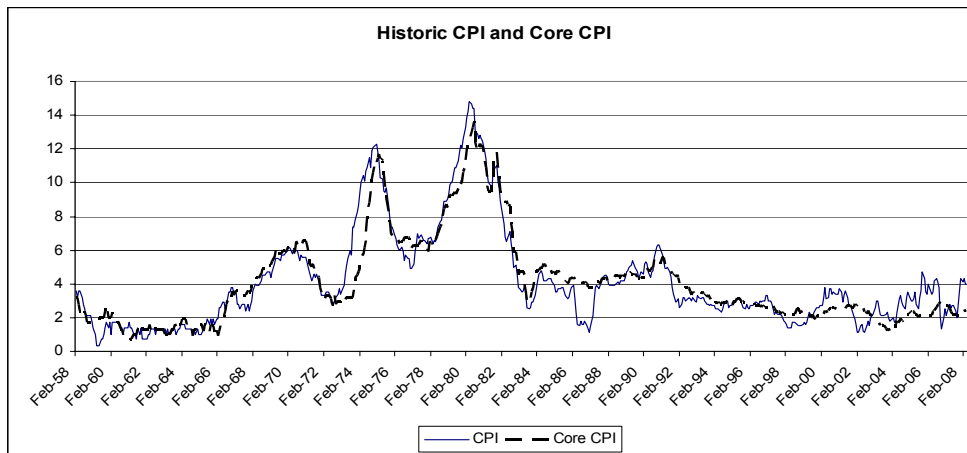


Introduction:

While this topic may at first seem inconsistent with our bottom up style, we believe it's important to be able to identify and understand a secular trend that the market may not be recognizing, one that could contribute to strong investment performance and benefit our clients. The topic of inflation has begun to weigh on many investors' minds. Articles on this topic are beginning to surface in the media with increasing frequency. It is an issue that is hard to ignore as perhaps that most visible of all price points, gasoline, which is displayed with four foot two high numbers on every street corner, seems to rise every day. How can this not be inflationary? There are opposing views, however, on whether or not inflation is indeed an issue and volumes could be written to debate each side of the argument. It essentially boils down to whether or not you believe the published statistics. If you do, inflation is not a big concern. If you don't, it is. Although it appears to have become the more mainstream view, the argument for inflation seems to hold water, and it is this side of the argument that will be focused on. We'll have a look at some evidence that would indicate that inflation is more of an issue than what has been published in the official numbers and then discuss investment strategies that will best position us to handle this type of an environment. For purposes of this paper, we will focus on the U.S. as it has such broad-based global impact.

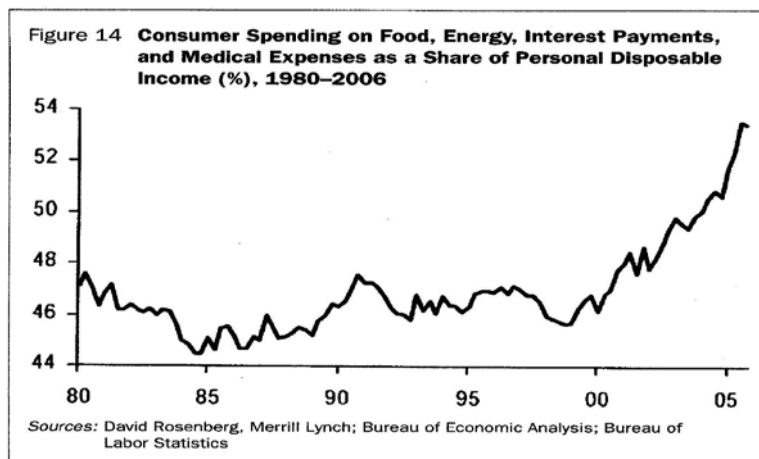
Inflation:

Starting with the basics: inflation is the rise in the general level of prices over time. A bit of inflation is generally perceived as being good for the economy. It is thought to force business and consumers to make purchases sooner rather than later as prices are expected to rise. It helps to encourage spending and borrowing and keeps an economy active. Inflation is measured by the percentage rate of change of a price index. The most common price index is known as the Consumer Price Index or CPI. Each month, the Bureau of Labor Statistics in the U.S. gathers 84,000 prices in about 200 categories to form the CPI. The categories are weighted according to an estimate of what the average American spends. The following chart shows what inflation, as measured by the CPI, has looked like over the period 1958 to 2008.



