NEXUS

Portfolio Management & Financial Counsel

Investment Outlook

April 2008

The Year of the Bear?

2008 may be the Year of the Rat in the Chinese calendar cycle, but it looks to be shaping up as the Year of the Bear in global financial markets. While the turmoil in financial markets certainly is a top news story, the true extent of the carnage may not be so well known. Consider the returns in a number of foreign stock markets during the first three months of 2008: in the U.S., the S&P 500 was down 9.9%, London's FTSE 100 was down 11.7%, France's CAC 40 was down 16.2%, Germany's DAX 60 was down 18.1%, Japan's Nikkei was down 18.2%, India's Sensex was down 22.9%, and China's Shanghai Composite was down 34.0%[1]. By comparison, the TSX Composite's decline of 3.5% positions Canada as one of the best performing markets in the world. Underneath this headline return, however, conditions here are more challenging than they appear. The TSX return was very narrowly based – only a powerful rally in gold shares, itself a bearish indicator, prevented the index from being much weaker.

As if the swoon in global markets was not sufficient to unnerve investors, volatility persists at sharply elevated levels. As an example, in the first quarter, the S&P 500 rose or fell more than 1% on 54% of the trading days. This compares with a long-term average where such volatility occurs on only 19% of the trading days, and makes the start of 2008 the wildest period since 1938. All-in-all, we've had a gut-wrenching start to the year. Thankfully, as a result of our defensive posture and emphasis on quality, Nexus portfolios have managed to weather this storm better than many.

U.S. Recession at Hand?

Much of what ails global financial markets has roots in the unraveling of the U.S. housing bubble and the related excesses in consumer borrowing. We have written about this often in the past. As we enter the 2nd quarter of 2008, house prices across the U.S. continue to slide. The Case-Shiller Home Price Index, a measure of house prices in various markets across the U.S., fell a further 10.7% year-over-year in the month of January. Not since the 1930's has there been a nationwide bear market in housing such as the U.S. now is experiencing. The decline in house prices has, of course, resulted in a rapid increase in mortgage defaults and foreclosures as the excess borrowing from halcyon days past has come back to haunt many Americans.

What began as a mortgage lending issue has now spread throughout the financial system. Many will be familiar with the recent demise of investment bank Bear Stearns, which is the most visible example of the depth of the financial crisis now facing investors. Bear, known as an aggressive and profitable firm, was one of the largest buyers of complex mortgage-backed securities. As the underlying quality of its assets started to decline, counterparties became more concerned about entering into transactions with the firm. In a matter of days, this fear culminated in an old-fashioned run on the bank, and Bear was brought to its knees. Fearing panic, the U.S. Federal Reserve intervened and facilitated the sale of Bear Stearns to JP Morgan where many of Bear's assets can be liquidated in an orderly fashion. Without this intervention, it is likely Bear Stearns would have collapsed.

With the decline in house prices and the disruption in credit markets it is unsurprising that the broad U.S. economy has weakened considerably. In early April, the monthly U.S. employment report revealed that a disappointing 80,000 jobs were lost during March. This was the third consecutive month of job losses in aggregate and the fourth consecutive month of job losses in the private sector.[2] As often occurs in an environment of rapidly deteriorating labour conditions, measures of consumer confidence have plummeted.

[1] All returns in this paragraph are expressed in local currency terms and exclude dividends.

[2] Only public service job additions, which more than offset private sector losses, allowed the overall report to be positive in December 2007.

As an example, the Reuters/University of Michigan Consumer Sentiment Survey hit a 16-year low in late March. The component of this survey that reflects consumer expectations for the future was the lowest recorded since 1973. Such is the state of economic conditions in the U.S. at the moment that many economists are convinced a recession is inevitable in the months ahead, if, in fact, one hasn't already begun.

De-Coupling: The New, New Thing

Historically, economic growth in Canada and many other export-oriented countries around the world has been heavily dependent on U.S. demand for their goods and services. When the U.S. economy faltered, so did many others. More recently, the idea that these economies may be "de-coupling" from the U.S. has come into the mainstream. While this concept is usually discussed in connection with emerging markets growth, it is also relevant to the prospects for Canada. In a nutshell, de-coupling means that economic growth in many emerging economies – for example, China, India and Brazil – no longer relies entirely on exports to the U.S. These economies have reached a point of critical mass where their own domestic demand is sufficient to ensure their continued growth, even in the face of a U.S. recession. Global growth may moderate, but the de-coupling theory predicts that it won't be completely de-railed by a U.S. slowdown.

This has significant implications for Canada, largely because the growth of these emerging economies relies heavily on the consumption of commodities such as energy and other basic materials. As a leading commodity nation, Canadians may see continued strength in these industries even if the U.S. falls into a recession. Of course, we still have many industries that will be impacted by a U.S. slowdown, and it would be naïve to assume Canada's economy will be unscathed, but the prospects for our economic health overall are decidedly better than they were in previous U.S. slowdowns.

A second element in Canada's favour is that Ottawa and many provinces have considerably more policy flexibility to deal with a slowdown than has been the case in the past. Fifteen years ago, who would have guessed that Canada's fiscal prudence would be the envy of the western world? It has become just that, and we will be rewarded in turbulent times like these. Low inflation, balanced budgets and a strong currency give policy makers a number of choices to offset the effects of any slowdown in the United States or, for that matter, the rest of the world. This is not to say that Canada will sail through this period unscathed. We should expect softness in economic growth going forward, but the outlook for our economy is decidedly better than that south of the border.

Light at the End of the Tunnel?

We don't know if we can see a light at the end of the tunnel, but it is there somewhere. Fixed income and equity markets have now discounted a lot of bad news. While the level of pessimism may yet prove to be justified in the short term, we believe it is also an environment where investors will be able to establish positions that prove rewarding over the long term. In every environment there is opportunity.

Investors should be mindful that, despite the obvious appeal of the safety of fixed income investments, interest rates, especially in government bonds, have fallen to levels where they provide the important characteristic of capital preservation, but little real return. Despite the current uncertainty, it is important to remember that stock markets will begin their recovery long before the fundamental data indicate that a solid economic recovery is underway. It is important to continue our focus on the highest quality equities with defensive characteristics. Future long-term investment success will arise from being able to survive the current perilous period with capital largely intact so that the rewards from equity investments can be realized once the market begins to recover.

FINANCIAL MARKET SUMMARY

Market Levels

Canada	March 31, 2008	December 31, 2007
TSX Composite Index	13,350	13,833
91-Day T-Bill Yield	1.92%	3.85%
30-Year Gov't of Canada Bond Yield	3.94%	4.10%
Prime Rate	5.25%	6.00%
Exchange Rate (1$ Cdn. = US$)	$0.9750	$1.0075

United States		
Dow Jones Industrial Average	12,263	13,264
Standard & Poor's 500 Index	1,323	1,468
30-Year U.S. Treasury Yield	4.29%	4.45%

Market Returns For Periods Ended March 31, 2008 (1)

	Last Quarter	Last 12 Months	Last 5 Years (2)	Last 10 Years (2)
DEX 91-Day T-Bill Index	1.2%	4.6%	3.4%	3.9%
DEX Universe Bond Index	3.0%	5.8%	6.4%	6.3%
TSX Composite Index	-2.8%	4.0%	18.5%	7.8%
S&P 500 Index (C$)	-5.8%	-15.4%	3.7%	0.2%
MSCI EAFE (C$)	-5.3%	-13.3%	13.0%	2.8%

Footnotes:
(1) Represent total returns, including income and capital appreciation (or depreciation).
(2) Compound average annual return.