Q2 2009
Market Commentary

GALILEO

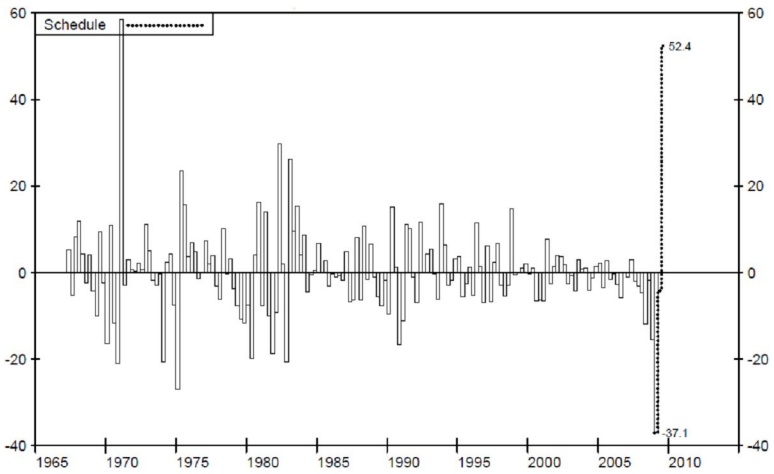
Date: *06/30/09*
Author: *Michael Waring*

With the very significant recovery during the second quarter, equity markets have likely run ahead of the near term economic fundamentals. While in Shanghai in May, we sounded a note of caution that investors should stand aside with further commitments to equities for the time being. Too far, too fast and it was becoming too easy for our liking. We are now experiencing a share price correction as doubts of the recent recovery have re-entered conventional thinking. Frankly, this was to be expected. Recoveries are never a smooth, easy process.

Yet we remain of the view that the global economy is in a bottoming phase and a recovery will become more visible in the quarters to come. We don't profess to know the exact timing, no one seldom gets the timing right. But we continue to see encouraging signs that a recovery is about to take hold and we have therefore opted to not try and 'time' the recovery in our portfolios. We have positioned our investments to benefit from an economic recovery that we expect to be more obvious by the first or second quarter of 2010.

We all know the long laundry list of worries and concerns; the press has done a magnificent job of pounding on them daily. We have to believe that much of the worry list is priced in. Offsetting this is the inventory swing. Recessions trigger inventory corrections and we know that global industrial production fell off a cliff in November and December of 2008. Simply put, production dropped below the level of sales. And from what we can surmise, sales have now begun to stabilize. That implies that many industries are now operating with minimal inventories and a re-stocking is the next order of business. To wit, Ward's Automotive has published their monthly update of the third quarter production schedule for the North American automakers based on revised plans in early July. It shows that manufacturers have scheduled production of 158,000 vehicles in the U.S. in the third quarter, a 36.8% increase from Q2. As John Aitkens of TD Newcrest points out, the third quarter is normally a seasonally weak quarter, on average declining 16.2% from Q2 levels. So if you adjust the projected production schedules for seasonality, the adjusted growth rate is 52.4%!

Chart One: U.S Motor Vehicle Production
Qtr/Qtr % Change, Seasonally Adjusted, Quarterly Rates



Source: TD Newcrest, John Aitkens

We suspect this will have ripple effects across a number of manufacturers and is indicative of the other side of the inventory swing. Reports we have read on the U.S. steel sector suggest that the current destocking cycle may be close to an ending.

In our opinion, the Obama government (unlike China) has been slow to get the stimulus plan to work. The plan's impact should become more visible towards year-end. However, if we are wrong, then another stimulus program is likely in the cards. No matter how you dissect it, monetary stimulus is hard at work.

Emerging Markets

Late last year, all the doomsayers were adamant that a decoupling of markets would not happened, western economies could not enter recession without taking all global markets down. And for a brief time they were right as institutional investors sold everything and retreated home. But lets take a look at the fresh evidence:

YTD July 10, 2009	
Frankfurt Xetra Dax	- 4.9%
London FTSE 100	- 6.9%
New York DJIA	- 7.2%
Paris CAC 40	- 7.3%
Hong Kong Hang Seng	+23.1%
Mumbai Sensitive	+40.0%
Sao Paulo Bovespa	+31.1%
Shanghai Composite	+71.0%
Taiwan Taiex	+47.5%

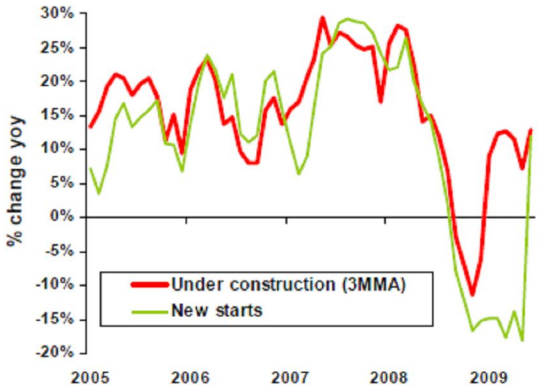
No surprise that we have not heard from them in a while. The simple point is that the emerging markets have become the de facto leaders of global growth and recovery. As investors, we need to pay less attention to every little twitch and nuance in the U.S. economy and more time spent analyzing these emerging economies. And no doubt, that is hard to do since we are bombarded daily by U.S. centric economic news by the press, especially CNBC.

