

## Trident Investment Management, LLC Opportunities Funds Commentary

December 31, 2009

### Performance Discussion

November and December brought to a close what can only be described as a tumultuous year for the financial markets. Equity markets continued their run upwards with the S&P 500 being up 5.7% and 1.8% in November and December respectively, the MSCI Europe Index up 0.8% and 6.1% and the Nikkei down 6.9% and up 12.9%. Fixed-income markets sold off with the 10 year Treasury yield in the U.S. rising 0.5% over the period to end at 3.8%. Credit continued to tighten with the Investment Grade (spread) index tightening to a 0.9%, a record low for the year. Commodities which powered the rally in markets over most of the year sold off dramatically in December with gold in particular falling 7% on the month to end at \$1,096.20 an ounce. The U.S. dollar rallied in December as well, with the U.S. Dollar Index appreciating 4% on the month (all figures in U.S. dollars).

Our funds experienced a difficult two month period. We performed well in November, but gave all that back and more in December, which left us down slightly for the year. We suffered in our credit book which continued to tighten to multi-year lows and on our gold exposure, which hurt us, especially in December. Our short positions in the U.S. dollar also detracted from performance. Our yield curve bets in the U.S. were the primary offset to our losses, but did not contribute enough to salvage our overall performance. While the curve steepened to record levels on the spot market, the forward rates did not move as much as the spot levels. As such, our longer-dated options struck off the forward rates had relatively muted returns.

#### 1. An Analysis of 2009

2009 proved a frustrating year for us and our funds. On the one hand, global economies remained relatively weak despite the rosy pronouncements of analysts. On the other hand, the equity and credit instruments of the most economically sensitive companies had one of the strongest years in recent history. Fiscal deficits in the developed world rose to record levels that would make a banana republic of yore blush, but yields on sovereign debt instruments hit generational lows thanks to government monetization of debt. In fact, governments in 2009 intervened in numerous areas of the economy in a manner almost unseen since the 1940s. As such, 2009 can be characterized as a year where perception and public intervention trumped reality and free markets.

Successful investing in 2009 required a willingness to suspend belief about reality to focus on the psychology of what the markets believed was going to happen. Moreover, one had to also take the chance that any change in sentiment that resulted in market corrections would be limited by government intervention. Put differently, one had to believe in an alternate reality and an omnipotent government, both of which were recipes for disaster in 2007 and 2008. In 2006 the same gap opened up between perception and reality albeit driven by different underlying causes. The memory of what followed has remained all too fresh in our minds, though perhaps not in the market's.

As we entered 2009, we were positioned for a significant breakdown in the U.S. and the global economies. To reflect this view, we had positions in short-dated fixed income instruments in Europe, the U.K. and Australia. We also had large short credit positions expecting numerous leveraged corporate players to suffer significant distress. In equities, we were net short with short positions in consumer stocks and selected financials, offset to some degree by longs in gold and gold stocks. Also, we anticipated a huge increase in U.S. government debt and were short the U.S. 10-year, primarily through 2-year-10 year curve steepener options.

The first three months in 2009 went much as we expected. The U.S. government's weak economic team and lack of any real plan to fix the banking system were perceived negatively by markets which led to both plunging equity prices and widening credit spreads. The situation, or at least the market perception of the same, changed in late March when the Federal Reserve committed to quantitative easing on a huge scale, followed shortly after by changes in the rules that permitted the banking system to hide losses by the suspension of the mark-to-market accounting rules. We anticipated that these actions might trigger some improved sentiment and possibly a market re-rating upwards, and so moved in late March to being net long in

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equities, and cut some of our more high-beta short positions, even as we initiated numerous long positions especially in commodity-oriented equities. We significantly boosted our outright longs in commodities and in particular gold, anticipating that the Fed's monetization of debt would result in a major revaluation of the metal. We trimmed some of our shorts in credit as well but retained the bulk of our position believing that the Fed's actions were unlikely to improve the credit outlook dramatically. Our adjustments initially worked as anticipated. Equities rallied and we were able to capture some of the gains. The yield curve steepened and helped performance. While credit tightened, this move was consistent with the marginal real economic improvement that we had expected.

