



RBC Dominion Securities

Special Market Commentary

PORTFOLIO ADVISORY GROUP

Tuesday, January 15th 2007

The final weeks of 2007 and the first few days of 2008 have been particularly trying for investors, with the S&P 500 falling as much as 8.5% from its early December high while the S&P/TSX declined by a more modest 3.0% (both indices have since partly recovered).

The weakness of the past few weeks can be largely attributed to two key issues: renewed concern over the outlook for the US economy following a job report that showed a higher than expected jump in unemployment and increased concern over the status for financial guarantors and the impact of their potential failure on the financial system. We briefly discuss each of these below.

Unexpected Jump in US Unemployment Rate

The US job report released January 4th showed that 18,000 net jobs were created in December, below the expected gain of 70,000 jobs and down sharply from the revised 115,000 gain reported in November. Note that based on RBC estimates, the US Economy needs to add 143,000 net jobs every month to keep the unemployment rate stable. Meanwhile, the unemployment rate rose from 4.7% to 5.0%. The data clearly suggests that the labor market is slowing down. On the bright side, the moderation in labor demand will likely ease the pressure on wages, which should in turn limit the growth in consumer spending and inflation, creating more room for further rate cuts from the US Federal Reserve. However, the rise in the unemployment rate also suggests that the slowdown in the US economy could be worse than expected. In fact, we've now seen an increase of 0.6% in the unemployment rate over the past year, an event that has occurred only 10 other times since 1948. In all 10 episodes, the economy had already entered recession. While the outcome could be different this time, the deterioration of the labour market does suggest more downside risk to the US economy.

Deteriorating Outlook for Financial Guarantors

US financial guarantors (also known as bond insurers) have been under severe pressure over the past months on concern that they could face significant losses on securities backed by US real estate. Shares of **Ambac (ABK)** and **MBIA (MBI)**, the two largest bond insurers, are down 36.7% and 58.8% respectively since December 10th. These companies typically provide guarantees to allow bond issuers to obtain stronger credit ratings to reduce the cost of funding and facilitate transactions. These guarantees are extended through a bond insurance policy or by writing credit default swaps. The headwinds facing financial guarantors have recently worsened as the pressure to raise equity to maintain their credit ratings continues to increase while new business has slowed considerably. On December 19th, S&P downgraded ACA, a relatively small financial guarantor, from A to CCC, and put some of the major bond insurers on negative watch. The downgrade or failure of some of these major US bond insurers would have serious negative implications for parts of the financial system, particularly for firms holding municipal bonds and certain collateralized debt obligations. The uncertainty surrounding these financial guarantors adds to the list of worries for the US financial system and the economy.

We remind investors that it is not unusual for long term bull markets to experience corrections, many of which have been caused by some form of financial crisis. The current financial crisis offers a unique set of challenges, not least of which is the substantial decline in housing values and the lack of transparency regarding the magnitude of losses related to structured investments and where they are likely to come from next. This has been particularly hard on the banks, causing them to rethink their lending practices, with possible negative implications for business and consumers, and for the central banks which rely on the banking system to transmit their rate cuts into the broader economy. History suggests that vigorous Fed easing rarely fails to result in positive equity returns over a reasonable holding period, giving us confidence that an investment in today's equity markets will ultimately be amply rewarded. However, any such reward is likely to be accompanied by higher levels of volatility than most investors had become used to over the unusually calm period that prevailed over the previous three years.

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