

## Investment Outlook

January 2008

### Has the Music Stopped?

As if reeling from excessive New Year's Eve celebrations, financial markets are staggering through the early days of 2008. In the U.S., the Dow Jones Industrial Average fell 566 points, or 4.2%, in the first three trading days of the year. This nervous beginning to the year is the Dow's worst since 1932. For some time, we have been writing about the growing risks to economic growth and financial markets from the U.S. housing market bubble and the surfeit of debt related to it. Clients will remember comments in our September *Outlook* describing how we have been confounded that stock markets could be hitting new highs at the same time that risks seemed to be becoming more severe. In the last several weeks, it seems that investors finally are starting to take these risks more seriously.

Increasingly, economists and investors are considering the possibility that the credit meltdown will lead to recession in the U.S. Both Merrill Lynch and Goldman Sachs are officially forecasting that the U.S. will enter a recession in 2008, and virtually every other economist has acknowledged that the risk of recession has grown. For some time, there have been furtive whispers about the possibility of recession, but it took a terribly weak December jobs report on January 4<sup>th</sup> to bring this discussion into the mainstream. That report not only disclosed a pathetic 18,000 new jobs created in December (the fewest in 4 ½ years), and an actual decline in private sector payrolls, but it also revealed that the unemployment rate had jumped to 5.0%. At 5.0%, the unemployment rate has already deteriorated beyond what the U.S. Federal Reserve predicted for the next three years.<sup>1</sup> Moreover, over the last year, the U.S. unemployment rate has risen from 4.4% to 5.0%, an increase of 0.6%. Only 10 times since 1948 has the unemployment rate risen 0.6% or more in a 12 month period, and in each and every one of those instances it turned out that the U.S. was already in recession. If this relationship holds again, December 2007 may mark the beginning of the next recession.<sup>2</sup>

The rising risk of recession primarily is the result of the ongoing deterioration of the U.S. housing market and the concomitant tumult in global credit markets. The U.S. housing market began to deflate in 2007, and the decline continues. There is little evidence yet that the bottom is near. While problems exist in all tiers of the market, nowhere are the troubles more acute than in the subprime market. Subprime, of course, refers to borrowers with poor credit histories or unreliable sources of income. In the first half of this decade, lenders made these borrowers' dreams come true – the lenders financed houses (often 100% of the house) that many Americans were desperate to own, but could ill afford. Much has been written in the media on the subject, although a recent report from the Federal Reserve Bank of Boston lays bare the essential issue around the subprime mortgage problem:

There have always been small-scale venues for subprime borrowers; for instance pawn shops and payday lenders have both existed for a long time. However, until recently, subprime borrowers were unable to systematically obtain large-scale loans such as mortgages. With reformed lending laws and increasingly sophisticated financial markets and instruments, a new mortgage lending channel emerged that services subprime borrowers in particular.<sup>3</sup>

All was copacetic so long as interest rates drifted lower and house prices continued to climb. When the reverse took hold, however, the music stopped and the party abruptly ended. Historically, 20% of houses purchased with subprime mortgages ended up in foreclosure; more recently, the rate has been 30%, with the risk that it rises even further as house prices continue to decline. Over the last several years, as many as

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<sup>1</sup> Philippa Dunne, The Liscio Report, quoted in *Barron's*, January 7, 2008.

<sup>2</sup> Analysis from Myles Zyblock, RBC Capital Markets.

<sup>3</sup> *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures*. Federal Reserve Bank of Boston, December 3, 2007. Quoted by Don Coxé in "Basic Points", BMO Financial Group, December 19, 2007.

25% of all new mortgages in states like California have been subprime<sup>4</sup>. Accordingly, the problem is significant, and financial institutions large and small are feeling the impact of rising defaults. Many smaller mortgage lenders have already gone bankrupt and even the biggest and brightest banks on Wall Street are expected to suffer tens of billions of dollars of losses. In this environment, the risk is that a full-blown credit crunch emerges if banks don't want to lend to even credit-worthy customers. A credit crunch, combined with falling house prices and rising energy prices, would severely impact consumers' ability to spend and the corporate sector's ability to invest. Without doubt, these headwinds will result in a significant slowdown in U.S. growth; time will tell whether the headwinds are stiff enough to send the U.S. into recession.

