

RBC Dominion Securities

Market Update

PORTFOLIO ADVISORY GROUP

Monday, October 06, 2008

Maintaining Course in Difficult Markets

Equity markets are continuing to deal with the fallout of the crisis in credit markets and a deteriorating outlook for the global economy. Being at the epicenter of the subprime mortgage bust, the US equity markets were the first to feel the brunt of a deteriorating financial sector and growing concerns over economic growth. However, as it became clear that European economies faced similar housing bubbles and problems in their financial sector, the outlook for global growth moderated significantly, and with it the outlook for global commodity prices, which is of particular importance to Canadian investors. Initially, Canadian equities were the single bright spot in the global markets. Despite benefiting from a banking sector that managed to avoid many of the worst excesses of some of their US and European peers, the heavy exposure of Canadian equity markets to the commodities sectors, mostly energy and materials, has seen the TSX play catch up to other markets since June.

Gauging Historical Bear Markets

Returns for the month of September were very disappointing, with the S&P TSX and S&P 500 down 14.7% and 9.1% respectively. From the market peak in October 2007 to October 6, 2008, the TSX and S&P 500 are down 28% and 32% respectively. Putting things into a historical perspective, the "average" bear market cobbled from data as far back as 1950 lasts about 13 months and posts an average decline of roughly 28%. The equity bear market is roughly in line with this average, approaching its one year anniversary in October.

Does this mean we are near the bottom?

Table 1 illustrates the underlying data from which these averages are derived. Note that there is a range of outcomes to previous bear markets, both in terms of duration and the percentage drop from peak to trough with the extreme being 31 months and 49%. In the view of the RBC Investment Strategy Committee, the path of the current bear market is likely to be more benign than some of the extremes of the previous bear markets, although history suggests there could still be considerable downside risk in our near term outlook.

Table 1: US Bear Markets

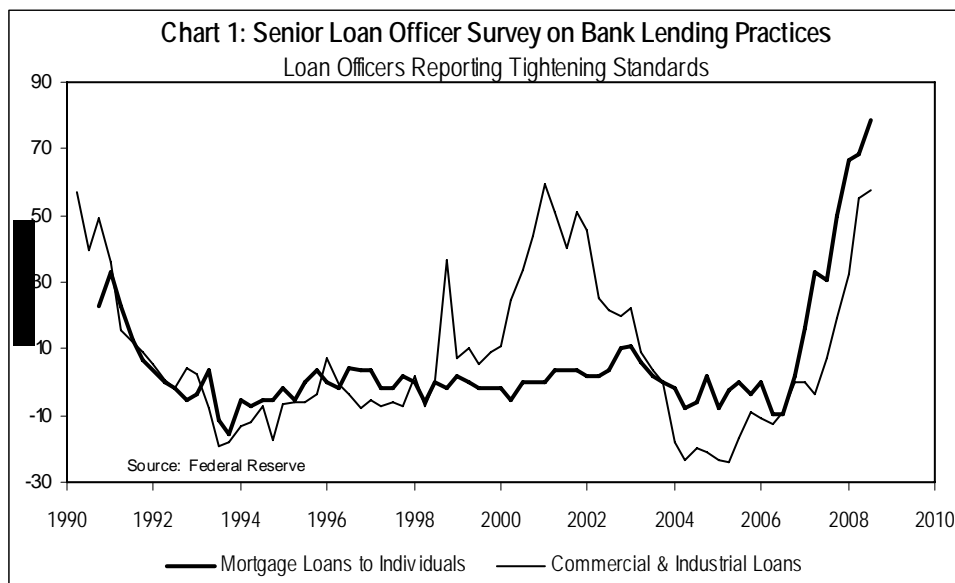
Bear Market Began	% Decline	Duration (Months)	3 Month Return from End of Bear Market	6 Month Return from End of Bear Market	12 Month Return from End of Bear Market	2 Year Return from End of Bear Market
1-Jul-56	-19.0%	17	5.3%	13.1%	38.1%	49.8%
12-Dec-61	-24.6%	6	2.8%	15.3%	26.7%	5.9%
18-Jan-66	-22.1%	9	4.9%	17.8%	26.3%	34.1%
14-Nov-68	-36.1%	19	15.8%	26.7%	37.1%	47.3%
11-Jan-73	-48.2%	21	7.9%	31.2%	32.0%	65.6%
21-Sep-76	-19.4%	18	11.7%	18.7%	10.6%	31.0%
13-Feb-80	-17.1%	1	11.9%	22.9%	33.2%	40.7%
28-Nov-80	-27.1%	21	11.2%	35.7%	51.8%	50.2%
25-Aug-87	-33.5%	3	16.3%	13.8%	18.8%	37.7%
16-Jul-90	-19.9%	3	13.1%	23.5%	29.1%	58.5%
17-Jul-98	-19.3%	2	21.5%	29.3%	37.9%	36.7%
24-Mar-00	-49.1%	31	7.9%	4.0%	22.2%	17.7%
Average	-28.0%	13	10.9%	21.0%	30.3%	39.6%
Median	-23.4%	13	11.5%	20.8%	30.6%	39.2%
9-Oct-07	-26.1%	11				

