



The Bottom Line

THE LATEST VIEW ON THE ECONOMY



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More Signs of Hope Needed

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We are in a negative-news cycle, to say the least, and it is difficult to see a near-term end to it based on incoming data, heated policy debates and wealth-obliterating market activity. The World Bank and the IMF now forecast a global contraction this year for the first time in 60 years, and editorials are debating the future of capitalism and globalization. World demand is in free-fall, while governments are tentative and mired in political debate about dealing with their financial systems. While fiscal and monetary stimulus is ramping up sharply, some countries, most notably Japan and Germany, have not done enough to stimulate spending. Moreover, the IMF has insufficient funds to deal with the serious problems in Eastern Europe, Asia or South America, and so far, the EU doesn't seem to want to take responsibility for their eastern neighbours, despite the significant banking exposure of Austria, Italy and Germany. An IMF solution would require significant devaluation, a no-no for potential euro adoption.

Essentially, without government action to adequately capitalize financial institutions and deal with the illiquid securities at the crux of the crisis, the contraction in spending and the fall in asset values will continue. Canada is particularly fortunate; our strong banking system allows our banks to tap private investors to raise capital, taking no government money. However, the cost of capital has risen sharply for these institutions and they will be competing for business in the future with government-subsidized institutions—certainly not a level playing field.

In this scenario, stocks hit new lows in early March, and after what seemed like the beginning of a thawing of debt markets early in the year, sentiment has deteriorated and bonds, other than short-term Treasuries, have resumed their selloff. Equity markets continue to be battered, as the S&P 500 fell to its lowest level since 1996 amid a wave of dividend cuts, earnings disappointments and a deepening recession.

The U.S. jobless rate surged to its highest level in more than a quarter century, at a simply stunning speed. While the official rate is 8.1%, the broader measure that includes the underemployed and discouraged workers is now posted at 14.8%, the highest since the BLS started to keep tabs back in 1994, and encompasses a scarcely inconsequential one in seven workers. This is a major reason why an estimated one in 13 U.S. homeowners is having trouble making their mortgage payments. Retail sales continue to be weak except at the major discounters and even they are seeing relatively weak sales growth. We are in the thrall of a negative feedback loop: the slide in asset values leads to a loss of household

net worth, consumer confidence, spending and then employment; and this process, in turn, feeds right back into more asset deflation and credit defaults.

Clearly, the White House budget is extremely aggressive and the Fed, Treasury and FDIC are doing everything they can, but the issues are highly contentious and the public does not like bailouts of any sort. The Congress, therefore, is balking at many of the Obama proposals; even the Democrats are leery about some of the proposed measures because they just can't explain them to the folks back home. Obama's approval rating is still high, however, and much of what Washington is doing is by trial and error, which only makes the public more nervous about government intervention.

In this environment, Treasury bills and shorter-term bonds are still in a bull market as government yields remain very low, but credit spreads have widened from already-high levels for investment grade and high-yield bonds. Investors are still waiting for key details

from the government about its plans to bolster U.S. banks and thaw the credit markets. Credit default swap spreads have also widened sharply reflecting both the rise in default risk but also the rise in counterparty risk (*Chart 1*).

While it is clear to everyone that Washington is having trouble with the bailouts of AIG and GM, not to mention the banks, the U.S. dollar continues to surge on a safe-haven bid. Being the world's reserve currency, and having the deepest and most liquid government bond market, the U.S. currency continues to dominate. The only alternative is gold, which has shown some upward movement in recent months, but is back below its peak. Other commodity prices, though occasionally edging higher, are still far from signalling a rebound in global demand.

With this backdrop, it is not surprising that the TSX also continues to slide, down a whopping 48% from its peak. As bad as that sounds, the peak-to-trough decline in the S&P 500 is a staggering 54%. Equity values have fallen off a cliff (*Chart 2*). Looking around the world, however, the Canadian stock market doesn't look so bad (*Chart 3*). And as much as Canadian bank stocks have been clobbered, they are generally outperforming most of the world's other

Chart 1

Some Progress

(basis points)

