Canso MARKET OBSERVER

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The financial markets and investors raised their voices and prices in praise of the new Lord of Money in the third quarter of 2006. Fed Chair Ben Bernanke, in his first move independent of the Greenspan legacy, chose to interrupt the two years of "measured" ¼% increases instituted by his predecessor and keep the Fed Funds rate at 5.25%. Mr. Bernanke's move was predictive, not predictable. Even though inflation continues to rise in the U.S., "Gentle Ben" decided to look into the future and predict an economic slowing that removed the need to continue the tightening of U.S. monetary policy.

Whether Mr. Bernanke's economic forecast will be right is a moot point. Clearly he has planted his feet on the side of gain rather than pain. Alan Greenspan, the prior Fed Chair, made massive easing at the first sign of Wall Street trouble his signature move. Mr. Bernanke has staked his turf on implementing monetary policy based on his visions of the future, a combination of central banker and economic Nostradamus.

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"I See Dead Economies…"

Bernanke's unenviable task is to make his mark after his knighted and universally acclaimed predecessor, "The Maestro", Sir Alan Greenspan. The Maestro's reputation is as an omnipotent all-seeing sage who deftly manipulated the levers of Fed policy and kept the U.S. economy rolling and prosperity flowing for 19 years. This is a very hard act to follow.

The public relations genius of Mr. Bernanke's move is that he has one upped the Maestro. Where Mr. Greenspan reacted only to the mundane present in applying his monetary wizardry, Professor Bernanke is not constrained in a temporal sense, he sees the future! We think the television rights could have tremendous potential. Instead of Patricia Arquette as the psychic housewife helping the DA in the TV series *Medium*, she could move to Washington and assist Bernanke in monetary policy deliberations: "I see dead economies..."

On a more serious note, Mr Bernanke has wagered much of his inflation fighting credibility on his predictive abilities. The strong world economy and higher commodity prices have been spilling over into prices. The core inflation rate is uncomfortably above 2% and has been increasing as have wages which are rising in the 4% area. If the economy does not weaken, further rate hikes will be inevitable and perhaps harsher. This has certainly been the case in the United Kingdom and Australia where pauses in monetary policy have been followed by economic strength and renewed interest rate increases.

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The Bernanke Drop Pitch

The financial markets have certainly bought the Bernanke economic drop pitch. The U.S. long T-Bond yield has dropped from 5.3% at the end of June to the current 4.7%. The Dow Jones has rallied to record territory. Commodity prices have tumbled from their record highs, particularly oil which is now trading below $60 a barrel compared to the peak of $78 in mid July.

The downdraft in energy prices has caught investors who had ridden the uptrend too long. Our clients and readers know our feelings on the current "Alternative Investment" mania. Greed, leverage and propaganda have legitimized speculation and investment idiocy as an asset class. Our last quarter's effort highlighted our concerns with hedge funds and the banks that lend to them.

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Hot Money Meets Cold Reality

Without rehashing in detail, our observation was that the Prime Brokerage divisions of major banks are relying on their "mark to market" daily pricing to protect them from losses in their lending to hedge funds on some very esoteric and illiquid investments. They also, as bankers are apt to at market peaks, believe that lending on asset values will limit the downside and protect against loss. Those of us who make a living from buying and selling things in the financial markets and have survived for a few cycles know that liquidity tends to be pro-cyclical and when markets are down and dirty, those bidding tend to do so at a significant discount.

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This has only recently been brought home to the legions of hot money hedge fund proprietors, their bankers and unfortunate clients. Most of our readers will know the sad story of the Amaranth hedge fund meltdown by now. This "Multi-Strategy Fund" had promoted itself as a conservative and moderate choice before it imploded due to some outlandish bets in the natural gas futures market in September, going from $9 billion to $3 billion in capital.

Delusions of Protection and Profits

Boosters of hedge funds are finding some solace in Amaranth's orderly windup. We are floored by the complete disregard for diversification of this unfortunate fund and the sheer illiquidity of the natural gas futures markets in which they chose to invest a substantial portion of their assets. Our criticism of hedge funds and their lenders is that they both suffer from the delusion that the very recent financial innovations of risk management and derivatives will protect them from loss and allow them to profit immensely from the booming market for high return and high risk investment products and services.

Stripped bare of the modern glitz, the alternative investment and hedge fund mania is simply a rehash of time honoured financial speculations. When prices of financial and other assets rise steeply over a period, investors and their lenders are emboldened to increase margin, the amount of money lent against the asset value, as their perception of the risk of loss drops and potential profits dominate their decision-making. This is the essence of every financial bubble and mania since the dawn of investment time.

