

Trident Investment Management, LLC Opportunities Funds Commentary July 31, 2009

Performance Discussion

Global equity markets continued their march upwards in July after the June hiatus. They started the month weakly, but reversed to end up significantly. The S&P 500 Index was up 7.4%, the MSCI Europe Index was up 9.2% and the Nikkei up 4.0%. Commodities were mixed. Gold rallied to end the month up 3.0% at \$954 and ounce, while oil was largely unchanged at \$71 a barrel. The U.S. yield curve and the 10-year rates were virtually unchanged. The U.S. dollar weakened marginally with the U.S. Dollar Index depreciating 2.2%. Credit spreads tightened significantly with the euphoria in equities (all figures in U.S. dollars).

Our funds suffered in July with the majority of our losses coming from our short positions in credit. The belief in the U.S. recovery has caused credit spreads to tighten to pre-credit-crisis and pre-recession levels, a move that we believe is entirely irrational given the challenging conditions faced by most companies. We also suffered from our equity shorts in consumer sensitive stocks, all of which rallied even as our gold and commodity-focused longs remained largely unchanged. Our fixed-income positions did not affect our performance materially this month.

We have made few, if any changes to our portfolio on the month. We continue to believe that the news is far worse than markets appreciate and that a number of problems are likely to come into focus over the rest of the year. We continue to have ample ammunition to add to our positions. The moves over the last few months have provided us with even better entry points for our best ideas and we expect to be adding to our core holdings over the next several weeks.

Market Outlook & Portfolio Strategy

1. The 1997 Asian Crisis and its Aftermath

The global situation is very worrisome today despite the recent market euphoria. To understand why, we need to look at the factors that caused the crises of the past few years and in particular, the real estate and credit turmoil of 2007-2008. The genesis of the crisis of 2007-2008 can be traced all the way back to the 1997 Asian crisis. The Asian countries in the late 1980s experienced a period of strong growth led primarily by exports. The economic success so engendered boosted wages and domestic consumption and ultimately inflation. As central banks in the region tried to rein in demand with higher rates, foreign capital surged into the area causing currency appreciation. The monetary authorities tried to fight this by keeping rates lower than domestic inflation concerns would have suggested. By the mid 1990s, due to stronger currencies and rising wages most of the Asian countries had lost their export competitiveness as reflected by rising trade deficits, but foreign investors remembering the successes of the last few years continued to pour funds into the region. The 1997-1998 Asian crisis was a consequence of the sudden realization by investors of the perilous state of the Asian export machine and the overvalued exchange rates that characterized the region. The devaluation in the Thai baht in July 1997 triggered an exodus of funds from the countries in the region which resulted in a collapse of their currencies and banking systems. Not surprisingly, this in turn led to a huge decline in Asian consumption which ordinarily should have resulted in a significant global recession.

The world recession that should have ensued after the Asian crisis was staved off largely because U.S. monetary policy was loosened dramatically in the 1997-1998 period, especially post the Russia/Long Term Capital Management crisis in 1998. Low U.S. interest rates triggered both a U.S. investment and consumption boom as corporates and households increased their leverage. These trends were reinforced by a dramatic increase in asset prices largely produced again, by easy liquidity. The strong U.S. economy was a boon to the Asian export sector which in turn was the locomotive for the rebuilding of the Asian economies after 1998. Unlike the period of the late 1980s, domestic consumption in Asia remained depressed especially relative to exports over the post-crisis period, a result that was not surprising given the massive wealth destruction that followed the 1997 crisis. The world in the post Asian crisis era operated with a U.S. Consumer/Asian Producer (USCAP) model which, at least initially, was perhaps what was appropriate. The fundamental underpinning of this USCAP structure of course, was exceptionally easy U.S. monetary policy.