China

We have visited China twice already this year (April and May) and plan a third trip in September. We could overload you with statistics and charts but suffice it to say that China's economy is recovering at a fast pace. To be sure, activity is down in the port cities, shipments from the port in Hong Kong have declined by 20% as an example. But once you step away from the coastal cities, growth is recovering led by domestic demand;

- The Chinese residential property market is exhibiting clear signs of improving with developers reporting improving sales and increased development plans. In Shanghai, Yanlord (a Singapore listed Chinese property developer) reported they will need to resort to a ballot system to control crowds when they launch their next development phase. This sector is critical to monitor since it is the largest consumer of copper, zinc and steel in the Chinese economy.

Chart Two: Strong recovery in construction from 2H 2008 collapse



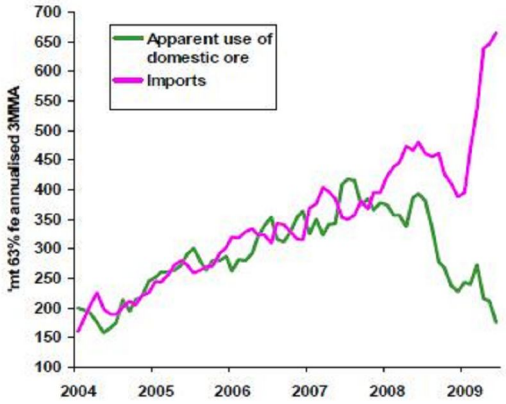
Source: NBS, July 2009

- In the steel sector, end users bought more steel in May and June, as demand picked up and they anticipated the onset of higher prices.
- In copper, another record level of Chinese copper imports was set in June. This was far ahead of expectations.
- The consumer is exhibiting a strong resurgence; passenger car sales jumped 46% Y/Y in June, residential building sales increased 80% Y/Y while retail sales rose 15.2% Y/Y.

China's export market has clearly been a weak point in the first half of the year. Yet China is fast becoming a continental economy driven primarily by domestic investment and consumption. Exports simply account for less and less of China's gross domestic product.

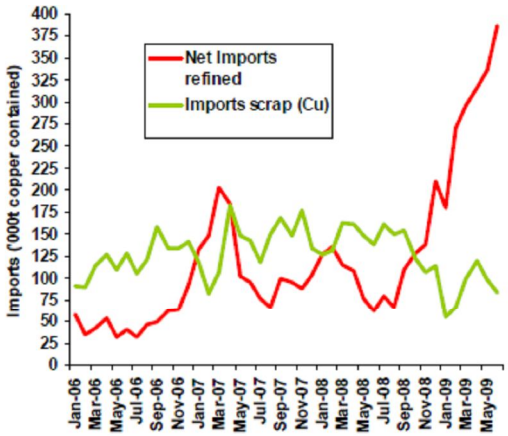
While attending a Macquarie Securities Conference in China mid May, it became obvious that China is now the largest global purchaser of copper, iron ore, metallurgical coal and nickel. Imports of all four resources have risen dramatically in the first half of 2009.

Chart Three: Soaring Chinese iron ore imports at the expense of domestically produced ore



Source: Trade data, Macquarie Research estimate, July 2009

Soaring refined copper imports



Source: Chinese trade statistics with estimate for June 09

A senior executive from Vale (the Brazilian iron ore miner and owner of Inco) stated that if western economies return to some sort of normalcy in terms of activity by Q2 2010, there simply won't be enough supply of these four resources in terms of demand. Yes, much could go wrong between now and then, but as global investors, we need to recognize that much has changed in terms of the drivers of the global economy.

Conclusion

So not withstanding an equity market that has gotten ahead of itself in terms of recovery, we remain constructive. An inventory restocking, massive monetary easing, delayed benefits of the U.S. stimulus plan and a recovery in emerging markets all suggest to us that a bottoming in global economic activity is occurring.

Yield is important as we wait for the recovery to become obvious so we are constructive on income instruments including corporate high yield debt. And as an aside, we have turned more bullish on the uranium sector, having been out of the space for the past two years. We think the fundamentals for higher uranium prices in the years ahead look very solid.

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