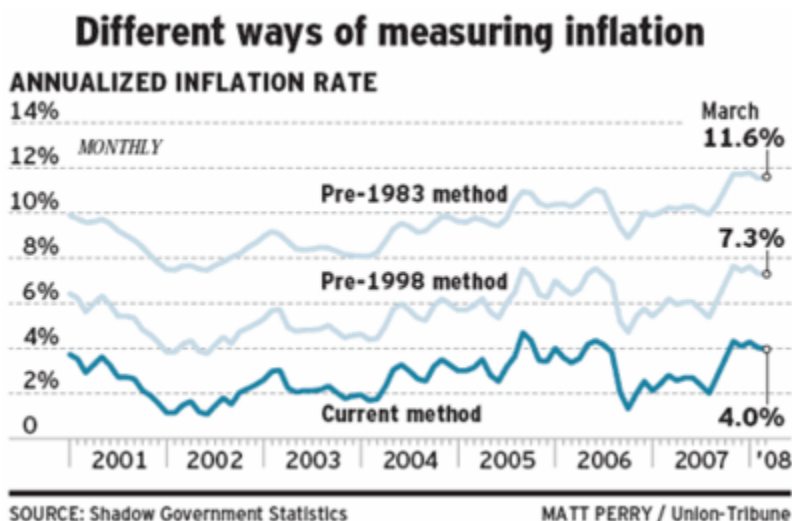
The CPI is currently only slightly above its long term average (of 4%) and nowhere near the inflation highs that were reached back in the '70s, but, at 4%, CPI has increased significantly during the past year or so from the 2% range. This would indicate that the economy has experienced inflationary pressure. Also included on this chart is Core CPI, which excludes the price behaviour of both energy and food from the CPI calculation, as these items are deemed too volatile and tend to cloud the picture of how overall prices are behaving in the economy. CPI, ex food and energy, currently sits at 2.3% and basically hasn't moved in 10 years. If one were to rely on this figure, they would conclude that inflation is not an issue.

A significant source of tension in the inflation debate arises when we consider these core and non-core rates of inflation. These figures are constantly debated by various pundits. Food and gasoline are two things that people would have trouble living without. To remove these items from the inflation calculation because of their "volatility" seems ridiculous. It's as though we publicly reported performance numbers that indicate that we beat the market, but only because we removed the performance of any stocks that hurt our relative performance from the calculation. The pundits may go back and forth on this but we believe the chart below more accurately depicts just what kind of a role these products play in an American's actual, everyday spending.



The issue between core and non-core becomes even more nonsensical when we consider that the last inflationary spiral that began in the early 70's was triggered by at least two shocks. The first, incredible as it may seem, was the collapse of the Peruvian anchovy fishery in 1972. This was a major source of fertilizer for the world and its collapse resulted in a series of secondary shocks to agricultural production, particularly in Latin America. The second shock was the success of OPEC in constraining the worldwide supply of oil. Food and energy triggered this inflationary spiral; from a practical perspective, it's nonsensical to exclude them.

Aside from the core vs. non-core debate, the issue that many have with the published inflation numbers is that they feel they are inaccurate, not comparable year-over-year and, perhaps, have been manipulated. Changes made to how the CPI is calculated over the years have dramatically altered what the rate is now and what it would have been had the calculation methodology remained the same. The following chart helps to illustrate this phenomenon.



While the source of this chart may sound a little “conspiracy theory’ish”, there are some valid points to take away from their argument. Changes to how CPI was calculated were made during the late Carter and early Reagan administrations. Of particular note, however, were the changes that were made during the Clinton administration, which have had the greatest effect. There are many reasons why the U.S. government doesn’t want high inflation, but the one that may have the most direct impact is that social security, medicare, and government salaries are all linked to this rate. The higher the inflation rate, the more the government has to pay out. In the early 90s, the inflation rate, as measured by the CPI, was ticking up into the 6% range. This meant that each year, social security cheques, for instance, were increasing by 6%. To rein this in and help control the U.S. federal budget deficit, it was decided that a change in how this CPI figure was calculated was required. Note the sudden drop in CPI during the early 90s from the historical chart on page 2. The changes worked. Funnily enough, one of the central figures behind this decision to change the calculation was none other than Alan Greenspan. Since one of the U.S. Federal Reserve Bank’s most important priorities, arguably their most important priority, is controlling

inflation, this worked to their advantage; at least, it appeared to work to their advantage at the time.

