

## Mr. Scrooge Meet Mr. Claus

Five months after the start of faltering credit conditions and after witnessing a growing list of distressed financial institutions, we expect the Bank of Canada and the Federal Reserve Board will again cut interest rates in December. The Bank of Canada meets December 4 and the Federal Reserve Board meets December 11. *(Since writing this letter, the Bank of Canada has dropped their overnight rate by 0.25 %.)*

The contraction in lending has erased the stock market gains in New York this year and much of the gain in Canada. The wobbly state of the banks is hurting business. We are seeing a steady stream of broken expectations, soft economic statistics, collapsing consumer polls, and faltering share prices. Technically, many equities and many of our holdings have broken their bull market up trends of the past several years. We think the evidence now clearly supports a change in direction from expansion to the contraction of the business cycle. On the other hand, the grim business news has supported a very bullish bond market, not something about which we are necessarily bullish.

The massive appreciation in the bond market, from its low in July to its year-high today, hints at the intensity of the distress in financial markets, and at the magnitude of the liquidity furnished by the Central Banks. Ten-year U.S. Treasury yields, now 3.9%, have fallen 140 basis points. The yield matches the low yields seen in 2005 and 2004. Canadian yields are at the same level. The plunge in bond yields suggests that banks are buying bonds and not lending. The powerful bond market today has very negative implications for business next year.

The reduced rates, the end of tax-loss selling in mid-December and the advent of some serious money from sovereign investment funds entering the equity markets set the stage for the fabled year-end or Santa Claus rally.

## QV's Pooled Fund – Month End Unit Values

Unit Values	Jun-07*	Sep-07*	Nov-07
Cdn Balanced	14.15	14.17	14.11
Cdn Small Cap	23.89	24.09	23.18
Cdn Equity Fund	10.60	10.57	10.37
Global Equity Fund	9.43	9.10	9.16
Cdn Income Fund	10.25	10.31	10.39

\* Post distribution

## Sovereign Funds

The oil exporting nations, Norway, Middle-Eastern countries, Russia, as well as China, now the manufacturer to the world, have built up U.S. dollar reserves sufficient to bid for chunks of foreign companies. The reserves earning low interest and at risk from a soft U.S. dollar will be invested in the equity markets. In an ironic twist, Abu Dhabi has financed the faltering Citigroup with a loan that triggered a rally in New York stocks. We will see more of these bailouts.

## Total Return – Capital Gains plus Income (%)

To Nov 30, 2007	1 Mo	YTD	1Yr	3 Yr	5 Yr	10 Yr
<b>QV Pooled Funds:</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Canadian Balanced Fund	-1.6	2.7	2.9	8.5	10.2	9.4
Canadian Small Cap	-6.0	9.2	11.2	17.7	23.2	16.4
Canadian Equity Fund	-4.4	4.7	5.4+	16.5+	20.1+	20.8+^
Global Equity Fund	1.9	-6.5	-	-	-	-
Canadian Income Fund	1.1	3.8	4.0	4.8	5.0	-

+ Historic equity returns from the Cdn. Bal. Fund ^8yr

## Benchmarks:

Balanced Fund Index	-2.9	6.2	6.8	11.7	12.4	8.2
BMO Small Cap Index (unwtd)	-9.7	-3.5	-1.5	8.7	16.5	6.3
DEX Bond Universe	1.5	3.1	2.3	4.9	5.9	6.2
S&P/TSX Comp. Index	-6.2	8.4	10.0	17.4	18.2	9.7
MS World Index (\$CA)	0.9	-6.7	-2.9	6.3	4.3	2.0
S&P 500 Index (\$CA)	1.0	-8.8	-5.6	3.9	2.1	2.5

- Pooled fund returns are gross of management and custodial of fees. Returns over one year are annualized.

- The Balanced Fund Index reflects the total rates of return earned by the DEX 91-Day T-Bill Index (10%), the DEX Bond Universe (35%), and the S&P/TSX Composite Index (55%).

## Credit Bears

The bull market in bonds will help offset some of the fall in equity prices in our Canadian Balanced Fund. Equity portfolios will face the challenge of a possible recession.

We have been “credit bears” for some time. Our opinion arose from the perception that interest rate settings were too low to prevent asset price inflation and too low to discourage North American consumers from leveraging their real estate.

We hold the same views as Joseph Stiglitz, a Nobel-prize winning and World Bank economist. “I am very pessimistic, Alan Greenspan really made a mess of all this. He pushed out too much liquidity at the wrong time.” To the easy money, we can add aggressive tax cuts in 2001 and an Iraqi war financed by fiscal deficits. We felt the stimulants, and the valuations they supported, were unsustainable.

We emphasised comparatively low equity exposures in balanced accounts, low exposure to financial services, quality bond portfolios, and sound credit standing in our equities. The failure of securitized loans puts a squeeze on financial institutions and precipitates asset write-downs.

Tightened credit spills into all aspects of the markets. This we expected. That said we too have suffered as National Bank disclosed their exposure to “asset backed securities” and as equity valuations have shrunk.

## Opportunity

The credit crunch interrupts the pace of consumption and investment for the future both globally but particularly in North America. While arguments suggest exports and emerging markets will counter the contraction in the U.S. and sustain the expansion, we note the shrink in U.S. economy and financial system will dwarf emerging markets.

No equities are recession priced. We expect at some point, share prices will tumble severely as fear and the need for short-term cash overrides investors’ commitment to a share of a business franchise providing long-term income.

We hold positions in businesses we expect will endure in adversity. After all, we must eat, clothe, shelter, and transport ourselves. We must expect the “third world” will still aspire to a higher standard of living. As prices fall to reasonable valuations, we will use reserves and income to augment our current positions. We will not be deploying our reserves soon. We will when we see equity values restored.