

## REVIEW & COMMENTARY 4<sup>TH</sup> QUARTER 2008

### Brave New World

What a difference a year makes; last year our title was ‘*Here a billion, there a billion....*’ Now, it would be more appropriate to substitute “... *Here a trillion, there a trillion....*” Without doubt this past year was very difficult. The financial cracks that first appeared over a year ago lay dormant until the final quarter when the disclosure of the embedded intricacies of financial engineering created by the dominant players in the US financial industry unleashed a crisis of confidence in world wide capital markets. Certainly some similarities were drawn to previous upheavals- 1929, 1961, 1973, 1980, 1987 and 2001 (there are probably a few I missed- thank goodness) but as we had mentioned in previous writings, these corrections are usually quick and quite difficult. The key is not to lose perspective.

Prior to proceeding any further with our customary predictions this time of year, it is important to discuss how we did last year in our annual prognostications. They were...

***We believe there is a significant premium to the simple supply/demand equation and thus where Middle Eastern tensions go, so will oil.***

Certainly our long term cautious stance on oil prices has prevailed. Admittedly, we did not anticipate such a significant drop to present levels. OPEC, primarily the Saudis, who were consistently reminding investors of the abundant supply of crude when prices were trading at \$140 US per barrel, are now equally determined to “stabilize” prices by cutting back production.

***The Canadian economy will not fall into a recession, however, it would certainly appear that the US will get quite close, if not lapse into one.***

This appears a reasonably successful prediction. Certainly the US economy was confirmed to have been in a recession by the end of the year and the Canadian economy, while moving closer, has not yet been officially declared to be in a recession. There is little doubt that this will be declared in 2009.

***This should bode well for the Canadian currency. The US economy will end up the year (2008) stronger than it started and US interest rates will bottom in the second half of 2008.***

The Canadian currency did do well for most of the year, hitting a significant and short lived premium to the US currency but the unraveling of the US credit markets and the falling crude price put an end to that. While our predictions of the US economy being stronger by year end were not accurate, our interest rate prediction was. However, given that we were unable to predict the circumstances leading to such a dramatic interest rate drop, a claim of accuracy in this case would be the equivalent of claiming victory over an opponent who had mixed up the dates of engagement.

***Predictions regarding the upcoming year...***

**Credit markets will continue to improve and the stock market will respond positively in 2009.** The TED SPREAD- a measure of the difference between the 3 month US Treasury bill rate and the 3 month LIBOR (London Inter-bank Offered Rate), considered an accurate indicator of the perceived credit risk in the general economy, has dropped significantly. Reaching a high of over 500 when Bear Stearns was taken under by JP Morgan Chase and was as recently as one month ago trading over 200, it is now trading comfortably below 100-a significant and positive development. Credit markets are starting to thaw. Commercial markets are not only narrowing the spread to government credit, financings have jumped considerably over the last few weeks. While economic statistics will continue to worsen over the next few quarters, stock markets often turn positive before the economy.

**Most commodity prices will rally in 2009.** With the ongoing financing of the US economy through increased Federal loans, and the prospects of additional fiscal stimulus from President-Elect Obama, there will be increased downward pressure on the US dollar. Given that most commodities are priced in US dollars, upward pricing pressure will result to most commodities. With lower crude prices, many international producers are reducing capital expenditures and closing marginal projects putting additional downward pressure on supply. With OPEC already promising supply reductions, these combined initiatives will create an environment where any potential increase in demand will push prices higher. Certainly, a few years from now oil prices could be significantly higher. This should bode well for the Canadian equity markets and the Canadian dollar.

**Volatility will remain high but the lows for the equity market were reached last quarter.** The volatility index, VIX, has lived up to its name in the last quarter of 2008. Achieving highs of close to 100 in October 2008, it has settled recently in the low 40's. This index is an estimated measure to the expected movement (up or down) in the S&P 500 index over the next 30-day period, on an annualized basis. Obviously when the index was closer to 100, investor uncertainty was at its greatest level and historical norms suggest a more moderate level of somewhere in the 20's or 30's. As Roosevelt stated the "...Only thing we have to fear, is fear itself..." takes on increased significance now. Without a significant political or geo-political disruption, fear will be less influential on our collective decision making and as credit markets continue on their present course of recovery, investors will move back steadily toward higher yielding investments forgoing government short term securities which provide virtually no return.

Are things going to get better? Yes, definitely. Have we hit bottom? We think so, though we expect further volatility which will continue to make dividend paying stocks attractive. Will we have a depression? We believe this is very doubtful given the collective perspective and efforts of global central banks to counter the financial upheaval. Monetary stimulus has been unprecedented and fiscal stimulus appears to be a certainty in many major economies. It will take time. Certainly some of the improvements can be strongly correlated to the central bank efforts to date. As long as politicians do not let bipartisanship impede these attempts, things will improve. And those who stayed the course, will prosper.

Thank you for your confidence and support and best wishes for health and prosperity in 2009.

Stodgell Investment Management Ltd.