Investment Commentary

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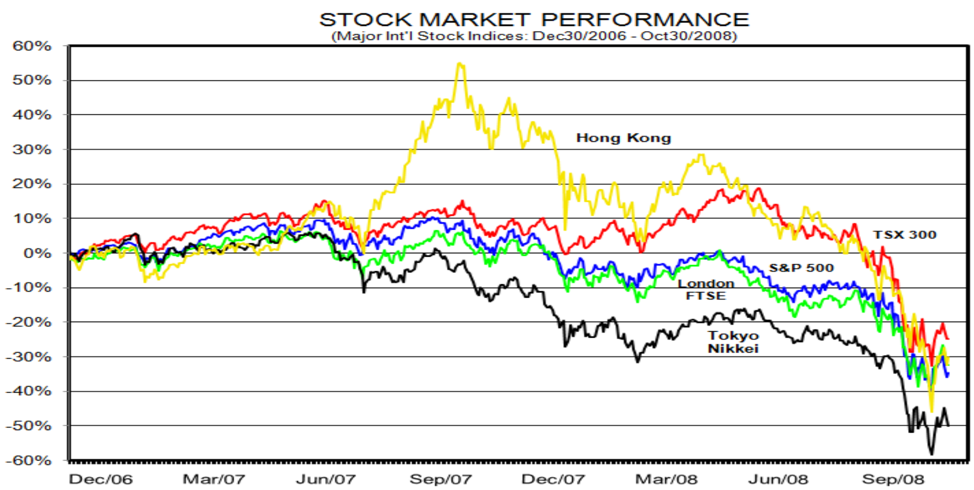
Panic 2008

Stock markets around the world have plummeted and investors are naturally in shock and disbelief. The chart below highlights the performance of some of the major stock market indices. No country has escaped the bloodbath and several of the smaller "emerging markets" have completely *submerged* with declines of over 60%. Headline news reports are depressing to say the least and there is much fear that a severe recession is now right around the corner. While it is possible to see further declines in stock prices, we would argue that most of the bad news is now fully discounted. Any good news in the economy or corporate profits, even if marginal, could act to lift spirits and investor confidence. That the world economy will slow in 2009 is a given. But as for financial asset prices, the worst may be over.



In the rush to try and avert a crisis in the U.S., government officials there have inadvertently alerted investors to the real and ghastly problems in the U.S. financial sector. The realization that the economic system was so fragile came as a shock. Comparisons were made to the panic of 1929 and the shock naturally turned into outright fear.

Investors are becoming more cynical and view efforts by government to bail out the financial system with scepticism. U.S. Treasury Secretary Paulson had repeatedly assured investors that the economy was sound. While it may appear the scale of financial problems were continually underestimated, in truth U.S.

authorities knew the seriousness of the situation. An effort to downplay the problems led to a series of miscalculations and unintended consequences. It has not been made clear for instance why Bear Sterns was forced to merge with JP Morgan while Lehman Brothers was allowed to go bankrupt. It is this later event that finally shook the investment world.

Banks around the world have written down approx $500 billion in bad debt and have managed to raise about $350 billion in capital. The banks therefore still require additional capital. The $700 billion bailout is a good step in providing urgent *liquidity* in exchange for unmarketable assets but it will not solve the more pressing need for equity capital. Leveraged financial structures were at the root of the current crises - a financial pyramid scheme based on shaky U.S. subprime mortgages.

Seven Worst U.S. Bear Markets – Dow Jones/S&P 500

Rank/Index	High Date	Low Date	High	Low	% Decline
1 D-J	September1929	July 1932	381.20	41.20	-89.19%
2 S&P	March 2000	October 2002	1527.46	776.76	-49.15%
3 D-J	March 1937	March 1938	194.40	98.90	-49.13%
4 S&P	January 1973	October 1974	120.24	62.28	-48.20%
5 D-J	November 1919	June 1921	119.60	64.90	-45.74%
6 S&P	November 1968	May 1970	108.37	69.29	-36.06%
7 S&P	August 1987	December 1987	336.77	223.92	-33.51%

Average Collapse?

Comparatively this downturn in the stock market is very much in line with some of the worst declines in the last 100 years. It may seem like the end of the world but we have been here many times before. The table above highlights the seven worst bear markets in the U.S. and except for 1929, it doesn’t appear abnormal by any means, at least not yet.

Many are trying to compare the current collapse in stock prices to the quick crash of October 1987, or to the 1973/74 time period. Neither is exactly comparable on economic grounds and the crash in 1987 was a very short affair lasting only 4 months from top to bottom. It merely corrected the excessive gains that preceded it; the calendar year as a whole ended with slightly positive returns. A recession did not follow. The 1973/74 episode has more parallels to today. This was the time of the first oil shock and a severe consumer recession set-in.