The problem with overly-easy liquidity in the U.S. was that it led to significant economic distortions that could not be easily corrected. The technology bubble of 1999-2000 was a consequence of over-investment and overly-optimistic asset pricing, both of which can be traced back to monetary policy. The bursting of the technology bubble in 2000 was the first warning sign that easy monetary policy and the USCAP model were both unsustainable. Unfortunately, policymakers responded to this with even more easy monetary policy, with the U.S. once again leading the way especially after September 11, 2001. This led to a gargantuan real estate bubble which in turn led to over-consumption as homeowners extracted and spent the rising equity of their homes. In fact, the U.S. recession in 2000-2002 post the collapse of the technology bubble was one of the most unusual on record in that it was characterized by an investment collapse even as consumption overall continued to grow. The Asian countries benefited from these U.S. policies again since they represented a continuation of the USCAP model. However, these policies set the stage for the real estate and credit crises of 2007 – 2008 and have created the unpleasant economic conditions of today.

The global economy now is in its worst downturn since the Great Depression and emerging from it is going to be difficult because of both an unprecedented level of U.S. and global leverage, and the virtual bankruptcy of the largest of the world's financial institutions. Interest rates almost everywhere are at record lows, even as fiscal deficits in much of the developed world are at eye-popping levels. Fixing the global mess requires a carefully thought out set of policies with the abandonment in particular of the USCAP model of growth. Any continuation of this paradigm is sure to engender even more crises. The transition from USCAP to a more sustainable growth model for the world will require significant global coordination and will be painful at least in the short run. However, the world really has no alternative at this juncture and this should be obvious even to the most casual of observers. Remarkably, however, even at this late stage, global policymakers are not willing to abandon this flawed paradigm while markets rejoice at any sign of growth without attention being paid to its sustainability.

2. *The Chinese Response*

Market observers, over the last few months have come to rely on China as being the new saviour for the world. The remarkable 7%+ annualized growth rate of the Chinese economy over the last several months in the face of declining exports has led numerous pundits to proclaim that the world economy will be underpinned by growth in

China and other developing countries such as India. Superficially, these arguments have merit, but a closer examination of the facts raises numerous issues that suggest that things are nowhere near as rosy as proclaimed.

The Chinese economy is unusual in that investment makes up a staggering 42% of GDP. With consumption at just 36.4% and a trade surplus of almost 8% of GDP, the country has a savings rate that is close to 50%, a very high number for any country, and especially a developing nation where most of the population lives in poverty. The high savings rate in China is at least partially due to the country's not fully coming to terms with its recent, rapid pace of growth. The country's focus for the last several years has been on measures that would safeguard its speed of development with little attention being paid to improve the actual living standards of the population. The government has expended considerable resources on aiding the manufacturing and export industries, and promoting select areas such as real estate. However, it has not attempted to the same degree to deliver a comprehensive system of medical care or medical insurance for catastrophic illnesses to the people. Measures such as pensions, that many in the developed world take for granted, are only now being contemplated and/or implemented for the majority of the population. As such, the rising living standards in the country have boosted consumption but also savings, and especially precautionary savings. Paradoxically, the Chinese instead of consuming all the fruits of their labour are instead trying to maintain their improved standards of living by saving for the proverbial rainy day.

The problem the Chinese government faces is that it cannot easily boost consumption in the country without addressing the fundamental concerns that have caused the population to save as much as they do. Specifically, it would need to work at improving the quality and delivery of medical care as well as providing medical insurance. Next, it would need to provide some kind of social safety net for unemployed and displaced workers possibly through jobs retraining programs and unemployment insurance. Again, a dramatic increase in consumption might also require a more fundamental change in the provision of consumer goods across the country, and not just in the urbanized export areas. China, in short, needs to create a thriving middle class along with the economic framework that is needed to support their own consumption. It also needs to convince this middle class that they have the longer-term security that will allow them to reduce their savings rates. Coming from its Communist past this task will prove something of a challenge. The main engine for creating this middle class is the manufacturing/export sector, whose continued success is thus critical for the country's continued transformation. That is, the export sector in China is not just the locomotive for growth, but also for change, and Chinese policies in general are biased to take into account this reality.

