



GLOBALIZATION IS ALIVE AND WELL AND LIVING IN THE MARKET

Globalization has arguably been the greatest driving force behind rising wealth and prosperity over the past 25 years. The opening up of global trade has led to a more efficient allocation of resources, thereby expanding the world's economic pie. The fall of the Berlin Wall in 1989 acted as an accelerant, as has China's move towards capitalism and away from communism as an economic model. As billions of people entered the global economy, companies from the developed world gained access to new markets. These same people lowered the cost of production of finished goods as they moved into manufacturing jobs. They received higher wages while we in the developed world got cheaper goods. Overall we have both become better off as a result of more liberal trade, notwithstanding the social costs. The current economic downturn, with its attendant pressures on people and their political representatives, represents a huge test for the secular trend of increasing globalization. A reversal in the trend could lead to a sustained drag on future growth and stoke the fires of inflation, and therefore represents a major risk to the global economy.

Western style free market capitalism has come under increasing pressure in reaction to the dramatic collapse of the credit bubble, but its survival doesn't appear to be in question, particularly as the perceived risk of economic Armageddon fades on a daily basis. Capitalism will survive this test, just as it survived the 1930s. Laissez-faire economics is by no means a perfect system. It tends to run into problems when excesses build during boom times. However, it has a far better track record than competing economic systems, particularly those predicated on central planning. It seems probable that the economies and markets in capitalist societies will come under greater government regulation and intervention over the next few years. This is just part of the typical backlash to any crisis. Perhaps the pendulum of free markets swung too far to the right and now it will swing too much to the left. Get ready for higher taxes.

Critics of globalization commonly cite its effect on employment in Western countries. Millions of manufacturing jobs have moved from developed economies to low-cost offshore jurisdictions, many with dodgy human rights records. Cries of worker exploitation in less developed countries appear to be quieting as companies have been pressured into policing their outsourcing arrangements. There has also been a realization, which some critics are loathe to admit, that these offshore jobs provide a path to lead people out of indentured poverty. A clear and present danger from economic growth is the cost to the environment, particularly when that growth comes from less developed countries which tend to have a higher level of carbon output for each unit of economic output.

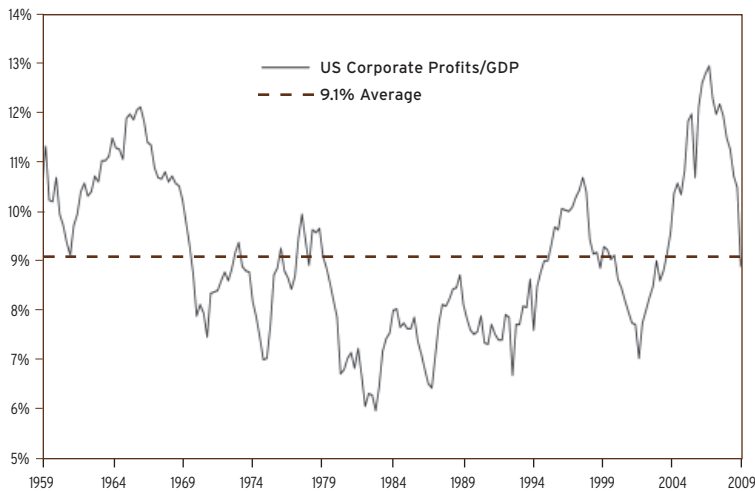
Whenever there is an economic downturn, many dormant "isms" crawl out from their hiding spots and gain populist support. A rise in protectionism poses the most immediate and direct threat to globalization specifically. Nationalism, the political cousin to economic protectionism, is a typical cyclical response to an economic downturn. Today both are on the rise and grabbing headlines.