Importantly, from the table we can observe that declines of 45-50% are about as bad as it gets. The average length of a bear market is about 18 months and the market usually recovers well in advance of any recovery in the general economy. Why should it be different this time? It would only be different if we were facing a severe recession/depression. For this to occur, the common run of the mill recession would need to be accompanied by major policy errors and/or a breakdown in global trade. This is very unlikely to happen.

Globalization has brought the world closer together and there is no indication of a pending breakdown. In fact a positive and cooperative dialogue exists as the world's leaders unite together determined to find a solution to this crisis. They fully understand the gravity of the situation and know a selfish go it alone approach is doomed to failure.

Also, the monetary framework is vastly different today. Gone is the anchor of a Gold standard and the disciplines of fixed currencies. Today the monetary system is based primarily on floating currencies which are only backed by the full faith of Central Banks. Theoretically this means governments can create money "out of thin air". At this point the actions of the U.S. Federal Reserve in conjunction with other Central Banks have been truly unprecedented. It seems they are prepared to inject unlimited amounts of money, potentially going overboard and risking inflation. Despite all the anxiety and all the forecasts for a depression, there is no solid evidence supporting it and a lot of critical work being done to fix this financial mess.

Importantly, while the *worst may be over for stock prices* there are very serious problems that need to be addressed. The economic news going forward will not be encouraging. It never is. This is why the stock market is often referred to as a *leading indicator.*

Credit: End of an Era

The financial engineering which facilitated credit growth did not just happen overnight. It was over a decade in the making primarily allowing U.S. residential mortgage debt to be sliced, diced, insured, and sold as securities into the marketplace. Never before has debt been manufactured and distributed to such heights. The economy appeared strong however its foundation was weak having been built on cheap and available credit. This "neutron debt bomb" has now exploded. The collateral underneath it has crumbled, i.e. stocks and real estate, but the debt is still left standing!

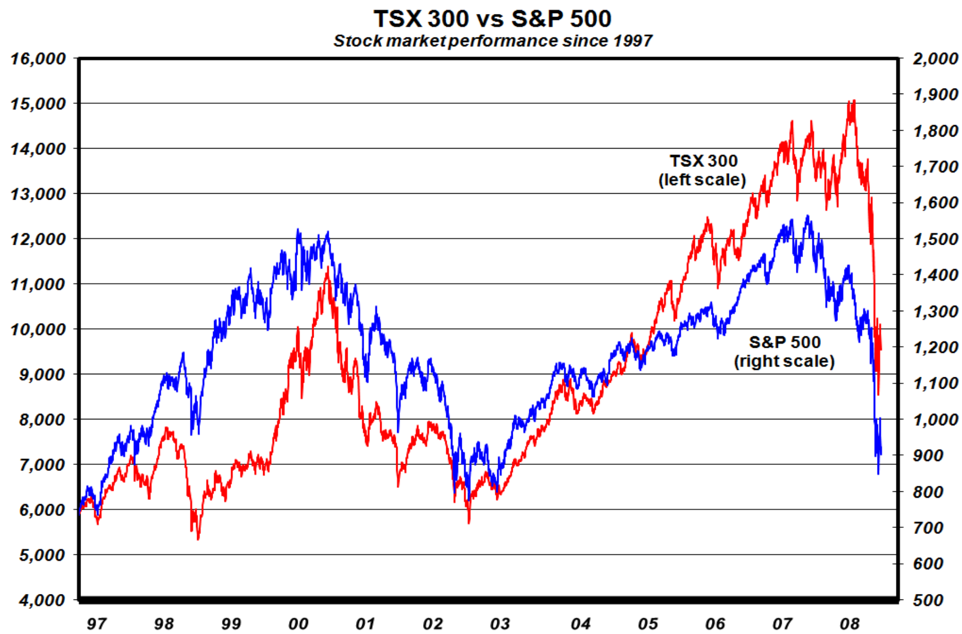
We could face a protracted *economic slowdown* as corporations and households de-lever and attempt to restore some health to broken balance sheets. A major behavioural shift on the part of consumers could be in order – a change from spending to saving. The silly notions of the past that "more debt equals more wealth" are probably seriously questioned. In any event even if consumers demanded more debt it is unlikely the banking and credit industry could provide it. Major changes there are underway as capital requirements are pressing. The idea that selling securities/loans with hedges can be risk free has fallen into disrepute. Bankers and governments know the lending system needs repairing. Bankers also need better risk management systems to deal more effectively in this modern and complex financial world. The banks claimed they were well equipped with new derivative products to diffuse financial risks. It turns out instead these esoteric derivative products have multiplied the risks as Banks and other financial firms were encouraged to make riskier loans thinking they were well hedged. The era of irresponsible and unlimited growth in credit creation is now over. Loans will likely continue to be written down for some time to come. Credit markets will eventually stabilize and new regulations will give rise to a healthier financial system with better checks and balances.

