



EDITORIAL

We ended October on an optimistic note fuelled by a European summit that was full of promises but low on details. At the time, we expressed caution as we thought that the hopes were founded on very little. To the surprise of all, Greece brought everyone back down to earth with a proposed referendum that no one expected. Even though the referendum was subsequently cancelled, the damage had been done. Very quickly, Italy's 10-year bonds rose more than 4.5% to exceed the 7% mark. Those are two very important figures, as at this point; the situation spiralled out of control for Greece and Portugal. Under these circumstances, it became very difficult for portfolio managers to outperform their index as a large proportion of performance now depended not on the financial health of companies but on unpredictable and sometimes illogical political decisions.

Many points of view have been expressed since the beginning of the European crisis; most are pessimistic – and rightly so. That said, and I repeat the policies are unpredictable and sometimes illogical; it would be naive to claim to know the outcome of the crisis with any degree of certainty. No one saw Papandreou's Greek tragedy coming and no one expected Berlusconi to leave so suddenly. All we can say is that this will be a long and painful process. On the one hand, austerity measures will have to be adopted and implemented. On the other hand, if the Italian rate remains above 7% and Germany encounters difficulties financing itself, the latter will have to resort to printing money via the European Central Bank because no single country or institution will be able to absorb Italy's debt.

Regarding our clients' portfolios, we have lifted the currency-hedging measures applied against the U.S. dollar during November. We have capitalized on the Euro nearing the \$1.40 mark to increase exposure to the U.S. dollar. The Euro has slid since and we will keep an eye out for an opportunity to take some of the profits when the latter hits that \$1.30 mark. With respect to other asset classes, as the markets gradually hit the lows they reached in the fall, we are assessing the possibility of integrating certain strategies that may now offer interesting opportunities.

Minh Nguyen, CFA
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FEATURE ARTICLE

Year-end review

This was a year of surprises, heart-stopping market volatility and a year that left most a bit poorer. We saw Gresham's law in action as we witnessed bad money driving out good. Printing money is a fundamentally dishonest endeavour. Governments, when they issue bonds, miraculously raise revenue without pain to anybody. But at the end of the day somebody pays. Free money does not exist, thus to pretend that there is no cost to accelerating the printing press is being naïve. Yes, currencies have been debased since the third century Roman inflation, but this is not a particularly comforting thought.

The problem is that we do not know who ultimately bears the cost. Financial markets have become a perpetual Ponzi scheme. The burden of the ongoing money creation silently seeps into the economy and it falls on unknown victims.

As we discuss the world we live in, we are misguided because we look at the wrong indicators. It is easy to look at product prices and judge that we live in an inflationary or deflationary environment. But products are only one destination for money. Are the bubbles, the asset price inflations, not more distortionary than product price inflations?

The CPI is used by economists to explain the present and predict the future. What is forgotten is that printing money is a tax. And the size of that tax, which is the inflation rate, can be measured by the rate of money growth. But since we don't know where the newly printed money ends up, and when it will get there, we cannot judge the exact inflation rate. The most reliable measure of inflation thus is the expansion of the monetary base. And who can doubt that this expansion is mind-boggling, thus that the cost must be astonishing?

Few accept this fact. Since a central banker does not wish to be remembered as the one who impoverished everybody, the printing press does not slow down.

And politicians wish to be re-elected; hence what counts is the next vote and not the longer-term consequences of any action. Greed and short-termism are what brought us to where we are today.

More than 2,000 years ago, Quintus Cicero observed that "Human nature being what it is, all men prefer false promise to a flat refusal." Since then we evolved in many ways, but that basic truth remains. Look no further than the Greek economic crisis. Michael Lewis observed that "the Greek state was not just corrupt, it was corrupting." The most celebrated politicians and bankers facilitated this process.



As we enter a new year we realize that what we truly need is honesty, honest politicians, bankers, plumbers, lawyers, and honest money. One day this realization will steer us in a better direction. For now we will have to live with the ebb and flow of emotional reactions to short-term solutions! Until the day when strong leaders emerge and impose unpopular but effective long-term solutions, look for continuing volatility and soft markets. It has been done in the past, think of Paul Volcker, Margaret Thatcher, Ronald Reagan. Maybe the best New Year's resolution would be that collectively we stop fooling ourselves!



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ECONOMY

Frontiers markets: Tomorrow's emerging markets

Frontiers markets are a sub-group of emerging countries that have lower liquidity and are smaller than the more developed emerging countries such as China, India, Russia and Brazil.

MSCI Frontier Markets (FM) Index				
Americas	Central & Eastern Europe & CIS	Africa	Middle East	Asia
Argentina	Bulgaria Croatia Estonia Kazakhstan Lithuania Romania Serbia Slovenia Ukraine	Kenya Mauritius Nigeria Tunisia	Bahrain Jordan Kuwait Lebanon Oman Qatar United Arab Emirates	Bangladesh Pakistan Sri Lanka Vietnam

Source: MSCI Barra

Many observers consider that these countries are now at a stage similar to the position that China and India were in 20 years ago. As a result, many can already see these countries rising to the same status as the more developed emerging countries. These countries have something in common with the other emerging countries: both their populations and their economies are growing. Will frontier countries take over from the traditional emerging countries? Vietnam and Bangladesh are already opening their doors to many companies that are looking to leave China, where labour costs have been on the rise for some time now.

The Risks

Although investing in the next China or Brazil seems attractive, certain elements are still major obstacles to investing in frontier countries. First of all, there is the geopolitical risk threatening the continuity of investments, as several of these countries are ruled by dictators and/or have been embroiled in wars very recently. Second, many of these countries do not have enough liquidity to attract pension funds; institutions need to invest a minimum of 1% of their portfolio in a class in order to have any impact on performance. The risk of concentration must not be ignored, as only a few companies have invested in certain countries. Lastly, these nations have relatively unstable currencies and, recently, they have all weakened considerably against the U.S. dollar, as the latter is still a safe haven currency.

