

## MARKET UPDATE

My last newsletter, dated April 30, 2007, suggested that a top in the market was here or rapidly approaching. The logic was that the “subprime mortgage” problem was about to become acute which would create problems worldwide. I wrote, “It will take about one and a half years for the bear market to play out. So I foresee an economy that declines for about two years. That will produce a bear market of monumental proportions.”

While the slowing economy has not yet met the traditional definition of a recession, which is two consecutive quarters of negative growth, it is clear that we are in a recession. The rise in unemployment, declining corporate earnings, restricted financial lending conditions, consumer confidence, or lack thereof, and imploding stock markets will create a global recession.

With history as our guide, the severity of the economic decline can be deduced from the stock market. Using the Dow Jones Industrial Average as our proxy for the stock market, we find that, post Second World War, ten months is the average length of the recessions. The stock market begins to rise about three months prior to the end of the recession.

Historically, the worst recession began in August, 1929 and ended in March of 1933 after a decline of 89% in the Dow. This was followed by the second worst recession in May 1937, ending in June of 1938, producing a loss of 49%. The third worst recession in history and the worst in the modern era (post World War Two) resulted in a loss of 45% on the Dow, beginning in November of 1973 and ending in March 1975.

I expect this recession and this bear market could be worse than 1973-5. Thus far, the Dow has declined from its high of about 14,000 in October 2007, to about 8,700. This is a drop of 38%. It has since rebounded to 8,850.

The Toronto market held up much longer because of the strength of commodities and the over-representation of those securities in the S&PTSX. The apex was touched in June of 2008 at more than 15,000 and the nadir since then was 8,761 or a remarkable decline of 42% in four months. It is no wonder that investors are shell shocked!

The volatility that we are experiencing is really not new. If we go back to the two previous market declines and recoveries it is apparent that market swings have become routinely exaggerated. Using the Toronto market as our example, the market was about 5,200 in October of 1998. It reached 11,400 in September of 2000. That is an increase of 119% in less than two years.

The Toronto market subsequently declined to about 5,680 in October of 2002 or a drop of 50%. While this is a significant bear market, there was little effect on the economy and so a very mild recession because so much of the market was represented by a small portion of the economy (think Nortel). At one point in that time frame Nortel represented over one-third of the TSX.

From the bottom in 2002, there has been an almost unbroken rise in the S&P500 until this summer when the market slightly breached 15,000. That is a rise of over 160%.

It is not my intention to discuss the easy money policies of governments, especially the U.S. Central Bank, that created the conditions for this stock market growth. I would prefer to anticipate the bottoming process of the present market decline and what sectors of the market to favor.

A case can certainly be made that the Toronto market could see its value reduced by half. That would mean a value of about 7,500 to 8,000 at the bottom. We are presently at slightly under 9,600 so there is room left to decline.

There are two caveats. Firstly, not all sectors of the market decline at the same rates and nor do they recover at the same rates. Commodities were the last to fall and will probably be the last to recover. Secondly, government actions to stimulate lending by banks in order to kick start economic activity will have unintended consequences. The money that is being extended by Central Banks may have future inflationary consequences. Or it may have little real effect except to weaken the balance sheets of those countries. That will simply provide a drag on their economies because of their need to raise taxes to pay for the spending.

The safest assumptions we can make regarding reentering the market are that we are likely to witness a slow recovery which will mean a U shaped stock market; there is likely to be considerably increased oversight by security regulators and Central Banks; and investors will be reluctant to place significant amounts of their capital in stocks because of their recent negative experiences.

The “nifty fifty” were fifty companies in the U.S. that were considered “one decision” stocks. That is, you made one decision to buy these companies and they were to be held forever because they consisted of growth industries and the companies would increase in value forever. This was the original “growth” story. This occurred in the 1950’s.

Prior to this period, stocks were considered very risky. In fact, prior to the 1950’s, the dividends on common shares exceeded the coupon on bonds. In other words, companies had to persuade investors to give them capital by enticing them with a return that was higher than the interest on a bond.

I mention this concept to emphasize the “value” versus “growth” argument. Early investors were more concerned with investing safely rather than focusing on capital gains. We are much more likely in the future to see investors gravitate towards safety. This will reemphasize the benefits of dividends. As a corollary we are also much more likely to see lower price/earnings ratios. Investing, in the future, is more likely to see increased regulation, corporate management compensation being tied more closely to results, and greater emphasis on long-term growth by corporations.

To conclude, there remains considerable turmoil remaining in international finance. Risks are still high. I expect the market will bottom sometime in the first quarter of next year and am looking for a value of between 7,500 and 8,000 on the S&PTSX.

Dividend yields at that time should be elevated and price/earnings ratios well below normal. We should expect slow growth for some time as economies purge themselves of the risk and excesses of the past few years. Dividends should provide a significant amount of the increase in value that securities will provide.

Demographics should play a larger part in the economies of the world with emerging nations continuing to play an increasing role in world finance. It will be necessary to consider these nations when considering individual securities and building portfolios.

The 1920's depression occurred for many reasons but it persisted because the economy was starved for credit. Ben Bernanke read his history and has made sure that the U.S. was provided with massive amounts of liquidity. But we are operating in unknown territory. There is no certainty that the actions taken (by all the developed nations) are sufficient to overcome the deflationary effects of the credit crisis. Neither do we know if the massive amount of liquidity unleashed has begun an inflationary problem.

It is extremely comforting to see international cooperation in the attempt to overcome the world's financial difficulty. We will be watching events unfold with concern but optimism.

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