Investment Commentary

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2008 A Year To Forget

For many investors 2008 is a year they would rather forget. Global stock markets were under severe pressure in the final months of the year. Seemingly out of nowhere, markets plunged by almost 40%, throwing the entire financial world into a state of complete chaos.

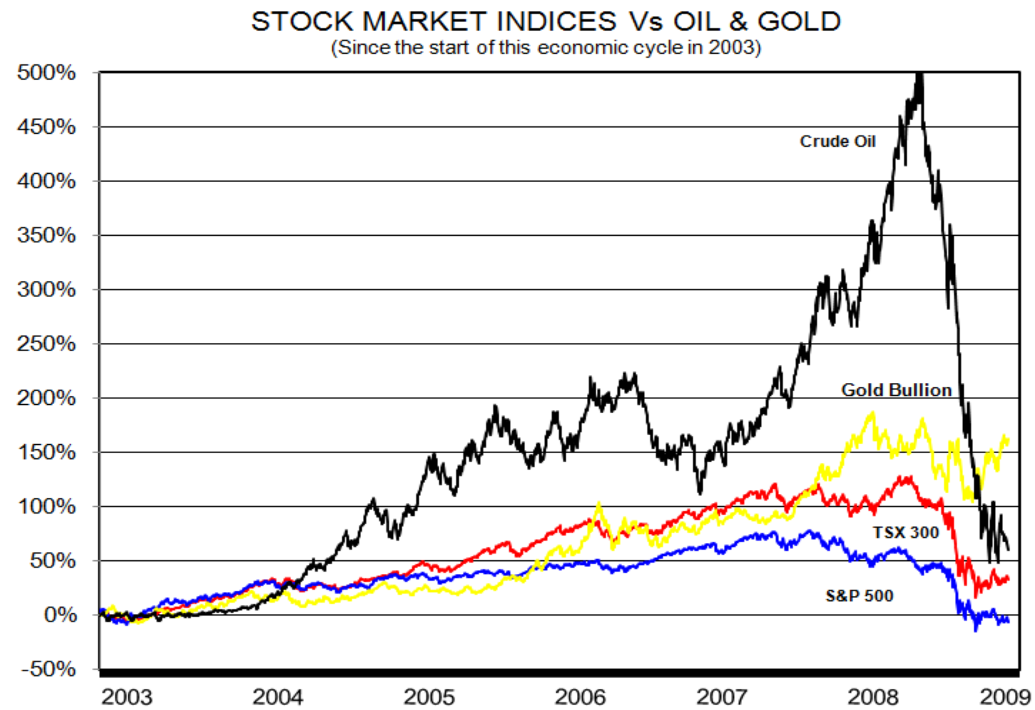
Reviewing the carnage, for the entire calendar year, the Canadian market (TSX) was down 33%, in the U.S., the S&P 500 was down 37%, or 23% in Cdn dollar terms (the U.S. dollar strengthened versus the Loonie). Bond markets performed well as interest rates declined. The benchmark 20 year Cdn Universe bond index advanced by 6.4%.

A Business Cycle To Forget

The appalling truth is that it was also a business cycle to forget. Starting from the trough in 2003, when markets last bottomed after the previous infamous “tech bubble” peak, we have come full circle - a six year climb and subsequent crash in both stock and commodity markets.

The chart below shows this cycle’s steep rise and fall in the price of oil, as well as the round trip in major stock markets. Apart from gold bullion which has held up nicely, it seems in hindsight as if it was all just a complete waste of effort to invest.

In the final two years, speculation was centered on the “inflation trade”. There was a large and persistent bet on all commodities, not just oil. As a result the TSX stock index outperformed its U.S. counterpart. Investors believed perpetual growth from the *developing* world would lead to chronic supply shortages. Investors were also blinded into thinking demand from the *developed* world could grow forever. The business cycle was forgotten. The coming cycle deserves a good breather and the recovery should therefore be more subdued. Governments around the world have other plans however, determined to get the economy right back up on its feet again.



