

Trident Investment Management, LLC Opportunities Funds Commentary

May 31, 2008

Performance Summary

Markets in May were mixed as reality started to intrude on the rosy scenario that was assumed in April. The bond market continued its decline from the previous month with yields on the U.S. 10-year Treasury note rising 0.33% to end at 4.06%. Shorter maturity bonds suffered even more resulting in an overall flattening of yield curves globally. The bond selloff was partly caused by inflationary concerns stemming from the continued relentless advance of oil. WTI crude rose 12.97% to end the month at \$127.35 a barrel. Gold rallied as well rising 2.54% to end at \$891.5 an ounce. Equities were mixed. The S&P 500 was up 1.3%, the MSCI Europe down 0.29% and the Nikkei up 3.53%. The dollar rallied on the month appreciating 0.51% (all figures in U.S. dollars).

We recouped some of the losses of the previous month in May, with our funds being up an average of about 2% (gross). Our gains stemmed largely from our short positions in equities, especially in the financial sector which suffered over the month despite markets overall being up. Our credit investments helped our performance as did our short positions in retailers and other consumer discretionary stocks. Our long positions in near-dated fixed-income instruments hurt us, but since we had established our positions through options, the net impact on our overall results was minor. We have continued with our core themes and have increased some of our positions in the credit arena expecting major credit problems to resurface shortly.

Market Outlook & Portfolio Strategy

Markets believed in April that the U.S. Federal Reserve's bailout of Bear Stearns essentially meant that the central bank would serve as a backstop to any failing financial institution. However, the action has put the Fed in the awkward position of having to extend virtually unlimited amounts of credit to the problem-plagued U.S. financial system even as inflationary concerns are mounting. More worrisome is the fact that the Fed has been forced into these measures before any significant decline in economic activity has occurred. In adopting these steps the Fed is jeopardizing its credibility at a time where global imbalances are at all-time highs, leaving the world financial system ripe for a currency and/or a bond market crisis.

To understand why the Fed has to worry about its credibility, one needs to go back to the European Exchange Rate Mechanism (ERM) crisis of 1992. The European Community introduced the ERM in March 1979 to reduce volatility of the cross exchange rates of member countries and prepare them for the eventual introduction of the Euro. The ERM structure permitted the exchange rates across member currencies to fluctuate but limited such fluctuations to a defined percentage (typically 2.25% to 6%) across a central bilateral rate. The ERM provided for loan arrangements among the member countries to allow for intervention in the cross exchange rates when any of them threatened to breach the defined band. Importantly, the ERM did not require a common monetary policy across member countries, even though the exchange rate bands resulted in a de facto monetary link. That is, a country could set its own interest rates, but too low an interest rate relative to other ERM members might trigger weakening of its currency against the others' beyond the defined bands. This would mean

intervention and ultimately a shrinking of the monetary base and higher interest rates. The ERM more or less worked from its inception until 1990. At that point a number of changes occurred that were fundamentally destabilizing to the system.

In 1990, West and East Germany reunified. Reunification resulted in a major economic boom in Germany partly due to expenditures, both public and private, undertaken by the new Germany to improve and profit from the East and partly because of monetary adjustments. A political decision was made during reunification to treat the East German ostmark at parity with the West German mark for all prices and wages and some basic savings up to 4000 marks per person. This represented a massive subsidy to the East from the government of the Federal Republic of (West) Germany. The overall impact of unification in the near term thus, was a massive increase in growth and inflation. The underpinnings for such growth were less than robust because the monetary adjustment rendered most East German industry uncompetitive.

Faced with these conditions, the German central bank, the Bundesbank, tightened policy significantly. Their actions were consistent with their primary responsibility which was to maintain price stability. Unlike the Fed, the Bundesbank was not officially responsible for the stability of the financial system or for being the lender of last resort. While the Bundesbank's domestic focus was entirely the correct policy for Germany, it did not work well in the context of the ERM in which Germany was a key member. Germany due to its special situation needed dramatically higher rates than the other members of the ERM could support. Weaker economies like Italy and Spain, suffered from the high interest rates imposed by Germany because they were forced to keep their own rates very high to ensure their currencies remained in the ERM bands against the German mark. The UK, a 1990 entrant in the ERM, was equally affected. A significant revaluation of the German mark within the ERM would have eliminated these pressures, but Germany was unwilling to undertake a large revaluation given its already uncompetitive East German labor force.

