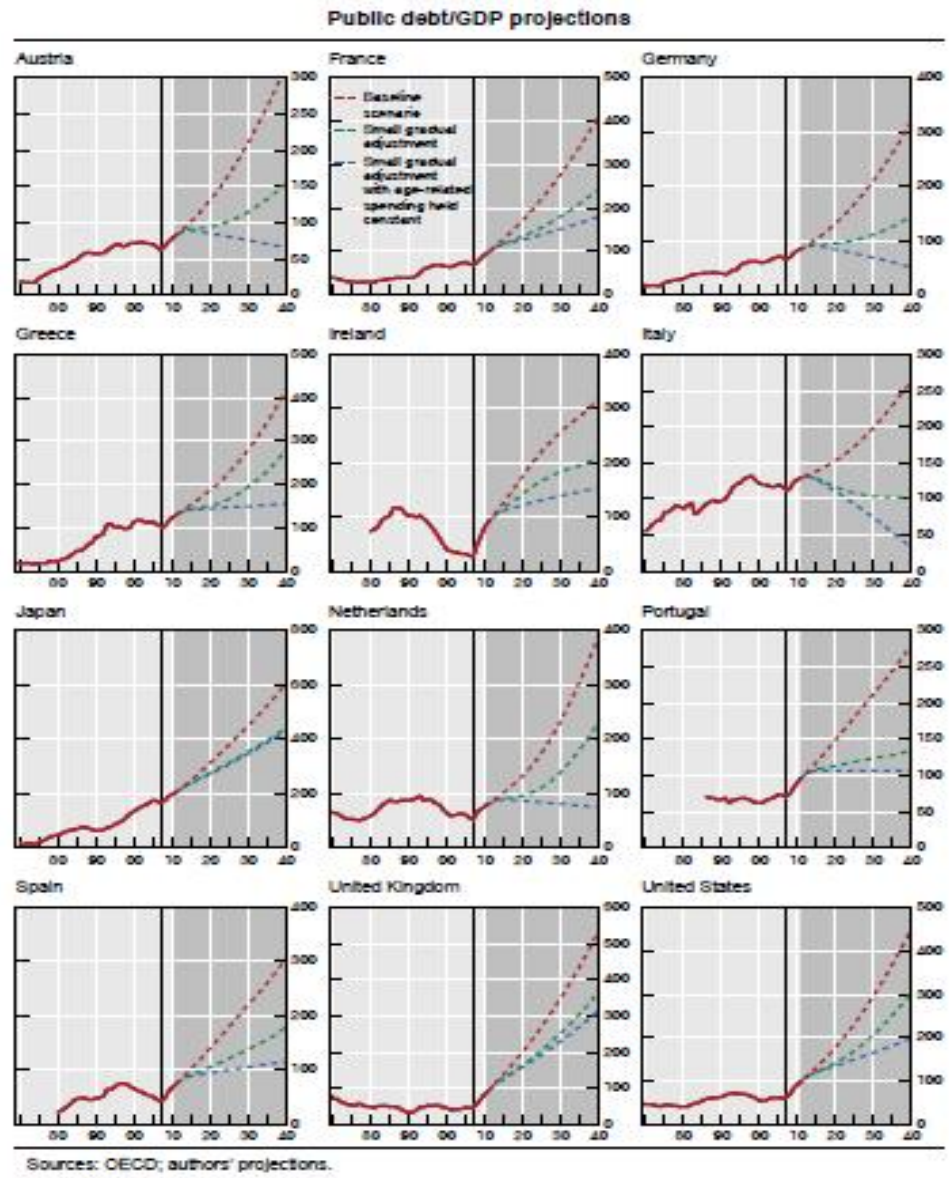
But the good news is... there is an answer to this problem! The Inflation-Deflation Timer model acts like a call option on inflation. By design, it should profit from the upside in inflation hedge vehicles during inflationary episodes. During deflationary or recessionary episodes, it uses deflation hedge vehicles to profit from investors' fear of recessions.

For more details see "A Call Option on Inflation" on page 8.

BIS: Structural deficits overwhelming

The charts below summarize the results of the aforementioned BIS study. The red dotted line depicts the baseline scenario, which assumes that government total revenue and non-age-related primary spending remain a constant percentage of GDP at the 2011 OECD projected levels. The green line assumes budget cuts of 1% of GDP for five years starting in 2012. The blue line assumes deeper cuts to entitlement programs, e.g. pension benefits, etc.