A Depression in 2009?

Talk of Depression is widespread. Since the year-end, it seems every day there is a comment from someone in the media comparing the current economic fallout with the Depression of the 1930's. We have heard the words "not since the Depression" countless times as various economic statistics get reported. The comparisons are front and center on everyone's minds.

At this juncture, any similarities to the Great Depression are grossly exaggerated. Any forecast is pure speculation based on the worst case scenario that the errors of the past will be repeated and that no practical solutions are possible. Let us quickly review the period of the 1930's and why we believe the situation we face today is quite different and more manageable.

In comparison to today, the economy of the 1930's was structured differently. It was an economy that was almost completely in the hands of the private sector. It was the era of the great industrialists. Government played a small role and regulation was limited. The world was also on a gold standard which meant trade and capital flows were more strictly controlled. Nations were more isolated in terms of communications and financial markets were much less sophisticated.

Unemployment in the 1930's reached 25% and a large part of the population was also under-employed. Again, the structural differences are significant. In the 1930's almost 40% of the labour force was employed in farming. It was not the financial Crash of '29 that caused an immediate and sharp rise in unemployment, rather that came as a result of the "dust bowl" of the mid 1930's. The severe drought led to massive crop failures and drew desperate workers off the farms and into the cities. Economists remain divided as to the exact reasons for the Great Depression and on the many mistakes that were made. The entire decade could be reasonably viewed as two severe back to back recessions. Importantly, many of the worst economic statistics were registered in the second half of the decade and well after financial markets had finally hit bottom.

The modern world has many economic stabilizers in the form of income and support payments. Without a Gold standard there is no restraint on Governments from printing money. In theory, governments can print all the legal tender their hearts desire should the bond markets not be able to absorb and fund the coming deficits. With quick and coordinated actions from world governments, loose fiscal and monetary policies will prevent a crash in money supply and incomes. These are major differences.

Confidence in the banking *system* will get us through this mess, notwithstanding some of the appalling banking practices. Unlike the 30's when depositors lost money due to bank failures and preferred the safety of a "stuffed mattress", no one today will lose a nickel on deposit - not even in a failed bank.

While we are hopeful the modern economy has the tools to mitigate any disaster scenario, the unintended consequences of fixing the crisis will certainly bring fresh new challenges ahead - namely inflation and unstable currency markets. These consequences are far enough in the future that we need not let them get in the way of solving the immediate problem at hand - preventing another Great Depression.

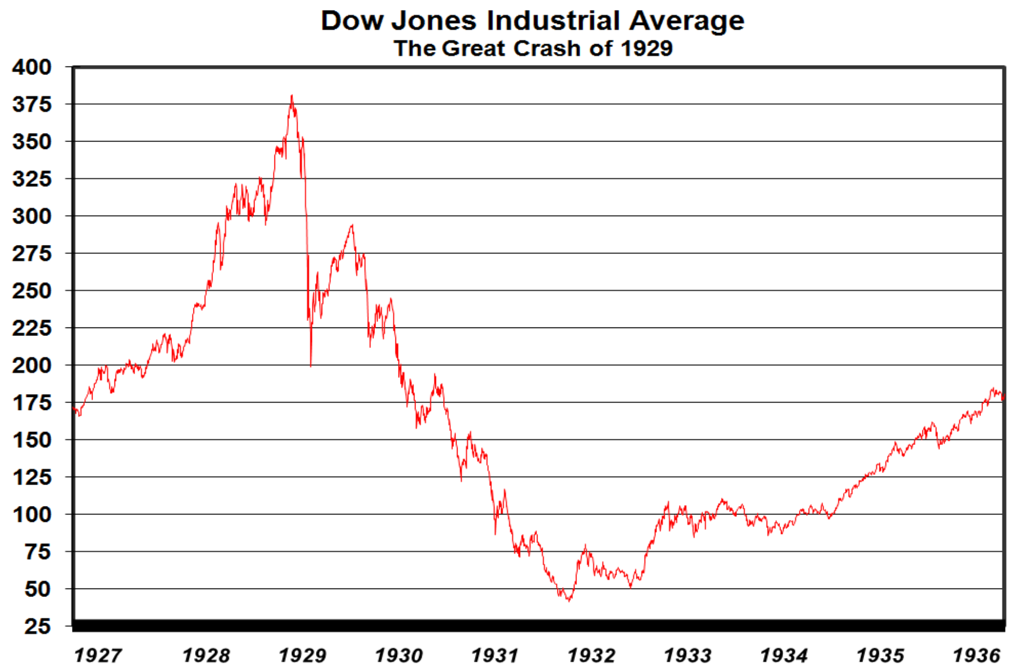
The doom and gloom forecasts can be expected to continue. They offer no solutions and believe that an endless spiral down awaits the global economy. Even the demographers are forecasting a depression. Based on their study of population trends and aging baby boomers, we are in for very difficult times. Savings need to be rebuilt as retirement incomes are now inadequate. This will severely impact consumer spending, the lifeblood of the economy. Keeping in mind that past predictions from this group called for a lower demand for residential housing and a high demand for financial services, thereby benefitting stock prices, current forecasts should be taken with a grain of salt. This only proves that while it is possible to see the herd coming, ie boomers savings, trying to predict their behaviour, how and where they invest, is a mugs game.

