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The Excessive Nature of our Markets - Second Quarter 2008

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The dominant concern in the markets today is a deepening U.S. recession fueled by a rapid unwinding of a credit bubble that has been ten years in the making. The sub-prime crisis not only significantly deflated the value of real estate in the U.S., its effects reached well into the world's financial systems, reducing liquidity and freezing borrowing. Meaningful personal wealth destruction has occurred in the U.S. and the world's equity markets are adjusting to a foreseen reduction in consumption by a nation whose massive economy is fuelled on consumption. Add to this negative sentiment a punitive pump price for a gas guzzling nation and the cold winds of a recession blow.

The equity markets worldwide are feeling the chill out of the U.S. In Canada, we experienced a significant sell-off of financial services such as banks and insurance companies which represent about a third of our markets worth. All was not gloom however, as the sun shone on resource heavy weights such as crude oil, gold, copper, nickel, zinc, and potash.

The Canadian equity market, substantially weighted by large resource companies (approximately 50% of our market) reached new highs over the quarter. This was due to continued speculation regarding demand for resources from India and China as well as perceived inventory shortages of crude oil. Despite an impressive Index performance, gains were very narrow in scope with only a handful of companies fueling a lopsided Index. The S&P/TSX Index would have experienced negative returns with the exception of about ten primarily resource based companies.

One must reflect on the impact of a reduction in imports by U.S. consumers on the export-driven economies of China and India, and consequently our resource-laden Canadian market which has been propelled by those countries. The common notion is that the demand from India and China will continue unabated and therefore demand for commodities will grow endlessly. While this prognosis created lots of noise in the markets, it also promoted excessive speculation in material and energy prices to the point that the term "bubble" began to surface in market analyses.

Markets are often excessive in nature; just reflect upon the technology boom of 2000 and its massive bust. Markets are known to over-pay for growth in times or conditions of optimism and can over-sell in the face of fear. We have experienced both over the past year. The China / India thesis fueled an over-pay for commodities and the credit crisis fueled an over-sell of financials. The speculative wind is now coming out of the sails of many commodities, while Canadian financials are rebounding off their over-sold lows. Consequently, Canadian investors have been living through volatile swings in our market to the tune of 200 to 300 points daily.

At Brownstone, we are concentrating our efforts to position portfolios against excessive holdings in the volatile resource sectors which are subject to excessive speculative trading. We continue to look for equities that become oversold under the current pessimistic investment environment that has gripped the major equity markets worldwide.