Two notable changes were made to how CPI was calculated. Historically, CPI was measured using a fixed basket of goods. The identical basket of goods would be priced at prevailing market costs for each period, and the period to period changes in the cost of that market basket represented the rate of inflation. The new method introduced in the early 90s allowed substitution. For instance, when steak got too expensive, it was surmised that the consumer would substitute hamburger for the steak, and therefore, the inflation measure should reflect the costs tied to buying the hamburger versus steak, not steak versus steak. Sure, this dropped the inflation rate, but also represented a decline in quality of living. The consumer had been priced out of steak. The old system told you how much you had to increase your income to keep buying steak. The new system only promised you hamburger.

The second change involved a switch from an arithmetically weighted average price calculation to a geometrically weighted average price. This automatically gave a lower weighting to CPI components that were rising in price, and a higher weighting to those items dropping in price, immediately reducing CPI on an annual year over year basis by 2.7%. To quickly illustrate this mathematical wonder, we'll pretend we have 3 equally weighted items in our basket. Item 1 increases in price by 33%, Item 2 by 10% and Item 3 by 5%. The arithmetic weighted average of these items is 16% $((33+10+5)/3)$. If we calculate the geometric average, we find an average increase of only 11.8% $((33*10*5)^{(1/3)})$. Perhaps this was a more mathematically accurate assessment, but at the very least, it was again an inconsistent measure and one that, coincidentally, served the interests of the government of the day.

There is much more to this discussion but I think it goes beyond the scope of what we're trying to accomplish here. Evidence suggests that the inflation rate that is being reported is very likely lower than the actual inflation rate that people are feeling. There are two ways that this can play out going forward. Things may carry on as is and the published figures never really show that inflation is an issue. Or, things don't carry on, and the published figures begin to reflect a more inflationary environment. Either way, whether it's reported officially or not, it is safe to say that inflation is having an effect on the economy. Given this outlook, it is in our clients' interests to consider inflation in our investment strategy.

Answer the question: what does well in an inflationary environment?

Investing with Inflation:

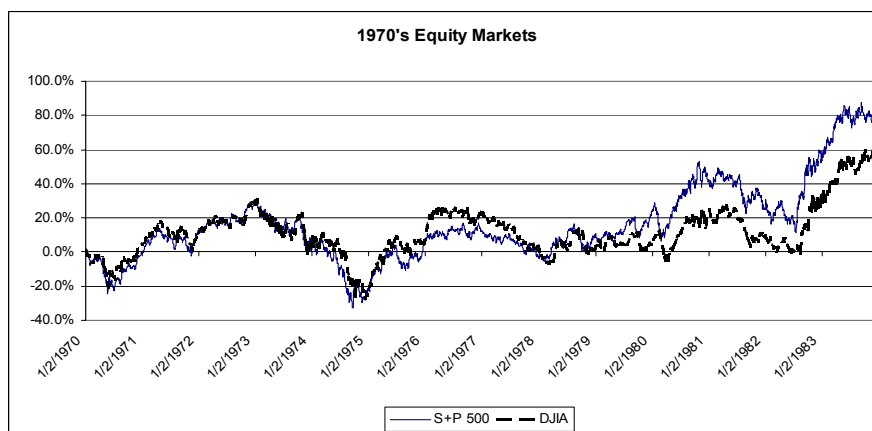
We'll start with a more macro outlook and then focus on specifics. The best period to look at and examine how markets behave during inflationary times is the 1970s. The chart below shows two significant spikes that occurred during that time. Some similarities exist between now and then, like record high oil prices. The difference however, according to David Rosenberg, is that inflation was tough to beat in the 70s because wages were increasing along with the general price level, which helped to perpetuate the spiral. This time around, wages are not increasing and therefore the current inflationary pressures are

not seen as have such an impact on the overall economy. Nevertheless, we'll carry on with the comparison.