Starting in August 2009 the correlations we had anticipated between various markets broke down. In particular, the 10-year U.S. Treasury rallied dramatically with yields falling from almost 4% to less than 3.25% in September. The Treasury yield curve flattened significantly suggesting either that the Fed would soon raise rates, or that the U.S. economy would get much weaker. Despite these signals from the U.S. bond market and continued evidence of an anemic overall economy, the credit and equity markets continued to rally suggesting a boom was in the offing. The only reasonable explanation that can be offered for the simultaneous rally in bonds, stocks and credit would be that of liquidity – an avalanche of money chasing paper assets. Unfortunately, the evidence for such a flood of private money, especially in the Treasury market, is sketchy at best. An analysis of the purchases of Treasuries by various buyers in 2009 suggests that almost \$600 billion (or more than 30%) of issued Treasuries were bought by the so-called “households” category which represents a catch-all grouping for buyers who cannot be identified. It is entirely possible that the Fed itself may have engineered these purchases outside the limits it set in its quantitative easing mandate.

The rampant liquidity in the markets in the second half of 2009 created significant losses in credit for us, in positions where we had felt that the spreads were already too tight given the economic circumstances. Our credit losses were partially mitigated by gains we had in equities and commodities. Our curve steepeners also helped performance, thanks to the dramatic rally in U.S. 10-year yields from May, but not nearly as much as we had anticipated. The continued stability, if not strength of the U.S. dollar, in turn meant that many of our currency options where we were short the U.S. dollar decayed in time value. The result of all this was that our portfolio was virtually flat on a gross basis and slightly down after fees.

We are not proud about our 2009 results, especially when they are juxtaposed with what are record equity and credit market rallies. Yet, it should be noted that even with the moves of 2009 the equity markets are nowhere near where they started in 2008. The credit markets are still slightly wider than the start of 2008, though numerous credits have now managed to tighten beyond 2008 levels, and some even to all-time tight spreads. Economic reality today is only marginally better than what it was at the start of 2009. Yet, governments have expended most if not all their resources already, even as most of the underlying problems remain and bullish sentiment is at record levels.

Our investment philosophy is to exploit opportunities where we see low risk and considerable relative upside. For the last few months, we have believed that the risks to the perennially bullish, market-consensus view were huge, even as the upside from the same was limited. Unfortunately, markets have demonstrated that they can continue to go up just on momentum and hope, much as they did in 2006. We feel strongly that we are in a bubble again today, much as we were then. The reckoning that came in 2007 and 2008 was painful and we believe that a similar cathartic adjustment is highly likely in 2010. And if there is one thing that we are most surprised about is that we can be writing about another bubble just nine months after the last bankrupted the global financial system – the consequences of a new blow-up are almost too painful to contemplate.

**2. The Global Situation in 2010**

We entered the crisis of 2007-2008 with some significant economic imbalances. The U.S. economy was the world's largest consumer by far, with China being the largest producer for export. The U.S. consumer's income was dependent largely on his ability to monetize the continued appreciation of the real estate he owned. A combination of extremely easy credit conditions and a real estate bubble permitted him to both lever up on real estate and extract the equity arising from price increases for consumption. While incomes did not grow rapidly, the U.S. job market remained strong with most of the jobs coming from sectors catering to the consumer such as real estate, mortgage finance and retailing. The U.S.' insatiable appetite for consumer goods was met primarily by the developing world and Japan, with China in particular being the producer of choice. The Chinese growth miracle of the last several years was largely predicated on the continued strength of its export industries, and its biggest customer by far was and still remains the U.S. The rest of Asia also largely adopted or

continued with a growth model geared to U.S. exports, so that the U.S. consumer could reasonably have been viewed as the locomotive powering world growth. The imbalances were compounded by the fact that China and some of the South East Asian countries adopted mercantilist exchange rate policies designed to keep their currencies weak with reserve accumulation in the face of capital inflows to ensure that their exports remained unaffected. China in this regard has been among the worst offenders, having accumulated over \$2 trillion in foreign reserves. The net result of all this was that the U.S. ran a large trade deficit for several years, even as the U.S. tradeable (manufacturing) goods sector shrunk as a percentage of the overall economy. The decline in U.S. manufacturing led, in turn, to a significant increase in global, and especially Chinese, manufacturing capacity.

A major characteristic of the U.S. consumer/Asian producer model is that it fosters much greater global economic interdependence. The housing and credit crises of 2007-2008 had seismic effects on the U.S. economy and in particular, the U.S. consumer who saw both a dramatic decline in housing wealth and savings, along with higher unemployment. The effect of consumer distress was felt in U.S. imports and thus on the exports of its major trading partners, several of whom saw major recessions that were in many cases worse than that suffered by the U.S. That is, with global trade being as unbalanced as it is, the U.S. problem was amplified into a synchronized global economic recession.

