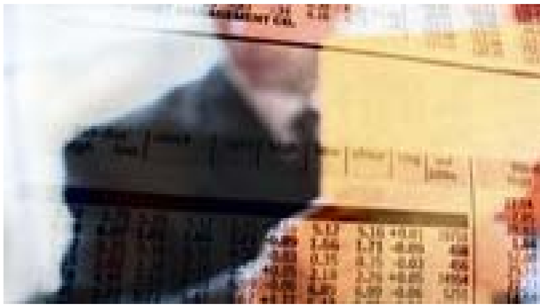


RBC Dominion Securities

Market Update

PORTFOLIO ADVISORY GROUP

Wednesday, March 11, 2009

The decision by the US Treasury to allow Lehman Brothers to "go under" in September of 2008 continues to have a widespread and long lasting impact on the global economy. While the world faced a general economic slowdown in the summer of 2008, the Lehman failure caused a major dislocation in credit markets, which spread like a contagion to equity markets and the broader economy. While the issues surrounding Lehman Brothers are complex, they can primarily be distilled down to a general loss of trust across the financial system. Banks, which had previously seamlessly interacted with one another in the interbank lending market, suddenly refused to deal with one another on concerns that their counterparty may not be able to honour its obligations. When the interbank lending market seized, other lending markets soon followed, with corporations finding it increasingly difficult to access new financing or refinance obligations. Global trade soon stalled, as merchants began to distrust letters of credit and instead demanded cash on delivery. The general slowdown of the summer of 2008 has thus morphed into a global economic recession the likes of which the world has not experienced in the post World War II era.

Since the Lehman collapse, much of what governments throughout the world have been attempting to do is to reinsert a degree of trust in the system. By essentially guaranteeing the interbank lending market, recapitalizing many financial institutions and acting as the lender of last resort, governments are attempting to promote a return to normalcy in credit markets. This is proving to be a daunting task, as what originally began as a problem in US subprime housing has grown into a global conflagration that has enveloped almost every country in the world. Emerging markets, once an area of global strength, have been especially hard hit, as their reliance on foreign investment has left them exposed to the near complete collapse in credit markets. Thus, to some degree, while governments work hard to address one problem, much like a forest fire, other problems sprout up on an ongoing basis that must be dealt with.

It seems clear the central banks and governments stand ready to use every tool in their toolboxes to deal with the crisis. Unfortunately, many of these tools are designed for "typical recessions" and this slowdown is proving anything but typical.

Typical Recessions

A typical recession is caused by inventory destocking cycles. Corporations build up inventories (excess capacity) in anticipation of demand that does not materialize and over the course of two to four quarters, inventories are unwound and economic activity slows. The central bank reduces interest rates to stimulate demand and often the central government introduces stimulus packages through either spending or tax cuts or both to fill the void of lost private sector demand. Eventually, this stimulus stokes demand, inventories, which are worked down, need to be replenished and a powerful economic rally develops.

An Atypical Recession – Monetary Policy

While some of these elements may exist today, this slowdown differs from what might be termed "garden variety" in that it is being driven by a massive amount of de-leveraging at the consumer and financial services levels. The latter has proven to be especially troubling, as the normal mechanism for transmitting central bank interest rate cuts is the banking system. Thus, if the banking system is not functioning properly, the ability of the central bank to jumpstart the economy through conventional monetary policy is limited. As a result, central banks have been forced to come up with new and innovative programs to ensure that the stimulus reaches the broader economy. The good news is that we have begun to see some impact from these programs, the bad news is that the process moves slowly and in the interim, the economy is under intense pressure.

An Atypical Recession – Fiscal Policy

As mentioned earlier, when an economic slowdown unfolds, central governments will often look to increase spending and/or reduce taxes in order to "fill the void" created by declining consumer and corporate demand. However, because this recession is deeper, central governments have been forced to launch ambitious spending and tax cuts plans on a level far beyond the norm. The good news is that this increased spending/tax cuts will likely drive significant economic growth over time, the bad news is that like monetary policy, the actual impact will not be felt for some time to come.

The Great Depression

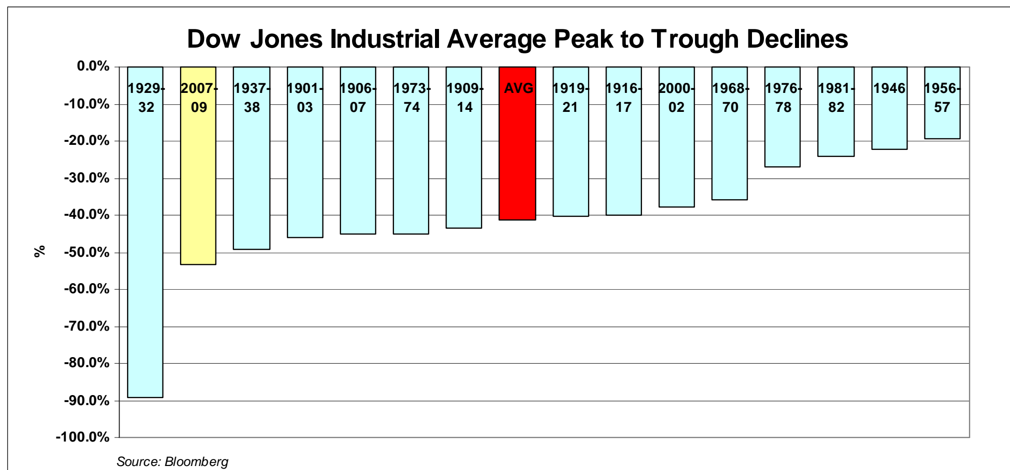
While the news is generally bad, it is important to note that the current crisis differs significantly from the Great Depression. The Great Depression essentially became "Great" because of several factors:

