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Market _____ – Are we there yet?
Bottom

February 9, 2009 – For investors and market pundits alike, the final 3 months of 2008 will long be remembered for its extremes! Amidst panic/forced selling and a credit environment on virtual lock-down, equity markets made multi-year lows on November 20th with the broad-based S&P 500 index touching **740**; erasing more than US\$5 Trillion (US\$5,000,000,000,000) from the books – this 39% drop was the steepest quarterly decline in 65 years! Price volatility as measured by the CBOE Volatility Index (VIX) registered a disconcerting **89.5** on November 20th; more than double that experienced post 9/11 and the Enron and Worldcom debacles. Pummeled by a continued crisis in credit, a downshifting global economy and the unwinding of complex financial derivatives, no market or sector was spared; even cash suffered as the Canadian dollar declined sharply in the wake of rampant/forced selling of resource stocks and the mass-exodus of foreign investment...

All hail the new Chief! – Though equity markets improved and volatility moderated somewhat as December drew to a close (after the wind-up of tax-loss selling season), the fact remains that US economy contracted by an estimated 3.8% in the 4th quarter; the most since 1982. Clearly, Mr. Obama’s new administration is facing some significant challenges ahead. In fact Scotiabank’s economist suggests that President Obama has inherited the worst economic climate since **The Great Depression**; with a deficit now estimated at US\$1.2 trillion in 2009 (8.3% of GDP.) Factoring-in Mr. Obama’s proposed US\$825 billion stimulus plan, the deficit could easily rise to 10% of GDP. By contrast, Canada has weathered the financial and credit crisis far better, though the proposed fiscal response as outlined in the Harper Government’s most recent Budget will expand the deficit on this side of the border to C\$40 billion in 2009 (2.5% of GDP) with another similar shortfall likely in 2010...

Corporate earnings update – Since peaking at US\$91.47 in Q2/07, US corporate earnings (S&P 500) have declined by an estimated 32%. Notwithstanding the fact that the S&P 500 itself has shed approximately 48% of its value (peak-to-trough,) and while according to Bloomberg, the S&P 500 is now trading at its lowest (trailing) multiple since 1991 (*a low price to earnings multiple is favorable*), the unfortunate reality is that the corporate earnings parade is expected to deteriorate even more in the months to come. Revised guidance by company management and financial analysts combined with negative earnings surprises are likely (expected) over the next two quarters as domestic and foreign demand retrenches further, and as consumers and businesses both, shore up balance sheets and rediscover the *virtue* of debt reduction and possibly even *savings*...

Overall, 2008 proved to be one of the most difficult years on record for US corporations – exacerbated by the *folly* of US financials. Closer to home, S&P/TSX constituents have not been immune to the severe corporate earnings recession – profits at Canadian firms are also forecast to decline further in the months to come; as a result of the sudden and stunning decline in commodity prices in Q4/08 (now not expected to recover until at least 2010), the troubled manufacturing sector and stagnating trade with our principal trading partner to the south (~70% of Canada’s trade is with the US.)

S&P 500 Q4 Earnings as of 2/09/2009		
Sector	Companies Reported	Market-cap Weighted % Change
Discretionary	45/80	-59.60%
Staples	23/41	15.50%
Energy	26/39	-24.80%
Financials	64/84	-1441.60%
Healthcare	38/54	10.10%
Industrials	48/58	-11.90%
Technology	57/74	-21.00%
Materials	22/28	-83.60%
Telecom	03-Sep	-9.80%
Utilities	15/33	6.30%
Total reported	341/500	-19.10%
Ex-Financial	277	-5.20%
Q4/08 Estimate	341/500	\$10.54
Q4/07 Actual	500/500	\$16.70
% Change YoY	500/500	-36.90%

*Source - Bloomberg

You can take that to the Bank... maybe not? – Amidst growing concerns about bank solvency, a number of US and foreign financials have seen their share prices decline significantly in recent months; as the crisis in credit deepened and asset write-downs became more prolific, market prices have become extremely volatile (Bank of America now trades at/near its 25 year low!) Despite coordinated interventions (capital injections) and more recently talk of an “aggregator” bank to buy up weak mortgages in an effort to help stabilize the (US) banking system and promote lending and confidence, US legislators now seems more intent on arranging a plan to guarantee so-called “toxic” assets (those with a higher risk of default) listed on bank balance sheets. Failing this, the notion of “nationalizing” the weaker financial institutions (regional banks) is a real possibility; expropriation by government of a bank’s assets would most likely result in the loss of all shareholder equity...

