NEXUS

Portfolio Management & Financial Counsel

Investment Outlook

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The Global Bear Market

There is no way to sugar-coat a description of current conditions in financial markets around the world. As the sun sets on the third quarter of 2008, and the fourth quarter begins, we are in the grip of a ferocious bear market. In Canada, the TSX Composite is down 15% in the first nine months of 2008[1]. The key U.S. stock market index, the S&P 500, is down 21% over the same period. Amazingly, these terrible market returns in North America are actually muted compared to what investors have experienced in many other regions. In Europe, for example, London's FTSE 100 is down 24% in the first nine months of 2008, the CAC 40 in France is down 28%, and the DAX in Germany is down 30%. Emerging markets are even worse. India's Sensex is down 37% and the Shanghai Composite in China is now down 56% on the year. Russian regulators closed stock markets for several days in an effort to calm investors.

It would be nice to be able to boldly predict that stock markets are near bottom and that investment portfolios are poised to recover in the final three months of 2008. We hope this is the case, but, unfortunately, there is no way to know. As this commentary goes to press, market conditions remain difficult and the credit crisis that is at the root of market turmoil continues to spread around the world. Stock markets in North America and abroad have had significant further declines in the early days of October.

Challenging Times for America

Over the last quarter, the U.S. has been gripped by the worst financial crisis since the 1930s. At least twice during this period, U.S. Treasury Bills, still the closet thing in the world to a risk-free investment, traded at a zero percent yield. While this may not be the most newsworthy occurrence over the last several weeks, it is important symbolically. In bidding up Treasury Bills to this level, investors are basically saying that they are willing to forgo a return *on* their capital so long as they get the return *of* their capital. In a world where bank deposits are no longer safe, it is clear that fear has gripped the market. Only once in history has this happened before: in the depths of the Great Depression.

Over the last decade, American consumers borrowed a mountain of debt based on the perceived stability of their residential real estate. After the housing bubble burst and prices began to decline, the collateral value underpinning much of this debt deteriorated. So precarious were the balance sheets of consumers and financial institutions, that the resulting defaults have shaken the financial system to its core. During this past quarter, the U.S. Treasury had to step in to take control of Fannie Mae and Freddie Mac, which were owners or guarantors of almost 50% of all residential mortgage loans in the U.S. There were many other high profile casualties: Washington Mutual became the largest bank failure in U.S. history; AIG, the largest insurance company in the world, had to be bailed out by the government; and Lehman Brothers, one of the most storied U.S. investment banks, filed for bankruptcy. Unfortunately, house prices continue to decline[2] and more bank failures are likely.

In an effort to avert a complete financial meltdown, the U.S. Congress passed the Troubled Asset Relief Program, commonly referred to as TARP, on October 3. TARP provides the U.S. Treasury with up to $700 billion of emergency funding to allow it to buy impaired assets from U.S. banks. Many questions remain to be answered, such as how Treasury will set the price paid for the securities, and how many institutions will take advantage of the program given its onerous conditions. The idea, however, is to relieve

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[1] The return figures in this first paragraph are changes in the index levels, excluding dividends. They are each in local currency terms.

[2] The most recent reading of the Case-Shiller House Price Index (July) showed a 16% year-over-year decline.

financial institutions of some of their most toxic assets so they will regain the capacity to extend credit. Indeed, credit is the lubrication that allows the gears of the economy to turn. Without it, the economy could seize up entirely.

Our view is that TARP is a necessary, but insufficient, step to restoring the strength of the U.S. economy. Compounding the effects of the financial crisis is the rapidly growing body of data pointing to fundamental economic weakness. On October 1, the monthly report from the Institute of Supply Management on industrial production showed a dramatic decline to levels which could portend a severe recession. On October 3, the Bureau of Labor Statistics announced that job losses in September were the worst in a string of nine consecutive months of employment declines. So far in 2008, the U.S. has lost 750,000 jobs and unemployment has risen considerably. Many believe that the U.S. is headed for a significant and prolonged recession.

Canada Won't Avoid the Side Effects

The decline in the Canadian stock market and our dollar has been severe in the past couple of weeks. This reflects global financial flows as investors pull money out of the great commodity trade. For several years, Canada was one of the darlings of world stock markets as our natural resource companies were deemed important players in the drive to feed and fuel the world, particularly the rapidly industrializing nations, such as China and India. However, as the financial crisis slams the brakes on growth around the world, investors are suddenly realizing that commodity companies are cyclical, even if there is a secular growth driver in the background.

Apart from these market gyrations, however, we continue to believe that the Canadian economy is fundamentally sound. To be sure, export-oriented manufacturing businesses in central Canada will be hurt by difficult conditions in the U.S., and we may not need as many welders in Ft. McMurray as the pace of oil sands development slows. Canada may well slide into a recession before 2008 is out. For certain, our economic performance will be bumpy in the period ahead as we are affected by the problems elsewhere. Generally speaking, however, both our companies and our governments are as well-positioned as any in the world to weather this extraordinary period.

Where is the Bottom?

Given the serious ongoing risks and the painful losses experienced by almost all investors over 2008, many may ask, "why remain invested at all?" Perhaps a portfolio of short-term government securities is the smartest course. The reality is that neither we, nor anyone else in the market, have an ability to forecast the market's path over the coming weeks and months. It may be that there is more downside to come. However, recovery is inevitable and stocks will trade sharply higher well before the economic fundamentals appear to have turned. Few will pick the bottom, and those who are uninvested will miss a critical upturn in the market. Generally speaking, we have positioned portfolios defensively with a greater allocation to cash and a lower allocation to equities than is normal. Nevertheless, we firmly believe that one must maintain an exposure to equities if one hopes to enjoy the superior returns that stocks generate over the long term.

Perversely, we actually feel more optimistic about the long-term opportunities in stocks than we have in some time. To be sure, some stocks have been appropriately devastated as companies have collapsed under the weight of their debts. Others have had their competitive position in an industry fundamentally altered for the worse. Yet much of the selling has not been fundamentally driven; it has been forced upon over-leveraged investors facing margin calls, or hedge fund or mutual fund redemptions. As a result, many companies with great long-term prospects now trade for prices that are as cheap as they have been in a generation. While the short-term risks to financial markets remain elevated, stocks now price in a huge amount of bad news. There could be more bumps and bruises in the short term, but the outlook for stock returns over a five or ten year period is better now than it has been for some time. We look forward to taking advantage of some of these opportunities in the period ahead.

FINANCIAL MARKET SUMMARY

Market Levels

Canada	September 30, 2008	December 31, 2007
TSX Composite Index	11,752	13,833
91-Day T-Bill Yield	1.75%	3.85%
30-Year Gov't of Canada Bond Yield	4.17%	4.10%
Prime Rate	4.75%	6.00%
Exchange Rate (1$ Cdn. = US$)	$0.9435	$1.0075
United States		
Dow Jones Industrial Average	10,851	13,264
Standard & Poor's 500 Index	1,166	1,468
30-Year U.S. Treasury Yield	4.31%	4.45%

Market Returns For Periods Ended September 30, 2008 [1]

	Last Quarter	Last 12 Months	Last 5 Years [2]	Last 10 Years [2]
DEX 91-Day T-Bill Index	0.8%	3.7%	3.3%	3.7%
DEX Universe Bond Index	-0.4%	4.6%	4.8%	5.7%
TSX Composite Index	-18.2%	-14.4%	12.0%	9.7%
S&P 500 Index (C$)	-4.7%	-17.0%	0.2%	-0.6%
MSCI EAFE (C$)	-17.3%	-26.1%	4.5%	1.3%

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