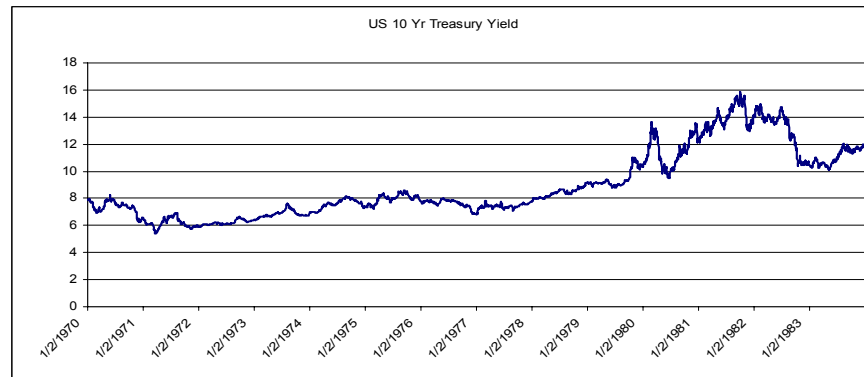
For us, we believe the key take-away from this comparison is that stocks slid through the inflationary times of the 70s quite nicely. The following chart shows the two US indices, and, when all was said and done, both were above the level from which they started. We see that the first inflationary spike through '73 and '74 wasn't kind to the stock market, but from there on, not a lot of pain was felt by equity investors. Some feel the logic behind this behaviour is that equity investors don't like uncertainty (who does?). The first inflationary spike in '73 took the equity folk by surprise, but once they wrapped their collective heads around the environment that they were in, the uncertainty vanished and markets marched upwards.

To put this into today's context, while many feel that inflation numbers are understated, it may not be until the reported CPI figures start to rise significantly that the majority of investors will actually believe this to be the case. They will be surprised, as they were in '73 and '74, and the equity markets could take a hit. In general though, equities aren't a bad bet in inflationary times.



Where you don't want to be is in the fixed income market, particularly when the Fed begins to fight inflation. This will be particularly true if the published numbers, which the Fed relies upon, begin to reflect what the folks at Shadow Government Statistics are professing. The Paul Volker Fed was credited for finally eradicating inflation from the system in the

early 80s by jacking the Fed Funds rate into the mid/high teens. The follow-on effect to this massive liquidity squeeze was that US 10 year treasury yields skyrocketed from mid single digits into the mid teens. Remember, yield up, price down. This was incredibly painful for fixed income investors.



The primary tool that the Fed has to fight inflation is the Fed Funds Rate. To fight inflation they move the Fed Funds Rate up, removing liquidity from the system. The Fed Funds Rate is essentially the rate at which banks are able to borrow money from the Federal Reserve. Borrowing slows as finance costs increase, which in turn slows spending, and eventually the entire economy. Prices in the economy eventually decline as higher priced items are substituted or replaced by cheaper goods: a cleansing of sorts.

Typically, the yield curve over the maturity spectrum tilts up as you move out to longer maturity dates. This implies a yield spread between the short term, medium term, and long term as investors are compensated for taking on the added risk of investing for a longer period of time. When the Fed increases rates at the “short” end of the curve, rates typically must rise at the longer end of the curve, which is exactly what happened in the early 1980s, as the inflation war was in full effect.

A similar scenario could emerge in today’s environment. If inflation begins to hit the published statistics in a more dramatic fashion, the Fed’s primary combat weapon is the Fed Funds Rate. Increasing the FFR to fight inflation will have a negative effect on the fixed income market, and yields in general. The pain will not just be felt by the bond market as any investment that pays a yield will be negatively affected if and when the Fed starts to lift rates. Three examples that come to mind are Income Trusts, REITs, and Preferred Shares. Holding all else constant, if a short term bond currently yields 2%, a mid term bond 5%, and an income trust 8%, and the bank rate is increased by 2%, the short term bond is going to yield 4% (+2%), the mid term bond 7%(+2%) and the income trust 10% (+2%) as the spreads are maintained. Essentially, if the implied spread that weaves its way through these yield bearing products is going to remain the same, and the yield on some of the securities increases, holding all else constant, the yield on all investment vehicles must increase as well. Again, these interest sensitive securities are most likely to be hit if inflation begins to really hit the published stats, as it is only then that we are likely to see the Fed take significant action.

Growth stocks are another group that will be negatively impacted by rising rates. These stocks typically trade on what their earnings are going to be. These earnings are discounted back to come up with an appropriate value for the company. When rates rise to fight inflation, that discount rate will also rise as investors expect a higher return – thus, decreasing the present value of the entity and causing the stocks to suffer.

Insurance companies are unlikely to weather an inflationary environment very well either, under this scenario. Property and casualty firms will be hit by higher insurance claims and their profitability will be damaged. Additionally, all insurance companies have sizeable bond portfolios and we saw what happens to yields above. This being said, as these bonds mature, they will be reinvested at higher rates; therefore, many of the insurers may welcome a rising rate environment as their portfolios may be positioned for such an occurrence.