Show me the money! – Canada’s financial institutions (and banking system) by comparison stand on a much more solid footing than the US and international counterparts. Strong underlying fundamentals; above average capital ratios, favorable forecast *Return on Equity* (+16% est.) and valuations far below historical norms (~7x P/E est.) have put Canada’s banks (and insurers too) in a more positive frame. Forecast earnings growth, combined with much more conservative balance sheets should allow for continued dividend growth, further supporting their already highly lucrative dividend yields. Scotiabank common stock for instance currently yields 5.49% – factor in the Dividend Tax Credit (non-registered savings accounts) and the pre-tax interest-equivalent yield is as much as 7.5% (middle tax-bracket assumed.) Canada’s largest banks have enjoyed an enviable track record of dividend growth; +10%/annum over the past 40 years and even more robust five and ten year track records of +18% and +15% respectively. *So why not get paid to wait for market/price recovery?*

The long road back – No question, the global economy is in the midst of a deep and prolonged slump; the root cause being the price and availability of credit; *the lifeblood of economic growth*. Without access to credit, economic expansion cannot progress; hindering corporate profitability, employment and ultimately consumer confidence. The current crisis in credit is far-reaching and economic data is forecast to deteriorate further in the months to come; however there are signs which suggest that frozen credit markets are beginning to thaw –credit spreads have narrowed significantly in recent weeks in response to the coordinated efforts of central bankers...

A paradox of thrift – According to Scotiabank, US consumer confidence dipped to a 42 year low in January as housing prices deteriorated further. As many as 25% of US homeowners (single family detached) are now under-water (or in a near-negative equity position) with respect to their mortgage. Though the recent improvement in the credit environment means that *qualified* borrowers can once again take advantage of (more favorable) refinancing terms, the notion that US homeowners can continue to *reach into their wallets* to finance their lifestyle expense is no longer an option for many – a *paradox of thrift* exists in that constrained consumer spending may ultimately impede forecast economic recovery. Though there may still be the potential of an additional (10%-15%) correction in housing prices, the economic stimulus when combined with historically low mortgage rates and newly proposed banking/lending reforms may ultimately help housing form a bottom...

Feed a cold, starve a flu – Though proposed stimulus efforts may well help to stave off full-blown economic depression, the lag-time involved in putting stimulus moneys to work in infrastructure, public works and energy renewal is likely in the order of 12-24 months. Further it is unclear whether proposed cuts to personal and corporate income taxes will have any immediate effect. Though never an ideal solution, when considering that the US consumer (representative of 70% of GDP) is currently on a sabbatical from spending, direct government stimulus is a *necessary evil* in order to help prime-the-pump in terms of employment and future economic competitiveness. At least this stimulus is focused primarily on at-home projects – if indeed the debt incurred is to take generations to pay down, then our children might as well enjoy the long term economic benefits...

Economic and market prognostication; a combination of science, art and luck – Equity and bond markets are a *discounting engine*; they attempt to forecast what might happen next based upon what has happened before. With history as a guide, the norm is for equities to trough 3-6 months prior to the end of the economic recession. Noteworthy too is the fact that the bulk of any rally in equity/bond prices occurs within 6-8 months of the economy actually turning positive and in spite of continued/worsening unemployment figures (generally a lagging indicator;) which often prevail for up to a year post-economic recovery.

