



“T” IS FOR INEVITABLE

As money managers we are inundated with investment research as we constantly look for other opinions, ideas, clues—from economists, strategists and analysts. Needless to say we have our favourites, usually preferring those that we have found are more often right than wrong.

Currently, we don't think we've ever seen such extreme divergences in views. Ranging from: a continuing Depression; a slow recovery from this Great Recession; the end of the recession currently; to a healthy upmove ahead. And of course, for stocks: a continuing bear, a retest of the lows; to a big upward move in a new bull market. The economic community is also divided on the prospects for either deflation or inflation. And, is the U.S. dollar going up or about to tank?

Alphabet Soup

Economists have their favourite letters of the alphabet to describe their views of economic recovery—from a pessimistic L, to a less pessimistic U, an optimistic V (sharp contraction and reversal) and a cautious W (contraction, rise and new decline). Former U.S. Labor Secretary, Robert Reich, just predicted a gloomy “X”, an “economy that can't recover”. Well, we're in the “T” camp—“T” for Inevitable. All we know is that, as someone said, recessions die of old age. This one, at 18 months of age, is already the longest since the Great Depression and likely terminal. “T”, for the inevitable end of the recession and the bear market, the inevitable beginning of economic recovery and the inevitable birth of a new bull market.

We're not economists but we can add and subtract. And apply common sense. And we try to deal with the *knowable* and avoid ideas where there are too many *unknowns*. Avoid speculating. Avoid imponderables. Go where the mere passage of time will make us winners. The main attribute we bring to the table is an unshakable commitment to value investing—to selectively seeking cheap companies with good balance sheets to which the “T” for their profit potential should ultimately apply. However and whenever. And we're finding lots of those today—small-caps, mid-caps, and, wondrous to behold, even big-caps where we've been denied value for years. “O” for opportunity.

Conflicting Opinions

It is noteworthy that investment experts can look at the same facts yet arrive at different conclusions. Investing is both science and art, analysis and intuition, right brain and left brain thinking. Decisions need to feel right and smell right. Common scents.

What do we *know*? First, that money is cheap. And plentiful. Good for consumers and for investors. And, the Fed is not likely to allow it to get more expensive or less plentiful soon. The yield curve is very positive, an incentive for banks to lend very profitably. Liquidity on the sidelines is still awesome. At the first whiff of a market correction, as recently, it heads back into money market funds, a bullish happening. Household liquidity is high too, the savings rate now up to 6.9% from zero just a couple of years ago. And consumer credit has declined now for four consecutive months. Potential demand.

Business inventories are low, falling 1.7% in May, down for a ninth consecutive month. A drag on GDP. One of our favourite strategists, John Aitkens of TD Newcrest notes that production is so far below sales it will take a couple of months of strong production to allow inventories to be rebuilt. And he forecasts massive motor vehicle production growth for July and Q3. Meanwhile, demand is pent-up from months of underconsumption. Confidence is improving, so ultimately the demand will be unleashed and industrial production will pick up. A plus for employment. A plus for earnings. A plus for GDP. U.S. retail sales for June rose 0.6%, the biggest increase since January. Meanwhile only a small proportion of the original \$787 billion stimulus package from February has been spent and a second stimulus package has been mooted.

Though U.S. 30-year mortgage rates have risen slightly recently with the rise in longer term interest rates, they are still relatively low at around 5.5% and housing is still very affordable. U.S. housing prices have essentially stopped declining and prices actually rose on a monthly basis in eight cities including Dallas, San Francisco, Boston, Atlanta and Seattle. In our own city, Toronto, June was a record month for housing resales. U.S. housing inventories, at about 9 months of supply are getting closer to their normal equilibrium. The reduction in new housing starts is helping too but even they are starting to improve. As housing stabilizes consumers will be encouraged to buy houses. Moreover, as housing is the most important asset of consumers, they will feel their net worth is less at risk, adding to their confidence.

Sure job losses continue, with the unemployment rate now at 9.5%, and hourly wage increases moderating (though last week's jobless claims number was better than expected). But all economists agree these are lagging indicators. Nonetheless they are clearly a negative because of the hardship on the jobless and because they, and those still employed but worried about their jobs, are reluctant to spend.