The Crash of 1929

The Crash of '29 was the result of massive financial speculation. Share prices rose spectacularly over the entire decade and had doubled in the final year. The chart below looks at the ten year period from 1927 to 1936. The stock market finally bottomed in July of 1932, dropping an incredible 89%. The economy continued to contract and unemployment reached a peak of 25% in 1936.

The experts are divided on the cause of the Crash. Some believe that a restrictive monetary policy was to blame. Others believe the subsequent government fiscal policy was not large or quick enough to stem the decline. It appears that we are now in for a good deal of both; low interest rates and plenty of money and large scale government fiscal spending. Will the economy get back on track? It most definitely should.

In the current circumstances, since the cycle trough in 2003, North American markets climbed steadily higher but did not get to extreme valuation levels. A good deal of investment flows were directed into residential real estate and also into commodities. The preconditions for a Crash in stocks, therefore, were not in place. Stock valuation levels are now actually at reasonable levels. This could not have been said one year after the Crash of 29, nor either in the year after the “tech bubble” burst in 2000.



Buddy Can You Spare a Trillion?

The U.S. government has enacted several “lending facilities” with acronyms such as TAF, TSLF, MMIFF and PDCF. Banks and Investment Dealers are being bailed out. The financial sector is vital to the well being of the economy and therefore deemed “too big to fail”. The bailout in the U.S. so far adds up to $2 Trillion and counting. In a word, stunning!

There is no choice. Recent economic statistics are dreadful. Industrial production seems to have fallen off the proverbial cliff. The North American auto sector in particular is hard pressed with annualized sales activity down almost 50% from about 20 Million vehicles to under 10 Million. Many companies in the U.S. and Canada have announced shutdowns and layoff notices are rising sharply. This is a global phenomenon - Europe, Russia, Japan, and China are all witnessing a steep downturn in production.

While the stimulus package will certainly help, loose fiscal and monetary policies will not by themselves produce a long and sustainable return to former growth rates. The U.S. and the world are in this financial mess precisely because of loose policies. Adding more debt is not a long-term solution to what is fundamentally a debt problem. The government cannot come to the private markets and borrow $2 or 3 Trillion without crowding out the private markets. Nor can they get away by printing money. There is no free lunch. **The consequences will either be a lower U.S. dollar or higher interest rates or some combination of the two.**

Though still early in the new year, many “experts” are now forecasting 2008/9 will be the worst post-War recession. These forecasts have of course changed dramatically in just a few short months. This is due to *linear thinking* where the tendency is to take the most recent data points and try to predict the future. This is always fraught with risk and particularly so at economic turning points. Hence on the basis of the last monthly or quarterly economic figures when the credit crisis hit and financing a purchase was near impossible, we are to presume this is a permanent condition leading to an endless and vicious down-cycle in consumer spending, production and an endless rise in unemployment. Having witnessed many recessions, we are inclined to be *slightly more optimistic*. The global economy will stabilize and private credit growth will once again feed an expansion. It is just a matter of time. We will then likely need to adjust to a period of perhaps higher inflation.

