Monthly investment commentary

January 2009

## 2008 HIGHLIGHTS

**What went up…came down**

- Domestic and global economic indicators weakened throughout the year, consumer sentiment soured, credit conditions tightened, and economic growth expectations were significantly downgraded.
- After hitting all time highs in the summer, the S&P/TSX composite finished down -35%, in line with most major world markets.
- Commodity prices rose to sky-high levels before a weakening global economic outlook spurred on their rapid decent. Oil prices hit an all-time high of $147/barrel (West Texas) in the summer before dropping over $100 to end the year at $39/barrel. Base metals such as zinc, copper and nickel fell 50% or more.
- 20. The number of days the S&P500 rose or fell more the 5% in 2008 (compared to eight days for the 10-year period between 1997 and 2007).
- 126. The number of down days in the S&P500 and, believe it or not, it is also the number of up days for the S&P500. Of course, the down days had much larger percentage changes than the up days did.

It's hard to imagine a more difficult year for investors than 2008. It didn't matter whether investors had money in plain vanilla Canadian equity or more specialized global or resource markets. All equity markets were shellacked in 2008. (See Table 1)

## LIQUIDITY FROZE, WHILE MARKETS MELTED

How did we get to this point? Toxic sub-prime mortgages contaminated the credit quality of virtually all institutions and investment products that had dared to hold them. The 'trust no one' attitude seized credit markets and rained financial Armageddon on some of the largest and most established companies in the world. The made-in-the-U.S.A. problem was now officially a global problem. This lack of available and affordable cash, coupled with weakening consumer demand, threatened the livelihood of mom-and-pop shops and giant automakers alike.

As investor concerns grew, so did the flight into cash or cash-like products. As demand grew, yields fell to ground-hugging levels. On December 4, 2008, the interest you could expect on a 3-month U.S. Treasury bill was -0.04%; meaning you where essentially paying for the privilege of lending money to the government. This scenario led to the coining of the phrase "return-free risk" to apply to government securities offering security, but virtually zero return for your investment.

**Table 1**– Summary of major market developments

| Market returns | Dec. | Q4 2008 | YTD |
|---|---|---|---|
| S&P/TSX | -3.1% | -23.5% | -35.0% |
| S&P500 (US$) | 0.8% | -22.6% | -38.5% |
| S&P500 (C$) | -1.1% | -11.1% | -24.4% |
| NASDAQ | 2.7% | -24.6% | -40.5% |
| Russell 2000 | 5.6% | -26.5% | -34.8% |
| FTSE 100 (U.K.) | 3.4% | -9.6% | -31.3% |
| NIKKEI 225 (Japan) | 4.1% | -21.3% | -42.1% |
| EAFE (C$) | 4.4% | -8.4% | -32.8% |
| EAFE (local currency) | 1.1% | -18.9% | -42.1% |
| Canadian Bond Market | 2.9% | 4.5% | 6.4% |
| World Bond Market (US $) | 2.4% | 6.1% | 9.2% |

*local currency (unless specified); price only

In Canada, 2008 was a tale of two halves. With more and more evidence of a world wide economic slowdown, and without the commodity boom that drove Canadian stock markets in the first half of the year, Canadian markets melted like butter in a pan. (see Table 2)

**Table 2 -** Sector level results for the Canadian market

| S&P/TSX sector returns | Dec. | Q4 2008 | YTD |
|---|---|---|---|
| S&P/TSX | -3.1% | -23.5% | -35.0% |
| Energy | -8.9% | -28.2% | -36.3% |
| Materials | 15.1% | -12.5% | -27.1% |
| Industrials | 4.1% | -16.0% | -26.9% |
| Consumer discretionary | 1.0% | -13.1% | -37.5% |
| Consumer staples | 8.0% | 2.8% | -7.8% |
| Health care | -3.8% | -12.7% | -34.4% |
| Financials | -9.4% | -30.8% | -39.0% |
| Information technology | -8.1% | -27.3% | -54.3% |
| Telecom services | -0.8% | -13.8% | -27.4% |
| Utilities | 1.7% | -7.9% | -24.0% |

*price only

## MOVING BEYOND

Pessimistic outlooks for the global economy in 2009 abound, but the fate of equity markets isn't quite so cut and dry. The effectiveness of economic stimulus plans and the forward-looking nature of the stock market are just two of the key factors that could play a role in the possible recovery of stock markets in 2009.

**Relief and rescues**

The unprecedented bailouts and economic stimulus actions being taken by governments around the world will be key to market results for 2009. These actions will play a large role in easing credit conditions and in influencing whether or not countries will be able to avoid the drawn out recession that the markets seem to have already priced in. Particularly in the U.S., the fate of the world's largest economy is resting squarely on the shoulders of President-elect Barack Obama and his new administration. If his gazillion dollar economic stimulus plan is able to gain footing and make progress (even if only to stop the bleeding), then this is likely to be taken as a 'better than expected' result and we could expect to see markets respond with enthusiasm.

**Have stock markets priced in enough?**

Stock markets are forward-looking economic indicators and as such they precede economic cycles - falling in advance of economic slowdowns and rising in advance of economic recoveries. The price of a stock today is a reflection of what investors think that company's financial future will hold. To gain insight into what the stock markets will do in 2009, the question isn't 'will the weak economy be a challenge for companies in 2009?' because we already know it will. Rather, the question becomes 'are the challenges facing companies worse or better than expected?" This current bear market already reflects a very unattractive and negative economic and corporate profit outlook for the year ahead. That severe bearish outlook gives many market pundits hope that the eye of the storm has passed and stocks have already priced in the negative economic sentiment towards 2009.

Take the last six weeks or so of the year as an example. Negative economic data, news and headlines continued throughout the month, but relatively little of it was reflected in losses for the stock markets. Most world markets finished the year well up from their late November lows. Bad news became 'as expected news', because investors had already anticipated and priced in their effect.

## INVESTING IN TURBULENT TIMES

We have been through one of the most difficult investment years in history and it is reasonable, even expected, that investors feel a certain amount of weariness and risk-aversion following living through one major crisis after another. We've gone from the one extreme of putting too low a price on risk to the other extreme of too high a price on risk and it is not easy to convince people today that markets will one day rally again. Yes, the equity markets could re-test their November lows again, market volatility is likely to continue, and we know the economy is facing serious challenges as well. But with pessimism running so deep these days, it is all too easy to forget another reality - that market cycles do, well….cycle.

The key to investing in a turbulent market is to avoid making hasty decisions that could seriously set back your long-term financial goals. Such emotional reactions can lead to a mis-alignment of your investment portfolio with your long-term goals and cause investors to jump in and out of the market with disappointing results. If you're positioned in a well diversified portfolio, one that matches both your time horizon (so for most investors that would include equities) and your risk tolerance (for most investors that would mean a portion in fixed-income holdings) – then you should be well positioned to benefit when the markets inevitably do turn around.