The Chinese response to the global real-estate and credit crises, which have taken a heavy toll on their exports, has been entirely in line with their economic situation. The government has reacted with expansionary monetary policy as reflected by a dramatic growth in money supply and credit over the first six months of 2009. M2 money supply increased 28.5% and yuan-based lending increased a staggering 34.4% in the first six months of 2009 alone. In fact, in absolute terms, new lending over the first six months of 2009 has been about three times the total lending in all of 2008. While such a pace of credit extension in itself has its risks, the problem in China is that the bulk of the new credit ends up primarily in the manufacturing/export sector which is the most developed

part of the Chinese economy. Given that cheap credit works through boosting investment, the unfortunate result is that investment is being boosted in a sector where there is already considerable excess capacity. China's economy grew 7.1% in the first half of 2009. However, fully 6.2% or over 78% of the first half's growth came from investment. Consumption contributed 3.8% to growth while net exports subtracted 2.9%. Thus, Chinese policies are serving to over-emphasize investment even now at the relative expense of consumption.

Any belief that the Chinese economy is going to be a longer-term locomotive for global growth is entirely misplaced. Chinese consumption will certainly continue to grow, but its continued growth depends on growth in investment which is probably the last thing that the world needs. Reorienting growth away to consumption at the expense of investment, or abandoning the USCAP model, is a longer-term objective for China but is not something that the government can undertake very quickly. Even if decisive action were initiated on this front, the near-term impact would be quite limited. In the Chinese context, the most effective short-term policies from a domestic perspective are exactly the credit creation measures that the government has pursued. Unfortunately, this response will ultimately prove counter-productive because creating capacity with faltering final demand is only going to postpone the reckoning. The Chinese response thus represents a victory of hope over reality. If export demand picks up substantially over the next few months, the leadership will be vindicated. If not, and reality suggests that it will not, the Chinese policy mix will prove to be a classic beggar-thy-neighbor export ploy that should ultimately hurt both the Chinese exporters and their global counterparts. Thus, not only is China far from giving up on the USCAP idea, it is actually reinforcing that model with its actions.

3. *The U.S. Response*

The U.S., whose leverage and over-consumption have largely led to this crisis, does not have the same constraints where it comes to the promotion of domestic consumption. Over 70% of the U.S. economy is consumption and as such, overall growth is highly dependent on consumer spending. Given the exceptional leverage and poor job prospects for consumers, a significant reduction in consumption's relative share of GDP seems inevitable. However, the bulk of U.S. policy attempts to perpetuate the already-high share of consumption paying little attention to the future growth prospects that such policies might engender. Thus for example, the U.S. government has moved to extend the period over which unemployment insurance benefits may be received. It has worked to create schemes to let distressed borrowers stay in their houses with federally subsidized loan modifications. It has also instituted a "Cash for Clunkers" program to encourage car purchases by giving car buyers a direct cash credit for trading in their old cars for a new more fuel efficient vehicle. It has also put in place an ambitious fiscal stimulus program whose impact is soon expected to be felt. Most observers in fact, are expecting a second, possibly larger fiscal stimulus package. And the government is doing all this even as tax revenues are plummeting and the fiscal deficit has soared to an almost inconceivable 13% of GDP. If all this were not enough, President Obama is attempting an ambitious overhaul of the nation's health-care system where health insurance benefits could be made available to the entire population.

The U.S. policy mix seems unusual when one considers how these expenditures should be financed. The burden of tax is likely to fall on those who have been prudent, accumulated savings and avoided the irresponsible, debt-financed consumption of the last few years – after all, they are the only ones with the resources to even pay taxes at the current juncture. But this means that a nation that is chronically short of savings is adopting a fiscal regime that is actively going

to discourage saving. With U.S. interest rates at virtually zero already, savers had little incentive to hoard wealth, and the tax policies are only going to make things worse for them.

As a digression, the health-care reform that is being proposed by President Obama seems particularly ill-timed when one considers the outsized expenditure it will surely entail. The Administration's plan will extend healthcare benefits to the uninsured even as it attempts to wring out cost savings by introducing a variety of measures to boost efficiency. We are not going to discuss the specifics of the various proposals that are being floated in Congress regarding health reform but are instead going to look at the macro consequences of embarking on health care reform at this juncture.

