

RBC Dominion Securities

Market Update

PORTFOLIO ADVISORY GROUP

Tuesday, January 22, 2008

Yesterday was an extremely bad day for Canadian stocks, as well as for those in Europe and Asia. It seemed to mark a departure from a market trending lower because of concerns about the economy to outright fear about the potential for future market losses. While 'fear' is usually a feature of the latter stages of a market decline, when you're in the middle of it, time can seem to move very slowly indeed.

We don't know when this phase will end, although we suspect sooner rather than later – many indicators are already deeply oversold – but the amount of damage done could still be considerable.

The stock market would seem to be already discounting a recession and an accompanying decline in corporate earnings. The stock market has incorrectly forecast a recession at other times in the past 50 years, so that kind of outcome is far from a foregone conclusion. And given the Fed rate-cutting already in place together with our expectation of more to come we would note that the odds are steadily shifting toward the emergence of more energetic U.S. economic growth in the second half after a much more problematic first half.

It could be that stock markets will need to see that economic improvement materialize before any sustainable uptrend can get underway. What would be much more typical, however, would be for the precursors of the economic reacceleration – in the form of further aggressive monetary leadership by the Fed and other central banks – to persuade investors that stocks had more to gain on the upside than lose in further decline.

It is worth reminding ourselves of the main points of our investment thesis:

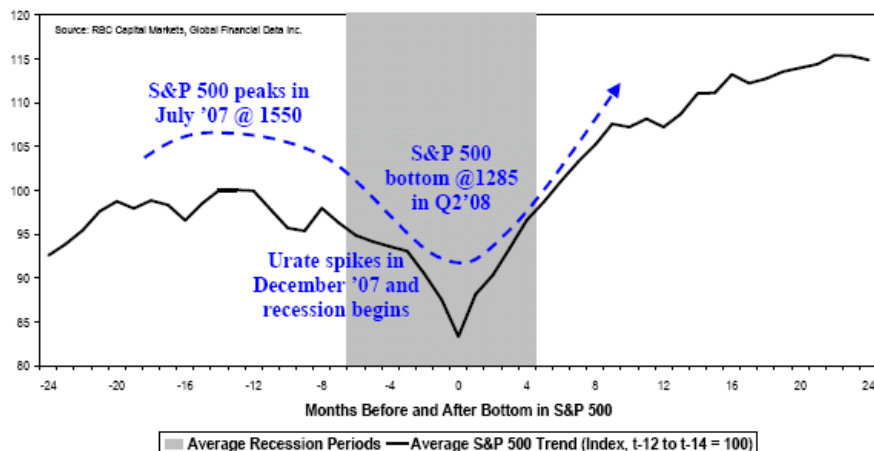
- Weak U.S. economic growth in the first half – which may or may not qualify as a recession – will give way to a more solid economic footing in the second half underwritten by lower interest rates from the Fed and reflecting steady growth in government spending (20% of GDP), further improvements in exports and trade delivered by the weaker U.S. dollar; no big decline in business investment; and positive albeit modest growth in consumer spending.
- Moderate but positive economic growth from the U.S. will extend the global economic expansion while removing the threat of an inflation breakout that would force central banks back to tightening mode.
- Investor conviction about sustained growth with contained inflation will push the U.S. market back up from discounted valuations to something closer to 'fair value' which we estimate will stand at or above 1600 for the S&P 500 one year from now. Other major large-cap markets in Europe and Japan offer similar potential.
- The Canadian stock market should be able to deliver worthwhile returns if the markets noted above follow the path we expect. However, if the U.S. and global economic picture were to deteriorate markedly from here, the Canadian market – still trading well above calculated 'fair value' – could endure a more difficult period of retrenchment than some others.

If there is a risk to our outlook, it is clearly towards greater probability of recession. With this in mind, we offer some basic metrics based on previous recessions:

1) There have been 10 recessions in the US since 1948. On average, they last 10 to 11 months and only 2 of these 10 recessions lasted more than 11 months. Stocks typically peak 6 months before the recession's onset and bottom about 50-60% of the way through its duration. If we were to assume the economy entered a recession in December, history suggests that the market should find a bottom in May or June.

2) From top to bottom, the S&P 500 is typically down by 17% during recession cycles, using monthly data. Using the July peak of 1,550 on the S&P 500 as a reference point suggests a bottom for the S&P 500 around 1,285. With today's drop, the S&P 500 is currently trading at 1,310 which is near recessionary levels.

The Typical Recessionary Price Path for the S&P 500: Stylized Roadmap for Today?



3) We have constructed a road map of returns of S&P 500 over the past 9 recessions dating back to 1953 using daily data, which captures the full effect of market volatility. The table below outlines the returns of the market in the 12 months leading up to the onset of recession, the returns during the recession and the returns over the 12 months coming out of the recession. Further, we have added the trough PE multiple for the market.

