



AFTER THE DELUGE, INFLATION?

A FLOOD OF WRITE-OFFS

Living in the Canadian Prairie city of Winnipeg, we've had a long history of floods. A few days before writing this, we faced yet another one as the snow melt and spring rains caused a rapid rise in the Red River. Readers may have watched news reports in late March of the flooding along the Red and the risk to the city of Fargo, North Dakota, which narrowly averted disaster. All of that water continued north to Winnipeg, supplemented by hundreds of miles of additional melting snow and added precipitation. Some homeowners have faced rising waters of biblical proportions. We can draw some parallels between the flood and the cascading credit defaults that are plaguing the global economy.

The International Monetary Fund has estimated that U.S.-originated credit losses will be \$2.2 trillion or more, a massive sum that indicates just how out-of-hand lending practices had become. There is no doubt that the implosion of the credit bubble is having a dramatic effect on both the economy and the capital markets and the question of the day is "what happens next?" Some are worried that lending will dry up, leading to deflation and ultimately a 1930s-style economic depression. Our view is more sanguine: time will heal all wounds, the write-downs will be absorbed and the economy will once again march forward. Global leaders and bankers are working overtime to avoid an economic catastrophe, in large part through policy measures that slow the rate of loss realization.

Both the flood and the credit de-leveraging have an element of inevitability about them, but in neither case is Armageddon a foregone conclusion. While we cannot stop the flow of the Red River - it is what it is - we can try to contain it with temporary dykes, which allow the river to rise beyond its natural capacity. Likewise, capital injections through the Troubled Asset Relief Program ("TARP") reinforce bank balance sheets to handle debt charge-offs. Additionally, to deal with the flood, Winnipeg has built a diversionary floodway, thereby reducing the risk to the city itself. In an analogous way, various policy initiatives, such as the Term Asset-Backed Securities Loan Facility ("TALF"), have enabled credit to keep flowing so the economy can continue to function.

Despite our best efforts, we won't know if we have avoided a flood until the barriers are tested by the water's crest. Experts have an idea of the magnitude of the problem, but ultimately it is the water's rate of flow that will determine whether or not it jumps the banks. The two largest factors that determine the damage of a flood are how much water the river is asked to hold and how quickly that water arrives to fill (or overflow) its banks. The faster the water moves in, the greater the volume and the greater the risk of damage to real property and the local economy. The city has engineered a slower rate of water flow, and thus far in April it looks like Winnipeggers will not need to build any arks. The Red will still handle a massive volume of water this spring; all that has changed is the amount of time it will take for that water to flow through its banks.

Similarly, banks face a flood of write-offs that have the potential to destroy their equity. The key to their continued solvency is extending the amount of time over which losses are recognized, because as time passes they can rebuild the equity capital required to absorb these inevitable losses. They are being helped by much improved business conditions. A steep yield curve is allowing them to borrow short-term money at very low rates and lend it out at significantly higher rates, an extremely profitable proposition.

The risk the world faces is if we stretch out the economic malaise too long: instead of decisively fixing the banks' capital problems, which would allow them to resume a healthy level of lending, we could end-up with "zombie banks" - too constrained to lend, but not sick enough to die. This is a realistic risk but we think it's overstated. From a public policy perspective the trade-off seems reasonable and we are watching carefully for signs of an end to the negative feedback cycle of the past six months. The banks we own in our portfolios strike a good balance between protecting their capital and taking advantage of opportunities to write profitable new business - at the expense of their zombie brethren.

REFLATION TILT

A wave of unprecedented stimulus spending is about to hit the global economy. Central banks are rapidly lowering short-term interest rates and have said they will do whatever it takes to avoid deflation. "Quantitative easing," the latest monetary policy tool to be deployed, is effectively the printing of money, an action that aims to reflate the sagging economy. While the last six months have been all about deflationary shocks, it would be a mistake to invest purely with a rear view mirror. Investors now need to look beyond the near term and position themselves for the probable return of inflation.

