



## 2008 Review and 2009 Capital Market Update

### Transcript - Capital Markets Update

**Dan Chornous:** Hi. I'm Dan Chornous, Chief Investment Officer of RBC Asset Management. In the next five minutes, I'm hoping to walk through how we got to this difficult point in the economy and in capital markets, how it's sorting out and how we hope to emerge, and what markets shape up for later in 2009.

If we go to this first slide, I've attempted to summarize all these complex interlinkages. There are really two problems out there. The first one is in the economy, which is in recession, and that's deepening as we speak, and the second one is in the capital markets, and one is feeding off of the other. We need to break this negative feedback loop. In all the programs that governments, Treasuries and Central Banks are involved in and the partial nationalization of large sections of the world financial system are designed to do exactly that. We think we know what we need to monitor. We need to monitor things like interbank lending rates, the degree to which new money supply creation is reaching the real economy and being invested in creating new jobs and savings. We need to monitor (the degree to what's?) [to what degree(?)] the collapse in housing prices in the United States has run its course, because that is the root of the problem that needs to be fixed before we can get into a sustainable solution.

Now, some of these things are happening. There are narrowing spreads of interbank lending rates. That means there is some confidence – not a lot, but some confidence – being restored between bankers. There is a bit of an increase in money supply growth. Money now is beginning to reach the economy. On the other hand, velocity of money is still unbelievably low. It's at levels that none of us expected to see in our lifetime, and so there are extreme difficulties still facing the economy. We have the lowest levels of interest rates in history.

These things take time to work. They are percolating. What's required though is the restoration of confidence for them to work in their normal fashion.

Until that happens, the economy is going to remain in recession. I think Canada will escape the most severe portions of that. The United States will have a much deeper recession because our balance sheets are in better shape and we didn't have the degree of problems in the mortgage market or in the underlying housing prices that support those mortgages.

The first half of 2009 will be very, very weak. This is what the Bank of Canada has talked about in its most recent monetary policy report: we can hope for a recovery late in the second half of the year. Now we perhaps don't look for as strong a recovery as they expect, but recovery nonetheless. This said, these policy initiatives are ticking away, interest rates are low. As the fix for the financial system as accepted by a broadening list of investors, we think that risk premiums will fall and markets will respond.

So, how much have they fallen? Well, I'm going to use one chart today to walk you through that. Those of you that have followed our work at RBC Asset Management over the years will be familiar with this chart. It's the S&P 500 in this case, although I could really use any major stock market in the world, including Canada. Here we've plotted against what we consider to be its range of fair value. At the midpoint of this channel, stocks are valued appropriately, relative to their historic relationship with key drivers in the economy: interest rates, inflation

and sustainable corporate profits.

Well, two-thirds of the time, the stock market remains within those inside bands. Usually, during periods of low inflation and mild interest rates, periods like the 1960s, the 1990s, and today, the market at a minimum trades at the midpoint of the channel. Now, sometimes you tumble a bit below that as you have these periods of tremendous fear. We did that during the tech wreck, for example; we did it once during the 1960s. But usually markets pretty quickly respond to any interest rate stimulation because asset prices have fallen below where they otherwise should be.

Well, this time, they kept going because interest rate stimulation hasn't been working, at least at this point. So they fall further. We fit a second set of lines. Only 2% of the time in the last 50 years – we're talking generations, we're talking all the way back to the Second World War – only 2% of the time has the market touched the bottom of those four bands, two standard deviations below mean. That's how extraordinary the positioning of the market is today.

So, what does that mean for the outlook? Well, there's only been two other times in that period where we've seen the same thing happen: 1974, 1981-82. Extreme dislocation in the economy in 1974; deep recession. And not only were we in deep recession, we stayed there for a long time, and the problems that drove you there, high and rising interest rates and out of control inflation, actually stayed in place for the following decade. Nevertheless, in that case and in the early '80s, from similar levels of valuation, the stock markets stopped falling and started to rise.

Now, clearly, we need more to be happening in the lending system. We need the credit crunch to thaw. We need the end of the decline in real estate prices. But if we're 80% to 90% of the way through the decline in real estate prices, and I think that's a possibility, then the lending crisis should ultimately clear, particularly with the help of government backstops, and stocks should eventually respond.

The current level of prices discounts about a 40% to 50% decline in corporate profits or the lowest P/E ratios relative to fair value in history. That's a pretty big premium against further losses. Now, it's not to say that the market will quickly recover, or that it'll immediately go back to fair value. But it does say that a very, very bad economy and continuing problems in the financial system have been well-priced into stocks at their current levels.

So, where [are we] going? Well, we're seeing tentative signs of a thawing of the credit crunch. That's a critical component to putting the economy on a normal track and to normalizing prices in the stock market and drive. To get there, real estate prices have to stop falling, and our indicators say you might be 80%, 85%, 90% of the way through what's required to put residential home prices back to fair value in the United States, to have adjusted fully for the bubble that preceded it.

Inflation, fortunately, is no longer a problem. As recently as eight, nine months ago, the rise in inflation was handcuffing Central Banks, while the threat now appears to be falling prices, not rising prices, and that really makes it possible for Central Banks not only to drop interest rates to historic levels, but to move into nonconventional forms of easing, buying assets and shoring up the financial system. They're doing all of that.

I think, ultimately, when we move out of this period of crisis we need to be aware that bond prices are very high, bond yields are very low, and while they're probably going to stay low in the near term as we sort through this crisis and all these pieces fall into place for the next recovery to happen, that yields will stay low. But, ultimately, you need this crisis to be sustained to sustain the current level of interest rates. As we move into a normal economy, they're likely to rise.

Stocks, as you saw a moment ago, are not only the most attractive level in a generation – in generations – ultimately, they'll gather interest as we move to a more normal environment.

Thank you very much.

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