REVIEW & COMMENTARY
NOVEMBER 2008

Bottom's up

For the first time in our history, we have decided to write to you during the quarter rather than at quarter end. Of course, the topic is the capital markets, in particular equity markets which have been victim of one of the most dramatic sell-offs in decades.

October has had a long history of poor returns- the most notable have been 1987 and 1929. Two one day plunges in those years can be matched to what has happened globally in the past 6 weeks. It is hard to imagine this could be reassuring. During the month of October 2008, the S&P/TSX was down 17%, the worst performance in over 20 years. However, the good news was that in the last week, the Toronto equity markets had their best performance in almost 40 years. One week does not indicate a trend but it has provided some stability in a market that has been driven by fear and uncertainty. There have been some recent developments that should help reinforce the stability of the financial markets.

First, the concerted aggressive monetary stimulus plans imposed by most Central Banks are unprecedented not only in their coordination but also the amounts they are committing. In the US alone, the amounts are staggering- the TARP (Troubled Asset Relief Program) instituted by the US Federal Bank is $700 billion dollars. Add the guarantees that the US Federal Government has provided to back stop money market funds and commercial paper markets, and the amounts of capital easily surpass 1 trillion dollars. This doesn't include the guarantees for AIG, Freddie Mac and Fannie Mae. If you add in the efforts of other central banks, the amounts are in the many trillions. And while this is taking some time, there is evidence that these funds are creating some traction in the capital markets.

In the past week or so, US Commercial paper markets are not only enjoying significantly lower borrowing rates but the volume of borrowing in these markets has increased by over $100 billion dollars. This is the life line of big and small businesses. Further, the three month LIBOR (London Inter-Bank Offered Rate) lending rates have enjoyed equally significant decreases making inter bank lending more affordable. Lowering borrowing costs are only a part of the problem, the other is to get these financial institutions lending again.

One way to encourage lending is to lower interest rates. Many central banks have done this recently and may continue to do so. Evidenced by Japan's decades of lower borrowing rates, decreasing interest rates don't always translate into an economic resurgence, however, the big difference this time is the direct investment many central banks are making in leading financial institutions. Not only are they bringing down interest rates but the central banks are investing directly in these companies. Eventually, with balance sheets and capital ratios richly reinforced many financial companies will start to lend. The TARP program has been extended to the largest institutions only recently; smaller ones have another week or so to go through the application process.

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A very important event in our opinion, which occurred on the last day of October, was an announcement by JP Morgan Chase, one of the TARP recipients, who declared their intention to renegotiate the terms on approximately 70 billion dollars worth of distressed mortgages with homeowners. Many cynics of the TARP plan worry that these banks would simply sit on the cash injections, pay bonuses and not work with struggling homeowners. As the first to announce such plans, we feel that this may set an important precedent for all lenders who participate in the TARP. If they do, real estate will stabilize and one of the most important catalysts to a full economic recovery will be set in motion.

Many of us have watched in the past year our Loonie, go from a 10% premium to the US dollar to over a 25% discount in less than six months. But the important perspective is not the Canadian dollar as much as the strength of the US dollar. Oddly, as the US financial crisis steepened, the US dollar gained strength. In some cases this was a flight to safety because international investors realized that this problem was not specific to the US, it was becoming a worldwide issue. But a significant factor was the unwinding of the "US/YEN carry trade". Up until recently, many US investors and large institutions, namely hedge funds, took US dollars exchanged them for Yen and borrowed money from Japanese banks at a paltry 0.5%. They took these new monies, leveraged them several times (borrowed even more money) and bought a number of exotic and not so exotic investments. Leverage is a tenuous strategy given borrowers are always beholden to lenders and as the markets worsened, investments soured, this Yen carry trade started to reverse. Thus investments were sold, Yen delivered back to Japanese banks and US dollars purchased. This forced liquidation by many hedge funds has been why the markets have behaved so irrationally. The recent weakness in the US dollar (our Loonie has rallied almost 10 cents in the last week and now, at the time of writing, sits at over 86 cents/ US dollar) may be signaling a very important indicator; much of the forced liquidation of the hedge funds may be behind us. If this is the case, and the US dollar strength subsides, it will not only stabilize many commodities, which being priced in US dollars were ravaged in the past several weeks, but also diminish the level of reckless selling that has gripped global equity markets. And given that the Canadian market is resource based, we should see not only our currency but also our markets regain some badly needed stability.

So with all this news, have equity markets bottomed? We have been strongly opposed to selling equities in our most recent quarterly and these new developments have increased the conviction we discussed in our 3rd Quarter Review and Outlook. While it is unlikely that this recent uptrend in equities won't meet with some reversal, and the imminent forthcoming economic news will test any restored confidence, now is not the time to liquidate. Cash investments, short term fixed income pay a fraction of what can be secured in conservative large cap companies' dividends or distributions – particularly for taxable Canadian accounts. And while the future price of any equity is never guaranteed, economies around the globe will improve and so will equities. It may take quarters, it may take years, but they will improve. Our bet is it will be the former not the latter.

Given that capital markets look forward, equity investors are the first to feel the pain during times of uncertainty. Thankfully, they are also the first to benefit when the horizon looks more promising. So we aren't quite sure whether we have hit bottom but we do know that efforts to date are starting to take hold and even though our confidence may be challenged again, we are more optimistic that we were a month ago.

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