Productivity And Profit

On the other hand, productivity continues to improve from labour cost reductions, and as industrial production rises, business has a pool of labour to effectively draw upon. Indeed, not only labour, but costs of production generally are declining.

GM, emerged from bankruptcy as a private company last week with its debts significantly reduced, its costs for labour and healthcare cut, its unprofitable lines and surplus of dealers eliminated. And it is floating the notion of an IPO in 2010. The new GM, streamlined like the Camaro. A smaller market share but ready to be competitive and profitable. Chrysler too, now recalling 1,200 jobs in Windsor, Ontario. Improving demand. Inevitable. Ford, in an effort to protect its stakeholders didn't go the bankruptcy route, did however reduce costs too, but is still over \$25.8 billion in debt, a challenge against its lower indebted peers. Ford, however, has been gaining market share for 8 months now as its competitors' products are shunned.

Clearly, improved productivity is good for earnings. And competition is diminishing as weaker players disappear allowing survivors to have more market share and better pricing power. For Best Buy, for J.C. Penney and Macy's, for restaurateurs such as Ruby Tuesday, even for mighty Goldman Sachs, reporting an upside surprise \$3.4 billion Q2 profit, coining it after the demise of competitors like Lehman Brothers and Bear Stearns. That all bodes well for the corporate earnings of the survivors and, when sales pick up from a general recovery, look out above. We have made the contentious point before that the general economy may recover slowly but corporate earnings, especially for some sectors and companies, may be very strong indeed. And stock prices are driven by earnings not unemployment figures.

World Growth

The monthly U.S. trade deficit for May, at \$26 billion, an 8½ year low, is less than half of what it was at its peak, another benefit to GDP. And much of the developing world, especially China (car sales there gained 47.7% in May), India and Brazil continue to grow, with them stimulating their domestic consumption too. Many governmental agencies are sniffing recovery. The IMF said the global economy was starting to pull out of its deep recession though recovery would be sluggish with growth of 2.5% in 2010 and moderate growth of 0.75% in the U.S. China and India were expected to be global growth leaders in 2010 with gains of 8.5% and 6.5% respectively. The OECD's leading economic indicator of OECD industrialized economies, designed to provide early signals of turning points, rose 0.8% in May—the biggest increase in 6 years. The World Bank is raising forecasts too, expecting China's economy to expand 7.2% in '09, up from earlier forecasts. In Canada, a central bank survey showed hiring intentions had improved in all sectors and fewer firms had problems obtaining credit.

The U.S. Dollar

The future direction of the U.S. dollar is highly contentious among the experts, and highly important for economic and stock and bond market outcomes. Our own view is that it would not be desirable for the dollar to rise and that, likely, the Fed doesn't want it to do so. A higher dollar would be deflationary, bad for consumption. A stable or somewhat lower dollar would allow a little inflation to encourage consumption, benefit U.S. exporters and multinationals and encourage foreigners to buy U.S. bargains. 13D Research recently notes, "For those who think a strong dollar is *currently* in America's interests, we point out that each time the dollar has strengthened in the past year, the U.S. stock market has fallen, and vice versa." A fast growing U.S. budget deficit, likely to exceed \$2 trillion this year, with the national debt now at \$11.3 trillion and likely on its way to \$15 trillion by end of 2010, more than 100% of GDP, should

keep pressure on the dollar inasmuch as it will depend on foreign investors to continue their appetite for U.S. treasuries. Questionable. Currencies are a relative game. In these days of slow economic growth and fear of deflation, all countries want their currencies lower to stay competitive. Indeed, Europe may be in worse shape than the U.S. with more potential turmoil in its financial sector from the higher leverage their banks employ compared to the U.S. Already the Chinese are talking about a world reserve currency other than the dollar. In the end it is likely the Fed will have to buy more treasuries, creating more dollars, and keeping interest rates lower than they might otherwise be—but restraining any upward move in the dollar.

