Daniel Hulak's

RandomComments...

Views and opinions
for the clients and friends of

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The previous couple of Random Comments were written with the intention of providing a historical context and 'big-picture' view of the current economic crisis. This edition will take aim at offering an update of what we're currently seeing in the economy and in the markets…

April 22nd, 2009

First, to recap…

After the tech bubble burst, interest rates plummeted, credit became virtually unlimited and available to all with a pulse, and complacency was the order of the day. Naturally, humans have a tendency to be greedy and the general America population couldn't be accused of anything to the contrary. Low interest rates and easy to obtain credit is fine, but couple that with loose (or perhaps a better adjective would be 'virtually non-existent') regulation, the ability to securitize and move debt off of balance sheets, and very little transparency requirements and you get the disastrous situation that we've been facing over the past 18 months or so. Ultimately, the party is now over, and we're dealing with the hangover.

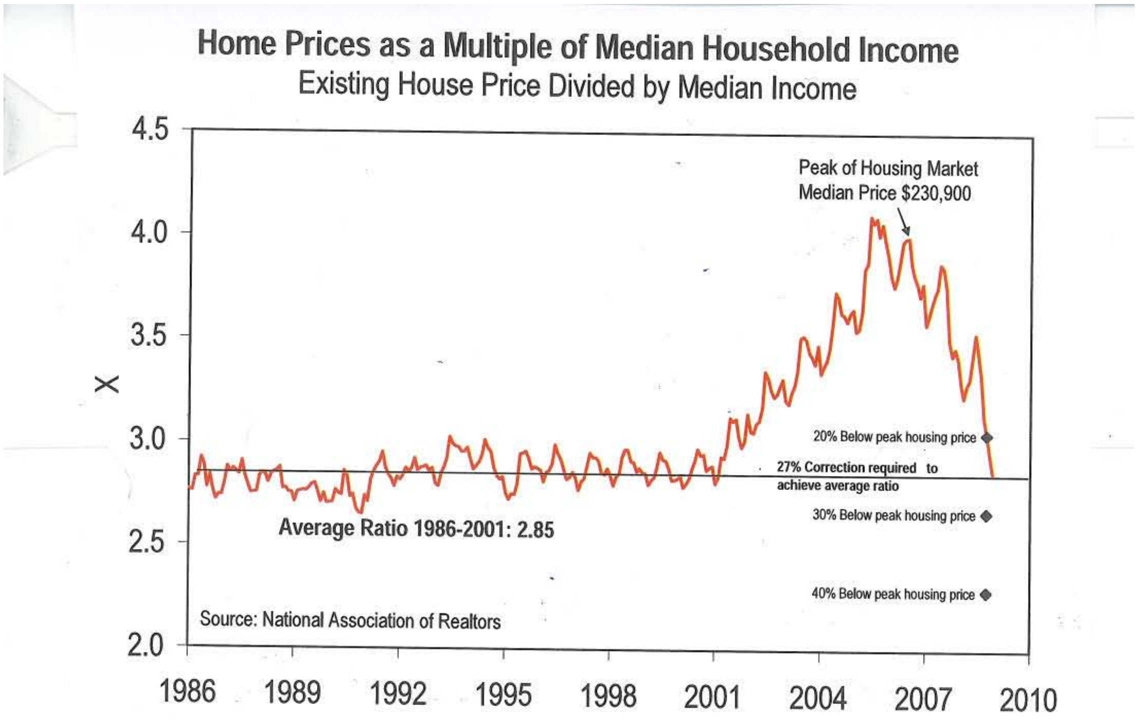
After the music stopped, many of the investment dealers, banks, institutions, pension funds and even governments all over the world were left holding these 'hot potatoes' that are now being referred to as 'troubled assets' or 'bad loans' consisting primarily of securitized mortgages and loans that should never have been approved. Even so, the situation looked manageable until September 16, 2008 when the powers that be in the United States decided to let Lehman Brothers file for bankruptcy – arguably for political reasons. (I'm not defending the decisions Lehman Brothers made to put themselves in that situation, but I honestly believe that if given the chance to go back and change their minds, policy makers would've kept Lehman solvent and the markets wouldn't have entered into a tailspin like they did). This man-made decision sent catastrophic shock-waves throughout the financial world and all of a sudden we were faced with having to re-price risk. Credit markets completely seized up, lending froze (even interbank lending as evidenced by the TED spreads), and all trust was virtually lost. The reason no one can honestly say that they saw this coming (RBC included), was that none of our pricing models account for this sort of systematic risk shock. For years, companies were priced in good faith. Something along the lines of "if all goes reasonably according to plan, company ABC should make this much in earnings, so I'm willing to pay $X for it in the marketplace". All of a sudden, after Lehman's collapse, the attitude became "under the worst case scenario, company ABC might only make this much in earnings, and because I don't know if I should trust anyone, the most I'm willing to pay in the marketplace now is $X." As a result we're experiencing a massive deleveraging of the financial system and a re-pricing of risk.

That's the bad news.

