



# **Weekly Market Insight**

*December 19, 2008*

## **NORTH AMERICAN & INTERNATIONAL ECONOMIC HIGHLIGHTS**

It is becoming very clear that the focus in the market is changing. It's no longer subprime, it's less credit crunch. It's really mostly about the economy: How deep and how long will the recession be?

What do we know about this recession? In the US, it is already twelve months old. It is a consumer-led recession. And it is far from over.

How can we define this recession? It's clearly not a typical recession which was usually triggered by too high interest rates, and was dealt with by lowering the cost of borrowing.

What we are seeing now, and it's extremely important to realize, is a structural change in the economy. We are in the early stages of a major de-leveraging—led by households but also seen in the corporate side.

We have only two examples for such a development. The great depression, and the lost decade in Japan—which perhaps can be seen as a modern version of a depression.

The great depression was a very severe shock to the system but it did not last as long as in Japan. The reason being that Japan used policy tools to ease the pain—but by doing so, it prolonged the recession.

Our current situation is something in between, it is clearly not as severe as the great depression, and it will not be as long as Japan. The main reason being the aggressiveness and the speed of monetary response in the US and elsewhere. That will eventually make the difference.

But with the effective fed funds rate already at 0%, what else can the Fed do? The short answer is—a lot. It can continue to buy MBS—a fact that is already helping to lower long-term mortgage rates and injecting life to the refinancing market. It can actively participate in the long end of the yield curve. And the Fed already indicated that it might accept high yields bonds as collateral from commercial banks. Such a move will lower the extremely high yields on these bonds. And there are some talks about the Fed issuing its own debt—perhaps an attempt to store ammunition for the time when there is a need to remove liquidity fast. So the Fed has still a lot of ammunition.

Turning to the main driver—the economy. The US economy is already twelve months into a recession and it's already two months longer than the average post-war recessions. We have at least six more months to go. And even the second half recovery will be a moderate one.

The reason why we call for a moderate recovery in the second half is mainly due to what's in the pipeline currently from a monetary policy perspective and equally as important, the fiscal stimulus that will be introduced by President-elect Obama the minute he takes control. We are talking about a budget deficit of \$1.5 trillion dollar in 2009—that's 10% of the economy—the largest deficit since 1945. And a \$1.5 trillion injection into a \$14 trillion economy is a huge lift.

And yes, we will see a significant de-leveraging by households with the debt- to-income ratio in 2009 falling for the first time in more than 40 years, and the saving rates rising—probably to 4%-5%. But the decline in consumption will be roughly \$400-\$500 billion which is only one-third of the increase in government spending. So simply put, the increase in government spending will more than offset the decline in households spending.

As for Canada, we are more or less the same in term of direction—less so in terms of magnitude. We will see the Bank of Canada cutting rates by an additional 75 basis point, so by Feb-March next year, the Bank rate will be 0.75%. And look for the government to increase spending by roughly \$30 billion. This will help to generate a moderate recovery in the second half of the year. So for the first half of 2009, we expect GDP growth to fall by 1%, followed by a moderate recovery in the second half. For 2009 as a whole we are talking about a 0.3% decline in GDP.

What does it mean for the TSX? The question is not how bad the economy is. We can make an educated guess here. The question is how much of it is discounted by the market.

We know that since 1920 Canadian stocks have tended to bottom between 3-9 months before the end of the recession. If you buy that we will see some recovery in the second half of the year. We are very close to this point.

But even if the market bottoms in the first half of 2009, this does not mean the beginning of a bull market. The likelihood is that 2009 will probably not be a terrible year for the TSX, but will it be a good year?

First, we have to recognize that corporate profit is falling. It will be down 5% this quarter—the first decline in five years. The market is busy downgrading its expectations—which is good. Currently, the market is talking about a 10% decline in earnings for 2009. Only three months ago, they were talking about an increase of 20%.

Second, commodity prices—there is a negative momentum which will continue in 2009—that will limit any recovery. And financial stocks will be impacted by a notable reduced retail activity. For example, mortgage outstanding in 2008 rose by 12%, in 2009 they will rise by only 3%, and in the coming twelve months, personal bankruptcies will rise by 30%. Most of these developments are already discounted by the market, but at this point, it is difficult to see any notable upward potential in the coming six months.