Importantly, U.S. and world governments are proactive. Large annual deficits will partly substitute losses in the private sector and money will be printed as necessary until the economy begins to re-inflate. Once the economy stabilizes it will put an end to the doom and gloom depression forecasts and investor confidence in financial markets will recover.

Gold

Gold bullion peaked in March of 2008 reaching $1,030 in U.S. dollars. It subsequently declined to a low of $800 and now stands again close to the $1,000 U.S. dollar mark. In Canadian dollar terms the price is at record levels. In contrast, gold stocks are still well below their March 2008 highs and have witnessed a tremendous amount of price volatility. Investing in common shares are definitely not for the faint of heart.

In their pursuit to stop a 1930’s style deflationary depression, governments worldwide are enacting inflationary policies. With the possibility of much higher inflation rates in the years to come, the price of Gold bullion looks set to continue rising. It is the ultimate safe haven against inflation. If investors increasingly believe they need to “hedge”, a small amount of gold in their portfolios will send the price considerably higher. In this economic climate Gold could very well be the asset class of choice as investors buy a little insurance in the event currencies are devalued.

While we still favour the purchase of gold stocks and believe they will provide good gains for client portfolios over time, we have decided to reduce positions at this time. In recent months the volatility in share prices is much higher than we anticipated, as compared to the price of bullion. We will endeavour to trade more often around these reduced “core positions” in client portfolios.

Preserving Capital

The first priority for successful portfolio management should be to preserve capital. Severe market declines come around at least every decade. To avoid these serious cycle-ending declines with 90 to 95% of capital intact should be the primary objective *when managing balanced portfolios for clients relying on income.* For more aggressive and longer-term oriented portfolios, especially when clients are still saving, preserving capital is less critical. These portfolios can ride out the volatile market in the knowledge that over time their capital will be returned. They also have the wherewithal to buy at lower prices and "average down" their costs. Still, no one wants to lose a significant amount even if only temporary. It is never a comfortable situation.

In 2008 an aggressive all equity portfolio would have resulted in capital losses of from 30-35%. In comparison, our aggressively managed portfolios suffered losses in the range of 6 to 8%. Balanced portfolios experienced modest losses of about 2% on average and our more conservative accounts registered small gains. We had a very successful year.

Equity Strategy

The stock market always bottoms well before the economy does. It is important to emphasize this because the stock market is not the economy. Many investors are confused by this. Liquidity supplied by central banks always finds its way into the financial markets first and then eventually into the real economy through the lending process.

If an economic recovery is expected next year, the stock market will be in recovery mode well before this. In fact we can expect the stock market to anticipate an economic recovery *a number of times* before it eventually does. These are commonly referred to as "bear market rallies". Just when investors believe the worst is possibly over, along comes evidence of a renewed slowdown.

We still believe the commodity sector, especially the agricultural commodities, have the potential to recover fairly quickly. The global economic slowdown could be deep however the majority of commodities are not oversupplied. In fact quite the opposite. Prices may firm up well before generally expected.

As a full economic recovery is uncertain, it does not make any sense to take big risks at this time. Many recoveries are quick and powerful in the very first year and investors do not like to miss an opportunity. This partly explains the dramatic upswings we have seen in the past couple of months. We would expect continued volatility for the balance of this year and we will endeavour to trade this volatility on a selective basis. As part of our risk management strategies, we may also again purchase on occasion exchange-traded "bear" funds. Importantly, we will remain vigilant and look for opportunities as they arise.