A Different Reality

Following recent signs of economic weakness, so-called traditional emerging countries started to soften their monetary policy. Brazil surprised everyone by lowering its lending rate. We may have thought that smaller emerging countries would have done the same, but the reality is completely different. Which country would increase its rates when its economy appears to be declining? The answer is: a country that depends heavily on foreign capital and is having to contend with very high inflation. Indeed, unlike Brazil and Romania, which have lowered their rates, countries such as Kenya and Uganda have increased their rates in order to stem an exodus of capital and a devaluation of their currency, which would lead to an increase in fuel and food prices. Kenya raised its rate by 5.5% less than a month after increasing it by 4%. Uganda's lending rate now stands at 23% following an increase of 3%. Inflation is a major concern for these countries; currently, it stands at 30.5% in Uganda. Although these countries will represent a greater proportion of the world's economy in the long term, we must not forget about the short-term risks.



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On China

By Henry Kissinger

Before 1969, the People's Republic of China and the USSR were seen as one large Communist bloc with its power centre in Moscow. Early that year, however, with Russian troops massing on the Chinese border, nuclear war between Russia and China appeared probable (to the extent that Chinese leaders were dispersed from Beijing to various locations around the country). At that point, U.S. President Richard Nixon decided that "Red China" was the lesser of two evils, which made possible a meeting—up to then viewed as unthinkable—with Mao Zedong in 1972. Relations between the U.S. and China have been relatively stable and peaceful ever since.

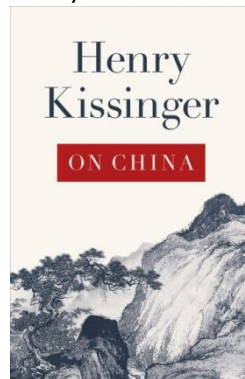
Henry Kissinger was National Security Advisor to Nixon at the time, and a key figure in laying the groundwork for the summit between the unlikely bedfellows. His book examines the history of China from its ancient origins, interpreting the nature of Chinese society and the belief in China's superiority in the world—not through proselytizing or crusading, as neo-cons have arguably done in their efforts to democratize the Third World, but through sheer confidence in cultural superiority.

That confidence had been badly shaken in the wake of the Opium Wars in the 19th century with the U.K., and the succession of embarrassing concessions, to a host of Western powers, in matters of trade, diplomatic relations and even ownership of Chinese territory.

Kissinger explores the civil war that led to the Communist victory (and the Nationalists' flight to and settlement of Taiwan), as well as successive Communist policy blunders like the Great Leap Forward, which aimed to increase industrial output fast

enough to overtake the West within 15 years. Its goals were so unrealistic, however, that local officials faked grain-harvest figures. Those numbers were then relied upon as Chairman Mao sold much of the country's grain reserves to the USSR in exchange for arms, triggering a famine that killed as many as 45 million people.

Then there was the Cultural Revolution, part of Mao's vision of continual revolution, an attempt to wipe out all traces of China's Confucianist civil service, which saw many senior mandarins purged and sent to work in the countryside. They included future leaders Deng Xiaoping and Jiang Zemin. Mao's right-hand man, Chou En-lai, nearly suffered the same fate.



On China is a very useful account of the various facets of the country's modern political history. It is interesting to compare Chinese foreign policy to a game of *wei qi*, in which two players place black and white tiles on a board, the object being to encircle one's enemy. Kissinger seems at times to be almost an apologist for Mao, and while some of the worst

excesses of "the Great Helmsman" are duly noted, there is more effort put into understanding his decisions in the larger context of Chinese history.

Kissinger, ever the hardline Republican, gives top marks in American foreign policy to Nixon, Reagan and both Bushes. Carter and Clinton are both criticized as too gung-ho in their efforts to impose Western values in a Chinese context.

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MARKET WATCH

Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX	MSCI World
November 30th	12045,70	4946,17	2620,34	1246,96	12204,10	1184,60
Monthly var.	0,76%	1,10%	-2,39%	-0,51%	-0,39%	-5,55%
Year-to-date	4,04%	-3,14%	-1,23%	-0,85%	-9,22%	-7,45%
Year-over-year	9,45%	1,86%	4,89%	5,63%	-5,78%	-0,75%

Index	FTSE	DAX.	CAC40	SMI	NIKKEI	EURO50
November 30th	5505,42	6088,84	3154,62	5652,31	8434,61	2330,43
Monthly var.	-0,70%	-0,85%	-2,72%	-1,38%	-6,16%	-2,30%
Year-to-date	-6,69%	-11,94%	-17,09%	-12,18%	-17,54%	-16,56%
Year-over-year	-0,41%	-8,97%	-12,63%	-10,46%	-15,12%	-12,09%

Commodities	GOLD	COPPER	CRUDE	WHEAT	LUMBER	CRB
November 30th	1750,80	357,40	100,26	661,00	224,00	313,82
Monthly var.	1,77%	-1,45%	8,07%	5,21%	-7,02%	-1,88%
Year-to-date	23,32%	-19,48%	9,69%	-16,78%	-30,00%	-5,70%
Year-over-year	26,48%	-6,28%	19,05%	-11,33%	-9,53%	4,12%

Currencies	\$CA	¥	€	£	\$AU
November 30th	1,0195	77,5500	1,3440	1,5700	1,0270
Monthly var.	-2,15%	0,78%	-2,89%	-2,34%	-2,53%
Year-to-date	-2,36%	4,50%	0,52%	0,64%	0,29%
Year-over-year	0,68%	7,35%	3,54%	0,93%	7,15%

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