While at this point we are neutral on stocks—a high dividend defensive portfolio is actually very interesting at this point. But beyond the next 6-8 months, is the market cheap?

Any measures of valuations suggest YES. If you look at the Fed model (that is, the forward earning yield on stocks or the inverse of the PE ratio should approximate the yield on long-term maturity), arguably you might want to use longer term corporate debt as opposed to government yields. And using this matrix a fair value is between 9,300 and 12,000. If you use the dividend discount model (and assuming 15% drop in dividends in 2009) you get something around 10,500 and if you look at the Q-ratio (where you do not need earnings assumption but rather replacement cost) you get below 1—which means a cheap market.

So to sum up, it's all about the economy now—this recession is far from over—and it's not a typical one. We are in a midst of a major de-leveraging process. The market is already discounting a lot of bad news. We might be getting closer to the bottom, but do not expect any near term recovery. But when we recover, all models suggest that it can be a nice recovery since markets are now relatively cheap.

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## International Stock Indexes

Thursday, December 18, 2008

Region/Country	Index	DAILY					% Chg		YTD % chg	52 WEEK			3-yr % chg
		High	Low	Close	Chg	-	+	High		Low	% Chg		
<b>World</b>													
World	<b>Global Dow</b>	1559.28	1520.48	1538.44	-6.32	-0.41			-44.9	2812.8	1264.68	-43.4	-2.7
World	<b>Global Dow Euro</b>	1040.84	997.32	1000.52	-14.8	-1.46			-44.4	1828.87	950.87	-43.9	-8.6
World	<b>DJ World Index</b>	174.69	169.76	171.87	-1.38	-0.8			-42.9	302.34	143.63	-41.6	-9.9
World	<b>DJ World ex U.S.</b>	151.21	147.06	149.37	0.41		0.28		-45.1	272.02	123.87	-43.1	-8.8
World	<b>MSCI EAFE*</b>	n.a.	n.a.	1264.97	5.09		0.4		-43.9	2254.05	1044.24	-42	-9
<b>Asia Pacific</b>													
Asia-Pacific	<b>DJ Asia-Pacific</b>	95.05	93.01	93.72	-0.1	-0.11			-40.7	158.84	79.11	-38.4	-10.1
Australia	<b>All Ordinaries</b>	3521.7	3466.1	3521.7	6.7		0.19		-45.2	6434.1	3332.6	-43.6	-8.5
Australia	<b>S &amp; P/ASX 200</b>	3581.2	3516.8	3581.2	10.6		0.3		-43.5	6353.2	3352.9	-42	-8.3
China	<b>DJ CBN China 600</b>	16482.52	15992.85	16479.42	334.4		2.07		-60.2	44607.91	12886.57	-57.7	25.7
China	<b>DJ Jones China 88</b>	183.6	177.46	183.52	4.3		2.38		-61.1	504.37	149.53	-59.2	24.9
China	<b>Shanghai Composite</b>	2016.57	1958.98	2015.69	38.88		1.97		-61.7	5497.9	1706.7	-60	21.4
Hong Kong	<b>Hang Seng</b>	15548.26	15301.16	15497.81	37.29		0.24		-44.3	28128.8	11015.84	-42.6	1
India	<b>Bombay Sensex</b>	10110.34	9633.04	10076.43	361.14		3.72		-50.3	20873.33	8451.01	-47.4	2.8
Indonesia	<b>Jakarta Composite</b>	1362.55	1340.67	1351.76	-12.22	-0.9			-50.8	2830.26	1111.39	-49.1	5.7
Malaysia	<b>Kuala Lumpur Composite</b>	880.5	858.92	880.5	18		2.09		-39.1	1516.22	829.41	-36.5	-0.5
New Zealand	<b>NZSX-50</b>	2709.19	2685.32	2707.59	11.66		0.43		-33	4068.63	2575.48	-31.4	-6.2
Pakistan	<b>KSE 100</b>	8086.06	7785.26	7785.26	-320.37	-3.95			-44.7	15676.34	7785.26	-46.9	-6.5
Philippines	<b>Manila Composite</b>	1910.67	1886.48	1901.46	-3.1	-0.16			-47.5	3667.64	1704.41	-45.5	-2.4
Singapore	<b>Straits Times</b>	1798.95	1769.59	1798.95	19.66		1.1		-48.1	3465.63	1600.28	n.a.	-7.2
South Korea	<b>Kospi</b>	1189.83	1164.6	1175.91	6.16		0.53		-38	1919.47	938.75	-36.2	-3.8
Sri Lanka	<b>Colombo Stock Exchange</b>	1531.61	1525.52	1526.27	0.75		0.05		-39.9	2681.27	1524.19	-39.2	-10.9
Taiwan	<b>Weighted</b>	4694.81	4625.69	4694.81	46.79		1.01		-44.8	9295.2	4089.93	-40.2	-9.6