That said, over the next few months, deflation - not inflation - is a mathematical certainty thanks in large part to year-over-year declines in home prices as well as commodities such as oil and agricultural products. Additionally, it will be difficult for businesses to increase prices while economic activity is slack (the so called "output gap"). Perhaps most importantly, rising unemployment is pressuring wages. So why are we worrying about inflation? Because there are too many reflationary policies being implemented to ignore and over time we anticipate a gradual tipping of the scale away from deflationary forces towards inflationary effects. Milton Friedman famously stated that "inflation is always and everywhere a monetary phenomenon." The tsunami of global monetary stimuli is unlike anything we have seen before. Fiscal stimuli are no less impressive. Governments are attempting to spend their way out of our troubles by borrowing gobs of money through the debt markets: unfortunately our problems are rooted in too much debt already. As we see it, the only way to eventually reduce the debt burden will be to allow for higher inflation levels. Foreign holders of the debt will take losses by way of currency devaluations.

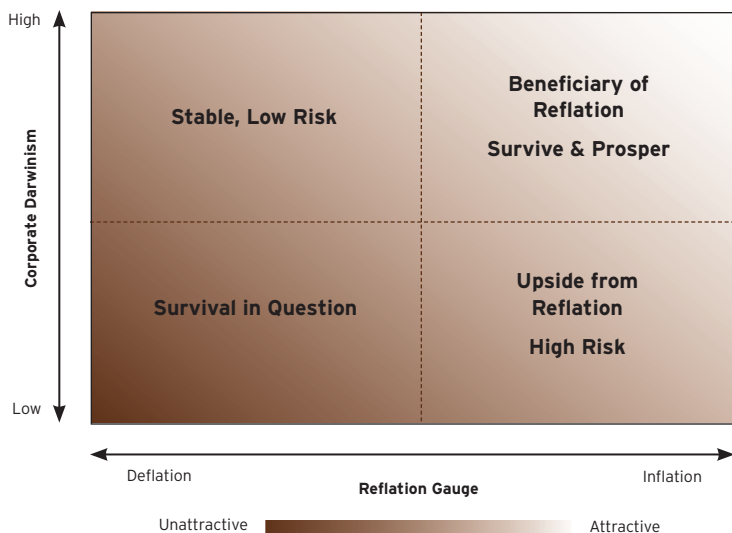




The politicians and policy makers tell us not to worry because they will curtail spending as the crisis abates and economic activity picks up. We've heard that one before. Politicians love spending money, and we think governments will err on the side of "caution" and keep their purses open for longer than is necessary or desirable.

What does this mean for stocks? In the January 2009 edition of the Tetrem Quarterly Review we provided a framework for picking stocks in the current environment. In a nutshell we have been favouring companies that have manageable debt, can emerge stronger from the recession (our Darwinian thesis) and are undervalued (ideally "hugely"). We have added another dimension to this framework by tilting towards companies that will benefit from reflationary forces. We're not just looking for defensive companies; we want to own companies that can also prosper in an inflationary world. Our framework for analyzing companies in this fashion is laid out in the Survive and Prosper matrix below [Figure 1].

PICKING COMPANIES THAT SURVIVE AND PROSPER [Figure 1]



Our focus is to invest in companies that fall into the top-right quadrant of the matrix. Resource companies with long-life reserves in the ground and strong balance sheets are the most obvious candidates, examples of which include BHP Billiton (BHP), Potash Corporation of Saskatchewan (POT) and Imperial Oil (IMO). Many technology companies also fit as they are leveraged to increasing economic activity, yet in many cases have rock-solid balance sheets. Two examples we own are Cisco Systems (CSCO) and Apple Computer (AAPL), which respectively hold Gibraltar-like cash hoards of \$30 billion and \$26 billion.

