RBC Dominion Securities
Market Commentary

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Equity markets have been under intense pressure over the past year, as the fallout from the US housing crisis has spread globally. For most of the period, however, the Canadian market was largely spared, holding up much better than equity markets south of the border and around the world. Yes, the big six bank stocks were down, but the magnitude of the losses relative to their US and global peers were much less acute. Meanwhile, the unique nature of the Canadian stock market and specifically its heavy reliance on energy and materials stocks acted as an offset to financial stock weakness, helping the benchmark TSX index reach all-time highs as recently as June of this year. More recently, however, the TSX has been in a steep slide, with energy and resource stocks getting particularly hard hit, which has overwhelmed the recent rally in financial stocks.

Against this backdrop, a number of financial shocks have occurred. What began as a meltdown in the sub-prime mortgage market has spread to all variety of financial instruments, eventually taking down venerable institutions such as Bear Stearns and more recently forcing the US government to effectively take over Fannie Mae and Freddie Mac.

Why did the US Government Bail-out Fannie Mae and Freddie Mac?

Fannie Mae and Freddie Mac are the largest buyers of US residential mortgages. Their existence is essential to the normal operation of the US housing market, as a bank's ability to originate mortgages is predicated on the its ability to sell some of these mortgages to others (primarily Fannie and Freddie), so as to free up capital to originate more mortgages. While Fannie and Freddie have always been among the largest buyers of residential mortgages, over the past year, they had essentially become the only buyers, as most other financial institutions were under tremendous pressure to lower their exposure to mortgage lending.

Fannie and Freddie were able to continue buying home loans from the banks because there had always been the perception amongst investors of the existence of an implicit government guarantee - if Fannie or Freddie got into trouble, the US government would stand ready to backstop the debt obligations of the two companies. Thus, while normally the credit worthiness of Fannie and Freddie might have been called in to question given the deterioration in the US housing market over the past 18 months, this perceived government guarantee helped mitigate any concerns. However, more recently, this trust began to deteriorate, as losses in the US housing market accelerated. As a result, the US government was essentially forced to step in and explicitly guarantee Fannie and Freddie's obligations. The government's actions were necessary to ensure that the US housing market continued to function.

What are the Implications of the Government takeover of Fannie and Freddie?

- Mortgage rates have already declined in the wake of the takeover. This should eventually act to stimulate housing demand or at least allow some significant proportion of homeowners to avoid default, thereby easing the downward pressure on house prices.
- The takeover has likely taken more severe scenarios off the table. Strategists and pundits often speak of systemic risk whereby one event cascades into a series of events that potentially brings down the entire system. Some feared that Fannie and Freddie presented just such a scenario and the takeover removes this risk.
- However, it is important to note that the takeover of Fannie and Freddie does not necessarily prevent house prices from falling further. The survival of Fannie and Freddie insures that banks will have a buyer for many of the mortgages they originate, but the US banks have still suffered large losses that hinder their ability to lend and inventories of new and unsold homes remain high.

What are some Sign Posts to Look for?

- **Housing Inventories and Prices**: The inventory of unsold homes needs to start coming down in order to enable house prices to find a bottom. This is especially important for both consumer confidence (as house prices stabilize, would-be buyers are more likely to become actual buyers) and bank lending, as it is difficult for banks to lend when they are uncertain as to the magnitude of write-downs they must take.

- **Credit Stabilization**: This flows from the above. The entire financial system is predicated on banks' willingness to lend. Currently, credit spreads (which give an indication of this willingness) are significantly higher than they have been in a number of years, indicating that consumers and corporations are having difficulty obtaining affordable credit. The Fannie and Freddie takeover was potentially an important step in resolving this process and we need to closely watch spreads in the coming weeks and months to determine whether banks are once again becoming more willing lenders.
- **Employment**: While mortgage rates and the availability of credit are important, one of the keys to both the housing market and the general economy is the level of job creation. Simply put, if people do not have jobs or do not feel secure in their jobs, they are much less willing to buy houses or stocks or stuff. Over the past half year, the employment situation in the US has deteriorated, with the unemployment rate rising to a multi-year high. We likely need to see the employment situation begin to stabilize in order to carve out a sustainable bottom.

Why are Commodity Prices Falling?

More germane to Canadian investors has been the abrupt reversal in the fortunes of the commodities related sectors of the market. We think there are two primary reasons:

1. **Global Slowdown**: For much of the past year, the consensus view has been that the US housing crisis would have a much bigger impact on US economic growth than it would on economies outside the U.S. Over the past few months, this view has shifted dramatically, as data out of Canada, Europe and even China has suggested that economic growth has materially deteriorated on a global basis. This has had a disproportionate impact on commodities since most of the growth in commodity demand has come from these newly industrialized economies over the past decade.
2. **Institutional Liquidation**: Coming in to June of this year, US hedge funds had huge positions in energy and commodities. The US hedge fund community tends to both drive and follow momentum swings in the market and just as there had been a self-reinforcing stampede into commodities when that part of the market was seen to be working, there has recently been an equally massive run out of the sector now that the tide has turned.

What are the Implications for the Canadian Market?

Over the past several years, there has been a huge shift in the investor base of a number of Canadian energy and material stocks. Many of these stocks were once primarily owned by Canadian institutional and individual investors, but this ownership base shifted to where many of these stocks are now primarily owned by US investors and by hedge funds. Many of these stocks are inter-listed (i.e. they trade on both the US and Canadian exchanges) and by looking at trading volumes both in Canada and south of the border, we can see just how acute the US influence has become. For example, consider that Potash Corp. has typically traded between two and three times as much volume south of the border as it has in Canada, but in the first six trading days of September, it traded more than 90 million shares in the US vs. about 13 million here in Canada. The Canadian market does not have the capacity to absorb such a tremendous amount of selling volume and thus shares of many of these companies have fallen far further than fundamentals might suggest was warranted.