Thailand	<b>SET</b>	455.38	446.02	451.72	5.78		1.3		-47.4	884.19	384.15	-42.9	-13.2
Japan	<b>Nikkei Stock Avg</b>	8728.36	8534.84	8667.23	54.71		0.64		-43.4	15653.54	7162.9	-42.3	-17
Japan	<b>Nikkei 300</b>	172.75	169.67	171.27	0.15		0.09		-43.1	307.53	152.8	-42.3	-17.3
<b>Europe</b>													
Europe	<b>DJ Stoxx 600</b>	198.6	195.6	197.31	-0.2	-0.1			-45.9	365.09	182.13	-45.1	-13.8
Europe	<b>DJ Stoxx 50</b>	2082.17	2041.09	2058.84	-4.8	-0.23			-44.1	3699.89	1894.31	-43.5	-14.9
Euro zone	<b>DJ Euro Stoxx 50</b>	2469.47	2430.78	2452.42	8		0.33		-44.3	4404.64	2165.91	-43.2	-11.7
Euro zone	<b>DJ Euro Stoxx</b>	223.85	220.82	222.57	0.86		0.39		-46.4	415.07	198.93	-45.3	-12
Austria	<b>ATX</b>	1738.71	1706.45	1716.09	-16.5	-0.95			-62	4532.1	1516.09	-61.2	-21.8
Belgium	<b>Bel-20</b>	1889.83	1852.26	1881.85	22.23		1.2		-54.4	4147.19	1783.7	-53.6	-18.7
Czech Republic	<b>PX 50</b>	841.7	831.7	833.5	0.3		0.04		-54.1	1818.2	699.8	-53.6	-16.7
Denmark	<b>OMX Copenhagen</b>	231.31	226.93	228.66	-2.42	-1.05			-49	448.77	215.4	-48.5	-13.6
Finland	<b>OMX Helsinki</b>	5382.63	5322.38	5341.9	-9.88	-0.18			-53.9	11619.2	5047.69	-52.8	-13.1
France	<b>CAC 40</b>	3260.01	3196.91	3234.15	-7.77	-0.24			-42.4	5627.48	2881.26	-41.3	-11.7
Germany	<b>DAX</b>	4784.72	4715.82	4756.4	48.02		1.02		-41	8067.32	4127.41	-39.6	-3.9
Hungary	<b>BUX</b>	13035.96	12426.98	12579.28	-36.29	-0.29			-52.1	26318.29	10751.23	-50.8	-15.7
Italy	<b>S &amp; P/MIB</b>	19608	19231	19557	205		1.06		-49.3	38554	17968	-48.4	-17.9
Netherlands	<b>AEX</b>	251.26	247.4	249.88	2.12		0.86		-51.6	516.43	222.93	-50.7	-17
Norway	<b>All-Shares</b>	266.67	262.84	264.71	-1.66	-0.62			-53.6	603.98	232.29	-51.4	-10.4
Poland	<b>WIG</b>	27683.71	27130.56	27394.89	0.7		0.002		-50.8	56560.93	24852.95	-50.5	-7.7
Portugal	<b>PSI 20</b>	6310.08	6222.29	6274.23	29.2		0.47		-51.8	13166.29	5801.76	-51.5	-9
Russia	<b>DJ Russia Titans 10</b>	2809.44	2614.48	2624.71	-179.4	-6.4			-65.8	7900.67	2216.22	-66.1	-11.7
Russia	<b>RTS Index</b>	699.86	668.22	668.31	-31.6	-4.51			-70.8	2487.92	549.43	-70.7	-15.3
Spain	<b>IBEX 35</b>	9327.9	9202.3	9257.8	60.9		0.66		-39	15289.3	7905.4	-38.9	-4.3
Sweden	<b>SX All Share</b>	207.25	203.99	206.48	2.49		1.22		-41.3	351.84	176.54	-40.1	-11.3
Switzerland	<b>Swiss Market</b>	5628.44	5484.02	5515.05	-33.15	-0.6			-35	8518.19	5144.02	-34.4	-9.7
Turkey	<b>Istanbul National 100</b>	26965.75	26364.2	26395.5	-369.57	-1.38			-52.5	55698.42	21228.27	-51	-11.2
U.K.	<b>FTSE 100</b>	4352.7	4282.6	4330.66	6.47		0.15		-32.9	6497.8	3781	-31.8	-7.8
U.K.	<b>FTSE 250</b>	6425.12	6300.1	6391.57	83.9		1.33		-40	10657.8	5491.46	-38.5	-9.3
<b>Americas</b>													
Americas	<b>DJ Americas</b>	227.36	218.9	221.44	-4.76	-2.1			-41.3	383.68	186.51	-40.7	-10.7
Argentina	<b>Merval</b>	1161.56	1104.72	1116.43	-31.54	-2.75			-48.1	2248.63	828.99	-47.8	-9.9
Brazil	<b>Sao Paulo Bovespa</b>	40497.88	38994.84	39536.27	-411.16	-1.03			-38.1	73516.8	29435.11	-35.9	5.9
Canada	<b>S &amp; P/TSX Comp</b>	8724.11	8262.1	8425.35	-298.76	-3.42			-39.1	15073.13	7724.76	-37.2	-8.9
Chile	<b>Santiago IPSA</b>	2360.84	2343.84	2351.37	3.64		0.16		-23	3096.11	2101.1	-22.4	5.6
Mexico	<b>IPC All-Share</b>	23098.15	22334.75	22347.17	-225.33	-1			-24.3	32095.04	16868.66	-23.3	8
Venezuela	<b>Caracas General</b>	34660.18	33461.77	34517.74	56.26		0.16		-8.9	41450.77	33894.41	-6.5	20.8
<b>Other Countries</b>													
Egypt	<b>CASE 30</b>	4516.73	4453.29	4453.4	-30.61	-0.68			-57.8	11935.67	3686.35	-56.6	n.a.
Israel	<b>Tel Aviv</b>	698.1	683.38	689.29	7.96		1.17		-43.4	1230.71	592.07	-42.5	-5.4
South Africa	<b>Johannesburg All Share</b>	22409.26	21813.75	22034.63	-374.63	-1.67			-23.9	33232.89	17814.42	-22.6	7.7