Flation

As noted, economists are evenly split on whether we will have deflation or inflation. The deflationists point to the output gap, the low capacity utilization rate, the high unemployment levels and the low wage growth, to make their case that prices can't rise. The inflationists point to the depreciating dollar, the burgeoning money supply everywhere, the coming scarcity of resources, the shrinkage of the future labour pool from demographics, the fact that typically much of the measured unused capacity never comes back, the growing demand for "stuff" from the emerging countries and the pent-up consumer demand as recovery ensues. U.S. PPI in June was up 1.8%, the biggest increase since November '07. We believe moderate inflation is desirable and will likely be engineered to happen. It's important to know that, because stocks, in which we are mainly invested, are an inflation hedge. Today's low-yielding government bonds are to be avoided, except perhaps, for TIPS (Inflation-Indexed Treasuries).

Commodities Bottoming

For resource companies, commodity prices have generally improved. Indeed, BMO Capital Markets recently opined that the easy-money policies flooding the world with cash, and demand fundamentals for resources in the developing world, "suggest that the commodity cycle should turn to a resumption of an extended bull market for many years to come".

For our oil companies, the outlook is better as the price of oil is up 70% from its low. And we think oil should go higher after its current pause. Regrettably, for us, committed to Corridor and other natural gas stocks, natural gas prices continue to be weak from a continuing glut of gas in North America, mainly from the cut in demand for power use from the industrial sector. But the natural gas drilling rigs currently operating have plummeted (672, down from 1610) and gas is starting to be shut in, notably by the biggest producers such as Encana and Chesapeake. Storage injection in the U.S. last week was below forecast for the fourth consecutive week and below the same period last year. A well known axiom of commodity traders is, "Buy the gluts, sell the scarcities." Higher natural gas pricing is an "I" too.

Finding Bargains

Notwithstanding the outsized drawdown we suffered in this crisis period, we actually think our current challenges are simpler than for the economists who have to guess the “when” and the “magnitude”. We believe the crisis is behind us, though there may be lingering effects and unintended consequences, from excessive money printing and the like. But, for selective value-oriented stock pickers, we’re finding many cheap big, medium and small-caps. We are holding and adding companies trading far below their fair market values. They should reward us. Inevitably.

For the first time since the bear market began, June was the first month-over-month increase in how often U.S. stock analysts were recommending “buy”. Money manager, Ken Fisher, believes statistics favour a bull market in '09. The market, he notes, “is not a register of current business conditions. It is an anticipator.” “A” for anticipate.

The “magnet” attracting stock prices to their normal fair values, still above most prevailing share prices, will pull stocks higher.

U.S. money manager extraordinaire, Jeremy Grantham concurs, saying, “Fair value is like a gravitational pull; it is not very powerful but is absolutely unrelenting. Everything catches up and eventually reaches fair value.” Sounds like inevitability to him too.

Stocks Undervalued

Two investment research services to which we subscribe, StarMine and Value Line, using comprehensive bottom-up inputs, both indicate that the U.S. markets are at least 20% undervalued.

StarMine, which provides quantitative analysis, recently published a study showing that a portfolio of the most undervalued and lowest P/E stocks, in North America and globally, resulted in nearly a 60% decline from early '08. Accounting for that 60% decline, that same strategy still produced more than a 10% per year increase over the last 10 years, higher than the overall market and the most overvalued stocks which produced little to no return.

Our own 10-year annualized return for our Long/Short Composite through the end of May '09 was 13.8% in US\$ (translated from CDN\$) and 10.4% in CDN\$, and this obviously includes the awful drawdown of the last 12 months.

Undervalued stock baskets almost always outperform. However, the 18 months leading up to March '09 were characterized by ultra-high inefficiency—value being completely ignored over that period. Market participants, fleeing to cash, dumped shares with wild abandon. U.S. Treasury bills were actually negative then, meaning that buyers were willing to pay more than they could get back in principal and interest. “I” for irrational. Only since the market bottom on March 9th has value mattered again. Value didn’t go out of vogue—it merely went on hiatus.

On March 9th, after the second worst 12 months on record for U.S. equities since 1850, stocks were trading, on average, at 60¢ on-the-value-dollar. From today's levels, now at 80¢ on the dollar, the Value Line Appreciation Potential is projecting market appreciation over the next 3-5 years of 14% per year.

Investors may need to be patient if the economy recovers slowly; but, it should be worth the wait as some extremely undervalued stocks and sectors continue to offer above-market potential returns.