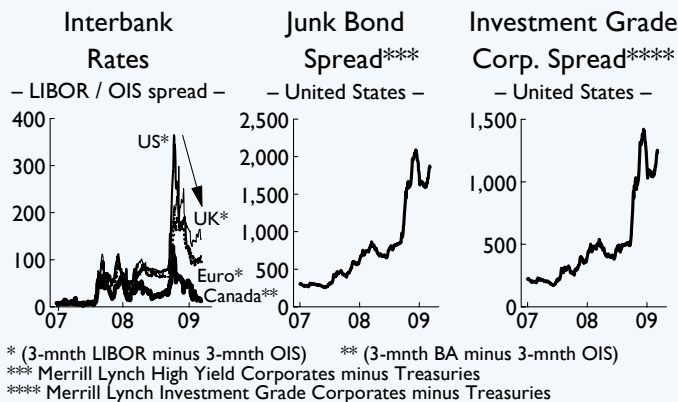


Chart 2

Equity Values Plunge

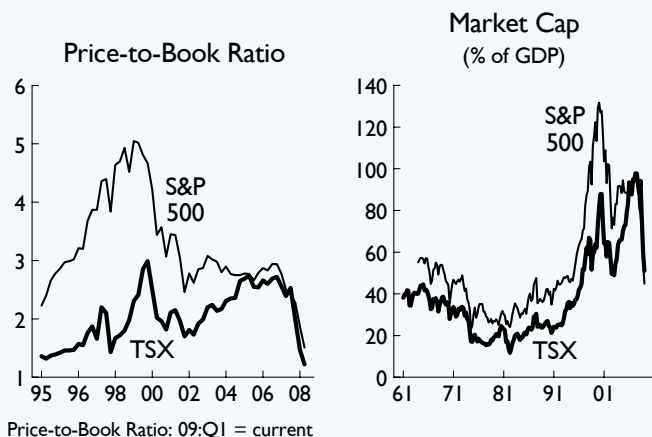


Chart 3

Global Bear Market

(% chng since August 1, 2007 : as of March 10, 2009)

Equity Markets

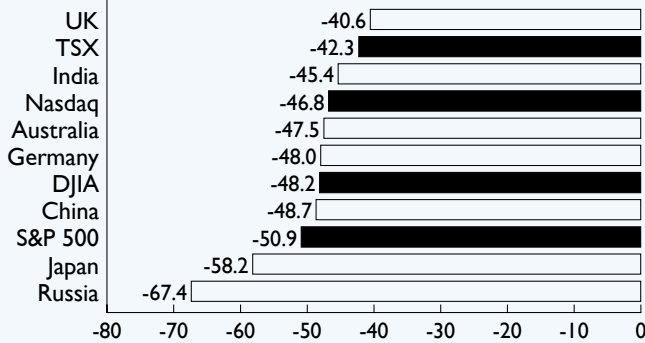
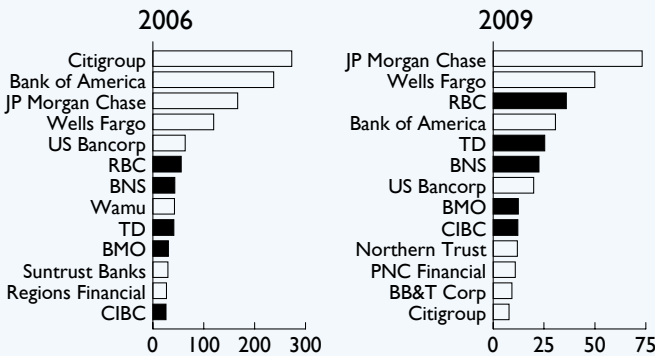


Chart 4

Canada Climbs the Ranks

North America's Biggest Banks by Market Cap (US\$ blns)

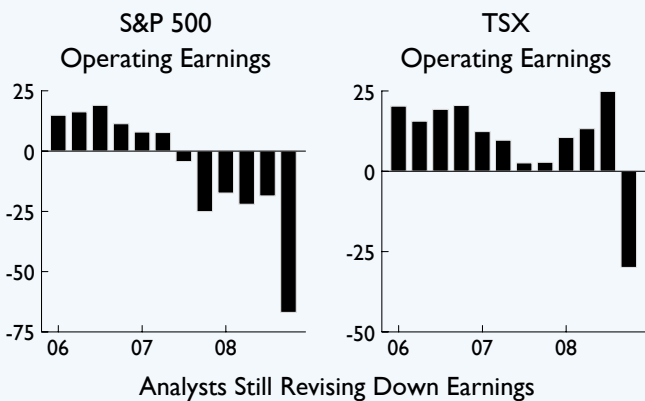


2009 = (as of March 10, 2009)

Chart 5

Commodity Decline Reduces Canadian Profits

(y/y % chng)



large banks and have become among the largest in North America, rising in the ranks as the U.S. banks' market valuation plummets (*Chart 4*).

Disturbingly, four S&P 500 companies are now in penny stock status, with another ten or so precariously close to that distinction. Meantime, at last check, there were 100 or so S&P 500 companies trading at single digit prices. The Dow has five of its 30 members bobbing below \$10, having just hit a 12-year low. Nearly two-thirds of the shares that trade on the NYSE now trade in single-digit territory, double the share when the market peaked in October 2007.

The S&P 500 has now posted six consecutive quarters of negative earnings growth on a year-over-year basis. The worst yet was likely the fourth quarter as earnings are estimated to have fallen 57.9% y/y, led by the decline in financial-sector profits. TSX earnings are on pace to post their first quarterly decline, down roughly 30% y/y in Q4, dragged down by commodity and consumer sectors (*Chart 5*). As a percent of the index, financial stocks have fallen from 19.3% of the S&P 500 and 30% of the TSX in October 2007 to just under 10% and 25%, respectively.

Valuations continue to contract amid relentless selling, with the S&P 500 now falling below 13x trend earnings for the first time since the early-80s—well below the long-run norm of 18x, but still above typical major bear-market lows of about 10x. Judging from recent trading, the only rallies we are likely to see much of this year are bear-market rallies.

