

# The Rubino Wealth Management Group's *Investment Review*



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## Portfolio Strategy

### Recommended Asset Mix

15%	Cash
25%	Fixed Income
60%	Equities

#### Equities

Contact us regarding our  
quarterly recommendations

#### Fixed Income

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#### Cash

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## Problems in US Financial Sector

The US financial sector has come under significant pressure recently. Several issues appear to be hampering the ability of financial institutions to extend credit to businesses and individuals, which could have serious negative implications for the US economy. The perceived lack of stability of the US financial system is also causing some volatility in equity markets. We examine below the challenges for the sector, the potential implications for the US economy and review the outlook for banks and other financial stocks.

### A Review of the Events Leading to the Current Crisis

Financial institutions have been forced to take large write-downs on subprime mortgages. Most of these institutions also had significant holdings of complex and highly levered structured investment products backed in part by riskier loans, which had to be written-down as well.

These large losses put severe pressure on the capital positions of the banks. In addition, the drop in investor demand for asset backed securities reduced the ability for banks to securitize loans, putting further pressure on their balance sheets and increasing funding costs. Many banks have been forced to recapitalize by issuing equity at a discount in order to solve liquidity problems.

At the same time, several trends are negatively impacting the profitability of the banking sector. The economic slowdown in the US has resulted in a deteriorating credit environment and higher loan losses, while the decline in capital markets activity is reducing the fees earned by banks for underwriting transactions and providing advisory services on mergers, acquisitions and other transactions.

Most banks now find themselves in a difficult position: their capital positions have weakened significantly while the deteriorating macroeconomic environment is putting pressure on earnings. Many still have significant holdings of structured investment products that are difficult to value and highly illiquid, which adds to the uncertainty surrounding the sector. The lack of investor confidence has made it very difficult for banks to raise capital at a time where they are most likely to need it.

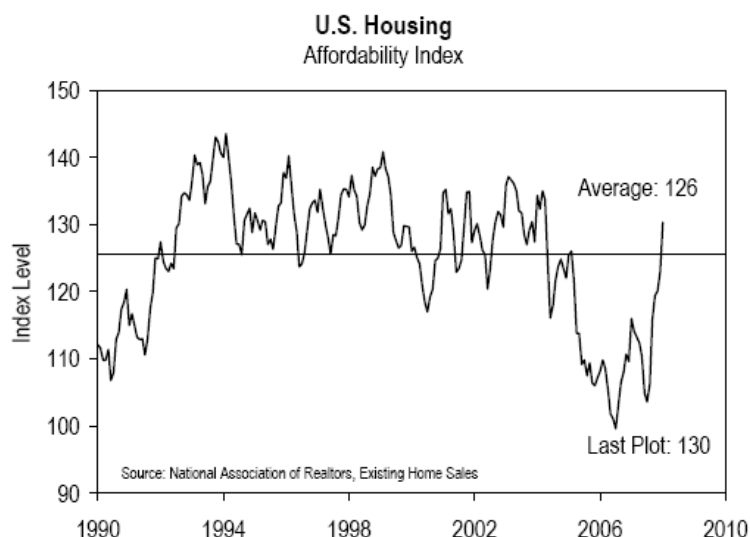
The quick deterioration of Bear Stearns's liquidity position, which led to the sale of the company, highlights the vulnerability of financial institutions that rely almost exclusively on capital markets to finance their operations. However, it is important to note that Bear Stearns faced several company-specific challenges including large holdings of illiquid assets, high leverage and above-average exposure to prime brokerage (banking services provided to hedge funds), which suggest that the problems encountered by the company are unlikely to spread to the rest of the industry.

Over the past several months, the Federal Reserve has announced several measures to help provide liquidity to the sector. While these measures appear to have provided some short-term relief, it is too early to tell whether the Fed's actions represent a longer-term solution to the problem of weak capital positions for the banks and to the lack of liquidity of structured investment products.