Counting on China

A few short months ago there was a strong belief in "global decoupling", i.e. that Asian economies would continue to show rapid growth and would therefore partially offset the slowdown in the Western world. This dubious theory has now been laid to rest as the global slowdown has drawn China into its orbit. Decoupling never made sense given the difference in economic size of the developed versus the developing world. Combined, the U.S. and Europe represent the bulk of world economic activity. However, *any early end to the global slowdown is certainly dependent on China* as it has the wealth to support the world financially and the capacity to grow domestically. It has an important role to play and could lift the world out of recession.

Ten years ago, China experienced hardship during the Asian financial crisis in 1998. The valuable lesson learned was to build trade surpluses and accumulate a huge pile of foreign reserves. It adopted many market based economic reforms, and determined to industrialize it focused on a manufacturing based economy. Their financial sector remained undeveloped and unsophisticated by Western standards – which as it turns out was very fortunate. China has very little debt and a very high level of savings. It is in a position to lever these savings to finance domestic growth. This will benefit the world at large and should in time provide the necessary economic stimulus so that a severe recession can be avoided.

Longer Term Returns



The chart above compares the U.S. and Canadian stock markets over the past dozen years. Both have declined sharply close to levels reached in 2003. In fact for the average "buy and hold" investor, the last ten or twelve years have resulted in very poor returns. In hindsight, the strategy to "buy low and sell high" is clearly evident. Unfortunately, because of either fear or temperament many investors do the opposite. With ten year rates of returns now virtually zero, the likelihood in losing money over the next few years is very low. Short-term volatility aside, this is finally a good time to be buying stocks *for the long-term.*

Significantly, the chart also shows the fairly high correlation in Canadian and U.S. stock markets. Equally, the chart on the first page is an example of how global markets are interconnected. This explains why we pay a lot of attention to the U.S. Their economy and financial markets are the main drivers of global macroeconomic events.

Portfolio Strategy

Success in managing investment portfolios means having to take risk when conditions are often dismal. A contrarian mindset is helpful. The greatest risk in stocks always comes at the top of the business cycle when prices are at their highest. Risk appears low because the skies have been blue for awhile and economic forecasts are always sunny. Conversely, risk appears high after prices have dropped and all forecasts call for stormy weather. The 35-40% stock market plunge should make this concept very clear for investors. *Price risk is now much lower than it was six months ago.*

The best values usually surface when the economy is weak, and the outlook grim. It is always a frightening time and impossible to know with any certainty that stocks will advance again within an acceptable time frame. Frustration is inevitable. The decision to buy is easier if done in steps. To wait and aim for the absolute "bottom of the market" is absurd and pure luck if successful. *Ideally, buying in three stages will result in 1) buying early, 2) near the bottom, and 3) again on the way up during the recovery phase.*

Should prices continue to drop even substantially from current levels, a full recovery could be expected within the year. This could not have been said when the TSX was in the 12-15,000 range. If the market continues to go down we stand a very reasonable chance of getting our money back. This is what a low risk investment strategy is all about. In the famous words of the late John Templeton, "buy at the point of maximum pessimism". The trick is to make a reasonable guesstimate of exactly when that is. We are certainly much closer today.

Equity Strategy

A “deflation mindset” has taken hold causing investors to dump inflationary stocks. Oil, base metals and Gold have been particularly hardest hit. Commodity index investors are selling Billions in futures contracts alongside hedge funds that are being forced to liquidate as loans are scaled back and client redemptions accelerate.

Still, the outlook is not bleak. A recovery in global spending will come from the ongoing need for infrastructure development. Billions will be spent in China, and in North America, on roads, bridges, airports and electrical power generation. Resource stocks will be in favour again.

Gold remains an appropriate investment precisely because the future is unknown. G**old will be in and out of favour as statistics support either inflationary or deflationary trends. Good q**uality gold stocks are now trading at 2003 prices back when Bullion was under $500 U.S an ounce. Companies have been caught up in the panic selling which will eventually subside. We continue to recommend this sector.

Oil-sands companies, such as Suncor and EnCana will be long-term beneficiaries of rising oil prices. Among the first to expand, they will have the most to gain when full production comes on-stream. Oil stocks have corrected significantly and we are beginning to buy now for the next cycle move up in energy prices.

As global growth gets back on track the price gains in natural resources could be phenomenal. In the past three or four years the major companies did not have an opportunity to significantly increase supply. It takes many years to explore and bring a mine or an oil field into production. Even if resource price inflation is more tempered going forward, current stock prices of the leading resource companies are discounting the end of the world.

The commodity sector, including agriculture, companies benefiting from infrastructure spending, biotechnology and “clean technologies” are all areas that should show promise in the future. In spite of an economic slowdown, and certainly well before the recession ends, the next growth areas will again command investor attention. Also, limiting exposure to the sectors and companies reliant on the consumer will likely be sensible over the next year.

Valuations will be a critical criteria in our investment decisions. Before and as the economic cycle recovers, we will be looking to take longer term “core” positions in leading companies and sectors with solid growth characteristics into the next cycle. We will still take our time and be as prudent as possible in these uncertain markets.