Under the baseline scenario, deficits spiral out of control for every western industrialized country under study.



Under the baseline scenario, deficits spiral out of control for every western industrialized country under study. What is more disturbing about this study is that, regardless of the level of budget cuts (with or without cuts to promises made about entitlement programs), debt to GDP continues to skyrocket for major industrialized countries such as Japan, the U.K. and the United States.

With no solutions, inflation wins in the end!

The authors of the BIS report believe that none of the standard economic solutions are likely to be effective:

- **Government austerity** - too painful and doesn't work in most cases. The charts on the previous page already show the projected effects of some very painful cuts, which, even if implemented, would make deficits still spiral out of control.
- **Monetary policy** – tight monetary policy, i.e. high interest rates, only serves to exacerbate the interest bill.
- **Bond market vigilantes** – they are too short-sighted, until it's too late.
- **Growth** – can't grow your way out of it.

The conclusion was that all roads lead to inflation [emphasis added]:

When the public reaches its limit and is no longer willing to hold public debt, the government would have to resort to monetization. The result, consistent with the quantity theory of money, is inflation. And anticipation that this will happen may also lead to an increase in inflation today as investors reassess the risk from holding money and government bonds. In such an environment, fighting rising inflation by tightening monetary policy would not work, *as an increase in interest rates would lead to higher interest payments on public debt, leading to higher debt, bringing the likely time of monetization even closer.*

Thus, in the absence of fiscal tightening, monetary policy may ultimately become impotent to control inflation, regardless of the fighting credentials of the central bank.

In other words, a Volcker-style approach of tight monetary policy in order to wring inflationary expectations out of the system may be futile. Inflation is ultimately a fiscal phenomenon.

The standard solution for believers of the free market is that organic growth, i.e. economic growth not from government stimulus, will eventually happen and that we can "grow" our way out of trouble. The authors of the BIS report believe that these structural deficits are so overwhelming that you can't grow your way out of trouble:

We doubt that the current crisis will be typical in its impact on deficits and debt. The reason is that, in many countries, employment and growth are unlikely to return to their pre-crisis levels in the foreseeable future. As a result, unemployment and other benefits will need to be paid for several years, and high levels of public investment might also have to be maintained.

What's more, bond market vigilantes won't solve the problem in time [emphasis added]:

(B)ond traders are notoriously short-sighted, assuming they can get out before the storm hits: their time horizons are days or weeks, not years or decades. We take a longer and less benign view of current developments, arguing that the aftermath of the financial crisis is poised to bring a simmering fiscal problem in industrial economies to boiling point. In the face of rapidly ageing populations, for many countries the path of pre-crisis future revenues was insufficient to finance promised expenditure.

There is no way out:

1) You can't cut the budget enough.

2) Tight monetary policy will only raise the interest costs and crowd out spending.

3) You can't grow your way out as the structural deficits are too overwhelming.

4) Bond market vigilantes can't help until it's too late because they are so short-sighted.

Leading analysts agree with BIS

David Rosenberg, of Gluskin Sheff, echoed the BIS conclusions that budget restraints won't work (see *Breakfast with Dave*, April 19, 2010) [emphasis added]:

Fixing the fiscal mess will not be achieved through spending restraint because ***spending is increasingly being dominated by locked-in mandatory entitlement spending and interest costs on the rapidly rising stock of public debt.*** Unlike the key propelling factors behind the onset of the secular bull market in 1982, which were tax reduction, less government and lower interest rates, we will see none of that going forward.

Bill Gross of PIMCO came to a similar conclusion as BIS about the trajectory of the US fiscal position (see <http://www.pimco.com/LeftNav/Featured+Market+Commentary/IO/2010/Rocking-Horse+Winner+April+2010+IO.htm>):

As a November IMF staff position note aptly pointed out, high fiscal deficits and higher outstanding debt lead to higher real interest rates and ultimately higher inflation, both trends which are bond market unfriendly. In the U.S. in addition to the 10% of GDP deficits and a growing stock of outstanding debt, an investor must be concerned with future unfunded entitlement commitments which portfolio managers almost always neglect, viewing them as so far off in the future that they don't matter. Yet should it concern an investor in 30-year Treasuries that the Congressional Budget Office estimates that the present value of unfunded future social insurance expenditures (Social Security and Medicare primarily) was \$46 trillion as of 2009, a sum four times its current outstanding debt?