### Implications for the US Economy

The Federal Reserve has aggressively cut interest rates over the past 6 months in order to stimulate the slowing US economy. Unfortunately, rate cuts are not effective if they are not passed on to businesses and individuals by the banking system. So far, rate cuts have in large part been offset by tightening credit standards (based on data obtained through the Federal Reserve's surveys of loan officers) and widening credit spreads on corporate bonds. Unfortunately, homeowners, consumers and businesses are not benefiting from easier and cheaper access to credit as much as would be expected because of the reluctance of banks to ease lending standards given their weak capital positions and deteriorating profitability.

However, there has been some signs of relief for homeowners as measured by the recent improvement in the housing affordability index, which has been driven by falling home prices and lower mortgage rates. But while affordability may be improving, the high level of housing inventory combined with tighter lending standards and lack of confidence suggests that it is too early to call a bottom for the US housing market.



### Implication for Equity Markets

The resolution of the problems in the US financial system represents a key step towards the recovery of the US economy. Unfortunately, the nature and severity of these issues suggests that a coordinated effort from regulators and industry participants may be required. The financial sector is likely to remain under pressure until a credible solution emerges. Meanwhile, equity markets are likely to remain volatile as the prospects of a US economic recovery remains clouded by the credit crunch.

Two key themes have emerged in the markets over the past months as a result of this uncertainty: 1) a flight to quality, as investors re-rate the risks associated with their holdings and favour defensive companies with visible earnings streams and 2) growing interest in alternative investments that are likely to be somewhat insulated from a US slowdown, particularly commodities (based on the belief that demand coming from China and other emerging economies will remain strong). The first trend is likely to be sustained as uncertainty around the outlook for the economy persists. The second trend, which has been particularly beneficial to the Canadian market given its heavy concentration in the resource sector, is largely dependent on the continued strong growth in demand coming from China and other emerging economies and may face some short-term headwinds if the sustainability of that growth was put into question. In addition, a prolonged US slowdown would no doubt have negative implications for the growth of the global economy, which could in turn

lead to weakening demand for commodities. We would note that following the recent correction, the US stock market is already trading at valuations consistent with the levels seen during previous recessions. While further downside cannot be ruled out, we believe investors should continue to overweight equities relative to bonds based on our belief that the Fed will ultimately be successful in its attempts to stabilize the US economy and the significant upside ahead if stocks were to trade back to levels that are consistent with a durable growth and low inflation environment.

However, in light of the prospects for continued volatility over the coming months due in part to the lack of visibility regarding a potential resolution of the problems in the financial sector, we believe there are a few measures investors should consider in order to navigate through this period of uncertainty:

1) Maintain a higher allocation to cash in order to reduce overall portfolio volatility and take advantage of opportunities that may present themselves if we experience further market sell-offs.

2) Favour high quality stocks with solid earnings visibility. As investors continue to re-rate risk across all segments of financial markets, companies with defensive attributes are likely to continue to see their valuations improve relative to their riskier peers.

3) Maintain an underweight exposure to the financial sector, particularly banks, both in Canada and the US.

#### **A Note on the Canadian Banks**

We believe a cautious stance on the Canadian banks is appropriate at this point given the deteriorating macro-environment and valuations that are still above those seen during previous periods of uncertainty for the sector. We would highlight, however, that there are several key differences between Canadian and US banks:

1) The Canadian banks generally have stronger capital positions than their US counterparts;

2) The Canadian banks operate in a more favourable macro-environment given the stronger Canadian economy, less intense competition and better credit conditions.

3) Loan securitization has played a less meaningful role in Canada over the past years, which suggests that the inability of banks to continue to securitize due to the drop in investor demand for structured securities is likely to have a milder impact on balance sheets.

4) Canadian banks are also generally less exposed to structured products backed by US mortgages, even though most had at least some exposure and had to take write-downs related to these holdings. CIBC was forced to complete a dilutive equity issue to replenish its capital position due to these losses.

Despite their better positioning than their US peers, the Canadian banks are facing a decline in profitability related to the slowdown in capital market activity and credit deterioration, albeit to a lesser extent than their US counterparts.

Within the group, we would favour **TD Bank (TD)**, **Royal Bank (RY)** and **Bank of Nova Scotia (BNS)** based on their strong domestic retail franchises and lower overall risk profile.

