

## Investment Outlook

July 2008

*It was 1974; Gerald Ford had moved into the White House; the chairman of his Council of Economic Advisors, Alan Greenspan, was passing out WIN buttons (for Whip Inflation Now), and after a sickening bear market, the Dow Jones Industrial Average bottomed around 570. That's when General Motors shares last closed at \$11.43, which is where they finished [June 27, 2008] after a 10.8% pasting for the session.<sup>1</sup>*

Subsequent to quarter-end, GM stock has fallen further and now stands at levels last seen in the 1950's. Similarly, Ford is at generational lows. Chrysler, which was acquired by a private equity firm not long ago, is rumoured to be close to bankruptcy. To be sure, the automobile industry faces some unique problems, but it is also victim of the two great challenges impacting the broad U.S. economy: skyrocketing energy prices and the ongoing financial crisis. Metaphorically, U.S. consumers have no gas left in the tank – energy prices have emptied wallets and the days of easy and unlimited borrowing are over.

### Obsessed with Oil

One cannot turn on the television or pick up a newspaper without being confronted by the dominant story of the year: the dizzying ascent of oil prices. At the time of writing this essay, crude is trading at US\$145 per barrel. Gasoline prices have surged to over US\$4 a gallon in the U.S. and are closing in on C\$1.50 a litre in Canada. Over the coming quarters, economic growth around the world will be hugely impacted by the level of energy prices.

CIBC Chief Strategist, Jeffrey Rubin, is convinced that the price of oil is headed to US\$200 per barrel. At that level, Americans won't be paying \$4 per gallon for their gas, it will be \$7. Rubin's argument for higher oil prices is based on the fact that much of the world's population, particularly in oil producing regions and in emerging markets, enjoys heavily subsidized energy prices. Accordingly, as oil prices have risen, the expected erosion of demand has been muted. Governments around the world have absorbed much of the price increase. As well, Rubin points out that Saudi Arabia and other large producers seem unable to increase production sufficiently to meaningfully alter the global supply and demand balance.

Another argument for higher prices recognizes that there is a new buyer of energy in the world – investment funds. Over the last several years, many large pension funds and other passive investors have concluded that commodity investments are a sensible component of a diversified portfolio. The theory is that commodities provide good long-term returns and are not correlated with traditional stock markets – hence they provide valuable diversification. Unlike Canadians filling up their gas tanks, these new buyers of energy are completely insensitive to the price. It is common to explain much of the increased demand for energy, and the consequent increase in prices, on demand from energy-hungry emerging economies such as China and India. While these countries have certainly been a factor, the increased demand from new 'investors' has been greater than the increase seen in China and India.<sup>2</sup>

Thankfully, we have profited from the significant investment we have maintained in the energy sector. We continue to believe that the long-term industry fundamentals are favourable. However, it would be a mistake to think the world will run out of oil just as Thomas Malthus predicted it would run out of food.

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<sup>1</sup> Randall W. Forsyth, *Barron's*, June 30, 2008.

<sup>2</sup> "Blame it on your Pension Fund!", Probability Analytics Research, May 19, 2008.

In the short term, evidence is growing that consumers are responding and demand is being eroded.<sup>3</sup> Even within a long-term secular uptrend, there will most certainly be cyclical downtrends. Nothing goes straight up forever.

### **The U.S. Economy Remains Weak**

The rise of energy prices has stoked fears of inflation at the same time that U.S. economic growth has stagnated. Spending on fuel in the U.S. has risen to more than 6% of wages. This exceeds the share of wallet that fuel achieved in the 1974-75 and 1990-91 price spikes, and is almost as much as the all-time peak of 7-8% reached during the 1979-80 oil shock. Measures of consumer confidence in the U.S. have reached the lowest levels ever recorded. It remains to be seen whether the U.S. can avoid recession, but it is evident that a significant consumer retrenchment has begun and that economic growth has come to a screeching halt.