In dealing with the crisis, policymakers had an important set of choices to make: whether to resurrect the existing U.S. consumer-led, unipolar model for global growth which was already proving difficult to control, or try to force a global realignment of economic priorities so that a more stable multi-polar model with additional growth engines could be created. Unfortunately, the measures undertaken to deal with the crisis have reinforced the unipolar model rather than change it. Let us consider the policies in some detail.

The U.S. responded to the events of 2007-2008 by acting aggressively to support its financial system which was almost irretrievably crippled by the crisis. The support was provided by the government either directly taking on or guaranteeing the bulk of the bad assets in the financial system, while providing it ample, low cost funding. The government also took additional steps to stabilize home prices and consumption. Specifically, the U.S., acting through the Federal Housing Administration, Ginnie Mae and the Fed, now supports over 80% of all activity in the mortgage market. It moved to extend emergency unemployment benefits to long-term displaced workers – in fact, with current legislation being contemplated, the unemployed may receive up to 97 weeks of benefits. The government also introduced a Cash-for-Clunkers scheme to boost auto sales. And in an unusual twist, the U.S. is undertaking a massive overhaul of the healthcare system that is sure to involve additional expenditures.

The thrust of U.S. policy has been to boost asset prices, leverage and consumption. There has been little attempt to redress the fundamental imbalances that characterize the economy, especially to boost savings or reduce dependence on imports. The nation however is already laboring with a gargantuan debt level. The ratio of total debt (public and private) to GDP is over 370%, and if the costs of Medicare, Medicaid and Social Security are factored in correctly, these numbers balloon to over 700%. The huge fiscal deficits engendered by the government's emergency measures cannot be funded easily by the capital markets – the U.S. in 2010 will issue close to \$3 trillion in total new public and private sector debt. The only guaranteed route to placing these huge amounts of debt without dramatic increases in interest rates would be with outright monetization.

China has responded to the global economic crisis with credit creation at an almost unimaginable scale. Total new bank credit created in 2009 alone was over 30% of GDP, a record for any economy. Moreover, the credit extension was engendered by fiat – banks were set numerical targets for loan growth with scant attention being paid to the quality of loans made. The corporate borrowers who were the primary recipients of the loans have used the additional funds either to build new capacity in a country that is already awash in it, or to speculate on asset prices. The Chinese by their actions have bought themselves time (at what will eventually be seen as an unacceptably high cost) to ride out the global economic slowdown until the developed world recovers. Their logic is unassailable from the domestic perspective because a dramatic recession in China will almost certainly threaten its political stability. Unfortunately, the additional investment by the country is going to add to excess capacity in a world that is already short of solvent consumers. Moreover, the Chinese have resisted any revaluation of their currency because it would be sharply at odds with their whole approach to dealing with the recent crisis. The simple fact is that Chinese policymakers view the current conditions in their export markets as a classic recession that will soon pass – a longer-term evaluation of their growth model does not even appear to be on the cards.

The Japanese economy was as badly affected as China's after the recent global crisis. However, the country does not have the same fiscal flexibility as China to force a credit boom, and, given the Japanese experience from the late 1980s, it is unlikely that the country would try to even if it did. Moreover, unlike China, Japan has seen its currency appreciate steadily over the last several years, worsening the environment for its capable export sector. The latter however, has still ended up representing over 70% of Japanese GDP growth since 2001. The saving grace perhaps is that the country has not moved to add capacity in its export sector as China is doing today. Japan is now facing an unenviable set of policy choices – any attempt to boost domestic growth with government expenditures will worsen the country's already dire sovereign fiscal situation, while a move to devalue the yen could well backfire if bond yields rise and make the current huge level of sovereign debt unserviceable. The obvious solution to this problem again is to monetize its domestic debt aggressively. Any decline in the yen with such a policy would keep rates low, but would serve to boost Japan's international competitiveness and domestic inflation, both of which would be positive outcomes for the country. Unfortunately, a resurgent Japanese export machine is the last thing the world needs today.

