

DECEMBER 2008

If you're in a bad situation, don't worry it'll change. If you're in a good situation, don't worry it'll change.

~John A. Simone, Sr.

CHANGE

Well, things have certainly changed in the economic and financial world, and painfully so, over a very short period of time. Mr. Barack Obama, U.S. president-elect, built his successful campaign on the theme of change, presumably without foretelling the massive and agonizing changes that would be thrust upon the world leading up to his election, and in the aftermath. Of course, we understand that change is a constant in this fast-paced world, but the transformations witnessed just over the past few months have been astonishing.

Economic forecasters have been revising their predictions faster than Wal-Mart rolls back prices as the U.S. is now in official recession and global-growth expectations slow considerably. It is interesting to note the drastic revisions 'blue chip' economists made to U.S. forecasts in the November Wall Street Journal survey, even compared to the recent September numbers.

In September, the consensus was still for real growth in the fourth quarter, albeit below average at 0.6%, but that has quickly been downgraded now to a -3% contraction. Similarly, the outlook for next year's first half has dropped from positive to negative and the expected unemployment peak has jumped from 6.3% to 7.7%.

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Further, these gloomy forecasts of slowing or contracting economic activity aren't limited to the U.S. but extend to global economies as well, where even China's growth is now predicted to be somewhat less miraculous going forward.

And today, even the good news of lower oil prices (a \$20 drop in the price of oil for a year is claimed to stimulate the world economy by \$700 billion) and lower inflation is perceived as bad news because of the potential deflationary impact.

These changing economic tides are a concern, and certainly a key factor in the stock-market swoon investors have been enduring. But governments and central banks have reacted in force with stimulus programs that have been described with superlatives ranging from extraordinary to massive and unprecedented. Initially conceived to deal with the credit logjam that has snarled both business and personal lending activity, and including rate cuts, liquidity injections, capital injections, backstopping and troubled asset purchases, the stimulus programs also are economic-friendly. Such activities require trust and confidence in the system to gain traction, and those elements

are still in short supply, but they will eventually take hold and be effective. As well, authorities around the world have made it clear they will 'do what it takes' with further fiscal and monetary actions to prevent a prolonged economic downturn. Alternatively, in Canada our politicians are taking a different tack, hoping their comedy routine will take our minds off the serious problems; unfortunately, the joke is on us, and it's not funny.

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Real estate and home values have been viewed as safe and secure by most owners, but there too we have seen big changes lately as the rest of the world catches up (or down) to the United States. There, residential real estate has been in recession for almost three years now in a market characterized by declining prices (down 17% in the past year on average according to the authoritative Case Shiller) and rising inventories (thanks to prior overbuilding and current foreclosures) even though new construction has fallen to 1990

levels. In Canada we claim to be relatively pure (little in the way of sub-prime mortgages, no tax deductibility and few government directives to lend money to people who can't afford homes), but even here the Canadian Real Estate Association calculates a national price decline of 10%, and in the U.K. it is set at 14%. Credit is crucial, of course, and in the U.S. efforts to free up mortgage credit and lending capacity should eventually resuscitate the market and stem the damaging wealth destruction.

Currency fluctuations tend to fade into the background for investors when stocks are tumbling, but recent changes in that mysterious market have been nothing short of dramatic. Just consider, for example, that about a year ago our loonie was flying high at \$1.10 U.S. but has recently been in a screaming nosedive, crash landing currently at the \$.80 level. This move is of more than academic interest since, on the one hand, it does make U.S. holdings worth more but, overweighting this on the other, it is another wealth destroyer for the country as a whole. Yes, Canada is in better shape financially than most, but the American status as a safe haven trumps all in times of trouble. As well, commodities have proven to be a double-edged sword as the disappearance of \$200 oil forecasts

and the decline in virtually every commodity we produce have hastened the dollar's decline (as well as the stock market's, of course) at least temporarily.

Investors often think of the bond market in fairly generic terms, with little differentiation assumed for the various market sectors. That view has definitely changed. Because of the prevailing credit concerns, there have really been two bond markets this year... the highest quality market and the lower quality market... and the results have been radically different. The best example is found in the U.S. where the fear-driven flight to quality has

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taken government issues to historically low yields, including virtually 0% on 90-day Treasury Bills and 3.20% on 30-year bonds. Can you imagine tying up your money for 30 years at 3.20%? Neither can we. Corporate bonds on the other hand, and here we are talking investment grade bonds, are yielding near 9% in 5-10 year maturities, taking the quality 'spread' in rates to historic highs.


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As a result, government bonds have produced a strong showing, up 9% so far this year, while the corporate side has suffered, down 9%, and high-yield (junk) bonds have lost their owners 32% on average with a current yield of 22%. The Canadian market is similar, but with more moderate numbers. This huge discrepancy in borrowing rates, repeated in the mortgage market, is symptomatic of the credit logjam and is a primary target of the authorities' attempts to get credit flowing again.