Legendary investor Warren Buffett worried about the effect on the US Dollar in an Op-Ed (see <http://www.nytimes.com/2009/08/19/opinion/19buffett.html>):

An increase in federal debt can be financed in three ways: borrowing from foreigners, borrowing from our own citizens or, through a roundabout process, printing money. Let's look at the prospects for each individually — and in combination.

The current account deficit — dollars that we force-feed to the rest of the world and that must then be invested — will be \$400 billion or so this year [2009]. Assume, in a relatively benign scenario, that all of this is directed by the recipients — China leads the list — to purchases of United States debt. Never mind that this all-Treasuries allocation is no sure thing: some countries may decide that purchasing American stocks, real estate or entire companies makes more sense than soaking up dollar-denominated bonds. Rumbblings to that effect have recently increased.

Then take the second element of the scenario — borrowing from our own citizens. Assume that Americans save \$500 billion, far above what they've saved recently but perhaps consistent with the changing national mood. Finally, assume that these citizens opt to put all their savings into United States Treasuries (partly through intermediaries like banks).

Even with these heroic assumptions, the Treasury will be obliged to find another \$900 billion to finance the remainder of the \$1.8 trillion of debt it is issuing. Washington's printing presses will need to work overtime.

He concludes with [emphasis added]:

Once recovery is gained, however, Congress must end the rise in the debt-to-G.D.P. ratio and keep our growth in obligations in line with our growth in resources.

Unchecked carbon emissions will likely cause icebergs to melt. ***Unchecked greenback emissions will certainly cause the purchasing power of currency to melt.*** The dollar's destiny lies with Congress.

David Rosenberg of Gluskin Sheff agreed with the BIS conclusions that budget restraints won't work...

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Legendary investor Warren Buffett worried about the effect on the US Dollar.

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?

Double-dip recession risks

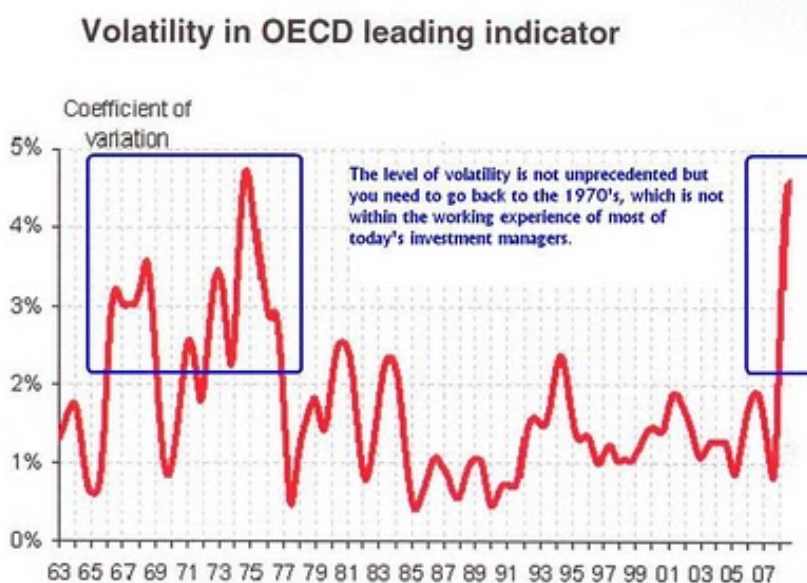
Investors are right to be worried about the prospect of runaway inflation. But at the same time, investors have to also worry about the risk of a double-dip recession. There are ticking time bombs everywhere indicating that the U.S. is at serious risk of another downturn:

- The next round of residential mortgage resets could plunge an already fragile financial system into a downturn.
- Commercial real estate is a disaster waiting to happen.
- State and local government budgets are under serious pressure. These entities are on the brink of financial catastrophe and could blow up the municipal bond market, leading to another round of cascading defaults.
- Chinese economic engine could slow. The Middle Kingdom has been an engine of growth in a growth starved world. However, there are signs that Chinese authorities are taking steps to cool off a property bubble. Should Chinese economic growth slow significantly, the fallout could very well plunge the global economy into a second downturn.

