



Portfolio Management & Financial Counsel

Investment Outlook

January 2009

Happy New Year!

Rarely have investors offered up this greeting so literally or so hopefully. We couldn't say goodbye to 2008 fast enough. About the only good thing one could say about stock markets in 2008 is that they provided interesting data for market historians.

For the record, the TSX Composite declined 35.0%¹ in 2008, with every sector posting a substantial decline. The peak-to-trough decline in the TSX during the year was approximately 50%, which was substantially the same as that experienced following the technology stock collapse in 2000. Only 1937 and 1929 were worse years in Canadian stock market history.²

Similarly, the Standard and Poor's 500 fell 38.5% in 2008. This is the third worst year for U.S. stocks on record, and the worst since the Great Depression. In October and November, volatility was the highest ever recorded, with the average intraday swing between high and low being 6.9% in October and 5.4% in November. Moreover, this dreadful year caps off a dreadful 10-year period in the U.S. Over the last decade, the S&P 500 has declined at a compound annual rate of 3.0% per year, making it the worst 10-year period for U.S. stocks since 1827.³

As miserable as these returns were in Canada and the U.S., they were not as bad as in many other markets in the world. In the developed world, France, Germany and Japan were all down a little more than 42%. In emerging markets, India declined 52%, China 65%, and Russia collapsed by a staggering 72%. Tragically, Iceland completely imploded, as its market declined more than 94%.

Troubled Times

The steep declines in stock markets began with the financial crisis that commenced in 2007 and climaxed with the collapse of Lehman Brothers in September 2008. More recently, however, the declines have reflected rapidly deteriorating economic fundamentals around the globe.

Today, the U.S. is mired in an economic recession that started a year ago and may well turn into the deepest and most prolonged since the 1930s. As readers know, much of the current malaise is rooted in the residential housing bubble that peaked in July 2006. Since that time, house prices, as measured by the Case-Shiller Home Price Index, have declined 23.4%. Despite wishful thinking a short time ago that house prices may be close to bottoming, the Index's most recent update in late December actually showed that the rate of decline accelerated.

¹ Market index returns in this section exclude dividends and are presented in local currency terms.

² Peter Buchanan and Meny Grauman, "Will 2009 Bring Any Cheer for Battered Equity Markets?", CIBC World Markets, December 18, 2008.

³ Morgan Keegan data quoted in *Barron's*, January 5, 2009.

In his recent U.S. economic outlook, Gary Shilling points out one of the frightening consequences of this decline: currently, approximately 12 million U.S. households, or more than 25% of all those who have mortgages, have negative equity in their homes.⁴ By negative equity, we mean that the outstanding balance owed on their mortgage is greater than the value of their house. Shilling's forecast is for house prices to deteriorate further and to bottom only when they have fallen about 37% from the July 2006 peak. At that level, 25 million households, or 50% of those with mortgages, will be under water.

Since so much of U.S. economic activity in the first seven years of the millennium was funded by debt-financed consumer spending, in retrospect it is unsurprising that the U.S. economy has stalled so abruptly. Early reports suggest that the Christmas shopping period may have been the worst in decades as U.S. consumers spent about 20% less in November and December than they did in the same period a year ago. Auto sales have collapsed – GM and Ford sold fewer cars in 2008 than they sold in any of the previous 50 years. Car sales in 2009 are likely to be worse, and one or more of the U.S. automakers face the grim prospect of bankruptcy. Measures of consumer and business confidence have dropped to the lowest levels ever recorded. Unemployment is rising sharply. In the face of this rapid decline in economic activity, President-elect Obama has vowed to implement a massive government spending program to stimulate the economy.

Previously, we had imagined that Canada, with its enviably strong fiscal position at all levels of government, and its strong resource sector, would remain somewhat insulated. This, too, has proved to be wishful thinking. The collapse of commodity prices since the early summer has battered the resource sector, and the impact of the rapid U.S. slowdown has affected Canadian exporters acutely. While Canada has not yet been officially declared in recession, there is virtual certainty that our economy is also declining and that this decline will be substantial. After years of maintaining excellent fiscal balance, it is likely that the Canadian government will initiate its own deficit spending program in 2009.

The Silver Lining

While the current economic environment we have described is grim, our outlook for financial markets is considerably less so. In short, the massive sell-off in stock markets in Canada and the U.S. during 2008 has had the effect of pricing in an enormous amount of bad news. Interestingly, stock prices have held up well in the last several weeks despite the continued onslaught of terrible economic data. While this is not any assurance of a bottom, it is encouraging.

Certainly part of the reason for the better tone in stock markets has been a notable improvement in credit markets. This stabilization has been largely based on the belief that governments around the world are prepared to backstop virtually any financial institution in distress. Both through direct investment in some institutions, and by the purchase of troubled assets from others, governments are attempting to ensure that the financial system keeps functioning. Additionally, central banks have responded by slashing short-term interest rates dramatically. In Canada, the Bank Rate is currently 1.5 %, half the level it was in the summer, and further cuts are expected. Early in 2009, the Bank of England also cut its benchmark rate to 1.5%, the lowest since the Bank was founded in 1694. The U.S. Federal Reserve has pushed administered rates essentially to zero. Slowly, but surely, these steps seem to be working.

Of equal importance is that panic selling of stocks through the autumn has resulted in valuations for many equities that are the lowest they have been in a generation. For the first time since 1958, the dividend yield on the S&P 500 is higher than the yield on the 10-year U.S. Treasury bond. Similarly, the yield on the TSX Composite is higher than the 10-year Government of Canada

⁴ A. Gary Shilling, "Semi-Annual U.S. Economic Outlook", December, 2008.

bond. By almost any relative or absolute measure, many stocks are cheap. For investors with a medium-term or long-term perspective, equities are very likely to provide excellent returns.

In the short term, however, much uncertainty remains. There is a strong likelihood that investors will have to endure more bad economic news in the weeks and months to come, and stocks could move lower still before a recovery finally takes hold. As we argued in our November client meetings, with such a difficult time in markets, careful financial planning is critical. In particular, most investors should consider how they can spend less and save more. By preserving capital today, investors will maximize the opportunity that lies ahead in the recovery. While we can't predict when this will come, we are convinced that great rewards are available to those invested in quality companies at current price levels.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>December 31, 2008</u>	<u>December 31, 2007</u>
TSX Composite Index	8,988	13,833
91-Day T-Bill Yield	0.89%	3.85%
30-Year Gov't of Canada Bond Yield	3.44%	4.10%
Prime Rate	3.50%	6.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.8166	\$1.0075

United States

Dow Jones Industrial Average	8,776	13,264
Standard & Poor's 500 Index	903	1,468
30-Year U.S. Treasury Yield	2.68%	4.45%

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

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years ⁽²⁾</u>	<u>Last 10 Years ⁽²⁾</u>
DEX 91-Day T-Bill Index	0.7%	3.3%	3.3%	3.7%
DEX Universe Bond Index	4.5%	6.4%	5.5%	6.0%
TSX Composite Index	-22.7%	-33.0%	4.2%	5.3%
S&P 500 Index (C\$)	-9.8%	-21.9%	-3.2%	-3.6%
MSCI EAFE (C\$)	-7.5%	-29.8%	0.6%	-1.4%

Footnotes:

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

(2) Compound average annual return.