Note: Bear Market defined as Peak-Trough correction exceeding 15.0%
 Data based on daily close prices
 Source: RBC Asset Management

The current environment calls for a two prong solution. One prong consists of lowering interest rates to stimulate economic activity, a policy which has rarely failed to rekindle economic growth over time, and which should help begin to stabilize US housing prices. The US Federal Reserve has led this charge with over 300 basis points of easing since the crisis began, with the Bank of Canada following with 150 basis points of its own. More recently, there are signs that the European Central Bank, long the holdout, has begun to modify its stance in favor of loosening monetary policy. The rapid receding of inflation and inflation expectations following the reversal in oil prices this summer has created a landscape more conducive to lowering interest rates and we would note that there remains ample room for most central banks to lower rates further, something we expect they will do if the situation requires it.

The other prong is a coordinated effort towards a resolution of the current credit crisis. To date, little of the Fed's monetary easing has been passed through into the US economy due to a constricting lending environment. According to RBC Capital Markets, this resolution is a necessary condition to tackling the broader economic contraction but is not sufficient in its own right, the same way that showing up for an exam is necessary to get an 'A', but not sufficient to guarantee it.

The credit crisis has spread to impact banks globally and the rapid failure and near failure of a large number of leading financial institutions has caused credit markets to freeze to the point where even good banks which have been prudent enough to avoid most of the others' excesses are finding their access to financing tightening, and their cost of borrowing rising. This has important spill over effects into the economy which is already dealing with the shock of falling housing prices and diminished consumer confidence. As illustrated in **Chart 1** below, US financial institutions have been rapidly tightening lending standards which threatens the outlook for housing prices, corporate profitability and employment, which could translate into more distress for the banking system as credit losses rise and the value of troubled securities continue to fall.



In our view, the credit crisis has reached a point where it can not be ignored by policy makers, and we expect to see increasing evidence of focus and coordination across political lines and between countries in dealing with it. Any solution must, in our view, accomplish two main objectives. The first is to increase depositors' confidence in the banking system by raising the level of deposit insurance to levels that will allow banks to maintain this valuable source of funding. The second is a means of providing capital to troubled banks. The US TARP proposal offers one means to this end, although it is conceivable that other solutions may emerge either in the US or in Europe.

