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Market Update – Treading Water

August 14, 2008 – Battered and bruised, world financial markets have now been suffering a full year of US *Sub-Prime* related woes. Continued weakness in credit markets have been fueled by an endless slough of asset write-downs; weighing heavily upon the consumer, the (global) economy and an *already* emaciated US financial system. With the US economy contributing 25% to global GDP it is not surprising then that the housing, mortgage and credit crisis has expanded beyond its borders – *so much for the theory of economic de-coupling!*

A self-fulfilling prophecy – An atmosphere of too easy-credit, encouraged by the US government and supported by tax-deductible mortgage interest has regrettably steered many (US) homeowners away from the *virtue* of mortgage freedom; instead diverting *equity within one’s walls* to finance *habitual* discretionary spending. Weak controls on lending and home refinancing practices had led to the proliferation of so-called “NINJA” loans (NO INCOME, NO JOB, NO ASSETS, NO PROBLEM!) further fueling speculation in housing prices...

Come full-circle – Deteriorating credit conditions and a decelerating economy have delivered a *One-Two Punch* to the US consumer –

skyrocketing debt servicing costs and declining real estate prices have put as many as 25 million US homeowners at risk of being *upside-down* (owe more than their home is worth) on their mortgage. With prices having already corrected by an average of 15.8% year-over-year, home foreclosures in the US have risen precipitously; up 121% in the 2nd Quarter. Home foreclosures have already topped one million properties year-to-date! Factor-in more than 11 months of inventory, worrisome inflationary pressures and near-record energy prices and it is no-wonder that the problems of Main Street have manifested on Wall Street!

A Bear’s Bear – The widely accepted definition of a Bear Market is a 20% price decline from a previous high. Mauled by the fall-out from the credit crisis and depressed housing prices, financial stocks (worldwide) have led equity (and bond) markets lower; the Dow Jones Industrial Average and more broadly diversified S&P 500 and MSCI (World) had actually slipped into bear market territory in June, the S&P closing at 1239 (1291 today) or 21% below its October 9th value of 1565. European and Asian equity markets had actually qualified for this dubious honor earlier this spring. Interestingly, the bond market (*generally bond prices react inverse to equity*

market movements) too has suffered steep declines due to the *widening* of credit spreads; as appetite for risk has diminished.

Eat my shorts! – In an effort to stem bouts of extreme price volatility, especially in the financial sector, the US Securities and Exchange Commission (SEC) stepped-in July 12th; mandating an emergency 30-day moratorium on ***naked*** short selling – short sellers must make specific arrangements to *borrow* shares, instead of merely getting a general assurance they can be located, making it more difficult (and costly) to take advantage of downward stock price momentum. (*In a short-sale, a trader borrows stock and then sells it, hoping its price will fall so that it can be repurchased later at a profit.*) Though *thankfully*, the Canadian Banks have a more limited direct exposure to the credit crisis, the uncertainty surrounding the US financials, housing and the slowing US economy have caused even the more *sure-footed* Canadian financials to sell-off in sympathy. With financial services representing more than 30% of the S&P/TSX Composite Index, even small price movements in the financial sector can have a significant impact on Canada’s major index.

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Canada; still an enigma – Even with a (3.14%) loss year-to-date, the S&P/TSX has *in-fact* outperformed by a wide margin. An overweight of energy and materials (resources are ~50% of the S&P/TSX) fueled the index in the first half of the year as crude oil, base/precious metals (and fertilizers) continued their climb to lofty levels; crude oil for instance climbed to an all-time record of \$147.90/barrel on July 11, up ~60% from the start of the year! Of the 263 companies which comprise the index, just 10 contributed all of the index's returns to mid-year – 9 of 10 were energy and materials companies! Strong commodity prices also supported our beloved Loonie, but also fueled inflationary pressures...