Choppy and volatile markets ahead

To state it simply, the economic environment is extremely fluid and volatile and the financial markets are likely to be very choppy as a result. The task for investors creating investment portfolios under these trying circumstances is especially difficult. One wrong move can spell disaster. The two scenarios of inflation and double-dip recession are diametrically opposed to each other. Inflationary hedges get mangled during deflationary periods, and deflationary hedges get massacred during inflationary episodes.

The chart below shows the level of macro-economic volatility which has skyrocketed to levels last seen in the 1960's and 1970's. Unfortunately, most investment managers alive today weren't in the business back then and may not be mentally prepared to deal with the new "old era" of heightened volatility.

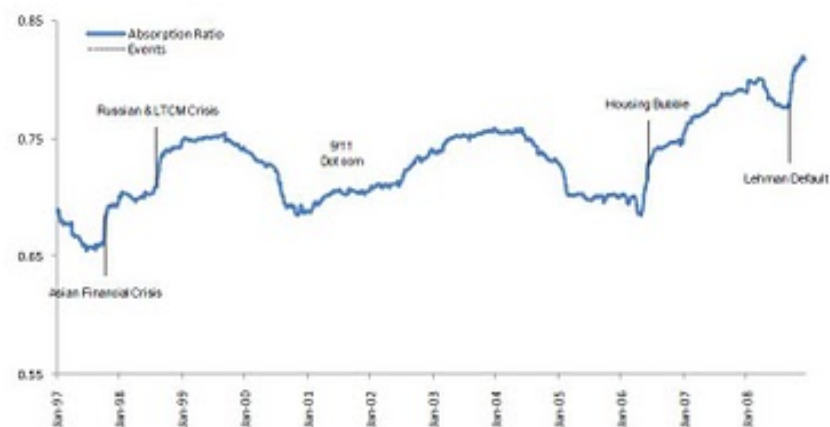


A fragile financial system

Mark Kritzman, President and CEO of Windham Capital, recently presented a fascinating paper on how to measure financial system fragility (see <http://www.qwafafew.org/filestore/download/752>). He develops a ratio called the absorption ratio that “captures the extent to which markets are unified or tightly coupled”.

Kritzman’s conclusion is that financial markets are tightly coupled and therefore system fragility is high.

Exhibit 15: Global Absorption Ratio



Kritzman’s conclusion, as shown by the above chart, is that financial markets are tightly coupled and therefore system fragility is high.

More Black Swans

Nicholas Nassim Taleb, author of *The Black Swan*, foresaw the subprime and derivatives crisis and is talking extensively about the current instability problem.

Mr. Nassim Taleb coined the terms “Mediocristan” and “Extremistan” to describe financial markets. The two concepts have been described as two world domains. In the former, extremes exist but are inconsequential, while in the latter, extremes are not expected, but play a massive role. In the former, the ordinary plays a massive role. In the latter, one’s wealth can change massively in a second.

Nassim Taleb: Wealth can change massively in a second.

While we believe the long-term path in commodity prices is upward, investors are likely to see several brutal up-and-down cycles in the next couple of decades and they should be prepared for draw downs of 50% or more in the downturns. Who can withstand that kind of volatility?

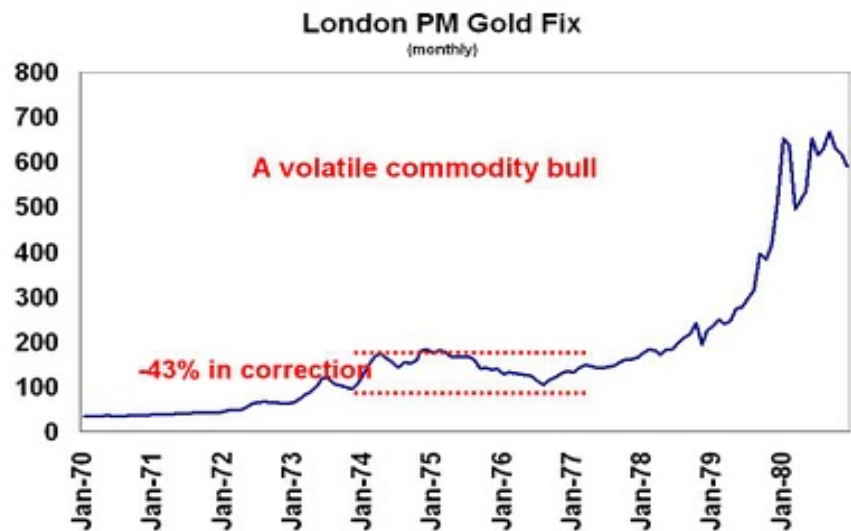
We remain long-term commodity bulls, but prepare for volatility