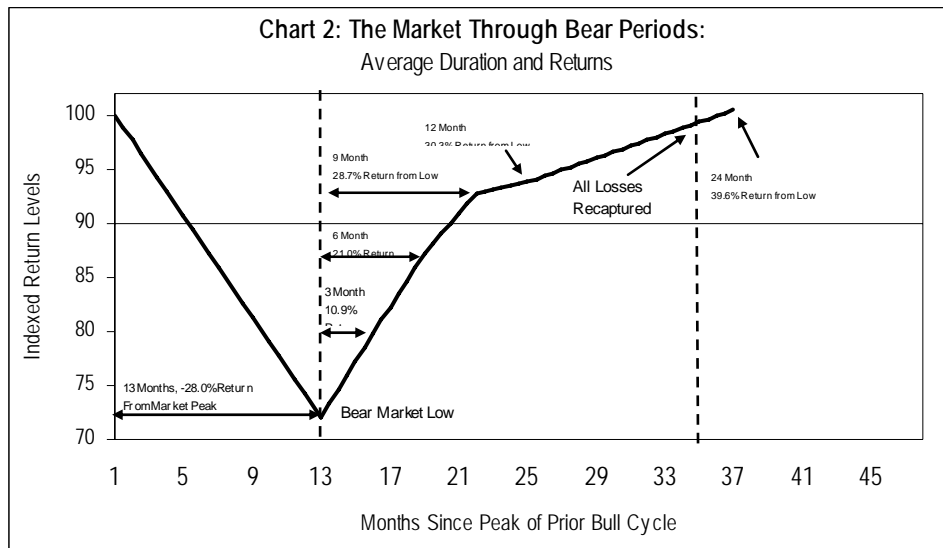
The importance of getting this right is key to the outlook for the economy and the markets. The RBC Investment Strategy Committee's base case outlook is that policy makers will increase the brevity of their efforts to match the seriousness of this crisis and succeed in the quarters ahead in stabilizing the credit markets to the point where the considerable amount of monetary easing in the system will begin to have its desired positive effect on economic activity. The US economy, and Canada with it, is likely to face a period of contraction over the next two calendar quarters, but evidence of economic recovery should be visible later in 2009 and equity markets, which normally anticipate economic growth in advance, will reward patient investors with higher returns.

If there is a risk to this forecast, it clearly lies with the authorities' ability to effectively deal with the credit issues, the amount of time that it takes for the financial deleveraging process to work itself out, and the uncertainty over what kind of lagged impact the current level of volatility and uncertainty will have on the US and global consumer. At present, many of the leading indicators that we would look to for signs of a potential turning point continue to deteriorate leaving the risks tilted towards a longer wait for this eventual recovery.

How should investors approach the current environment?

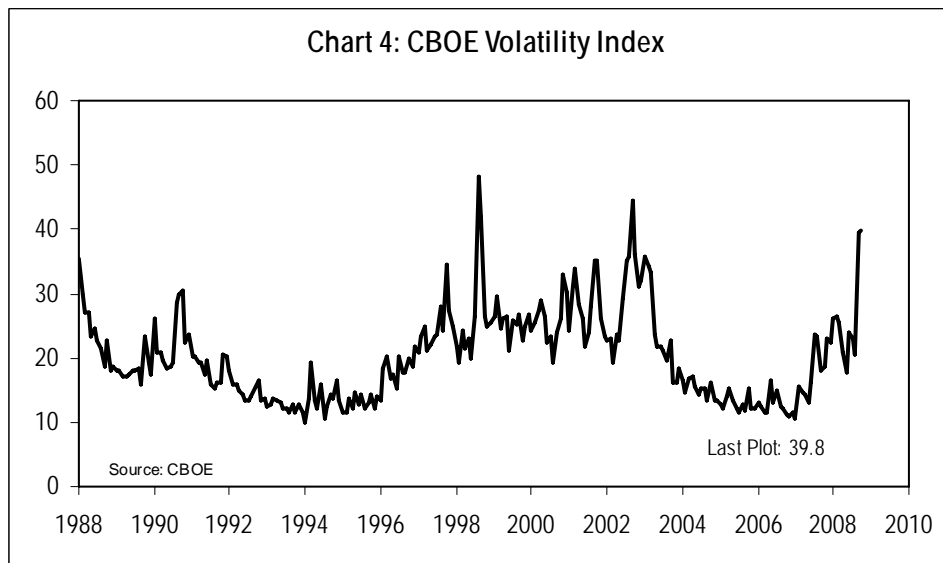
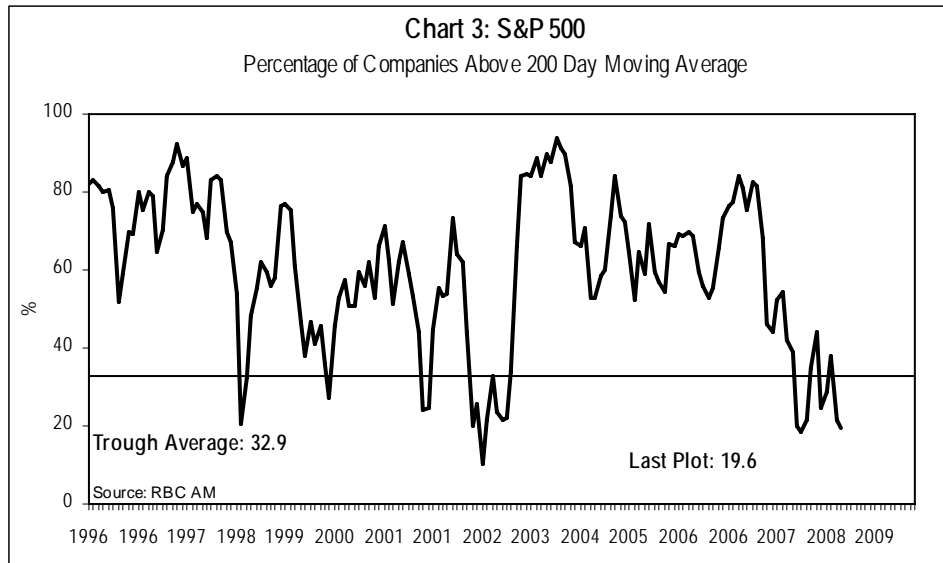
In this environment, investors would be well served to set aside their emotions and gain a larger perspective on the markets and their long term investment program. To this end, we can offer up a number of observations.

