Review and Outlook

SEEKING A CATALYST FOR CHANGE

Equity markets have been largely trading sideways since both the Federal Reserve and the Bank of Canada cut their key lending rates in mid-January. With North American indices now down 9% (Canada) to 18% (U.S.) respectively from their highs in October, many investors have begun to wonder if the bottom is at hand.

Pinpointing the Bottom

Last quarter, we talked about the perils of forecasting change, especially trying to predict when that change will occur. One of the primary issues is that inertia tends to favour things that are in motion will remain in motion. In addition, we noted that it's often unclear whether a developing trend will evolve beyond its infancy, but once it takes hold and gets used to its surroundings, it's usually reluctant to go away. Often, a catalyst or some kind of force is required to alter the environment.

The recent announcement that Bear Stearns, the fifth largest securities firm in the U.S., was forced to sell to JP Morgan at a price of roughly $2 per share in stock to avoid a potential bankruptcy, may have been that catalyst.

Historical Perspective

While there have not been that many high-profile, large-scale failures in the financial sector (Long-Term Capital Management LP [1998], Barings Plc [1995], Drexel Burnham Lambert Inc. [1990]), it may be helpful to look at some of the historical parallels to today's crisis. While crises are never exactly the same, history often provides some useful information or a roadmap on how a crisis is likely to evolve or get resolved.

If one looks at the history of financial crises, it becomes immediately clear that all are due to financial leverage. Put simply, "no leverage, no crisis." In essence, leverage allows people to obtain assets far beyond their means in the hope that asset prices continue to rise. However, when asset prices start to fall, those who borrow to buy are the first ones to be wiped out. Today's credit crisis most resembles the savings and loan (S&L) debacle between 1989 and 1991.

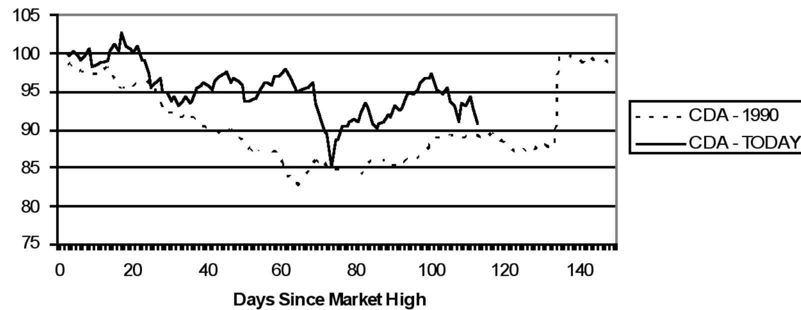
Both crises are deeply rooted in a real estate problem. Back in the early 1990s, it was commercial real estate values that were deflating. Today, the problem is in the residential market. It is hard to judge which one is worse. We can acknowledge that both episodes are pretty bad as well as both ominous and threatening to economic growth and financial markets.

During the S&L crisis in the early 1990s, there were thousands of institutions (thrifts) that were wiped out from the U.S. financial industry because their balance sheets were all badly "mismatched." Of course, today's credit market problem is also very grim and highly charged, but it is not appropriate to say that this crisis is far worse than the S&L debacle.

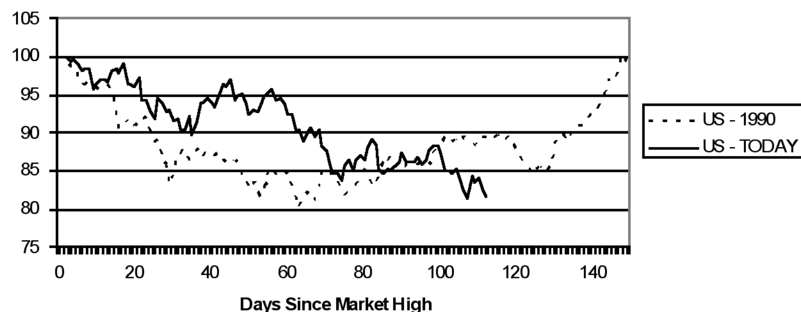
If we are right that this crisis is comparable to the S&L crisis, one would expect financial markets to make roughly similar adjustments. The top-to-bottom decline in the S&P 500 during the S&L debacle was 20% and the bear market lasted six-to-nine months.

Applying this experience, it is possible that the U.S. market has already bottomed, because we have had a total drawdown of 18% between the October 9th peak and March 17th, 2008. Of course, no two crises look exactly the same, but the S&L debacle may provide a gauge for the current market turmoil. Here in Canada, we have been a little more insulated given our exposure to natural resources.

S&P/TSX Composite – Comparing Financial Crises – Canada



S&P 500 – Comparing Financial Crises – US



While the near failure of Bear Stearns highlights the potential risks to the financial system, it also illustrates the ability to heal itself, with the strong institutions taking over the weak. The fact that the U.S. Federal Reserve provided only temporary liquidity and left it to the private sector to work out a deal is key.

Financial markets tend to be anticipatory in nature and move ahead of economic data. Therefore, even if a rally in stock prices starts to pick up steam, economic data may likely get progressively worse. So while the broader risks of an economic slowdown remain, this is being increasingly factored into the valuations of capital markets. Never ones to rest (or at least, stop worrying about the next shoe to drop), we are keeping a keen eye on inflation. While Canadian inflation appears to be quite benign, advances in commodity prices are starting to pressure producers around the world to pass on these increases through higher prices.

Today's Market

Overall, we remain constructive on the equity markets over the next twelve months. Our forbearance to maintain a disciplined approach to investing makes it easier to put some perspective around the issues of the day and focus on achieving our clients' goals. We are currently defensively positioned in our portfolios while holding some cash balances so that we are able to both weather and benefit from this decline in equity markets.

On the fixed income side, the recent gains in the Canadian government bond market have reduced the potential return for the coming months. There appears to be very little value left in this segment of the market as prices have been largely supported and propped up by risk aversion. As a result, we have continued to overweight corporate bonds, which we believe offer greater potential as many issuers have been unfairly tainted and therefore offer superior yields (income) in today's low rate environment.

As spring is starting to emerge, remember that successful investing isn't easy, but it is simple: buy low, sell high. Convincing yourself to buy low (or at least, stay invested), when everyone else is selling, is what makes it hard.

* All opinions contained in this document constitute our judgement as of March 17, 2008, are subject to change without notice.

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