Recession	Prior 12 Months	Prior 6 Months	During Recession	Next 12 Months	Peak to Trough	Trough PE	Trough 10-Year
July 1953 to May 1954	-2.6%	-6.2%	17.9%	29.9%	-22.2%	NA	NA
August 1957 to April 1958	-4.8%	4.5%	-3.9%	32.6%	-21.5%	NA	NA
April 1960 to February 1961	-3.2%	8.6%	11.6%	12.9%	-14.0%	16.2x	3.78%
December 1969 to November 1970	-14.5%	-8.1%	-7.5%	10.1%	-37.3%	13.7x	6.84%
November 1973 to March 1975	-11.4%	-4.9%	-17.9%	20.7%	-49.9%	7.5x	6.73%
January 1980 to July 1980	11.2%	8.0%	8.0%	7.8%	-16.0%	14.8x	9.78%
July 1981 to November 1982	7.8%	-2.9%	7.0%	19.6%	-28.0%	12.9x	10.55%
July 1990 to March 1991	8.5%	5.9%	3.4%	9.4%	-20.1%	20.9x	7.85%
March 2001 to November 2001	-17.8%	-19.2%	-4.7%	-17.1%	-39.2%	25.9x	4.57%
December 2007 to ?	-11.1%	-12.2%	?	?	-19.7%	?	3.58%
Average	-3.8%	-2.6%	1.5%	14.0%	-27.6%	16.0x	7.16%
Average (ex Tech Bubble)	-1.1%	0.6%	2.3%	17.9%	-26.1%	14.3x	7.59%

We would note a few things:

- The market is down 11% over the last 12 months, which is significantly worse than the typical recession scenario.
- The returns during the actual recession are generally flat, indicating that the market has often discounted the bad news ahead of time.
- Trough PE multiples are typically in the mid-teens. With the exception of one recession (1960-61), the ten-year yield is typically far higher than it is today, which suggests a higher P/E multiple is justified today. If we apply a roughly 14% historical decrease in earnings to today's 12.2x consensus forward Price / Earnings multiple, we get a P/E of 14.2x.
- Peak to trough declines, which are measured from the market high over the prior 12 months to the recession low, average around 27%. This implies that in the short term, if the recession has begun and history is any guide, there could be another 5 to 10% downside.

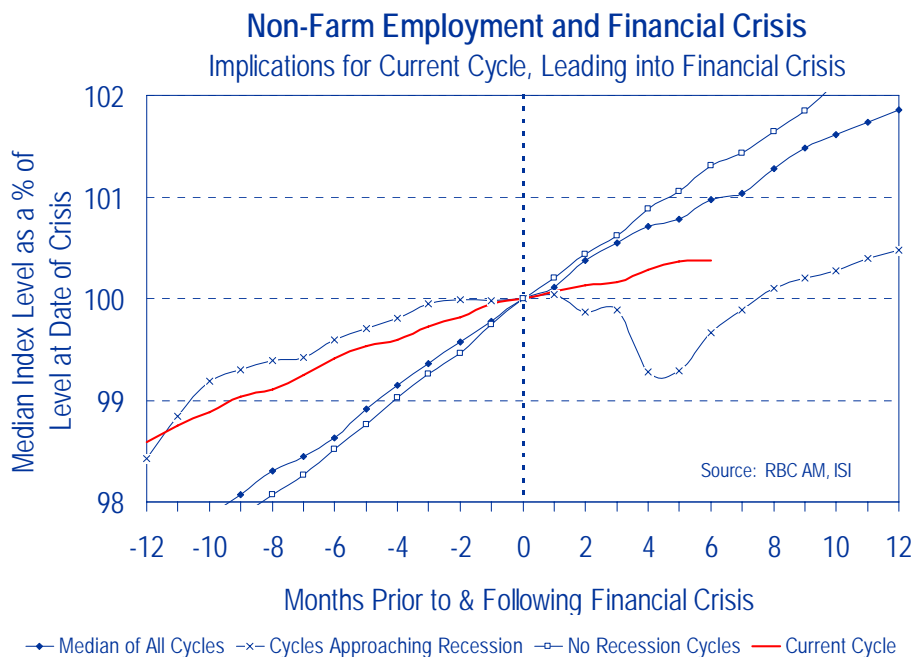
4) While few are projecting a recessionary outcome for Canada, it is interesting to look at how the Canadian market has performed during past US recessions. We would note that during US recessions, the TSX has typically lost about 7% of its value; however, during prolonged recessions (73 to 75 and 81 to 82), the TSX has suffered losses of as much as 25%. Considering that the TSX is off more than 10% in the past week, the Canadian market appears to have priced in a typical recession and has even begun to price in the risk of a more prolonged US recession.