The North American stock markets remain “on buy” in our SVA™ work. And most sectors remain on buy too. Some economists may believe that stocks are still too highly priced but we don't see it. The multiple for the S&P 500 and the Value Line (1600 companies) is 13x next 12 months' earnings. And, bottom-up (company-by-company) analyst estimates have been increasing, after months of declines.

We believe there will be more positive than negative earnings surprises going forward. Moreover, quarterly earnings comparisons should be easier to beat based upon the last dreadful 12 months. All good for stocks.

Some economists and strategists who believe that this market is not cheap compared to other down periods, such as 1981-82, based on price to earnings ratios for example, frequently ignore some important variables, such as, that U.S. 10-year treasuries yielded 15.8% in 1981, because inflation was rampant, and P/E ratios are influenced by prevailing interest rates as well as growth rates.

Or those who compare stocks to bonds, or dividend returns to interest returns, contrasted with previous periods, often ignore how much more favourably capital gains and dividends are taxed today than interest income compared to yesteryear, meaning stocks don't have to appreciate or yield as much as bond interest for the same after-tax return.

Top Holdings

Corridor Resources continues to languish in the face of the poor natural gas prices. But if one is bullish on the future outlook for natural gas, it is an excellent proxy for the commodity itself, inasmuch as it gets a premium to the Henry Hub price as it sells to North America's best market, the Northeastern U.S.

Clearly we don't think current earnings will shine, but debt free Corridor is living within its means, only spending within its cash flow receipts and husbanding its unused line of credit.

In the meantime, Corridor's current cash flow, which comes mainly from its Hiram Brook sand formation (where its low costs still allow for positive cash flow at current depressed gas prices), more than justifies its current price. Furthermore, a petroleum consulting firm has recently estimated Corridor's shale gas exposure in the lower Frederick Brook formation at an enormous net 59.1 TCF of gas in place. This shale formation is very thick, naturally fractured and could be one of the best shale plays in North America. But it will likely need a joint venture with a

major partner for the capital and expertise to develop it, and while Corridor is exchanging information with several major, it may need better gas prices to do the deal it would like to. Corridor is currently focused on a workover program to maximize production from its existing producing wells using different remedies.

We believe Corridor is significantly undervalued based on its existing reserves and cash flow potential with the upside from its huge shale resource, its proposed Salt Springs gas storage facility, its “Old Harry” 2 billion barrel potential oil prospect in the Laurentian Gulf and its Anticosti Island prospect—all for free. “O” for optionality.

Orca Exploration, also debt free, should not be affected much by current gas pricing since much of what they sell is to the Tanzanian power sector at regulated prices, and prices to their industrial users, in many cases, have floors (and caps as well). Orca trades far below its \$11 Net Asset Value (at only 4x '10 estimated earnings) and we believe it will ultimately be sold at or above NAV sometime over the next two years when markets normalize. Orca also seeks opportunities to further expand its assets through acquisition of cheap assets regionally as opportunities present themselves.

We are still waiting for the overdue test results of *Petrolifera Petroleum's* costly La Pinta-1 exploration well in Colombia expected in days. The bids for the company's Argentina assets were unacceptable to the company so they will maintain those assets. An asset sale would have eliminated the company's debt but between ongoing cash flow and some additional financing *Petrolifera* should be able to exploit its significant exploration potential in Peru and Colombia.

Sterling Resources continues to make progress with the development of its major gas discoveries in the North Sea and Black Sea, is finalizing details to bring its reserves onstream and is waiting for completion of joint ventures to finance development. We expect a long awaited announcement on the joint venture for its Breagh field shortly. Sterling has little debt and should have substantial cash flow in three years. With a net asset value more than double its share price, Sterling is cheap, with contingent resources, if developed, increasing the value even more.

St Andrew Goldfields is ramping up for production in Q4 '09 at its Timmins gold mining operations having secured the US\$20 million financing it required through an expensive gold note and some additional royalties but without incurring any share dilution at cheap share prices. It is currently awaiting a court decision on a royalty dispute over its Holt property which should be resolved soon. In the meantime, it is intending to start production from its Holloway mine and anticipating additional production from an open pit at its Hislop property once an independent engineering report is received. This production should give the company significant free cash flow in 2010. We believe that when Holt is eventually brought onstream the company could produce in excess of 100,000 oz annually at a cost of about US\$500 per oz and generate significant free cash flow (utilizing its tax pools of over \$160 million) especially after 2012 when all debt should be repaid.