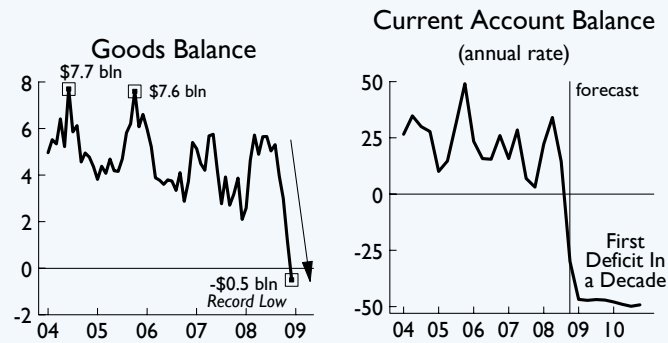
Canada's Recession Deepens

While the U.S. downturn started about three quarters before our own, the Canadian economy has weakened sharply since the Lehman debacle in mid-September last year. Even earlier, there were signs of trouble as Canadian financial stocks have been falling since late 2007 and the plunge in oil and other

Chart 6

Canada's Trade Surplus Turns to Deficit

Canada (C\$ blns)



Trade is One-Third of Canadian Economy

Chart 7

Confidence Buckling

Conference Board

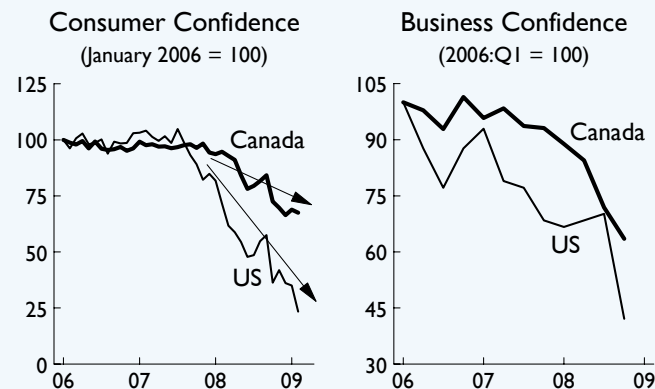
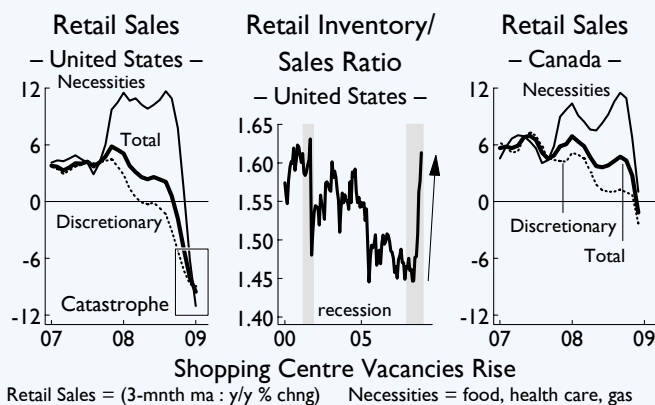


Chart 8

Retail Spending in Freefall



commodity prices has decimated the bull market in commodity-related stocks. Capital spending plans in the oil sector and elsewhere have been scaled back or shelved altogether. Meantime, our goods trade surplus dwindled, finally posting a deficit for the first time in over three decades (*Chart 6*). The fall in the Canadian dollar, accelerating recently to below 77 cents (U.S.) does little to improve our trade situation because U.S. and global demand for imports is very depressed. Manufacturing was already hard-hit by the automaker troubles, but the contraction in that sector has been even more dramatic in the past few months than many feared. Even now, it may be that at least one of the Detroit-Three file for bankruptcy protection, the ultimate impact of which will be very negative on Southwestern Ontario.

The Canadian jobless rate is rising rapidly now, and is approaching 8% all too quickly. It is no wonder that Canadian consumer and business confidence has fallen sharply and consumer spending has plunged (*Chart 7*). Canadians too are increasing their savings rate from historic lows and cutting back on discretionary spending (*Chart 8*). In the U.S., even spending on necessities has plummeted; we haven't gone that far in Canada yet, but the outlook isn't great.

Housing as well has slowed, albeit less dramatically than the debacle stateside. Nevertheless the plunge in housing starts and sales, as well as the drop in prices, is all too reminiscent of what is happening in the U.S., U.K., Spain, Ireland and Australia, particularly in western Canada where over-building during the boom was more prominent. The commercial real estate sector has also slowed, reflecting rising vacancy rates and weakening retail spending.

With all of this doom and gloom, some suggest that the worst of the news is priced into the stock market or at least priced into the financial stocks. We might be much of the way there, but even seventeen

months into the financial crisis we have little evidence that a solution is in place. Value investing has been disastrous so far this cycle as markets overshoot on the down side (just as they did on the upside). Nevertheless, pent-up demand is growing and there is a mountain of cash on the sidelines. But, before the bear market ends, we need to see signs of improvement in U.S. housing and a bottoming in financials.

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