Economic conditions in the ERM member countries deteriorated markedly in the early 1990s. By 1992, it had become abundantly clear that high interest rates were choking the peripheral economies in Italy, Spain and the U.K. Even France, was suffering from the high interest rates imposed by Germany. The U.K. in particular, suffered a housing market crash as its Treasury moved interest rates to prohibitively high levels. Currency markets anticipated that these policies would be unsustainable. Speculative pressures began to mount on the cross exchange rates between Germany and the peripheral countries with sterling, the Italian lira and the Spanish peseta all coming under significant pressure against the mark. While the governments initially resisted the markets, ultimately, the economic costs of resisting became too great. The U.K. made an ignominious exit from the ERM in September 1992 with a massive devaluation of sterling against the mark. Italy and Spain also devalued their currencies though they returned to the ERM system with broader bands and adjusted central parities. The rules of the ERM had to be relaxed further in 1993 even post these devaluations because speculative pressures continued on the currencies, most notably on the French franc against the mark. The ultimate form the ERM took involved much wider bands so much so that there was very little constraint on domestic monetary policies for member countries.

An important point to note from the ERM crisis is that Germany was facing inflation due to its unique domestic conditions. One could not have argued in 1992 that the world was struggling with inflation or that growth was too strong. In fact, Europe as a whole was suffering from weak growth, commodity prices were well behaved and the U.S. was struggling with a major housing crisis that had left its largest banks in trouble. Japan, which had been booming through 1990, was entering the first phase of its deflationary bust. But all of these factors did not enter into the Bundesbank’s thinking – their mandate of controlling inflation required that they move rates higher and they did. The problem faced by Europe was that the Bundesbank was the de facto rate-setter for Europe as a whole and their focus was not on Europe but on Germany.

Fast forward to today, and we have the European conditions of 1992 in reverse. There is an informal pegging of currencies especially in the developing world to the U.S. dollar. In particular, most Middle Eastern and Asian currencies shadow the U.S. dollar and their moves against the U.S. have been very limited over the last several years. Even Japan has managed to keep its currency largely stable against the U.S. during the period. The latter fact is surprising but note that at the start of 2000 the yen was at 102.50 to the U.S. dollar and at the end of May 2008 it was at 105.50 – while the moves each year since 2000 have been significant, the overall level of the yen has barely changed.

The U.S. is faced with an economy that is weakening rapidly, a banking system that is in crisis and an overvalued currency that has resulted in the biggest trade deficits in history. The rest of the world, and especially the developing world, is growing strongly, and is preoccupied with inflation that has resulted from a combination of high oil and food prices. A sustained pickup in inflation expectations and wages, especially in the developing world is highly likely given the high and rising cost of living. These economic conditions coupled with the informal ERM-style currency arrangement that seems to exist, leaves the world economy with the same problems faced by the EU in 1992 where the members had vastly different growth rates and policymakers with different agendas.

Most of the world today needs dramatically higher interest rates to quell runaway demand, especially for energy and other commodities. However, if we believe the official inflation statistics (and these are worthy of a separate treatise in themselves), the U.S. needs very easy monetary policy because it is already facing a credit crunch stemming from financial system problems. The U.S. Fed still retains a Bundesbank-like stature in the world, especially where it comes to the developing countries, despite having followed policies that virtually created both the housing and credit crises not to mention the huge trade deficit. Like the Bundesbank, the Fed is focused on its domestic agenda and not the world’s concerns. As such, it is concerned primarily about sustaining U.S. growth with inflation being a distant second objective unlike the Bundesbank. Easier monetary policy in the U.S. would stoke further inflation in the rest of the world if the other countries remain determined to prevent a huge appreciation of their currencies. Tighter policy would create more economic and credit problems in the U.S. and would put the Fed in a tough domestic situation. The Fed thus is faced with a Hobson’s choice here: their only real “choice” is whether to adopt even easier monetary policy or do nothing – raising rates at this juncture, especially with the housing market and economy in free-fall is not viable.