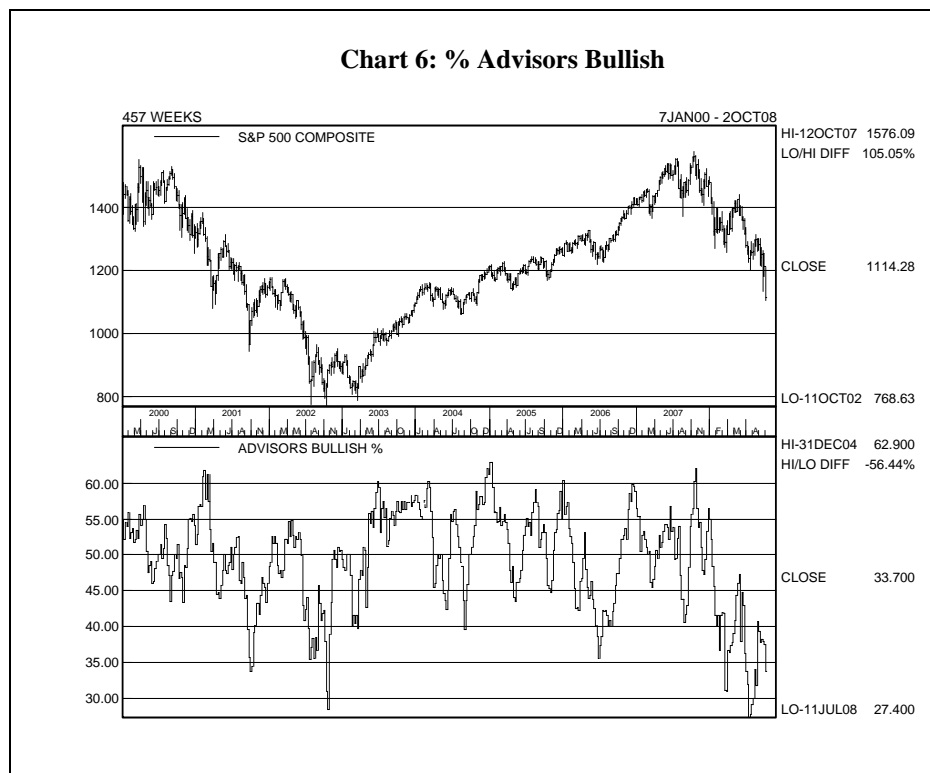
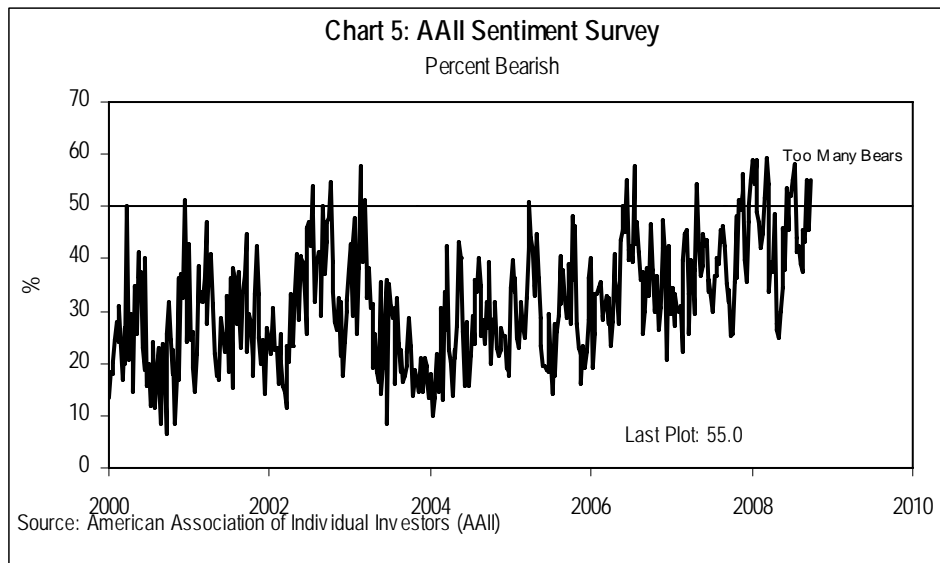
- **The situation is unlikely to play along the lines of Japan in the 1990's** – Many press reports have highlighted the similarity between the current banking crisis and the one experienced in Japan in the 1990's in which a real estate bust led to a decade of economic stagnation. In our view, there may be similarity in the causes, but the scale and rapidity of the US response makes any further comparison moot. Over the past 12 months, banks have recognized over \$590 billion in losses and raised \$430 billion in new capital bringing them close to half way in dealing with the anticipated total amount of eventual losses. By comparison, one year into the Japanese crisis, the Japanese financial system had barely begun to recognize and deal with its own losses.
- **Bear markets can be violent, but they do pass and equity prices do rise again** – On average, bear market losses are restored an average of 19 months after the bear's end. As illustrated in **Table 1** and **Chart 2**, markets often recoup a substantial portion of their losses in the months following the bear's trough. Missing out on these first few months of recovery is a significant risk for investors becoming unnerved by recent events.