As we have written in the past, another key factor in the current slowdown is the decline of the U.S. housing market. Over the course of the last quarter, the U.S. housing market continued its downward slide. The S&P/Case-Shiller Home Price Index measures the average price of houses across 20 major markets in the U.S. and is a key gauge of the health of the housing market. It peaked in July 2006 and has been declining ever since. In 2008, it is doing so at an accelerating pace. Mortgage delinquencies and foreclosures are increasing. There is no sign yet of a bottom.

At the time of our last *Outlook*, financial markets were reeling from the collapse of Bear Stearns and the enormous asset write-offs taken by banks around the world. Over the course of the quarter, it seemed like tensions in credit markets were easing and liquidity was coming back to the market. Unfortunately, further write-offs and worries about the viability of several financial institutions have caused a renewed deterioration in financial market conditions over the last several weeks. As well, at the consumer level, surveys of bank lending officers reflect a significant ongoing tightening of credit conditions.

### **Canada is Softening, but Stable**

In contrast to the U.S., Canada has enjoyed a period of relative stability in 2008. On a year-over-year basis, headline inflation released in May was 2.2% and the core rate was only 1.5% – enviable circumstances as compared to the experience in the U.S. and Europe. Housing markets have softened, but not declined materially.

As the U.S. economy has weakened, however, demand for our exports has fallen and growth has slowed considerably. As well, general comments about economic conditions overlook the fact that conditions vary widely across the country. The issue of imbalance between regions and industrial sectors is as acute now as when we first worried about the ‘Dutch Disease’ more than three years ago. The disparity between the economic performance in the resource-rich western provinces and the manufacturing and export-oriented provinces of Ontario and Quebec likely has never been larger.

### **Cautious, But Invested**

For all the risks and the litany of bad news over the last quarter, as well as the devastating declines in many foreign markets, client portfolios enjoyed quite satisfactory returns. Going forward, however, our message of caution is largely unchanged from that we have articulated over many quarters. There remain many risks to investors from the economic challenges we have discussed, and our portfolios will continue to emphasize high quality companies in defensive industries.

As much as we believe it prudent to be cautious, we also believe it critical to be invested. Attractive long-term investment returns cannot be made by sticking money under a mattress or by rolling over treasury

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<sup>3</sup> Editorial note: this is being written in the Thousand Islands over the July 4<sup>th</sup> weekend. There are *far* fewer boats on the river than there would normally be – gasoline prices *have* impacted behaviour.

bills. Satisfactory long-term results come only from being invested in companies with a strong competitive position in an attractive industry. Our client portfolios remain well diversified and we believe the stocks in which we are invested are positioned to ride through the current turmoil. We may experience a few more bumps on the road, but one thing is certain: long before it seems clear to most investors that the current economic malaise is behind us, stocks will have moved significantly higher and much of the 'easy money' will have been made.

## FINANCIAL MARKET SUMMARY

### Market Levels

<u>Canada</u>	<u>June 30, 2008</u>	<u>December 31, 2007</u>
TSX Composite Index	14,467	13,833
91-Day T-Bill Yield	2.50%	3.85%
30-Year Gov't of Canada Bond Yield	4.08%	4.10%
Prime Rate	4.75%	6.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.9823	\$1.0075

### United States

Dow Jones Industrial Average	11,350	13,264
Standard & Poor's 500 Index	1,280	1,468
30-Year U.S. Treasury Yield	4.51%	4.45%

### Market Returns For Periods Ended June 30, 2008 <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	0.6%	4.1%	3.3%	3.8%
DEX Universe Bond Index	-0.7%	6.8%	5.2%	6.0%
TSX Composite Index	9.1%	6.8%	18.2%	9.0%
S&P 500 Index (C\$)	-3.6%	-16.8%	1.6%	-0.8%
MSCI EAFE (C\$)	-3.1%	-14.4%	10.2%	0.0%

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#### Footnotes:

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

(2) Compound average annual return.