\*Europe, Australia, Far East: U.S.-dollar terms

Three year percent change is annualized.

Sources: Reuters; WSJ.com

MARKET INDICES	Dec 18	a month ago	a year ago
S&P/TSX Composite	8425.35	8835.73	13358.07
S&P 500	885.28	859.12	1454.98
Dow Jones Industrial Average	8604.99	8424.75	13232.5

INTEREST / FX RATES	Dec 19	a month ago	a year ago
Prime Can (%)	3.50	4.00	6.00
Prime US (%)	3.25	4.00	7.25
30 Day BA Can (%)	1.656	2.381	4.603
3 month US T-Bill (%)	0.01	0.03	2.89
3 month Can T-Bill (%)	0.870	1.874	3.877
10yr US Bond (%)	2.123	3.206	4.068
10yr Can Bond (%)	2.82	3.45	4.00
10yr-2yr US Spread (bps)	140.10	214.80	97.70
10yr-2yr Spread Can (bps)	155.00	161.00	20.00
US\$/Cdn\$	0.8220	0.7791	0.9959
US\$/Euro	1.3932	1.2562	1.4383
Yen/US\$	89.4550	94.9538	113.7530

INTERNATIONAL INTEREST RATES	Dec 19		
	3 mo LIBOR (%)	Spread vs US (bps)	a wk ago (Spread—bps)
United States	1.50	NA	NA
Canada	2.30	80	31
Euro-zone	3.08	158	138
Switzerland	0.74	-75.9	-101.9
Japan	0.90	-60	-124
Australia	4.84	334	293
	10 Year Bond (%)	Spread vs US (bps)	a wk ago (Spread—bps)
United States	2.12	NA	NA
Canada	2.82	69.7	48.6
Euro-zone	3.79	167.0	102.5
Switzerland	2.14	1.5	-47.1
Japan	1.23	-89.7	-118.9
Australia	4.03	190.2	172.8

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