Notwithstanding the likelihood of equity markets (worldwide) remaining range-bound (S&P 500 for instance trading between 750-950; with the possibility of even retesting November's lows) until US economic data stabilizes, equity and bond markets now appear to be in the midst of a *bottoming process* – a peak in jobless claims (Canada and the US both reported record unemployment in January of 7.2% and 7.6% respectively, the highest since 2004 in Canada and a 16 year high for US unemployment data) and stability in manufacturing and housing are important catalysts to watch for as the year progresses. With a view that the economy may actually turn the corner in the latter half of the year or early in 2010, it is conceivable then that equity markets begin to recover in anticipation (mid-2009?) concurrent with improving earnings forecasts and guidance. For the interim however, price volatility is likely to persist. When considering the swift and steep decline in equity prices however, eventual market recovery may arrive as furiously; *US markets likely leading...*

The real cost of economic stimulus – though the threat of inflation appears contained for the near-term (as a result of the muted economic outlook and constrained consumer spending,) the real cost of government stimulus (a huge increase in the physical money supply) will undoubtedly lead to an inflationary bias down the road. Securities which offer both an opportunity for growth and income will help portfolios pace forecast inflationary pressures...

Conclusions; down but not out! – While the global economy may actually deteriorate further over the next few (2) quarters, equity and bond markets are not expected to repeat the same kind of *gut-wrenching* free-fall as was incurred in Q4/08. Though it may yet be too early to call an end to the current **bear market**, especially when unsettling economic, financial and corporate news is very likely to dominate the media for months to come (and long-after the troubled credit markets and the economy turn the corner,) the fact remains that current and forecast interest rates are hovering at historical lows; and when combined with decisive and coordinated fiscal response and now also a massive government stimulus, the odds of a sustainable market recovery are likely to improve...

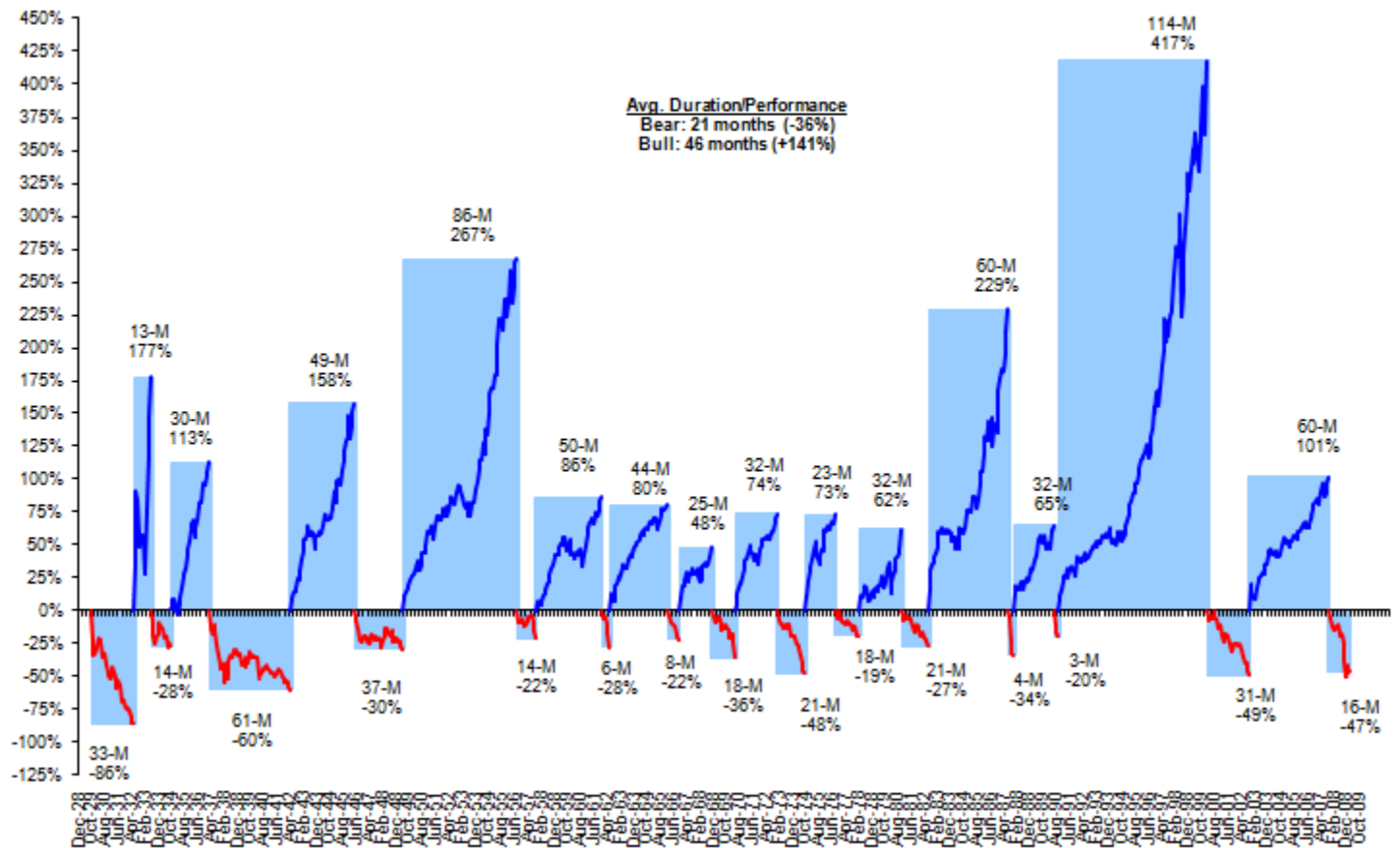
A call to action – Please contact me today to arrange a detailed review of your asset mix policy and of your portfolios overall; to ensure they remain well-positioned for *eventual* recovery. Where appropriate, let us also consider whether any rebalancing of your portfolios is necessary; in an effort to improve credit quality and to focus on *core* positions. Beyond the notion of getting paid to wait (dividends,) dollar-cost-averaging-in has proven to be an effective tool for moderating *market timing risk* -- with the 2008 RRSP season soon drawing to a close and with equities and select bonds *on sale*, there may be no time like the present...