Recession	Prior 12 Months	Prior 6 Months	During Recession	Next 12 Months
July 1953 to May 1954	-5.2%	-6.0%	6.8%	37.3%
August 1957 to April 1958	-6.5%	1.6%	-20.8%	23.0%
April 1960 to February 1961	-9.0%	-3.7%	12.4%	18.6%
December 1969 to November 1970	-1.0%	-8.8%	-14.3%	-0.3%
November 1973 to March 1975	18.3%	11.9%	-24.3%	6.8%
January 1980 to July 1980	38.4%	12.0%	13.7%	14.5%
July 1981 to November 1982	14.5%	4.1%	-24.9%	33.1%
July 1990 to March 1991	-5.8%	-10.7%	-2.3%	3.5%
March 2001 to November 2001	-11.5%	-28.2%	-14.8%	-9.2%
December 2007 to ?	-3.2%	-10.2%	?	?
Average	2.9%	-3.8%	-7.6%	14.1%
Average (ex Tech Bubble)	5.5%	0.0%	-6.7%	17.1%

What these figures tell us is that based on the historical performance of the US and Canadian stock markets during previous recessions, the S&P 500 and the TSX now appear to be close to pricing in a full blown US recession. Further downside would imply expectations of a more deep and prolonged recession (such as the one from 1973 to 1975). In our view it would appear too early for the market to start reflecting such a negative outcome, especially since the US economy is structurally different than it was 30 years ago, as it is much less exposed to manufacturing, intractable unions and hard goods, which are typically much more susceptible to hard landings and prolonged recessions. We would also reiterate one of our earlier points that markets frequently have predicted recessions that have not occurred

What are the signposts that we would watch for? On the downside, the unquantifiable and unforeseeable nature of financial contagion has been the primary cause of market instability. The possibility that the fire catches on tinder in other, poorly or misunderstood segments of the financial markets remains a threat. The impact on investor and consumer psychology of increasingly gloomy media coverage also should not be discounted.

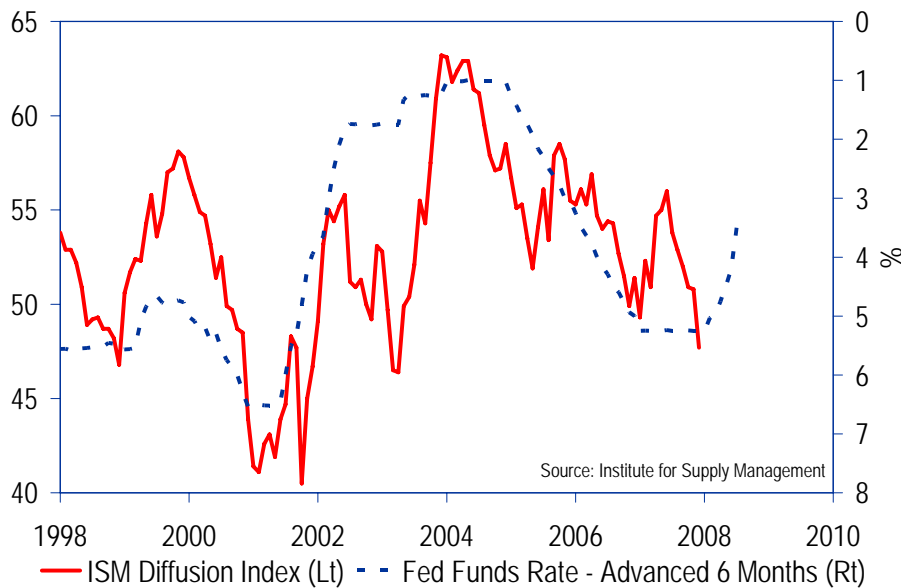
In our view, the most pressing barometer of future economic health is the unemployment data. While a jump in the unemployment rate such as the one witnessed last December may typically be associated with a recession, the weekly US jobless claims have yet to register at the kind of levels that would be expected in such a scenario. The chart below best sums up the current situation where the current employment data are in the area in between those scenarios associated with cycles where financial crises do and do not lead into recession.



All told, while not as bad as we would fear, the numbers do not give us as much confidence as we would ultimately desire, leaving us in a position of relative uncertainty befitting what should be expected during the bumpy part of a soft or hard economic landing.

Finally, the most obvious prescription for dealing with challenges to the economic outlook remains monetary easing, and this morning's 75 bps cut in the Fed Funds rate and 25 bps cut by the Bank of Canada highlight the current high state of vigilance amongst the central banks. Rate cuts will not shield the market from some of the specific issues facing bank balance sheets and bond insurers, but they have consistently proven to have a powerful lagged effect on overall economic activity, as demonstrated in the chart below.

U.S. ISM Manufacturing Index & the Fed Funds Rate
Fed Funds Inverted and Advanced Six Months



In summary, market movements in the last few days have been driven by fear, which is a powerful force which must often run its course. This makes it difficult to determine if we are near a bottom or if there is more to come. However, by historical benchmarks, the market has already gone a good ways towards reflecting the impacts of any recession scenario and the central banks have demonstrated a commitment to responding in force.

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