Perhaps the greatest advantage we and our investors gain from this new analytical step in our investment process is that we avoid companies that fall into the bottom-left quadrant of the Survive and Prosper matrix (i.e. those that face the risk of business failure - a risk that has increased palpably in the past year). In adopting this stance, we acknowledge that we will miss a few stocks that deliver strong investment returns as they emerge from near-death experiences. However, our view is that if we cannot determine a company's survivability with a high degree of confidence, an investment in it would be too speculative. Over the past few months this rational framework has allowed us to triage and focus on what we feel are the best investment opportunities.

We are seeing some positive near-term effects from the monetary and fiscal policy initiatives aimed at slowing down the intense negative feedback loop that has mired the economy. We will likely avoid a collapse in the financial system and an ensuing economic depression. However, these policy initiatives come with a cost: they are inherently reflationary and will likely lead to inflation over time. We don't know if the worst is over, and investors need to continue to protect their portfolios from economic downside in the near term. Longer term we are hedging against the risk of inflation, and more importantly we are preparing our portfolios to take advantage of it by owning companies that stand to benefit from its likely return.

Daniel A. Bubis, CFA

President and Chief Investment Officer

U.S. MARKET REVIEW

When equities sold off in February, we were struck by the pervasive state of fear within the investment community. Entering 2009 we had thought the November 2008 market lows would hold. However, President Obama's budget proposal and Treasury Secretary Geithner's initial recovery plan were deemed insufficient, which drove the market to new lows in early March. In hindsight we probably needed to see the high expectations of Obama and his team get washed out. While we did not get the big one-day capitulation panic selling that many had been looking for, we probably saw a capitulation in market psychology. This capitulation seemed the polar opposite of the Internet bubble, when Wall Street analysts routinely set unrealistically high price

targets on the stocks they followed, only to see investors get swept up by the euphoria, often causing the stocks to reach these optimistic targets in a matter of days. In a notorious example of hubris, a Paine Webber analyst offered a \$1,000 price target on Qualcomm (QCOM) on December 29, 1999, sending the stock up 31% that same day when it closed at \$652. It peaked at \$791 three days later and for the next two and a half years it was all downhill until the stock bottomed 88% lower in August 2002.

In today's environment many analysts are engaging in similarly irrational behaviour, only this time they are being unreasonably





TETREM QUARTERLY REVIEW

pessimistic. They are applying trough multiples to trough earnings to arrive at their price targets, which feeds into investor fear. As it was in 1999, so it is in 2009: analysts' vision has become (even) more myopic than usual, and their characteristic impulse is to overreact to the most recent negative data points by extrapolating a similar trend in perpetuity. In our view, many companies are likely "worth" something that is very different from sell-side analysts' targets, and this provides investment opportunities for those brave enough to think long term. Our investment process focuses on estimating what a company is worth as a business and we continue to find many stocks trading at levels that significantly undervalue them. We believe that when we look back at today's environment three to five years from now, we will shake our heads in amazement at just how short-sighted the market had become. For instance, one analyst's recent price target of \$8 for high quality insurer Aflac (AFL) will likely, in hindsight, look just as farfetched as that 1999 call on QCOM.

The Tetrem U.S. Equity Composite fell 6.8% (in U.S. dollars) in the quarter, outperforming the S&P 500 which fell 11.0%. Our

outperformance was helped by our initial higher-than-normal cash levels, which we worked down to nearly fully-invested levels in late February and early March coincident with the market's lows. The energy sector was one of the top contributors to our performance. Despite last year's cyclical downturn we stayed true to our long-term thesis and in fact took a more aggressive stance by selling the more richly-valued and conservative integrated companies Exxon Mobil (XOM) and Chevron (CVX) and replacing them with the cheaper Marathon Oil (MRO) and Apache (APA) which will likely benefit more from the momentum of rising energy prices. Given the extreme dislocations in credit markets, the financial services sector was by far the market's worst performing sector, but we bucked the trend thanks to our picks in stocks such as CME Group (CME) and Goldman Sachs Group (GS), which more than offset our loss in former holding Hartford Financial Services (HIG).