With all its infrastructure in place, including a 3,000 tpd mill, in a safe jurisdiction with the benefit of a lower Canadian dollar, with significant exploration potential on its large property in the camp, and an excellent management team in place, we believe St Andrew is on the verge of finally generating the upside we have believed in for so long. Higher gold prices, which we think are coming in a world awash in dollars, would be the icing on the cake.

Income Accounts

Last quarter we wrote that we believed that the markdown period was over and we hoped to be able to mark positions back up in the future as asset values rise or positions mature. We did have one further markdown in the quarter (*Richards Oil and Gas*). On a positive note, we collected interest arrears in *Specialty Foods*, our SMK Speedy notes matured at full value, *Avcorp* just announced a financing that should fully fund its business and the *First Metals* reorganization is virtually complete and we'll get freely tradable shares shortly.

Our income accounts currently yield about 10% annually with additional capital gain potential.

Recent Changes

We recently sold two-thirds of our *Ruby Tuesday* position after the stock's nearly 800% climb from its March 9th low. Investor sentiment and valuation of restaurateurs has turned overly bullish even with negative national store traffic and average check per guest. But the company continues to positively surprise with better than expected sales and earnings while continuing to reduce its debt outstanding. Ruby's value message is resonating with consumers. Store traffic has turned positive while guest surveys are extremely high. With the company attractively valued at 5x free cash flow and 7x earnings, we would be delighted to buy back our shares should the stock price sell off.

We divested our *Walgreen* position during the quarter as upside to our Fair Market Value no longer met our required rate of return, plus our SVATM work gave us a sell signal. We are still attracted to the U.S. healthcare sector as evident by our *McKesson* position. McKesson trades at a meaningful discount to its fair market value while its underlying business continues to post positive sales and earnings growth.

Thanks to a combination of uncertainty in the broader healthcare sector and a specific short-term profit margin issue, we were recently able to add shares of the health insurer, *Aetna*, at an unusually favourable price. Aetna is arguably the best run national health insurer with the best plan designs and best-in-class underwriting standards. We began accumulating the stock at 6x earnings (all free cash flow) versus our 14x fair value assessment. Given the wide margin of safety versus fair value, we are more than compensated for the uncertainties surrounding President Obama's healthcare initiatives. Ultimately, a more regulated, slightly less profitable private health insurer sector should emerge. Under this somewhat public/private structure, Aetna should still produce at least 8% operating margins (versus 11% 2004-2007) or \$4-\$5 of earnings per share. At 14x earnings, Aetna's fair value is in the mid \$50s today and expected to be in the mid \$60s in three years versus its current \$26 share price.

Recovery Underway

We have a lot of ground to make up. For those who joined us at the top in '07, getting back to even seems daunting. Clients who've been with us since inception have suffered a big decline from the highs but are still respectably profitable over the entire period, respectably in line with the S&P TSX and well ahead of the S&P 500 returns, in the same period. That's attributable to 9 years of outperformance before the debacle starting in late '07. We have suffered from a "value trap", holding cheap small-cap stocks that became incredibly cheap, thinly traded and sometimes unfinanceable. Prices disconnected from reality. "I" for inefficient. All value managers suffered in the bear market. We more. Much to atone for. Common sins.

For growth accounts, our 3-year targets for the smaller-cap names, from their severely depressed levels, is about 50% per year. For the larger-cap names we've been adding recently, our 3-year targets exceed 25% per year. Clearly the smaller-caps are significantly cheaper. We're also enamored of our big-caps whose return prospects are high and where the higher trading volumes allow us to use our SVA™ work to trade more effectively and efficiently, and increase returns. Common cents.

Clients want to know when they will recover. We're pleased that since the end of February (and more so from the market bottom on March 9th) we've had a meaningful recovery, in most cases better than the market. The overall market is undervalued and our holdings are even cheaper and very prospective. The excessive and unrealistic drawdown, offering inordinate values, could portend a significant recovery back to fair market values. "I" is for improvement.

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