

## Investment Outlook

October 2007

### Bad is the New Good

This is an uncertain time for stock market investors as sentiment whip-saws between fear and greed. Over the last quarter, the path of stock indexes was v-shaped. In mid-July, several stock market indexes reached new highs as corporate earnings continued to come through and investors remained sanguine about the usual risks to economic growth and corporate profitability. By mid-August, this happy complacency gave way to fear as the onset of a global credit crisis sent stocks into retreat. A rapid and aggressive response by the U.S. Federal Reserve, however, ensured that the stock market plunge was short-lived and stock indexes resumed their upward climb. As the dust settled, stock indexes recorded a positive quarter in local currency terms<sup>1</sup>, although rising volatility kept things more nerve-racking than many would like.

What happened in mid-August? Simplistically, rising defaults in the U.S. sub-prime mortgage markets led to a rapid increase in credit spreads for all loans. Unlike the old days when banks actually collected the interest from the people to whom they lent money, today many of these mortgages are packaged up and sold off in complex derivative and structured financial instruments. While this has the beneficial effect of broadly distributing risk, it has the less desirable effect of reducing transparency in financial markets. At the time of the August crisis, financial intermediaries realized they had no clear idea where risk lay and credit markets seized up.

It is a concern to us that investors have discounted so quickly the risks to markets that were demonstrated in August. Moreover, it confounds us that investor attitudes remain so optimistic that all news is good, even when it is bad. Many examples abound over the last several months. One such event came on October 1<sup>st</sup> when global banking behemoths, Citigroup and UBS, each announced enormous write-offs for rising loan losses: \$5.9 billion in the case of Citi and \$3.4 billion in the case of UBS. As well, Merrill Lynch announced that it also suffered steep losses in the August credit crunch. Following these dire announcements, the S&P 500 rose 2% to an all-time high with bank and brokerage stocks leading the way. Apparently, the activity of disclosing of losses is sufficient evidence for investors to conclude that the troubles are behind us and have been dealt with. This tendency to believe in quick solutions to what are manifestly serious problems betrays a serious under-appreciation of risk. In contrast to the cheery consensus, we believe that there are still good reasons to be cautious.

As we look at the current investment environment, we see three main risks. First, analysts and investors continue to forecast expanding corporate profit margins, despite the fact that margins are at the high end of their historical range. Because high margins attract more competition, corporate profit margins are one of the most powerfully mean-reverting statistics in all of economics. Accordingly, the risk of disappointment is real. Second, we believe the U.S. housing market correction is far from complete. Over many years, average home prices have equaled about 4x average family income. Currently, in many large U.S. cities, prices average 6x family income.<sup>2</sup> There remains the potential for further price declines in many markets. As well, the growing swell of sub-prime mortgage defaults is far from peaking. Most sub-prime mortgages originated over the last several years had low “teaser” rates for the first two years that then reset to significantly higher levels (often 30% higher). The peak of these resets doesn’t occur until the spring of 2008. Accordingly, the news on the sub-prime front will get worse before it gets better. Finally, as the title above suggests, we remain in a period where we believe risk is not being priced adequately. As Jeremy

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<sup>1</sup> While positive in US\$, the appreciation in the Canadian dollar caused U.S. returns to be negative in C\$ terms.

<sup>2</sup> *Fortune*, September 17, 2007.

Grantham put it in a recent *Fortune* article, “On some data, indeed, investors actually appear to be paying for the privilege of taking risk.”<sup>3</sup> This, too, must come to an end. In due course, investors will be offered a greater reward for taking risk. In other words, many financial instruments will be cheaper.

### **The Loony Loonie**

As newsworthy as the stock market gyrations in August were, so too has been the dramatic rise in the Canadian dollar. Clients would have called us loony if we had predicted a year ago that we would close the third quarter of 2007 with the Canadian dollar at par with the U.S. dollar. The dollar’s rise has been rapid and dramatic. It is up 20% against the U.S. dollar since early March. While some of this strength has been the result of U.S. dollar weakness, the Loonie has also advanced strongly against our other major trading partners. On a trade-weighted basis, the Loonie has appreciated 11.5% year-to-date against a basket of other currencies.