## **Federal Budget 2008**

### **Tax-Free Savings Account (TFSA)**

The federal budget proposes to introduce, possibly as early as 2009, the Tax-Free Savings Account (TFSA). This account appears to have elements of both a non-registered account and an RSP.

It is similar to an RSP in that funds within the account grow tax-free, the account is subject to the same qualified investment rules and subject to a similar concept of "contribution room". Unlike an RSP, your TFSA contributions are not deductible and your withdrawals are never subject to income tax. This means your investment will be made with after-tax dollars, similar to an investment into a regular non-registered account, however the income on the investments will be tax-free. Since your withdrawals will not be subject to tax and will not be considered as taxable income, it would not impact your income-tested benefits and income tax credits

such as Old Age Security, Employment Insurance benefits and your entitlement to the age credit.

### **Contribution Room**

All Canadian residents, age 18 and older will acquire \$5,000 of contribution room each year, indexed to inflation, regardless of income. Similar to your RSP contribution room, the Canada Revenue Agency (CRA) will determine and track your TFSA contribution room as you file your tax return each year. Unused contribution room will be carried forward indefinitely. Amounts withdrawn from the plan, including the tax-free growth, will be added back to your contribution room for the following year which means you will be able to withdraw amounts and reinvest those same amounts as you choose without losing any contribution room. This type of “revolving” contribution room will help you meet your financial planning goals throughout your lifetime since you will be able to save funds in this account and withdraw funds as necessary without losing your ability to reinvest in this account for future goals.

### **Income Splitting Opportunity**

The budget proposes that since the income earned within the TFSA is not taxable, contributions made by a taxpayer into their spouse’s TFSA would not be subject to the income attribution rules. Unlike conventional income splitting strategies that consider the source of the invested funds, this account allows for you and your spouse to both earn tax-free investment income regardless of whose money is invested. Also, relative to traditional income splitting strategies, your TFSA will also allow for greater tax savings, thus greater investment growth and in a shorter time frame.

### **Financial Planning Opportunities**

The various attributes of the TFSA including the tax-free investment income, the ability to invest in your spouse’s plan without triggering attribution, the revolving contribution room and the fact that the withdraws do not effect any income tested benefits or clawbacks can provide you with greater flexibility for savings and investments throughout your lifetime. Though the TFSA may add to the overall complexity of your financial situation, it will also provide you with more flexibility with regards to choosing which sources of income to draw upon during retirement.

The TFSA is an ideal compliment to an RSP, especially if you are able to make the maximum contribution to each of these two plans each year.

Since the investment income earned within the TFSA is not taxable, any interest paid on funds borrowed to invest in the TFSA will not be deductible for income tax purposes. Unlike RSPs, there will not be any constraints with respect to using your assets within your TFSA as collateral for a loan.

## **These Are NOT Normal Times**

Currently, the most bullish word on Wall Street is “*Recession!*”

The reason is that in almost all cases, by the time a recession is finally recognized in the media headlines and by financial pundits, then most of the bear market

damage is typically over. In fact, most of the time, it is the widespread gloom of recognizing the recession that creates the last leg down in the bear market.

And we have certainly seen the current recession recognized, both in headlines and full color magazine covers this time around. Normally, that would be a classic scenario for a bear market bottom!

### **The Caveat...**

The caveat to this valuable historical tool lies in the words, “*in almost all cases*” and “*normally.*” There have been a couple rare exceptions –most notably when the Federal Reserve has lost control– that recession headlines have not been a good precursor of a bear market bottom. That is when the Fed’s efforts to stimulate the economy by lowering interest rates proves as ineffective as pushing on a string. *Unfortunately, could be one of those times.*

**There are only 3 instances in history when the Federal Reserve cut the Discount Rate 8 times, and the stock market was subsequently lower than when the Fed easing began: 1929-1932, 2000-2002, and today.**



Note that in both prior instances (1930 and 2001), the bear market continued for more than a year after the 8th discount rate cut before hitting bottom.