Seems like just yesterday – Recall *way back in April*, crude oil was then trading at (just) \$100/barrel. Then came some very lofty predictions – \$150, \$175, \$200, even \$250 oil was not only possible, but seemed inevitable! *Naturally* oil prices shot up 48% over the quarter; but for no overwhelming *fundamental* reason – now with the US economy and consumers on government-funded *life support* (U\$168 Billion in tax-rebates with another U\$400 Billion set aside to help troubled homeowners get more affordable government-backed mortgages,) and with real inflation creeping higher, “demand destruction” was probably inevitable... With energy and materials prices too having already begun to *roll-over* (oil for instance has declined **-\$31.59 (21.35%)** from its recent high water mark,) it is no wonder that Canada's currency has also pulled back ~ 6% in less than a month!

Eye on the Economy – Generally defined as a period of inflation + economic weakness, **stagflation** is of concern to the Central Banks as it constrains what can be done in terms of shaping monetary policy ahead. Balancing economic growth and inflation is often best accomplished by expanding the money supply, influencing interest rates, or both. Stimulating economic activity through “easing” (lowering interest rates and/or increasing the money supply) may however inadvertently fuel inflationary pressures which could/often result in a more pronounced and/or prolonged economic downturn. On the other hand, raising interest rates may help to tame price inflation, but to the detriment the (global) economic growth. With little room to maneuver, the US Federal Reserve and Bank of Canada too are expected hold steadfast on monetary policy for the near-term; waiting instead for slower forecast economic growth and ultimately for *demand destruction* to affect prices and in-turn, *naturally* moderate inflationary pressures.

Although tax rebates (benefiting US taxpayers) will certainly provide a near-term boost to consumer spending (south of the border,) the weakness in housing, credit and financial markets is expected to linger well into 2009. Financial de-leveraging, tighter lending practices, increased debt servicing costs, a concern over rising unemployment and high energy and food costs will continue to weigh heavily on the consumer; impacting discretionary spending and further propagating the *near-term* corporate earnings recession.

Index	YTD	1 Year
S&P/TSX	-3.30%	1.02%
TSX Mid-Cap	-10.30%	-10.36%
TSX Small-Cap	-12.48%	-16.53%
DJIA	-13.06%	-11.48%
S&P 500	-12.43%	-9.86%
Nasdaq	-8.43%	-2.82%
MSCI World	-15.56%	-11.58%
EAFE	-13.52%	-14.99%
Emerging	-15.99%	-6.17%
London	-15.62%	-11.31%
Paris	-21.57%	-19.63%
Germany	-20.39%	-13.51%
Hong Kong	-23.08%	-2.79%
Japan	-15.36%	-23.08%
Shanghai	-46.57%	-44.80%
TSX Sub-Index	YTD	1 Year
Financials	-12.39%	-11.65%
Telecom	-11.17%	-12.77%
Utilities	-5.86%	2.16%
Industrials	3.22%	-1.05%
Discretionary	-21.56%	-23.22%
Staples	-7.70%	-15.71%
Energy	4.30%	10.51%
Materials	1.52%	15.58%
Healthcare	-15.36%	-22.80%
Technology	11.09%	47.37%
Commodities	YTD	1 Year
Oil (WTI)	20.82%	60.24%
Natural Gas	13.10%	21.90%
Gold	-1.83%	22.47%
Silver	-0.54%	15.05%
Platinum	-0.78%	18.75%
Palladium	-16.35%	-10.81%
Copper	8.58%	-5.73%
Nickel	-30.09%	-35.13%
Zinc	-28.85%	-51.32%

