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Second Quarter 2008

The Dow Jones Industrial Average had its worst June since 1930 and its worst first half since 1970. Most of the world's stock markets are now down 20% from their October highs and are officially in bear markets. Even the once hotter than hot Chinese and Indian stock markets have gone into a deep freeze, down -43% and -38%, respectively, in 2008's first half. Markets heavy with oil are the exceptions.

The energy sector climbed to new highs in the second quarter and was responsible for 136% of the TSX's return in the first half. (The material sector was the only other positive contributor to the index and was responsible for 95% of the 2008 year-to-date index price return). All of the other 8 sectors had negative returns. Investors in what traditionally have been viewed as less risky stocks, such as banks, did the worst.

Marked down global equities are now trading at about 14 times trailing earnings, down from 16 times at the start of this year and well below the long term average of 17 times. Equity market valuations this far below historic norms indicate an opportunity for good returns once confidence is restored. But that assumes history is any guide. Dow Jones newswire quoted an unnamed trader at an industry shindig: "My broker tells me 'historically'. I don't want to hear historically right now. Historically Bear Stearns was in business for about 100 years."

The combination of rising oil prices and falling house prices is troubling. The median selling price of U.S. homes is down 13% from its 2006 peak which suggest a staggering \$3.1 trillion loss in value. Estimates are that a further 12% fall in house prices will be needed to restore equilibrium with incomes.

On June 20th the New York Times reported that in the first week of June, Israel carried out a military exercise that "appeared to be a rehearsal for a potential bombing attack on Iran's nuclear facilities." The New Yorker reported that U.S. Special Forces have stepped up their operations in Iran. As I've said before, we just don't know if we're about to bomb Iran before the new presidential term of office. It is also hard to judge how much of a speculative element is in today's oil price.

Crude oil prices are up 100% over the past year, while the TSX Energy Index is only up 20%. Either there is a high amount of scepticism about the sustainability of the price of crude or, there is a huge amount of value in the shares of energy companies. RBC DS figures Canadian energy stocks have priced in about an \$85 price for oil, not nearly \$140.

A super bear like V. Prem Watsa of Fairfax Financial talked at the annual meeting in April of a bear market the like of which only occurs every 50 or 100 years. The U.S. after 1929 and Japan after 1989 are his analogies. Watsa takes comfort in “our cash, our bonds and our concern. Our thinking is very simply that if this recession that we’re going into is like any that we’ve had in the last 50 years, then this is a really good time to be buying, this is a good time to be aggressive. But if it is the 1-in-50 or 1-in-100 year event that we worry about, then, of course, you might be too early. So we are focused on worrying about that - but we’d like to think we can handle that type of concern.” (Outstanding Investor’s Digest, May 2008).

Jeremy Grantham, chairman of money manager GMO, says “we are still in the super bear of 2000.” After the great bull market of 1982-2000, equities never flushed out their excess “because of the [former Federal Reserve Chairman] Greenspan-inspired chain of bubbles from growth stocks to real estate to commodities.”... “Great bear markets always take their time, and the most likely end is 2010.” Since we’re 8 years into it, another 2 years seems like spitting distance.

The old adage is that the people who got rich during the California Gold Rush were not the men digging for gold, but were instead the one’s selling them the picks and shovels. A new selection to your portfolio is Finning International. Earl Finning founded the company in British Columbia in 1933 and it is now the world’s largest distributor of Caterpillar equipment. Finning is best known for the heavy equipment used in the Alberta oil sands, but also supplies equipment to the mining, construction, energy, and forestry sectors in Western Canada, the U.K. and Latin America. Also, Finning has raised its dividend 17.3% per year over the last 5 years.

Sincerely,

George Stedman, CFA
Portfolio Manager

P.S. Please visit us at www.georgestedman.com