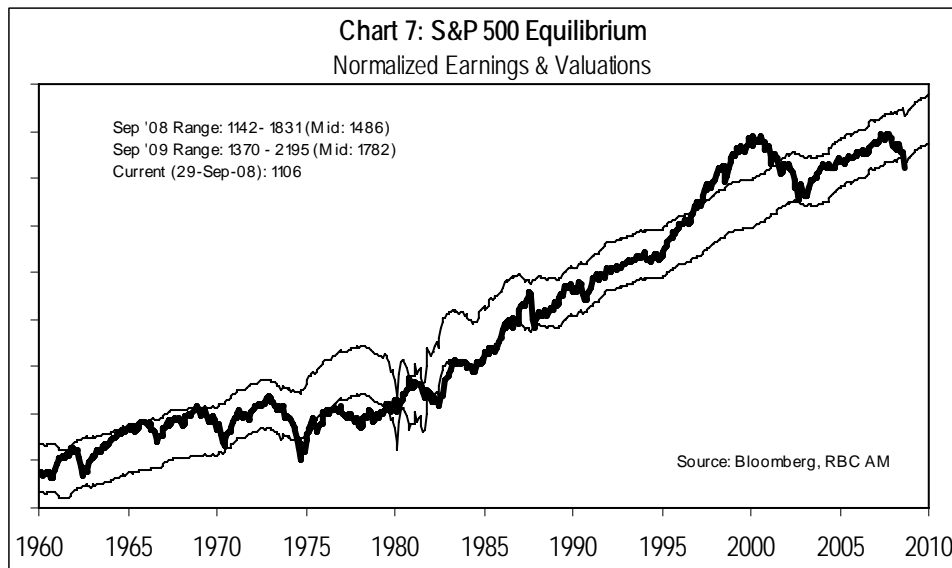
- **The trough in equity markets often happens well before people realize it** – Typically, the trough in equities would precede the trough in indicators of manufacturing activity by three months, the trough in unemployment by seven months, the trough in earnings by six to nine months, and the trough in consumer sentiment by four months. Thus, even while the economy continues to exhibit deteriorating signals, the equity market often looks into the future and begins pricing in a recovery well in advance, which conforms to our experience following the launch of the Resolution Trust Corp after the US Savings and Loan crisis of the early 1990's. **Put another way, by the time the average investor begins to feel confident that the bear market has begun to fade, much of the post-trough upside in equity prices may already have passed.**
- **Many current market indicators have reached levels reminiscent of previous bear market troughs** – Examples include the rapid decline in the number of companies trading above their 200 day moving average (**Chart 3**), the CBOE Volatility Index (**Chart 4**), the American Association of Individual Investors Sentiment Survey (**Chart 5**), and the % Bullish ratio (**Chart 6**). Similarly fixed income markets, which have been the recipient of much of the flows out of the equity markets are showing corresponding signs of being overbought. Other indicators demonstrating similar extremes are the Put/Call