**As of August 14, 2008; Source - Bloomberg*

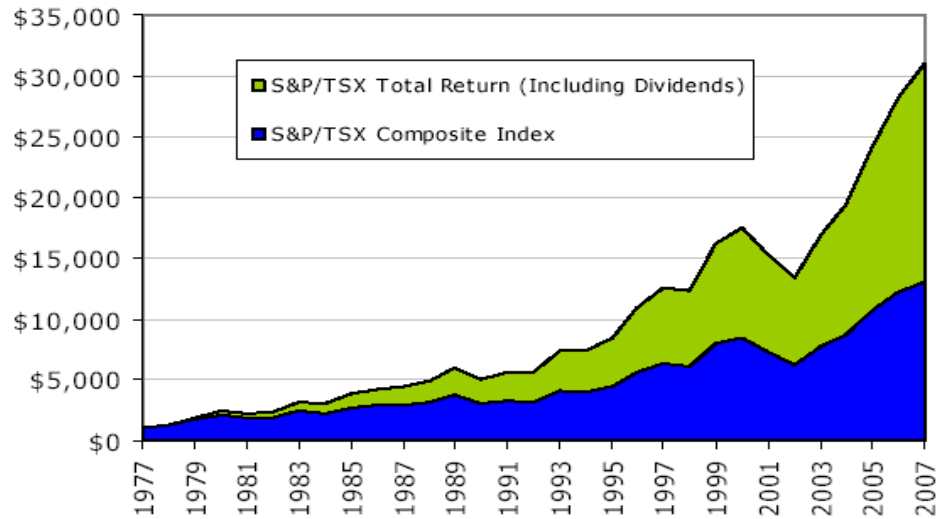
Down and out or on the road to recovery? – Though there appear to be a number of obstacles ahead, global economies (and financial and real estate markets too) have the capacity to rebound from their current malaise. As restrictions on access to financial credit are overcome, the opportunity for *synchronized* global growth; as a function of increasing demand from emerging nations for raw materials, energy (and food,) will ultimately take hold. With its vast resources, Canada in particular is well positioned to participate...

Buy Low/Sell High – Though it may seem like a simple enough concept, one’s emotions can impede even the most well thought out investment strategy. Extreme price volatility can cause any investor to second-guess their long-term investment strategy, however volatility can just as easily be considered a tool. **Dollar-cost-averaging** for example; by way of automated pre-authorized contributions and/or by simply *averaging-down*, has been a proven investment tactic; one which encourages discipline with respect to new deposits, but which may also benefit from many more chances to buy-in at low(er) prevailing prices.

An Owner’s or Renter’s Interest? – Investing for the *long-run* in companies (stocks) that consistently raise their dividends (generally a sign of profitability) has proven to be a very rewarding strategy over time. Over the past 30 years (*period ending December 31, 2007*) the S&P/TSX Composite had returned a favorable +8.94%/annum – thus \$1,000 invested 30 years ago would have returned \$13,055. With dividends reinvested however, the total gain would have been significantly more (+12.12%/annum) – the same \$1,000 would have grown to \$30,967 (137% more!)

When taking into consideration the various economic challenges ahead, and with the global stock and bond markets likely to remain volatile for the near-term, it may prove to be difficult, even for the resources-rich S&P/TSX Composite Index, to achieve the significant capital growth returns of recent years.

Growth of \$1,000 over 30 years - Dividends Reinvested...



Dividend yield then is likely to be a major contributor to one’s overall investment return for 2008 – **so why not get paid to wait?** While recent bouts of price volatility may have sidelined the stock values of many *blue-chip* dividend paying companies (Trusts and REITs too) for the near-term, lower stock prices have been a boon for dividend yields. Factor-in the Dividend Tax Credit (Canadian Corporations held outside of one’s *registered* plans,) and after-tax returns are even more lucrative by comparison to bonds, GICs and other interest bearing securities.

Conclusions -- Though portfolio valuations today are indeed reflecting the current economic funk, the cyclical nature of the North American and Global economies, of financial and housing markets too, suggest that longer-term investors will ultimately be rewarded with recovery. Pacing inflationary pressures in the interim and ensuring that one’s portfolios remain well-positioned for *balanced-growth* is fundamental.

And when contemplating what might be next for housing, though success in real estate was until recently thought simply to be a function of *Location, Location, Location*, the current state of the global credit environment is a reminder of how unified and connected financial markets and global economies have become...

As for the (US) economy *treading water*, at least celebrated 10-time Gold Medalist Olympian, **Michael Phelps** and the rest of the US Swim Team are concerned, water doesn’t seem much of a challenge at all... Maybe Canada’s highly touted *Men’s Eight* rowing crew will finally deliver on the promise of an ever-so elusive (gold) medal when they race in Sunday’s final? If not, we can all at least take some solace that Vancouver-2010 (and hockey) is just around the corner -- **Go Canada!**

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