The predictability of the Fed's actions in the near term suggests that the adjustments on rates have to come from overseas. A dramatic tightening of policies globally will mean a significant slowing of global growth and very likely a huge decline in the U.S. dollar. This, coupled with the slowing U.S. economy and already-significant financial problems, has the potential to spiral into an undesirable global depression. If easy policies were to continue however, there should be continued increases in oil, food and other commodities until inflation does pick up globally. Wage pressures in the U.S., and the developed world overall, today still remain low given the relatively fragile economic conditions and the outsourcing trends of the last few years. As such, the developed world is unlikely to see wage inflation very quickly. However, it will see sustained inflation eventually with the transmission mechanism being from commodity prices, to emerging markets wages to the prices of exports from these countries and then finally to wages in the developed world. The problem with such inflation is that it will be exacerbated by currency revaluations of the developing world and it cannot be contained by domestic U.S. monetary policy unless a severe recession is permitted. The unfortunate truth is that we are in an economic mess in the world today and there is no simple fix.

Given the current conditions, what is surprising is that there has not already been a massive speculative attack on the U.S. dollar with a corresponding exodus from U.S. sovereign debt. The more the increases in overseas inflation due to higher oil and food prices, the more likely is such an outcome. Further economic weakness, heightened credit problems or more housing issues could all trigger such a speculative attack. If and when such an attack begins, U.S. policymakers cannot mount an effective defense – any rise in rates would be unsustainable and any cut in rates will foster further currency declines, inflation and bond market problems. The reason such an attack has not begun yet is that the Fed, amazingly, still retains its global credibility. Ben Bernanke is looked on today as a determined, effective central banker much like Helmut Schlesinger of the Bundesbank was in 1992. Unfortunately, Bernanke is presiding over an economy that is arguably in worse shape than that of the U.K. in 1992. He should be best compared to Norman Lamont, the Chancellor of the Exchequer in the U.K. when the pound was forced out of the ERM.

The more experienced hands in the Fed surely recognize the precarious position the institution is in. Any significant loss of credibility for the Fed could result in a currency crisis with the dollar plunging and a huge increase in U.S. inflation. As such, it is particularly important for the Fed to pay attention to the level of the U.S. dollar, inflationary risks and global stability in setting policy. Many of its policy choices with these constraints are not going to be popular or politically expedient. With this context, actions such as the Bear Stearns bailout seem ill-advised, and ultimately, not in the national interest. Unfortunately, the current Fed is riddled with internal conflicts of interest and is not up to the task of making the hard decisions. Consider for example, the New York Fed, which provides much of the insight and intellectual leadership where it comes to Wall Street. The New York Fed has three Class A directors elected by the member banks to represent them, and three Class B directors, elected to represent the public. Two of the Class B directors are Richard Fuld, Chairman of Lehman Brothers, and Jeffrey Immelt, Chairman of General Electric (whose subsidiary is the huge GE Capital), both companies that would be major beneficiaries of a Fed bailout. And these are the directors that represent the public!

We believe that we are rapidly reaching a tipping point in the markets. The U.S. economy is gradually weakening and the housing and credit problems are only getting worse. The Fed has exhausted a considerable amount of its resources in bailouts when the real problems with the overall economy have not even started – its credibility is under threat. An ERM-style global adjustment may soon be in the offing with the U.S. dollar and/or U.S. assets being in the forefront.

We have continued with our major investments of being short U.S. financial stocks and U.S. credit. We have also added to our shorts in U.S. consumer focused companies. On the long side, we have seen some reversals in our positions in short-dated non-U.S. sovereign bonds. We have used these declines to add to our holdings. Finally, we continue to be long gold using near term corrections again as opportunities to add to our positions. The markets are poised for some major moves and we believe strongly that we have the right positions to profit.

Performance Summary at May 31, 2008

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)
1.3%	-2.5%	7.8%	106.7%	35.2%	29.2%	18.4%	N/A	7.0%	12.6%

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)
0.6%	-4.5%	0.8%	107.1%	36.1%	29.6%	15.7%	15.1%	1.3%	20.4%

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