### **Canada: More Resilient Than It Used To Be**

Canadians have been raised with the notion that when the U.S. sneezes, Canada comes down with a cold. Should the U.S. slip into recession, it would be ridiculous not to expect substantial slowing of the Canadian economy as well. The U.S. does remain our largest trading partner by a wide margin. However, times have changed, and Canada is not the branch plant economy that it once was. We think our economy will be significantly more resilient than it has been in the face of a U.S. slowdown in the past.

To start, the housing market in Canada is in much better shape than it is in the U.S. While we certainly have enjoyed strong price appreciation, we have not had the debt-financed excesses found in many U.S. regions. Our inherently conservative nature has served us well in this regard. Secondly, despite the U.S. slowdown, global growth remains strong thanks largely to the development of China and India. As global growth translates into strong demand for commodities, our country is well positioned to benefit. Lastly, the fiscal prudence of our governments (who would have ever imagined!) provides substantial scope and flexibility for support should the economy require it.

These factors give us considerable optimism about the prospect for slower, but still decent growth in the Canadian economy. However, our optimism for ongoing strength in Canada is, of course, general. Not everyone will benefit equally. The December employment report, for example, highlighted the grim reality of the high Canadian dollar as manufacturing employment fell dramatically. Even as Canada performs well overall, we would expect export-oriented industries to face tough sledding.

### **Still Investing Cautiously**

Predicting market movements is a pastime we strenuously try to avoid. Nevertheless, certain observations can always be made. Perhaps most notable is the fact that U.S. stock and bond markets seem to be predicting very different futures. As BMO strategist, Don Coxe, so succinctly phrased it, "...equity markets continue to behave as if they are driven overwhelmingly by Greed, while debt markets are driven overwhelmingly by Fear. Major equity indices have held up remarkably well, despite daily torrents of bad financial news and talk of impending recession."<sup>5</sup> In contrast to equity markets, debt markets have priced in aggressive interest rate cuts from the Fed in response to the rapidly deteriorating economic landscape.

Time will tell whether the equity market or debt market is making a better prediction of what lies ahead. What seems certain, however, is that it will be a bumpy ride for a while longer. While overall U.S. earnings growth seems likely to disappoint in an economic slowdown, those U.S. companies with international exposure will benefit significantly from the weak U.S. dollar. In Canada, the reverse will be true – domestic business will likely do better, while export-oriented ones will struggle under the weight of the strong loonie. In short, much selectivity will be needed to navigate this tricky investment landscape. We also continue to position client portfolios on the side of caution. As we said last quarter, we would rather err by being too conservative than by not being conservative enough. Nevertheless, as the current challenges work their way through the system, we expect many great investment opportunities to emerge. Patience will be rewarded.

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<sup>4</sup> Don Coxe, "Basic Points", BMO Financial Group, December 19, 2007.

<sup>5</sup> *Ibid.*

## FINANCIAL MARKET SUMMARY

### Market Levels

<u>Canada</u>	<u>December 31, 2007</u>	<u>December 31, 2006</u>
TSX Composite Index	13,833	12,908
91-Day T-Bill Yield	3.85%	4.15%
30-Year Gov't of Canada Bond Yield	4.10%	4.14%
Prime Rate	6.00%	6.00%
Exchange Rate (1\$ Cdn. = US\$)	\$1.0075	\$0.8581

### United States

Dow Jones Industrial Average	13,264	12,463
Standard & Poor's 500 Index	1,468	1,418
30-Year U.S. Treasury Yield	4.45%	4.81%

### Market Returns For Periods Ended December 31, 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>
DEX 91-Day T-Bill Index	1.1%	4.4%	3.2%	3.8%
DEX Universe Bond Index	2.8%	3.7%	5.6%	6.3%
TSX Composite Index	-1.3%	9.8%	18.3%	9.5%
S&P 500 Index (C\$)	-4.1%	-10.6%	2.7%	2.1%
MSCI EAFE (C\$)	-2.6%	-5.7%	10.7%	4.7%

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#### Footnotes:

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

(2) Compound average annual return.