The two most obvious players on this populist stage are China and the United States. China, understandably concerned about its \$2 trillion of foreign exchange reserves, vocally frets about the stability of the U.S. dollar as the global reserve currency. In response to worries about U.S. economic competitiveness and jobs, Washington regularly criticizes Beijing for its alleged currency manipulation. Both play the game; neither can afford to alienate the other. The U.S. needs China to continue to hold and invest in its debt securities to keep interest rates low and finance its deficit, while China cannot afford to lose the U.S. as an export market. A prolonged economic contraction in the West would lead to massive job losses in China. This could provoke political unrest and threaten the very existence of the Communist Party. When it comes down to it, globalization will survive the current test as it is in our collective best interest for it to continue. Maintaining political power and avoiding severe economic pain are great motivators.

"Buy American" clauses attached to U.S. stimulus spending legislation initially increased the risks of protectionism. There has since been some backtracking on these clauses and it now looks like a retaliatory trade war can be avoided. For example, the U.S. "cash for clunkers" legislation does not discriminate between foreign and domestically produced vehicles. If anything, it favours Japanese auto companies because the cash incentives are designed to influence purchases of fuel efficient vehicles, a niche where Japan holds an advantage over Detroit. The legislation could have been written to favour U.S. automakers, especially in the wake of the government bailout of the domestic auto industry, a bailout primarily designed to save domestic jobs. While this is just one anecdote, it suggests to us that protectionism hasn't gone feral.

That is a good thing, because the profitability of corporate America has clearly benefited from the trend of globalization as shown in Figure 1. In the recent earnings cycle, profit margins expanded to a 50-year peak, thanks in large part to the export of capital intensive activities. This has had the salutary effect of reducing depreciation and interest expenses, while increasing labour productivity relative to sales. Profitability has retreated sharply from these peak levels during the current economic downturn.



**U.S. CORPORATE MARGINS HAVE HELD UP [Figure 1]**

Source: Tetrem Capital Management, Bloomberg

Of note though, profitability is troughing at a much higher level than was experienced in previous cyclical downturns. Simply put, globalization has facilitated corporate America's switch from a fixed cost business model to a variable cost model. This is a clear positive for the stock market, but the cost is being borne by labour as job losses rapidly mount.

Back in February the concern was that stock markets and the economy had entered a negative feedback loop. It was difficult to see how the self-reinforcing cycle of negativity could be broken, and this weighed heavily on investor sentiment. In surprisingly short order, not only has the cycle been broken, it is now giving way to the early stages of the risk-taking "animal spirits" of John Maynard Keynes. Investors and corporations alike are gradually

emerging from a bunker mentality of pure survival and coming to the realization that they must use the economic downturn to invest for future growth before time passes them by. This change in sentiment ultimately sows the seeds of economic recovery. Not all the seeds will grow into roses however, and many challenges remain.

High levels of debt held by consumers and financial institutions imply a continued period of deleveraging. In such an environment, it is difficult to see how job creation can be robust. Looking even further ahead, it is clear that we are facing a new bubble in the form of government entitlement programs, such as health care and social security. This will likely constitute our biggest economic headwind for several decades. As the ratio of retired to active workers ramps up over the next decade, we will see that entitlement funding is a big Ponzi scheme that would make even Bernie Madoff blush. The most disappointing part of the current crisis is that it created an opportunity to fix the issues and politicians have dropped the ball. In fact, it appears that current government action will make the entitlement time bomb grow larger - unless the birth rate starts to ramp up dramatically, effective immediately. This has all been known and discussed for years - today the issue is becoming much more salient.

Bottom-line, it seems we are in the midst of a cyclical recovery for the economy. Globalization has been threatened, and has passed the test which will boost confidence in the economic recovery and lift share prices. One could even make the case that investors will attach lower risk premiums (higher valuations) to equity securities in this scenario. It certainly will be interesting to watch. That said secular challenges remain which will make it difficult for equity markets to reach new highs, which leads us to believe it is a great time to be an active investor.