Companies that face tough competition and are subject to inflationary pressures (ie. higher costs) are also a bad bet. Because of the tough competition, it is unlikely that they will be able to pass along the higher costs to their customers. Cascades is a company that is experiencing this dynamic right now. Their input prices are increasing more than they are able to pass along. In general, industrial/manufacturing companies who produce a commodity like product generally fit into this category.

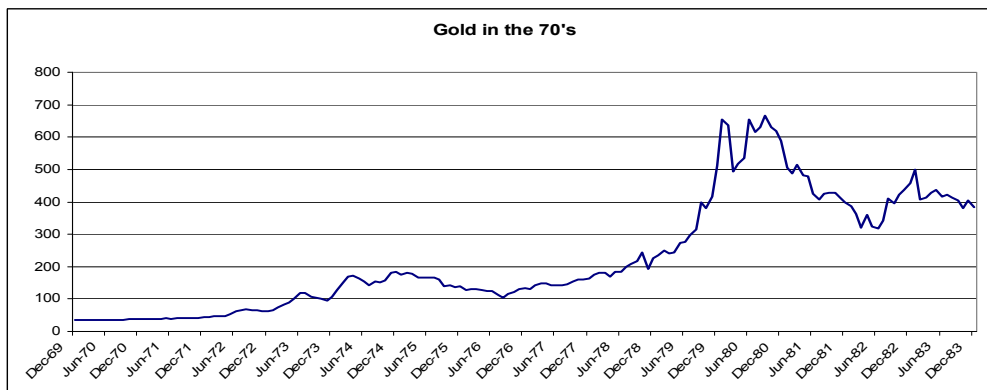
Whether or not inflation hits the published stats or not, there are areas of the market that tend to benefit: those who produce the things that are causing inflation. Right now, that would be oil, food, and metals. These points are summarized by the following table, which was put together by the Chief Investment Strategist at Standard and Poor's. He analyzed eight periods since 1969 when inflation accelerated and moved above 4%. During these periods of time, the S+P 500 lost on average of 1%, but there were some clear winners and losers.

Winners and Losers During Periods of Rising Inflation

High Avg. % Change and Freq. of Market Outperformance	Low Avg. % Change and Freq. of Market Outperformance
Aluminum	Airlines
Containers (Metal & Glass)	Auto Parts & Equipment
Foods	Automobiles
Gold & Precious Metals Mining	Computers (Hardware)
Metals Mining	Consumer Finance
Natural Gas	Electric Companies
Oil & Gas (Drilling & Equipment)	Household Furnishings & Appliances
Oil (Domestic Integrated)	Retail (Department Stores)
Oil (International Integrated)	Truckers
Tobacco	Trucks & Parts

Source: Standard & Poor's

Energy was the best sector during high inflation, gaining an average of 24%, followed by materials and telecommunications services, which posted average advances of 12% and 10%, respectively. Gold shows up on the “Winners” side of the chart and I’ve added in the price chart for this commodity during the 70s.



The biggest loser has been the financial sector, underperforming the market 75% of the time during high inflation and posting an 8% average decline. Insurance companies were mentioned above, but as lending slows due to higher finance costs, banks are likely to suffer. Consumer discretionary stocks underperformed 62% of the time with an average loss of 6%.

Conclusion:

There is reason to believe that inflation is at best around the 4% level in the U.S. Incidentally, this pales in comparison to the inflation rate of 8.5% currently being experienced in China, but is still nearly double the level experienced during the past 10 years. Because of the inconsistencies in CPI calculation noted earlier in the paper, the inflation picture in the U.S. may be much worse.

The Canadian market should do better than most in an inflationary world due to its heavy exposure to Energy and Materials stocks, which historically have done well under such conditions. The fact that Canada is one of the top performing markets in the world to this point of 2008 is probably not a coincidence given these heavy exposures.

Sionna's portfolios are well positioned with an underweight exposure to financials, which don't react well to inflation, and overweight exposure (ex cash) to materials and energy. A bigger bet on gold may be warranted if inflationary pressures continue, but it is a tough argument to make given company valuations. Additionally, we have been, and may continue to be hurt by a lack of exposure to agriculture and food. Again, a similar problem exists with food as with the gold stocks. Value just doesn't exist and ultimately, our investment decisions are driven by value and not top-down macro calls.

While this report has covered a mere pittance of the entire picture and touches on only one side of the inflation argument, there is enough evidence to support a portfolio strategy that continues to be cognizant of the impact of inflation on the North American economy in the coming months.