Index	YTD	1 Year
S&P/TSX	1.03%	-28.86%
TSX Mid-Cap	0.49%	-35.04%
TSX Small-Cap	1.42%	-41.32%
DJIA	-5.76%	-32.43%
S&P 500	-3.43%	-33.42%
Nasdaq	0.92%	-31.40%
MSCI World	-4.70%	-38.00%
EAFE	-9.3%	-40.6%
Emerging	-0.64%	-43.7%
London	-2.85%	-24.53%
Paris	-2.58%	-33.05%
Germany	-2.98%	-30.80%
Hong Kong	-3.52%	-38.62%
Japan	-10.31%	-38.96%
Shanghai		
TSX Sub-Index	YTD	1 Year
Financials	-3.97%	-37.39%
Telecom	-3.07%	-19.45%
Utilities	-1.57%	-23.61%
Industrials	-2.43%	-26.72%
Discretionary	-4.88%	-32.65%
Staples	-3.25%	-3.43%
Energy	1.37%	-31.64%
Materials	4.97%	-26.95%
Healthcare	15.15%	-19.30%
Technology	36.98%	-27.29%
Commodities	YTD	1 Year
Oil (WTI)	-11.30%	-57.74%
Natural Gas	-14.41%	-43.61%
Gold	2.90%	-2.51%
Silver	20.57%	-25.10%
Platinum	6.38%	-48.65%
Palladium	9.09%	-53.57%
Copper	21.21%	-54.93%
Nickel	6.53%	-58.90%
Zinc	3.92%	-51.82%
Currency	YTD	1 Year
CS/US\$	1.64%	24.00%
US\$/Euro	-7.19%	-11.03%
US\$/Sterling	0.68%	-24.62%
US\$/Yen	-1.28%	13.78%