Aaron Clark, CFA
Vice President Investments

CANADIAN MARKET REVIEW

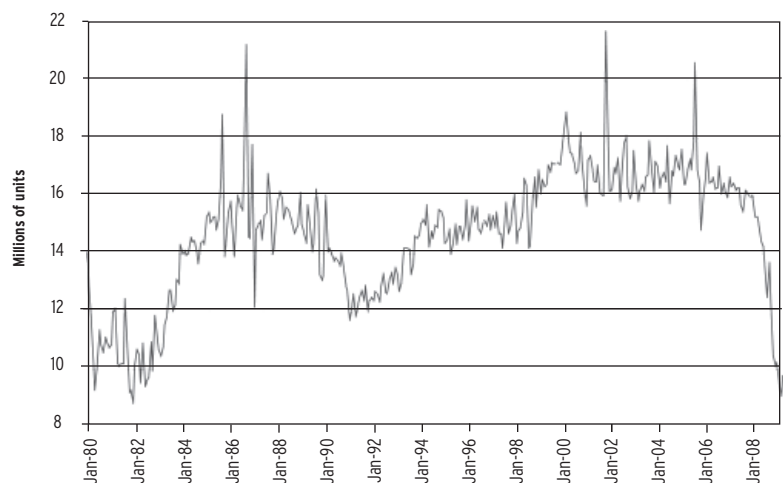
The late 2008 rally fizzled early in the new year and by February's end the S&P/TSX Composite index was re-testing its November lows, only to rebound again in March. In the end, the index fell 2.0% over the quarter. Strong performance from gold stocks such as Newmont Mining (NMC) and our new insurance holding ING Canada (IIC) was not enough to offset our overweight position in poorly-performing energy services companies such as Precision Drilling Trust (PD.U). As a result, Tetrem's Canadian Equity Composite underperformed its benchmark by 1.7%, falling 3.7%. In this environment our trading activity was higher than normal as we raised cash and redeployed it within a few weeks as we found new opportunities, in many cases at or near market lows. For example, we introduced positions in Progress Energy Trust (PGX.U), Canadian Oil Sands Trust (COS.U), TransCanada Pipelines (TRP), and Potash Corporation of Saskatchewan (POT).

The North American automobile industry provides a poignant example of how weak economic indicators were during the quarter. From 2000 to 2007 U.S. light vehicle sales averaged nearly 17 million units annually; this declined to 13.2 million in 2008 and fell precipitously to 9.6 million (the seasonally adjusted and annualized rate, or "SAAR") in January of 2009 - a 43% decline from the 2000-07 run rate. Auto sales are at their lowest levels since the early 1980s [Figure 2].

We took advantage of the extreme pessimism and initiated a position in Magna Inc. (MG.A), the Ontario-based auto parts manufacturer. Investors are justifiably concerned that one or more of Detroit's Big Three automakers may file for bankruptcy. The whole sector is under duress and cash-strapped companies are going under as we write; the good news is the survivors are picking up new business from their bankrupt competitors. In our view, when

all is said and done, people are still going to buy cars, and likely at a higher run-rate than today's levels. If one company stops production, the others will pick up the slack and the industry will continue to rely on parts suppliers such as MG.A. The company has an enviable liquidity position, with nearly half of its market value in net cash (after subtracting the small debt), which gives us confidence the company will emerge from the turmoil a winner.

US LIGHT VEHICLE SALES [Figure 2]
Seasonally Adjusted Annualized Rate (SAAR)



Source: Ward's Automotive, BMO Capital Markets





TETREM QUARTERLY REVIEW

We initiated a position in an erstwhile high-flying tech stock, Research in Motion (RIM). We have always liked the company's products, but optimistic earnings expectations, and a persistently high valuation, had kept us on the sidelines until recently when the shares fell below \$50. The company is well positioned competitively for the product upgrade cycle, has a flexible cost structure that helps protect profit margins and has a strong balance sheet. We were able to buy shares at a forward price to earnings ratio that was approximately 20% cheaper than that of the market despite RIM's much stronger sales growth profile. Subsequent to the quarter's end, RIM reported a big earnings beat and the shares have risen sharply.