The only major region of the world that is unwilling to monetize aggressively is the Euro zone. The European Union, and especially Germany, has had a legacy of hyperinflation and as such, the institutions set up in the region such as the European Central Bank, do not have a growth mandate nor do they have the ability for outright money printing. Unfortunately, the implications of this are not pleasant for Europe. In a world where monetary responsibility has been abandoned almost everywhere, Europe has to deal with the prospect of a substantial growth slowdown coupled with currency appreciation. Moreover, the region does not have a national government that can boost consumption to address the problem of global capacity. In fact, the Euro bloc does not even have a simple framework to provide support for its peripheral members such as Greece and Spain which face recessionary domestic economic conditions.

The one thing that should be very clear from our analysis is that with the policies being followed globally, we are not on a sustainable trajectory for stable growth. Even worse, it seems unlikely that the markets on their own, can generate any outcome that will result in stability without extreme global pain. The U.S. needs very low rates while issuing record amounts of debt to revive its moribund consumer and housing market. This will require monetization on a grand scale since the markets are simply not large enough to absorb such huge issues of debt. The Chinese, with their peg to the U.S. dollar, have responded to U.S. monetization with credit and capacity creation and show no signs of changing these policies. Japan appears to be on the verge of a new cycle of money-printing. And the Europeans are likely to suffer most from the profligate actions of their trading partners.

In sum, our sobering conclusion is that we have not put the crisis of 2007-2008 behind us. Policymakers are responding to a global “balance sheet recession” caused by too much leverage and over-consumption by trying to encourage much more of the same behavior almost everywhere, and creating more capacity at the same time. In the short run, they have managed to postpone the full reckoning. But since their measures have yet to address the fundamental problems that ail the world, the real question is what the postponement of the ultimate adjustment (which is coming at colossal cost) is going to serve. The longer the postponement, the more likely it is that we will lurch into an even bigger crisis eventually. As things stand, we expect a sequence of mini-crises, if not a full-blown one, to start in 2010 with the final result very likely being a fundamental change in the nature of corporate, crony capitalism that has characterized the U.S. in particular over the last several years.

### 3. Market Opportunities for 2010

Most market participants today are of the opinion that things are back to normal globally, thanks to China and Fed chairman Ben Bernanke, and that an economic boom is actually possible. Asset prices reflect such an outcome. We believe that there is considerably more risk in the markets and that there is high probability (over 50%) for crisis. A range of potential crisis outcomes could occur but given the optimism in market pricing we can position to profit significantly from most of these scenarios while taking relatively little risk.

There are four possible economic outcomes we foresee, all of which result from the problems with the various regions of the world discussed above coming to a head. The scenarios are not mutually exclusive and differ primarily in terms of where and how the problems begin and progress. We consider these scenarios below in greater detail and then take up the market implications and how we expect to profit.

#### a) *The Goldilocks Resolution*

This “benign” resolution is perhaps the one that will get us closest to a true fix of the current global situation. In this scenario, all

parties make the proper domestic and exchange rate adjustments to allow for longer-term economic stability. Specifically, the U.S. dollar would be allowed to depreciate 20% or more against its trading partners, including China. The U.S. would accept the fact that unbounded debt issuance with monetization is not acceptable and the Fed would end its quantitative easing and backdoor supports for the banking system. The U.S.' trading partners would move to boost domestic consumption at the expense of their exports while increasing their imports from the U.S. A global recession under these circumstances would be almost certain, but could be partly mitigated by aggressive fiscal policy which would lead to higher global interest rates because monetization in this context would simply be too risky, especially for the U.S. The world would thus be weaned off the drug of cheap and plentiful leverage – the focus would be on generating sustainable growth with the near-term attendant pain being inevitable.

The problem with this scenario is that it is politically not possible to implement barring a major crisis. The simple fact is that while the measures described here might be ultimately beneficial, they will be extremely painful in the short run. Moreover, they will require abandoning domestic priorities for the greater international good, something that most politicians simply cannot do given electoral considerations.

Even in this relatively benign scenario where the pain of adjustment is shared globally, there are some very obvious market implications. First, the U.S. dollar will have to depreciate significantly. Next, the U.S. consumer has to undergo further retrenchment and U.S. rates have to rise. Since leverage will no longer be cheap and growth will be weak, the credit markets will suffer especially given the current euphoric pricing we observe. Finally, countries with solid sovereign fiscal positions such as Australia will be rewarded with relatively lower borrowing costs. Our funds are positioned to profit from all of these outcomes since we are short the U.S. dollar, especially against the Chinese Renminbi. We are also short consumer stocks and credit overall. Finally we are long sovereign fixed income in Australia and selected other regions where fiscal discipline exists.

