

In 2008, balanced portfolios recorded their worst returns in at least 25 years, with declines of 15% to 20% for the year. More specifically, the median return for Canadian pension funds was about -16% last year. If only Canadians had seen increases in other areas. But that was not the case. House prices were down by about 10% on average, while the commercial real estate market cannot be evaluated because it has come to a complete standstill.

What does 2009 hold? The stock and bond markets are already pricing in a severe recession. The question is whether the recession will turn into a depression or whether an economic upturn will start later in 2009 or early in 2010. Last year, central banks in industrialized countries injected an unprecedented amount of liquidity to stabilize the global banking system, and this year governments are prepared to run budget deficits averaging about 2% of GDP to restart the economy. We believe that an economic recovery will begin in the United States in the second half of 2009. Since the stock market anticipates the economy by at least six months, it is time to start buying equities again. In fixed income, corporate bonds currently offer a very appealing risk-return ratio.

We must not underestimate the potential of the stock markets at this time. The U.S. market, for example, is trading at only 12 times earnings estimates for next year, which is very inexpensive given today's interest rates.

Stock market performance 2008

	Local currency	Canadian dollars
Canada	- 32.4%	- 32.4%
United States	- 36.6%	- 22.1%
Europe	- 44.7%	- 32.1%
Japan	- 40.8%	- 8.1%
Emerging markets	- 53.3%	- 42.7%

ECONOMIC OR FINANCIAL CRISIS?

Despite the impression conveyed by the media, the world did not experience an economic crisis in 2008. It is quite possible that in 2009 we will go through the most severe global recession of the past 30 years, but it is far from certain that the recession will degenerate into a crisis.

What is certain, however, is that capital markets around the world are grappling with the biggest liquidity crisis since the 1930s.

Two large sectors of financial markets – banks and hedge funds – are forced to liquidate a portion of their assets at the same time. In the case of banks, governments have come to the rescue by providing capital and purchasing certain assets. Hedge funds have not received any government assistance and have had to delay reimbursing their clients while they try to sell assets. Investors who would normally purchase such assets are proceeding cautiously because they do not know just how far the liquidation process may go.

Obviously, prices fall when everyone is trying to sell at the same time; even the price of high-quality securities.

STOCK MARKETS IN THE FOURTH QUARTER

All major stock markets were down 20% to 25% in the fourth quarter, in Europe, Japan and the United States. The declines in emerging markets were a little more pronounced, with a decrease of 28% in local currency. The uniformity of the decline suggests there was no arbitrage between markets, but rather a widespread liquidation, which is often the way bear markets end. However, there is no guarantee of that, since the previous period of liquidation and consolidation, in 2002-2003, lasted nine months. This one is about three months old.

GOVERNMENT BONDS

Since the liquidity crisis is concentrated mainly in the United States, the U.S. Federal Reserve has thus far been the most aggressive central bank in injecting liquidity in the financial system. As a result, interest rates on treasury bills are now close to zero, and long-term treasury bonds are yielding slightly more than 2%. In Canada, the central bank has been somewhat more restrained, and short-term rates are 1.1% while 10-year bonds are at 3%.

Some analysts are saying that the level of interest rates indicates that investors expect prices to fall in the years to come, but it is quite possible that the very low rates simply reflect investors' preference for liquidity and safety at this time. To maintain these very low interest rates, the Fed announced it was considering the purchase of treasury bonds in 2009, something it has not done for more than 30 years.

Regardless of the reason, Government of Canada bonds and U.S. treasuries are not an appealing investment at this time.

CORPORATE BONDS

While the yields on Canada bonds and U.S. treasury bills were dropping, yields in the other sectors of the market were rising due to economic uncertainty as well as the large volume of new bonds being issued by banks. The yield spread between government bonds and corporate bonds always widens during a recession, but lower quality debt is usually affected the most. This time, however, even the best-quality debt is affected, with yield spreads reaching unprecedented levels. For example, a bond rated AA in Canada usually trades at 0.5% to 1.0% above the yield on a Government of Canada bond with the same maturity. Currently, the spread is more than 3.0%.

Corporate bonds are an excellent investment at this time, since the reward offered for the risk assumed has reached an unprecedented level.

HOUSE PRICES

House prices continue to fall in the United States but the rate of the decline is slowing. For the broad market, the decline since the 2006 peak is now 24%. There are almost no housing starts and the inventory of unsold houses has dropped considerably. However, the number of houses whose mortgage exceeds their value remains high. The U.S. government has taken measures to maintain mortgage lending and prices are expected to stabilize by mid-year.

In Canada, the average decline was about 10% in 2008 and given the incipient recession and tight lending conditions, it is unlikely that house prices will rise in 2009.

STOCK MARKETS OVER THE LONG TERM

The return on U.S. equities over the past decade (1998-2008) was -1% annually. In real terms, the return is even lower. This represents one of the worst 10-year returns in more than a century. After such a period, it is useful to remember that the real return on equities has been close to 6% a year over more than a century. Moreover, it is rare to have two poor decades back to back.

In addition, the performance of equities, even over a period as long as a decade, is affected significantly by their valuations at the outset. Equity valuations are very attractive right now. The price-earnings ratio is 12 based on earnings estimates for 2009 and, moreover, dividend yields compare advantageously with governmental bond yields.

DASHBOARD

December 31, 2008	
Canada	
Canadian dollar vs. U.S. dollar	0
Corporate bonds	++
Long-term government bonds	-
S&P/TSX 60	+
Small Cap	0
REITs	0
United States	
U.S. dollar vs. euro	0
Long-term treasury bonds	-
S&P 500	++
Nasdaq	+
Small Cap	+
Europe	
Euro vs. U.S. dollar	0
Long-term bonds	+
MSCI EMU	+
Asia	
Yen vs. U.S. dollar	-
MSCI Japan Index	0
Emerging markets	
MSCI Emerging Markets	++

0: neutral
+: overweighted
-: underweighted