Daniel A. Bubis, CFA

President and Chief Investment Officer

CANADIAN MARKET REVIEW

These have truly been manic times: the mood of "Mr. Market" has ranged from unseemly despair in early March (causing him to sell out of fear) to renewed despair in April and May that he'd miss out on the recovery (causing him to buy at a higher price, also out of fear). The S&P/TSX Composite Index rose 20% during the quarter (and was up some 39% from its March 6 trough). Tetrem's Canadian Equity composite rose 21.2% (gross of fees), outperforming its benchmark by 1.2%. Broadly speaking relative performance benefitted from our overweight position in the energy sector and certain cyclical stocks in the consumer discretionary and technology sectors. This more than offset the relative underperformance of our large-cap gold stocks. We continued to trade actively as the

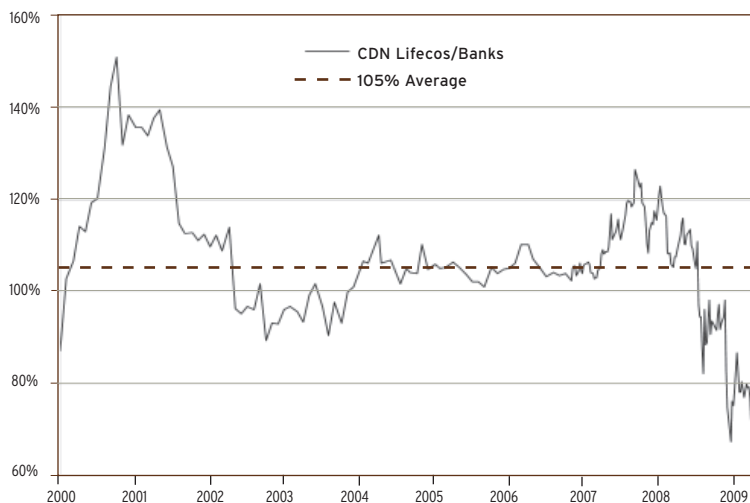
valuations of individual shares changed rapidly in the volatile environment.

Canadian financials merit special mention. As a sector they rose nearly 33% over the quarter and although we were underweight relative to our benchmark, we were able to add value through stock picking. We exited our longstanding position in CIBC (CM) and effectively redeployed some of the capital into Bank of Montreal (BMO), the least loved and most undervalued of the Big Five, which returned a peer-leading 51% (including dividends) during the quarter. Among life insurers, holding Manulife Financial (MFC), the insurer most sensitive to the equity markets, caught fire and





LIFECOS HISTORICALLY CHEAP VS. BANKS [Figure 2]
Price / Earnings of Canadian Lifecos vs Banks



Source: Scotia Capital, Bloomberg

by quarter end had approximately doubled from its March lows. In our view the long-term opportunity for Canadian life insurance companies is significant and we have recently favoured them over

the banks, in part due to relatively attractive valuation. Figure 2 shows the insurers' price-to-earnings ratio relative to that of the banks is at historically attractive levels: when the line is higher, the lifecos are more expensive than the banks and vice versa. We recently added Sun Life Financial (SLF) to the portfolio. SLF is regarded by some as MFC's "poorer cousin," but we believe the company has several catalysts ahead of it, not least of which is a turnaround in performance at its U.S.-based asset management division, MFS Advisors. We were able to buy the shares at close to book value and with a dividend yield of approximately 5%.

In our view, the Canadian market, with 45% of its capitalization in energy and materials names, is well positioned for a reflationary environment. Last quarter we argued that energy stocks, and the service names in particular, were undervalued. In the second quarter the energy names rallied alongside crude oil as investors started to price in a recovery. Many of these companies are still attractive from a valuation standpoint, which indicates to us that it isn't too late to invest in them. With the U.S. becoming increasingly indebted and effectively printing money through quantitative easing, we think investors should think carefully about how to protect themselves from the possibility of a return of inflation, the so-called "cruellest tax."