What can investors do in such an era of instability?

We concur with the BIS report and believe that inflation will ultimately rear its ugly head. Investors should have long-term core positions in inflation hedge vehicles such as hard assets, commodities and stocks of commodity producers.

Here is the dilemma. Global economies are currently mired in a fragile slow-growth environment, but inflation could break out at any time. Investment hedges that perform well in a runaway inflationary environment will do poorly in a recessionary period and vice versa. Investors can get the big picture right but still get hurt in the interim.

Consider the chart below which shows the monthly price of gold during the 1970's. Even though the yellow metal rocketed from \$35 in the early 1970's to \$850 in January 1980, investors would have suffered a correction of 43% - and that's based on monthly prices! The peak-to-trough correction in gold would have been even more using daily pricing.



While we believe the long-term path in commodity prices is upward, investors are likely to see several brutal up-and-down cycles in the next couple of decades and they should be prepared for draw-downs of 50% or more in the downturns, but what investor can withstand that kind of volatility?

A call option on inflation

The Inflation-Deflation Timer acts like a call option on inflation... but limits downside risk during deflation or recession episodes.

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, which is well-suited for an environment where market expectations oscillate between the equatorial heat of runaway inflation and the arctic deep freeze of deflation, economic depressions and recessions (see http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_november_2009.pdf).

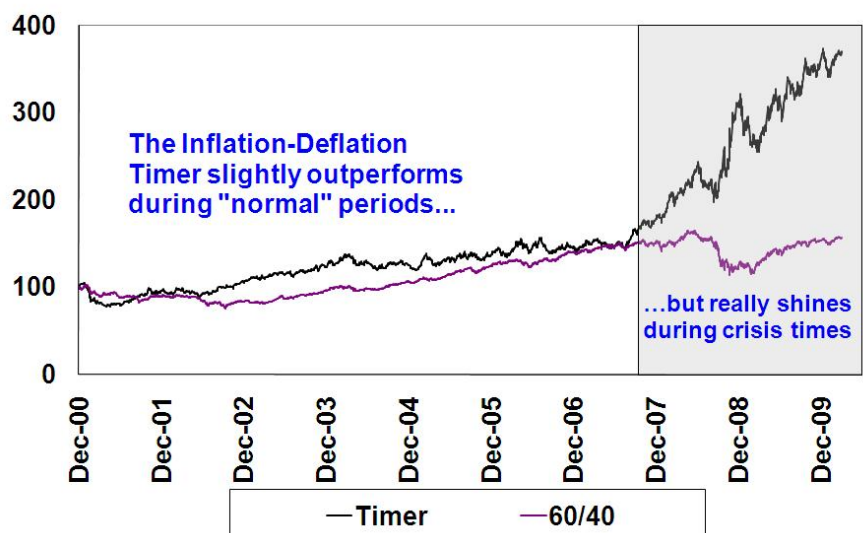
The Inflation-Deflation Timer model acts like a call-option on inflation. By design, it should profit from the upside in inflation hedge vehicles during inflationary episodes. During deflationary or recessionary episodes, its downside is limited compared to more traditional inflation hedges because it uses deflation hedge vehicles to profit from recessionary fears.

Inflation-Deflation Timer Model

Results 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

The graph below shows how the Inflation-Deflation Timer model performed during periods of rising asset values (inflation) and falling asset values (deflation) over the last 10 years. The model performed roughly in line with a 60/40 balanced fund but returns really stood out as inflationary expectations took off in late 2007. It also behaved well during the deflationary floor episode of 2008 when virtually all asset prices declined.

Cumulative Returns



*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.

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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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