*b) US Stagflation with a Dollar Crisis*

This outcome could be precipitated if the U.S. Treasury is unable to place its bonds at reasonable rate levels. A few failing bond auctions with sharply higher bond yields could force the Fed into more drastic monetization, triggering a disorderly drop in the U.S. dollar. The consequences of a sharply weaker dollar would be higher inflation which in turn would result in higher bond yields, requiring further monetization. If this loop were to continue we could end up with U.S. hyperinflation. Unfortunately, the rest of the world in this situation has few palatable choices. They can accept sharply lower exports to the U.S. and much weaker growth, and mitigate these effects somewhat with fiscal policy. Or they could respond to U.S. monetization with monetization of their own, so we enter a global race to devalue paper money. In either case, we will have weak global growth with high U.S. inflation.

In this situation, we believe gold will rise to over \$2,000 an ounce. Also, the Treasury market is likely to be relatively weak and this despite an anemic U.S. consumer. Finally, the financial system is likely to be under significant duress because such environments typically lead to an exodus of deposits towards current consumption. Our portfolios are long gold and short U.S. treasuries through curve steepeners. We expect both these to be significant performers for us in this situation. We also believe that our long fixed income positions outside the U.S. will perform in this case, given that stagflation in the U.S. should mean weak growth overseas.

*c) Global Deflation with a China meltdown*

The officially sanctioned Chinese bubble is arguably creating bad loans at a frenetic pace. Examples abound of completely empty skyscrapers in secondary Chinese cities, and factories which lose money even on a marginal cost basis from the first day of operation. Several policymakers within China are beginning to express concern about the scale of credit extension. Unfortunately, any attempt to rein in credit in China could trigger a wholesale collapse in the investment bubble there. This in turn could result in much weaker Chinese growth and even more global excess capacity. Given the fragile state of the global economy, this could easily plunge the world into a synchronized recession which will very likely lead to deflation. This will truly be a painful world where growth is nowhere to be found.

In this case, we would expect sovereign fixed income to rally dramatically the world over, with risky assets such as higher yielding credits and equities suffering. Such an eventuality could trigger more monetization though it is unlikely to have much effect, as in Japan. We expect our short credit positions and our long sovereign debt positions to power performance in this situation.

*d) A Japanese Debt Crisis*

In some ways, this scenario is the most difficult to analyze. Japan’s debt is already reaching crisis proportions. If the country suddenly faced higher interest rates, the collapse in the debt market that might result would almost certainly force the government into a program of monetizing issuance. Were this action to trigger a significant fall in the yen, there is no doubt that Japan’s export sector would benefit at the expense of those in China and Europe. Even better for Japan, its foreign debt holdings would rise in value, while it experienced higher domestic inflation – both ultimately positive for the country. Unfortunately, however, a Japanese problem would force dramatic action in the rest of the world. It would increase the pressure on its export partners to monetize faster, or barring that, living with a deflationary outcome. But, one thing is virtually certain. A Japanese crisis cannot be “contained” any more than the US subprime crisis could be given the size of the country’s economy.

As far as markets go, a Japanese problem could well be the most difficult. A crisis starting here would unambiguously help some of our longs such as gold and possibly sovereign fixed income in the best managed countries such as Australia. It should also lead to a bout of global risk aversion, which should help our short positions in credit.

It is hard to believe that we are in the midst of a new market bubble such a short time after the virtual collapse of the global financial system. We are back today in an environment that is eerily similar to what existed in 2006, with even more fundamental problems and less in the way of resources to deal with them. We feel a lot like weatherman Phil (played by Bill Murray) in the movie Groundhog Day who was forced to live through the same day over and over again. Fortunately, we find no shortage of opportunity today – the major question we are wrestling with is not whether markets will reflect reality, but how quickly they will in the face of policymaker efforts to prevent the same.

**Performance Summary at December 31, 2009**

**Trident Global Opportunities Fund**

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	10 Yr.	YTD	Since Inception (Feb. '01)
-3.0%	-0.4%	-4.9%	-3.7%	17.6%	37.8%	22.6%	N/A	-3.7%	13.5%

**CI Global Opportunities Fund**

1 Mth.	3 Mth.	6 Mth.	1 Yr.	2 Yr.	3 Yr.	5 Yr.	10 Yr.	YTD	Since Inception (Mar. '95)
-3.0%	-0.5%	-4.2%	-3.8%	17.1%	42.1%	23.0%	8.5%	-3.8%	20.5%

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