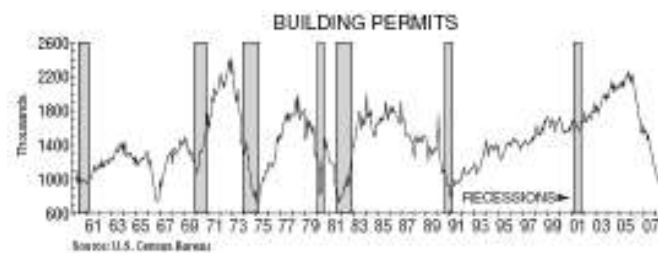
So this anomaly is a major reason for our hesitation to rely on our “Recession-Cover” tool this time around. It may already be working, since the market hasn’t hit a new low in over 3 weeks, but we cannot depend on it in light of the ongoing anecdotal warning flags...

**No Bottom In Sight...**

Whether you’re looking at housing or consumer confidence, there’s little or no evidence that an economic bottom is at hand.

If you think our cautionary note is an overreaction, then read what our former Federal Reserve Chairman and the president of the private group that officially sets the starting and ending dates of U.S. recessions are saying:

In barely two years, both Housing Starts and Building Permits have fallen from 24-year highs to 17-year lows. In spite of massive liquidation sales by the country’s home builders, the inventory of unsold homes continues to plague the depressed housing market.



On the surface, there was no surprise from the drop in Consumer Confidence last week. If we are in recession, these are the gloomy confidence levels we should be seeing. However, there was a more ominous note in the “Future Expectations” of this consumer confidence report, which tumbled sharply to its lowest level in 35 years!



Don’t think these are unprecedented, dangerous times? Consider...

- For the first time since the Financial Crisis of 1914, the Federal Reserve has cut the discount rate twice within 2 days. *And they not only did it once, but on two separate occasions – in both January and March!*
- In the \$30 billion bailout of the fifth largest U.S. investment bank, Bear Stearns, *the Fed invoked a little-known depression era law last used in 1932!*
- On the most recent rate cut (#8), the Federal Reserve reduced the discount rate by a whopping ¾%pt... from 3.25% to 2.50%. *In its 95-year history, the Fed has never made an aggressive cut of that size when the discount rate was already at less than 4%!*

Clearly, Bernanke & Co. are pulling out every imaginable stop to halt the slide in consumer and investor confidence. And while Fed officials and bankers will always claim (to their dying breath) that “*the Fed does not target stock prices,*” you can bet your bottom dollar they’re doing exactly that right now.

The special January 22 discount rate cut was announced prior to the market open – when stock index futures were initially down over -500 points. Result: the DJIA closed down only -121 points. Again, on Sunday, March 16, with Asian markets plummeting and widespread fears that a Bear Stearns debacle might cause a freeze-up on Wall Street, the Fed initiated a unique weekend discount rate cut. Result: the DJIA actually managed a 21 point gain on Monday, after the gloomy bailout news became public.

The Fed is closely watching Wall Street’s reaction to every twist and turn in the financial news and credit markets. If Wall Street stabilizes, then Fed officials breathe easier. If Wall Street drops to new bear market lows –*especially after 8 discount rate cuts now*– then expect additional rate cuts and even more dramatic, confidence-restoring announcements from Bernanke and the Federal Reserve.

## Trend & Cycle

Date: April 1, 2008	Long Term: (6-18 mths)	MidTerm: (5-10 wks)	Comments:
TSX 60:	↘	↗	• long term problem forming, spring rally may suggest a selling opportunity
Dow Jones Industrials:	↘	↗	• intermediate rally may begin soon
90 Day Interest Rates:	↘	↘	• short term rates continue to fall
5 Yr Interest Rates:	↘	↘	• rate approaching lows
30 Yr Interest Rates:	↘	↘	• rate approaching lows
Gold:	↗	↘	• a significant correction will present a buying opportunity
Canadian Dollar:	↘	↘	• CDN\$ is flat to down in the future
<b>LEGEND</b>	↘ ↗ bottom forming	↗ buy	↗ ↘ top forming
			↘ sell



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