As consumers, many Canadians celebrating the greater affordability of Florida vacations and L.L. Bean merchandise. However, the rate of appreciation has been so rapid that many industries are only just waking up to the dramatic impact it will have on their competitiveness and profitability. While, in the long run, a strong currency is a desirable aspect of a strong national economy, a change as sudden as we have experienced can be fundamentally disruptive. Avid readers of the *Outlook* will recall our discussion in previous issues of the so-called “Dutch Disease”. This is the phenomenon where the frenzied run-up in a nation’s currency (often in response to similar frenzy in that country’s natural resources) has the effect of undermining the country’s industrial base. Over time, the currency frequently reverts to a more sustainable level, but the country’s industrial base typically suffers permanent damage. This is what happened in Holland at the time of North Sea oil discoveries in the 1970’s and has happened in several countries since, each time with unfavourable results.

The flip side of the Loonie’s strength is the well-publicized weakness of the U.S. dollar. The Fed’s trade-weighted index of the U.S. dollar against other major currencies has fallen to the lowest level since the inception of the index in 1971. It is only sensible to consider the destabilizing ramifications of further U.S. dollar weakness. Should the Chinese feel that they don’t need quite so many U.S. Treasury bonds, or should the Saudis decide to start selling some of their oil in Euros, the dollar could continue to be under significant pressure. The consequence of a further decline would be sharply higher interest rates in the U.S. This would almost certainly plunge its economy into recession.

### **The Yellow Light is Still Flashing**

While stock market index returns were positive over the last quarter and the last year, market breadth was narrow. As an example, while the S&P 500 has provided a respectable return of 9% in the first nine months of 2007, more than 40% of its constituents were down. In Canada, leadership has been even more restricted with a single stock contributing 20% of the TSX return during 2007.<sup>4</sup> While the indexes tell a fairly positive story, the return from an average stock tells a more cautious tale.

We have maintained a defensive posture in portfolios, both in terms of cash levels and the specific securities we hold. In fact, over the last quarter, we have built additional cash as the result of several takeovers and selected reductions to equity positions. We believe that the risks are such that we would rather err on the side of capital preservation. If we’re wrong, we would rather it be because we miss the last surge higher than because we were on the cutting edge of a major correction. We are convinced that a time is coming when risk will be priced attractively; we look forward to the opportunity to take advantage of this.

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<sup>3</sup> *Fortune*, September 17, 2007.

<sup>4</sup> This is BlackBerry maker Research in Motion.

## FINANCIAL MARKET SUMMARY

### Market Levels

<u>Canada</u>	<u>September 30, 2007</u>	<u>December 31, 2006</u>
TSX Composite Index	14,099	12,908
91-Day T-Bill Yield	3.96%	4.15%
30-Year Gov't of Canada Bond Yield	4.43%	4.14%
Prime Rate	6.25%	6.00%
Exchange Rate (1\$ Cdn. = US\$)	\$1.0037	\$0.8581

### United States

Dow Jones Industrial Average	13,896	12,463
Standard & Poor's 500 Index	1,527	1,418
30-Year U.S. Treasury Yield	4.83%	4.81%

### Market Returns For Periods Ended September 30, 2007 <sup>(1)</sup>

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years <sup>(2)</sup></u>	<u>Last 10 Years <sup>(2)</sup></u>
PC Bond 91-Day T-Bill Index	1.2%	4.4%	3.2%	3.8%
PC Bond Universe Bond Index	1.7%	1.6%	5.5%	6.1%
TSX Composite Index	2.0%	22.8%	20.4%	9.1%
S&P 500 Index (C\$)	-4.4%	4.0%	5.2%	3.1%
MSCI EAFE (C\$)	-4.3%	11.5%	12.6%	4.5%

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#### Footnotes:

(1) Represent total returns, including income and capital appreciation (or depreciation).

(2) Compound average annual return.