At the peak, the TSX was comprised of almost 50% energy and materials stocks compared to less than 20% for the US market. Thus, a correction in commodity prices and commodity stocks has had a disproportionate impact on the performance of the TSX relative to the US or most other global indices. Since June, most commodity stocks are down between 30 and 50%, which to some degree reflects the sharp pullbacks in the underlying commodities, but also flows directly from the massive amount of selling from US hedge funds.

When will it end?

- **Valuation**: From a valuation perspective, many of the energy and resource stocks are already pricing in dire scenarios that may not be supported by the underlying fundamentals. Thus, while the slowdown in global growth has had a negative impact on demand and pricing, many of the stocks seem to discount a slowdown in growth and demand that is well beyond the levels we have seen so far or are likely to see going forward.
- **Price Action**: Market bottoms are typically associated with cathartic waves of selling where investors seem determined to exit positions regardless of price. Consider that over the first six trading sessions of September, the average daily trading volume on four of the largest inter-listed stocks in Canada (Potash, Research in Motion, Suncor and Encana) has been more than 75 million shares vs. less than 50 million shares per day in May of this year (we ignore the summer months because volumes tend to be lower during these months). This sort of trading volume is suggestive that a bottom could be approaching, but these things are very difficult to predict.

What Should Investors do?

- **Think Long-Term**: The sell-off is potentially setting-up a very attractive buying opportunity. However, if one is worried about short-term fluctuations in their holdings, it should be noted that the extreme volatility may continue for some time to come. The Canadian market has just come off four successive calendar years of well above average gains. At the June peak, the TSX was some 165% above the March 2003 lows. It is still 120% above those levels. While the period of intense price declines may not have much further to run it would probably be overly optimistic to imagine that after a short sharp correction, the Canadian market would revert immediately back into a sustained bull advance. However, Investors with a long-term focus should recognize that this period of adjustment will present an opportunity to acquire great businesses at attractive valuations.

- **Emphasize Diversification**: The turmoil since last summer has been particularly wearing on the Canadian investors' psyche because the two sectors hit hardest in the sell off - financials and commodity/energy stocks – add up to some 75% of the value of the Canadian market. While long-term investment returns tend to increase with the level of risk taken, it is also true that investors are unlikely to be rewarded for taking risks they could have reasonably avoided or diversified away. The market action of the past several months serves to underline this fact of investment life. Prudent, conservative investors do not have to accept the high degree of sector concentration risk inherent in the make-up of the Canadian stock market. They can and should mitigate those risks by diversifying their portfolios to include businesses and sectors not well represented in our domestic market.

- **Avoid Chasing the Market** - Many of the recent extremes in the market have been driven by short term focused hedge-funds and hedge-fund-like investors which have the ability to cause highly dramatic and quick swings in whichever markets or sectors they may have a momentary interest. We believe that an investment strategy that tries to time these types of fluctuations will do little more than chase the market, with disappointing results. Rather, we would focus on a discipline that identifies high quality companies with market-leading positions and strong management teams capable of adapting to changing environments, preferably in a broad range of industries and geographic locations. Such a portfolio would usually not be able to avoid a market decline altogether, but it might be more resistant to decline and it would often recover earlier and more vigorously than the overall market.

- **Look for opportunities that fit the situation**: Emphasize stocks and sectors that tend to do well in an economic slowdown. Unfortunately for Canadian investors, these stocks and sectors tend to be in short supply in Canada, as the traditional defensive areas of the market – Consumer Staples, Health Care, Utilities – are generally under-represented. This just re-emphasizes the point made above: investors may need to look south of the border or abroad to gain more exposure to traditional defensive sectors.

- **More Cash is Okay**: The RBC Investment Strategy Committee notes that historically, the amount of easing put in place by the US Federal Reserve would normally have resulted in a noticeable increase in economic activity at some point, and that given a moderate outlook for inflation, there would be an expectation of attractive equity market returns in the year ahead. Indeed there are indications that some parts of the U.S. economy (e.g., manufacturing) are improving. However, the general consensus is that the economy continues to be challenged by the persistence of the crisis faced by the banking system which has reduced the availability of credit and impeded the transmission of lower interest rates into the economy, such that the expectations for the timing of the economic resurgence has been pushed steadily into the future. Moreover, the risks to this outlook remain biased towards the downside, and the rapid flow of funds related to leveraged, momentum based 'hot money' has increased volatility and made it that much more difficult to value companies on a rational basis.

  For all Canadian portfolios, the RBC Investment Strategy Committee has recommended carrying a much higher-than-normal cash position for more than a year. That recommendation reflected the extra risks facing Canadaian investors:

  - The fact that Canadian stock markets had put together four back-to-back years of well above-normal gains;
  - That 75% of TSX value was tied up in just two sectors – financials and commodities – the latter having a history of very high volatility; and
  - That surging commodity prices were raising questions about a possible resurgence in long-term inflation, which if it transpired would be bad for bonds, some significant parts of the stock market, as well as the economic cycle and corporate profits generally..

  Having more cash in an environment such as this is not only by its nature more defensive, but it also gives investors the liquidity necessary to seize opportunities when they are presented. The decision of how much cash to hold, however, remains a personal one related to the risk tolerance of the individual investor. After five previous years of low volatility and strong equity returns, it would have been easy for many investors to let their perception of their own risk tolerances drift higher with the markets. Faced with the prospect of higher volatility and continued downside risks, investors might reconsider their risk tolerance and review what cash weighting is most appropriate for them.