Stock markets, everyone knows, have changed miserably for the worse and the financial media have reported continuously on their decline. Markets around the world have been in surprising sync, with most dropping in the 50% vicinity. The decline has been fast and furious (our market peaked in June), gut-wrenchingly volatile (major moves in hours rather than months) and amazingly broad-based (the ten major sectors in Canada all down at least 20%).

The once bullet-proof banks provided no safe haven, matching the market decline, and even gold stocks, the usual go-to sector in troubled times, fell victim to the forced selling syndrome, dropping 60%. This is history, of course, and we know the market is forward looking, so the difficult question for investors is how much of the financial and economic trouble has been discounted by the slide in stock prices, i.e., what is priced in the market? The troubles look daunting with many months of bad news likely yet to come, including weakening corporate profitability, as the recession unfolds. But stocks are on sale as prices have been rolled back again and again to try and attract buyers. So far there is no certainty of a bottom, and definitely no unanimity of opinion, but valuations look cheap based on

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underlying assets, dividend yields, and 'normalized' revenues and earnings. Caution is called for, but if history is a guide, stocks will start their recovery in the midst of the turmoil, well before any 'all clear' signal is given and likely before most investors expect it. 

TAX FREE SAVINGS ACCOUNTS


Beginning January 1, 2009 "Tax Free Savings Accounts" (TFSA) will be available for Canadian residents 18 years of age and over.

Contributions are not tax-deductible but withdrawals are tax-free. Annual contributions limits are \$5000 per individual, and contribution room not used may be carried forward indefinitely. Any income or capital appreciation in the account is non-taxable. Your capital is always accessible and if withdrawn, may be replaced, but not in the same calendar year.

This is an opportunity for income splitting among family members over age 18 without triggering the attribution rules.

Withdrawals will not increase your taxable income compared to registered account withdrawals that may negatively impact your income-tested benefits from the government, i.e., OAS, GIS, CCTB. This is a great vehicle to complement your current registered savings plan.

For people who participate in employer-sponsored pension plans and have little RRSP contribution room, this is a great opportunity to save, invest and avoid paying taxes on the investment income or growth on those monies.

If you have any questions or want to know more about how a TFSA would fit with your personal financial situation, please speak to your Portfolio Manager or please call the office for your TFSA account application package. 

QUOTING OUR TIMES

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With so many opinions expressed about this extraordinary environment, we thought our readers would be interested in this mixture of recent views.

Prem Watsa, CEO Fairfax Financial, prescient forecaster of the downturn: *“This recession may be long and deep...(but) we are buying many common stock positions at these prices...we see a ton of opportunities in stock prices we have not seen in a long, long time now.”*

Paul Volcker, former chairman of the Federal Reserve Board, advisor to Barack Obama: *“I don’t think anybody thinks we are going to get through this recession in a hurry.”*

Jim Grant, Grant’s Interest Rate Observer, noted bear: *“Those glib comparisons with the great depression ignore the reality of the economic backdrops. In the Thirties nominal GDP was sawed in half...”*

TD Securities: *“The vast majority of people still have jobs, are paying their mortgages and are otherwise reasonably secure.”* (An aside: contrary to popular opinion, 90% of sub-prime mortgages are current, making payments on time.)

Bank Credit Analyst: *“A deep recession is underway...but we have entered an extraordinary era of policy stimulus...and the equity markets are discounting a bleak economic outlook.”*

An esteemed competitor’s ad: *“Market volatility isn’t the enemy. Short-term thinking is.”*

Ed Clark, TD Canada Trust CEO, on Canadian banks cutting dividends: *“I think that’s an unlikely event.”*

Donald Coxe, commodity manager: *“Over the next five years, commodity prices will go higher than they otherwise would have because of the massive reflation going on.”*

Warren Buffet, famous market supporter: *“Be greedy when others are fearful.”*

Barton Biggs, hedge fund guru: *“Nobody, and I mean nobody, really knows what hedge fund liquidity is or what redemptions are or will be.”*

BMO Nesbitt Burns, on Fed purchasing mortgages: *“The Fed and the Treasury are starting to behave as a macro hedge fund, issuing debt at 50-year low rates and buying long-term assets. They could make a fortune.”*

John Templeton, renowned investor: *“Invest at the point of maximum pessimism.”*

Another esteemed competitor: *“I have been in the investment business some 32 years and the valuations are the cheapest they have been during this time.”*

Bank Credit Analyst, on Chinese rate cuts, tax cuts, spending plans: *“They are in an all-out war against this slowdown and they are doing it with force.”*

Gasoline comment: *Prices at their lowest level in almost 4 years.*

CPMS, equity consultant: *“We’ll look back five years from now and say it was a great deal for the long-term investor...but in the short term fear is definitely ruling the markets.”*

David Dodge, former Bank of Canada Governor, on mark-to-market rules: *“A major contributor to volatility.”*

Ken Curtis, former Goldman Sachs head in Asia, on China: *“Contrary to what many foreign observers are saying, there is a vast construction boom in the making.”*

National Bank Financial, on historical bear markets and recoveries: In six comparable periods of financial stress, stocks were down an average of 43% but once the bottom was hit, they recovered 48% in six months and 86% in 12 months. 