ratio and the concentration of days in which 90% or more of stocks in the S&P 500 have declined. JP Morgan notes that the amount of cash parked by investors in money market funds has reached levels equivalent to the peaks reached during the 2002/2003 technology induced bear market. Finally, markets have now retraced over 50% of their bull market gains, which is a technically significant event.





- Good companies are trading at valuations that are very attractive by historical standards, even if earnings continue to fall** – By many gauges, stocks have become increasingly undervalued. One such measure is the RBC Investment Strategy Committee's equilibrium models for stocks based on normalized earnings and inflation outlooks. By this measure, as illustrated in **Chart 7**, the S&P 500 is 38% below its one-year forward fair value and testing the lower limit of its fair value channel. Clearly, the risk to future earnings is to the downside, but investors with a long-term focus should recognize that this period of adjustment will present an opportunity to acquire great businesses at attractive valuations. However, if one is worried about short-term fluctuations in their holdings, it should be noted that the extreme volatility may continue for some time to come.



- **History suggests it is difficult to time the market** – Investor psychology plays an important part in explaining why markets tend to overshoot to the upside in a bull market and to the downside in a bear market. Numerous studies of individual investor behavior have documented the tendency of individual investors to buy near the peak of a bull market, and capitulate near the trough of a bear market, thereby guaranteeing underperformance relative to their long term investment plans. Moreover, such a capitulation is often followed by a reluctance to reengage in the equity markets until well after a bull market has been re-established. One study in particular, by Dalbar Inc (Dalbar Inc, 2008 Quantitative Analysis of Investor Behavior) goes on to identify that investors are prone to making the greatest mistakes near the market bottom when sentiment is at its worst. In our view, while not downplaying the ongoing risks in the equity markets, determining a long-term asset mix that optimizes the trade-off between long-term appreciation potential and short-term volatility based on an individual's risk tolerance and time horizon and then diligently sticking to it will outperform an approach based on market timing.
- **The Buffet Effect** - We have been asked by some if recent purchases of Goldman Sachs and GE by famed investor Warren Buffet represent a signal to commence buying the market. In our view, Mr. Buffet's actions exemplify many aspects of the approach above; specifically, recognizing that some of the best companies in the US can be bought at substantial discounts to their long term value despite the risk that they may continue to fall in price in the near term. Moreover, Buffet has made these purchases within the context of a broader diversified portfolio of stocks (many of which will have seen their market value decline), bonds and cash. In other words, this is not an aggressive move back into the equity markets, but a chipping away at good opportunities while maintaining an overall balanced portfolio.

In Summary

We believe that now is not a prudent time for investors to break with or substantially alter their long-term investment program, although it may be prudent to revisit how current portfolios relate to that plan. The decision of how much cash, bonds, and equities to hold is a personal one related to the risk tolerance and time horizon of the individual investor. After five previous years of low volatility and strong equity returns, it would have been easy for many investors to let their perception of their own risk tolerances drift higher with the markets. In the current environment, investors might consider reviewing asset allocations with their Investment Advisor.

In summary, by no means are we prepared to sound the All-Clear on the equity markets given the heightened state of uncertainty in the credit markets and the global economic outlook. That said, the bear market is sufficiently advanced, we are noticing many signs that were last evident near the trough of previous bear markets and there is the potential for significant intervention by governments and central banks that can influence the overall direction in the market.

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