Alec MacIsaac, CFA
Investment Analyst

U.S. MARKET REVIEW

The market's sharp snap-back from its March lows continued into the second quarter and the S&P 500 enjoyed its best quarter since 1998, returning 15.9% (including dividends). The move in the market was broad based as all 10 S&P 500 sectors rallied. The gains were led by the most beaten down sector, financials, which was up 35%, while more defensive sectors such as telecommunications and utilities lagged. The unprecedented amount of global fiscal and monetary stimuli seems to have stabilized the capital markets and offered hope of economic recovery. As the "world is ending" scenario began to look less likely, investors regained their appetite for risk, driving up commodities and emerging markets' equities. We successfully positioned the portfolio in advance of these occurrences: the Tetrem U.S. Equity Composite delivered a return of 23.1% (gross of fees) in the quarter, outperforming its benchmark by 7.2%. We believe our contrarian, value-based approach is particularly well-suited for environments like this, as stress in the system combined with behavioural overreaction have given rise to attractive investment opportunities.

The energy sector was our top contributor to performance (helped by crude oil's 41% increase to \$70 per barrel), followed by consumer discretionary stocks and financials. In the energy sector,

land driller Nabors Industries (NBR), did particularly well as the market began to price in a recovery in the down-and-out sector. In financial services both State Street Corp (STT) and Aflac Inc (AFL) were strong contributors: according to our analysis both stocks should emerge from the turmoil with an unimpaired business model and earnings power largely intact. Our turnover has been higher than normal given the extreme moves we have seen in individual stocks. For instance, we initiated a position in Cummins Inc (CMI) in March, but sold the entire position within about three months as it rose faster than expected and approached our estimate of fair value. We also sold out of our entire position in high-end retailer Nordstrom Inc (JWN) after it had more than doubled off its lows. Both were strong contributors to performance, but we could no longer justify owning the shares at current prices based on our estimate of potential upside versus downside risk. Two detractors from performance were long time holding Merck & Co (MRK) and Newmont Mining (NEM), both of which declined modestly while the market was increasing.

Where do we go from here? Many of the most depressed stocks have gained well over 100% from the lows, and the popular debate centers around whether we just experienced a classic bear market bounce, or if the market is starting a new bull phase. While we





TETREM QUARTERLY REVIEW

can't know for sure, we have a view on the risks and opportunities investors face. The consensus continues to focus on the risk of deflation, but we are becoming increasingly convinced that recent U.S. fiscal and monetary actions could lead to inflation problems down the road. In our view, commodity oriented stocks and some industrials could benefit if inflation were to pick up. We also see select opportunities in financial stocks which are cheap relative to their normalized earnings power. We believe that the monetary and fiscal stimuli already in place, combined with emerging market growth, will support risk-taking and an improvement in confidence. In our view the worst is behind us and there are still value opportunities to be exploited in the market despite the strong rebound in share prices. We remain focused on diligent, objective study, doing as much work assessing the downside risk as the upside potential, and our analysis indicates our current portfolio is well positioned for the long term.

Aaron Clark, CFA

Vice President Investments

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 employ 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 June 30, 2009					Calendar Year Returns				
	Q2 2009	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem CDN Equity	21.21%	-19.64%	-3.36%	6.18%	11.26%	-28.27%	3.18%	9.27%	31.13%	15.05%
Tetrem CDN Equity Plus	21.66%	-21.08%	-3.30%	5.75%	10.56%	-31.38%	6.10%	9.80%	29.88%	15.24%
S&P/TSX	19.97%	-25.69%	-0.89%	6.58%	6.15%	-33.00%	9.83%	17.26%	24.13%	14.48%

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

	Annualized Returns to June 30, 2009					Calendar Year Returns				
	Q2 2009	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem US Equity	23.14%	-23.27%	-4.80%	2.65%	6.98%	-39.16%	8.32%	19.04%	15.22%	15.92%
Tetrem US Equity Plus	24.30%	-25.41%	-4.48%	4.93%	7.98%	-39.11%	11.49%	19.17%	22.64%	15.17%
S&P 500	15.93%	-26.21%	-8.22%	-2.24%	-2.22%	-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 June 30, 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 June 30, 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 June 30, 2009 are gross of management fees and prepared using time weighted rates of return using the Modified-Dietz methodology.

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