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Investment Heresy?

Things tend to come a cropper when prices fall and lenders are forced to liquidate their collateral when other lenders are doing the same thing. *"What about the increased ability to hedge brought about by the derivatives boom trumpeted by no other than Alan Greenspan, the living deity of central banking and the financial markets?"* you ask impatiently. At risk of being accused of worshipping the false financial gods of valuation and diversification rather than the true modern financial gods of derivatives, efficient markets and complex mathematics, we quote instructively from the letters to *"Investors in Amaranth's Multi-Strategy Funds"* for our defense against a potential charge of investment heresy.

The first letter was issued just after the huge losses came to light and the natural gas futures positions had been transferred (of course) to another hedge fund.

> September 18th: "[The assets sales and transfer of the natural gas futures portfolio] *helped us to avoid the termination of our credit facilities and the risk of forced liquidation by our creditors….. We have continued to meet all our margin calls. Our major financial counterparties have confirmed that they are now comfortable with our portfolio and overall liquidity position..."*
> Source:CNNMoney.com

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> September 29th: *"While we continue to evaluate the situation in light of the liquidity of the funds' portfolios and investors' desires, our current intention is to dispose of the remaining positions in the funds' portfolios in an orderly fashion over time, seeking to maximize sales proceeds and to make periodic cash distributions to investors on a pro rata basis, subject to anticipated reserves…. We estimate that as of Friday September 29th, 2006, the Net Asset Value of the multi-strategy funds had declined approximately 65% to 70% month-to-date and approximately 55% to 60% year-to-date."*
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> Source: CNNMoney.com

Although the financial markets have seemed to take the Amaranth fiasco in stride, without the panic and back room strong-arm by the Fed that were necessary with Long Term Capital, the second order affect of Amaranth is likely to be increased caution by lenders and investors in regards to hedge funds. "Why, since the Amaranth implosion caused barely a ripple in the alternative asset sea of opportunity?" would be the selling pitch of the well dressed and well paid lobbyists of the Managed Fund Association.

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Governance Lilliputians

The lobbyists of the MFA will soon have to yield to another set of well paid and dressed hangers-on. There is an industry waiting in the wings to apply their dark skills to the alternative investment sector. In our schizophrenic capital markets, the mania of alternative assets is accompanied by the vogue of governance. The people who brought us politically correct investment,Y2K, and Sarbanes Oxley are now pumping disaster planning for the Bird Flu. It is inevitable that their greedy gaze will take in hedge funds.

What better area for fear mongering than one with lots of fee income, fear and incredible downside? The gods of the hedge fund industry will inevitably labour under the same constraints as the mortals of the investment industry. Like Gulliver in Lilliput, this giant of an unbridled industry will slowly and surely be tied down by the small people who make rules and check lists their weapons. Undoubtedly, there's a pension or endowment fund staffer somewhere ruing their Amaranth losses and wondering how to explain the 60% meltdown of their conservative, diversified and multi-strategy hedge fund to their committee. Since they undoubtedly had a consultant to help them choose Amaranth, they will likely hire a consultant to help explain the loss and develop a program to avoid against future Amaranths.

The more pensive of them will consider the damage caused by this solitary event in a good economy and liquid markets and reflect on the damage that might have resulted in less robust conditions.

The risk models of banks and credit rating agencies will also undoubtedly be tweaked to reflect the Amaranth experience. Although Amaranth's lenders seem to have been spared the proverbial haircut on their loans, the severity of the markdown on Amaranth's collateral will not escape the scrutiny of bank regulators worldwide. The more pensive of them will consider the damage caused by this solitary event in a good economy and liquid markets and reflect on the damage that might have resulted in less robust conditions.

Outlook

Our consistent view for the last year or two is that the U.S. and world economies were far more resilient than most believed. While things are now

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slowing in the U.S., particularly the housing market, we look at the vigour in the U.S. corporate sector and believe that it will be hard to have a severe slowdown with corporations in such good financial health. We also look at the surprising endurance of American consumers who have defied many premature predictions of their spending death. Critics who focus on the amount of household credit fail to recognize that it is availability that is key. It is hard for an individual or corporation to go bankrupt when there is always a new lender waiting to provide the funds to escape a credit crunch.

Sooner or later the financial markets will receive retribution for their excesses with leverage and hedge funds. The timing of this is uncertain, as it takes considerable financial disaster or substantially tighter monetary policy to precipitate a financial crisis. We can't see the present speculation continuing without an "attitude adjustment" from Mr. Market. We are wary on credit and valuations at present. ***When risk becomes its own reward, smart investors stay on the sidelines.***

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