The poor economy notwithstanding, we are seeing some positive signs for the market. In general the Street has reduced earnings estimates to levels that are finally realistic, or in some cases overly pessimistic (as discussed in the U.S. Market Review). Analysts who were in denial have been forced to readjust their expectations, and when this happens it becomes increasingly likely that surprises will be to the upside.

Alec MacIsaac, CFA
Investment Analyst

ABOUT TETREM

Tetrem Capital Management offers money management services to institutional and select high net worth clients. Our investment mandates are focused on Canadian and U.S. equities, rooted in our long-standing contrarian value style and tailored to the specific needs of our clients.

Investing is our profession and we are committed to doing it well. Our experienced team's primary focus is seeking out and investing in undervalued companies. For each of our investment mandates, we utilize quantitative and fundamental analysis in our rigorous stock-selection process, with a focus on preserving and growing our clients' assets.

For more information about Tetrem Capital Management please visit our website, www.tetrem.com, or call and ask to speak with us about our investment services.

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TETREM'S CANADIAN EQUITY MANDATES (Gross of Fees in CDN \$)

	Annualized Returns to March 31, 2009					Calendar Year Returns				
	Q1 2009	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem CDN Equity	-3.68%	-29.31%	-9.85%	2.72%	9.90%	-28.27%	3.18%	9.27%	31.13%	15.05%
Tetrem CDN Equity Plus	-4.70%	-32.07%	-10.25%	1.99%	9.38%	-31.38%	6.10%	9.80%	29.88%	15.24%
S&P/TSX	-2.00%	-32.42%	-7.83%	2.76%	4.91%	-33.00%	9.83%	17.26%	24.13%	14.48%

TETREM'S US EQUITY MANDATES (Gross of Fees in US \$)

	Annualized Returns to March 31, 2009					Calendar Year Returns				
	Q1 2009	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem US Equity	-6.75%	-37.22%	-10.99%	-0.89%	6.74%	-39.16%	8.32%	19.04%	15.22%	15.92%
Tetrem US Equity Plus	-7.09%	-38.56%	-10.89%	0.95%	6.77%	-39.11%	11.49%	19.17%	22.64%	15.17%
S&P 500	-11.01%	-38.09%	-13.06%	-4.76%	-3.00%	-37.00%	5.49%	15.79%	4.91%	10.88%

TETREM
Performance Disclosure

Prior to June 1, 2004, performance returns were owned by Assante Asset Management Ltd ("Assante"). Tetrem has concluded that these returns meet portability requirements and as such, have been linked with Tetrem's returns for the sole purpose of providing supplemental information to the Tetrem's Composite Performance Presentation. This information is provided to present a longer track record using records available to Tetrem and may have limited usefulness.

Canadian Equity and U.S. Equity returns from January 1, 1997 to December 31, 2003 are based on an audited equity-only (excluding cash) composite of all segregated accounts and are owned by Assante. Performance from January 1, 2004 to December 31, 2004 is based on an unaudited equity-only (excluding cash) composite of all segregated accounts. The calculation of performance returns excludes expenses and is based on a monthly valuation using the Modified-Dietz methodology. Returns from January 1, 2005 to March 31, 2009 are gross of management fees and prepared using time weighted rates of return using the Modified-Dietz methodology.

Canadian Equity Plus returns from January 1, 1998 to May 31, 2004 are calculated using the audited NAV per share of a representative account within the composite. The NAV per share excludes management fees and is net of operating expenses. Performance returns for this period are owned by Assante. Returns from June 1, 2004 to March 31, 2009 are gross of management fees and prepared using time weighted rates of return using the Modified-Dietz methodology.

U.S. Equity Plus returns from January 1, 1998 to May 31, 2004 are calculated using the weekly NAV per share, closest to month end, of the sole account within the composite. The NAV per share excludes management fees and is net of operating expenses. Performance returns for this period are owned by Assante. Returns from June 1, 2004 to March 31, 2009 are gross of management fees and prepared using time weighted rates of return using the Modified-Dietz methodology.

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