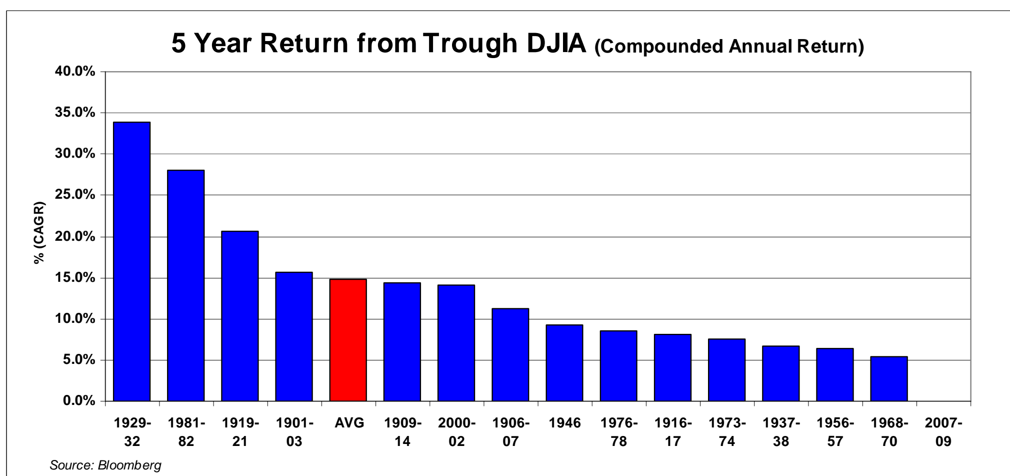
- A laissez faire style of government that ignored the slowdown for most of the first four years;
- Rising rather than declining interest for much of the first half of the crisis;
- A global trade war touched off by the Smoot-Hawley Tariff Act of 1930;
- A massive drought that ran for two years through the Mississippi Valley;
- The lack of any sort of social safety net such as unemployment insurance or healthcare.

With the exception of global trade (and perhaps the weather), which remains somewhat in a state of flux, the rapidity of response through this crisis makes what happened during the Great Depression beyond the scale of what is likely to unfold during this crisis.

The Equity Markets

Against this backdrop, equity markets have suffered enormous losses. Given the uncertainty over the pace of an economic recovery, it is difficult to make any sort of short-term call on the directionality of the markets. However, from an intermediate to long-term perspective, it is interesting to note that the five-year average returns from the trough in bear markets has always been greater than 5% per annum (excluding dividends) and has averaged approximately 15% per annum. Further, the deeper the sell-off, the better the subsequent five-year returns have tended to be (we are now in the midst of the second worst sell-off on record). Of course, timing any bottom in the market is difficult to achieve, but hopefully the following exercise will demonstrate that in terms of long-term returns, being early in terms of predicting a trough does not necessarily devastate long-term returns.





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- **Scenario 1:** Today's level on the market marks the trough – $100 invested today would be worth $201 in five years based on a 15% compounded return (historic average from troughs) plus dividends received.
- **Scenario 2:** The market trades down 20% in year one and then troughs - $100 invested today would be worth $160 in six years (we added one year because of the initial sell-off) plus dividends received. This would be approximately an 8% compounded average annual return for the six year period.
- **Scenario 3:** The market trades down 30% in year one and then troughs - $100 invested today would be worth $140 in six years plus dividends received. This would be just under a 6% compounded average annual return for the six year period.

Clearly, timing the trough of the market can have a big impact on long-term returns and if it takes more than another year, the returns in the scenarios above would be lower. However, it is worth noting that even in an extremely negative outcome in which the market trades down another 40% from current levels, the six-year average return is positive based on the average outcome in past bear markets. Further, the current dividend yields on the TSX and S&P 500 are greater than 4%, so when dividends are factored in, all of the returns would be significantly higher.

Takeaways

There is a tremendous amount of stimulus in the system and central banks and governments from around the world are constructing an unprecedented effort to reverse the slide in the global economy. While some of these plans have proven difficult to implement and key transmission mechanisms remain clogged, we remain cautiously optimistic that the roots of a recovery can begin to take hold in the months ahead. That said, the next 12 to 18 months are fraught with uncertainty. Thus, ensuring that one is well-diversified with adequate amounts of cash and fixed income is of paramount importance. However, for those that can take a longer-term view, under even the most negative scenarios, the long-term returns can be quite meaningful even when faced with sharp declines from current levels.

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