Numerous studies have estimated that anywhere from 46 to 55 million Americans, or 15-20% of the population, lack any kind of health insurance. Even accounting for the fact that as much as 20% of the population is not covered, U.S. per capita expenditure on health care at over \$6,000 per annum is the highest in the world today. It is certainly true that for people that have health insurance, the U.S. system is the envy of the world. But it comes at a correspondingly higher cost. Were the U.S. to extend health benefits to the uninsured at the per capita rates of about \$3,000 that prevail in Canada where medicine is socialized, the cost of this would be at least \$150 billion per annum. While some cost savings might be gleaned with true reform of the entire system, it is unlikely that the government will do so – after all, were cost savings the main driver, a reform of Medicare would have to come before any comprehensive plan for the uninsured could be contemplated. Even worse, any move to cutting health care costs will almost certainly require the government's being forced to ration care as is typically the case in most other developed nations. Exotic procedures such as transplants, new drugs and the like cannot possibly be covered by the government at low cost.

In purely economic terms, health-care expenditures are just consumption despite any arguments regarding fairness and equality. Put differently, the ability to enjoy a healthy life with quality care is not a basic human right. Even worse, when the individual does not safeguard his health with proper exercise and diet, the cost to the system to keeping such an individual in good health truly represents luxury consumption. As always, the question that surely must arise is just how this cost burden should be borne by society. The current administration believes that the wealthy need to be taxed more heavily to pay for these additional expenditures, which means again that the savers need to pay for the consumption of the spenders. What is very clear is that the U.S. is still trying to boost consumption, while doing little to increase savings or exports suggesting that the USCAP view is still the dominant operative framework. Unfortunately, the U.S. drive to boost consumption may lead soon to questions about the solvency of the U.S. consumer if not the nation itself because the current pace of deficit spending is requiring the assumption of record levels of debt.

4. Conclusion

In sum then, the world is far from abandoning the USCAP model of growth. China, the country with the world's highest savings and investment ratios as a percentage of GDP, is actually increasing investment even though doing so is going to prove more destabilizing for the world. The Chinese are doing what is most rational given their economic growth model but are creating global excess capacity while doing relatively little to boost domestic demand. The US, the world's biggest spender, is working to increase its consumption when it can ill afford to

consume even at current levels. The U.S. actions seem entirely rational given the political environment faced by its government and the U.S. dollar's status as a reserve currency. However, with collapsing tax revenues, ever increasing indebtedness is an inevitability of the U.S. policy mix, which in turn will mean more monetization of debt. Thus, while the U.S. and China may be engaged in individually justifiable policies, there is no doubt that together they have put us on a trajectory to another global crisis that could very possibly dwarf even that of the last two years.

I have this terrible feeling of déjà vu when I consider the markets today. I recall the days of 2006 when all the data suggested that the real-estate crisis was in full swing, but policymakers and the pundits all argued that there would be no correction in home prices. Even worse, 2006 was a banner year for every type of fraudulent loan as executives at our fine financial institutions rushed to fabricate earnings at any cost to get paid their handsome bonuses. Today, the perverse economic policies adopted by the U.S. and China, the main protagonists on the world stage are at least as worrisome as the early signs of the real estate problems in 2006. Again, Wall Street and the policymakers are reassuring the public that the worst is behind us, every trashy company is once again embarking on huge debt issues and the bonuses are in full flow, even as the ratio of insider sales to purchases of stock hits new highs. Most market participants claim that the problems of 2007 and 2008 arose because of the unprecedented decline in nominal U.S. home prices. They believe that this decline could not have been anticipated since it had never happened since the Great Depression. We benefited from having positioned our funds to profit from such a crisis. The extreme imbalances in the world today are even more unprecedented. We believe that a correction of these imbalances is imminent and are positioned to profit when this reckoning begins.

Performance Summary at July 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)
-2.2%	-0.1%	-3.7%	19.5%	46.8%	37.3%	23.1%	N/A	-0.9%	14.6%

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)
-1.6%	0.0%	-3.5%	23.1%	48.2%	40.3%	24.7%	12.3%	-1.2%	21.4%

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