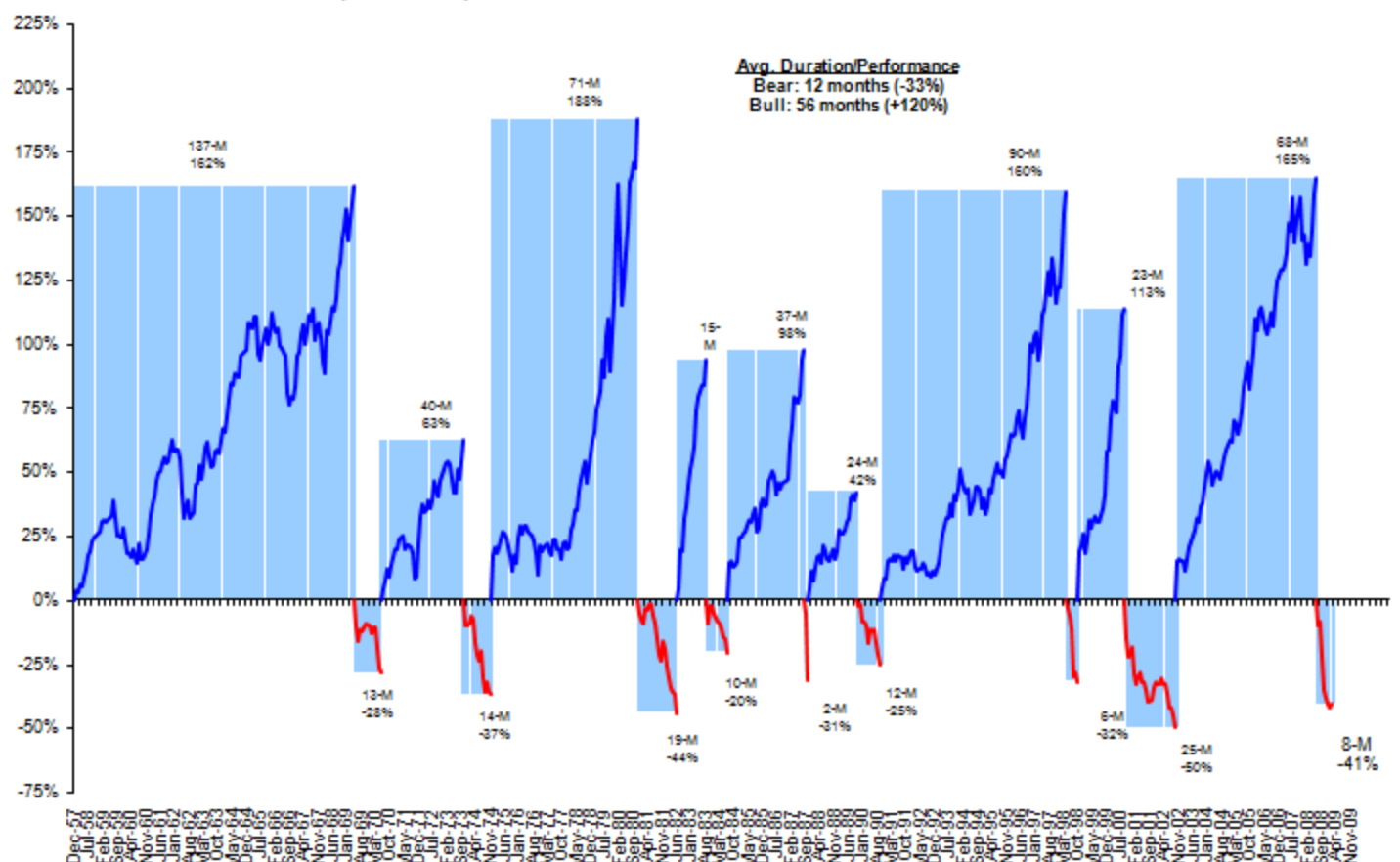
*As of February 9, 2009 - Bloomberg

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S&P 500 Bear & Bull Markets (1929-2009)



S&P/TSX Bear & Bull Markets (1957-2009)



Based on month-end data until 1975 and daily thereafter. Bear market is defined as a 20%+ decline from peak to trough.

Source: Scotia Capital