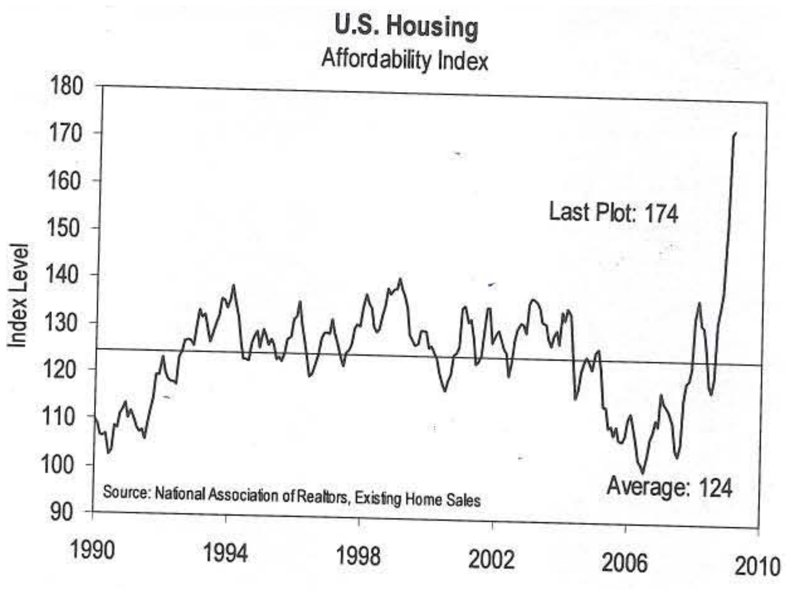
The good news is that recently we've seen signs of this 'systematic failure fear' abate somewhat, and people are realizing that yes, letting Lehman go was probably a mistake in hindsight, and yes it likely caused far more damage than it should've, but we've learned our lesson, the sun will come up tomorrow, and now we have to clean up the mess and move on as best we can. Governments and policy makers all over the globe have put forth incredibly massive efforts to address the issues and it appears that we are now beginning to see signs of the credit freeze thawing and some confidence being restored. That's not to say that things aren't still bad…they're just a little "less bad".

Now I'm a graphics, numbers, and charts kind of person, so I apologize in advance for those that don't care for them, but the following are some very interesting tidbits of information:

First, US housing. The epicentre from which all of our current problems have stemmed. How can you fix the patient's symptoms without first addressing the underlying ailment? The following chart is a graphic representation of US home prices as a multiple of household income. The average home price has historically been about 2.85 times average household income. At the peak of the housing bubble in 2005-2006 that number went up to over 4 times median income! The good news is that with the sharp decrease in housing prices, we're basically back down to historical averages.



Further, with interest rates as low as they now are and housing prices having fallen as hard as they have, the US housing affordability index is at all-time highs…

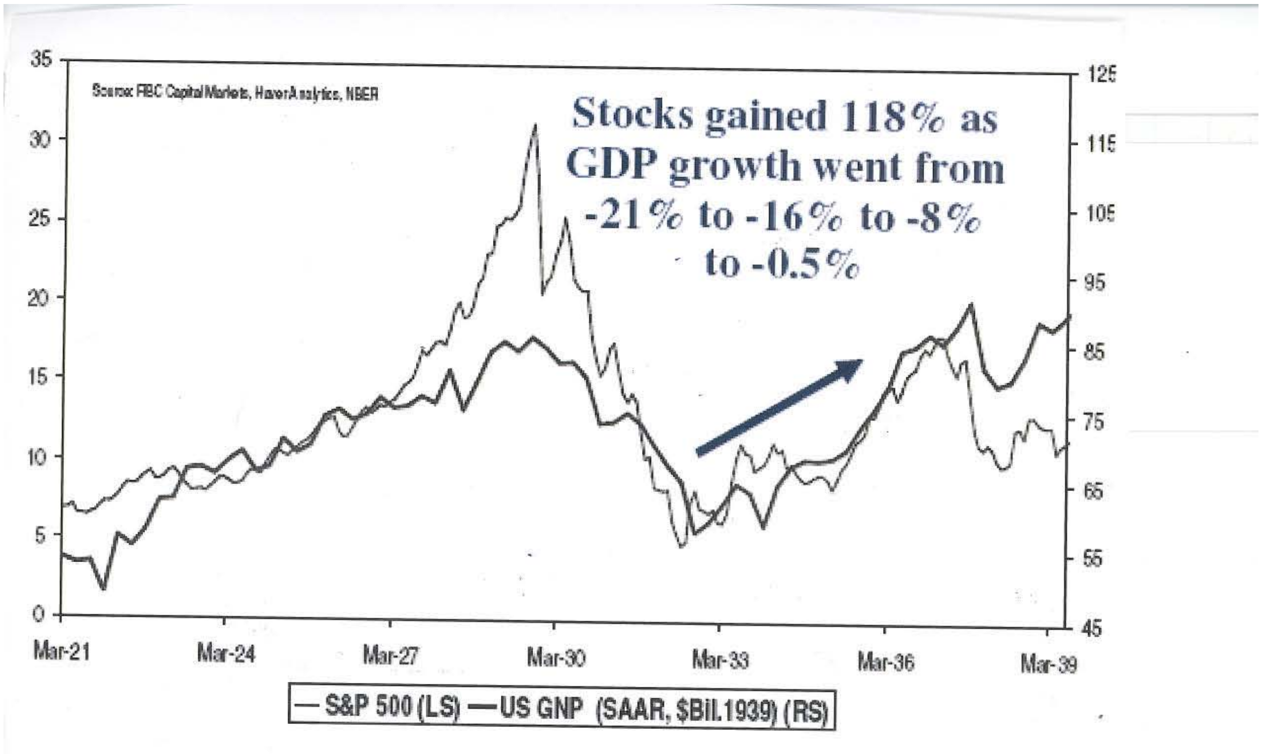


So do I expect that US home prices have stabilized and will once again begin their screaming ascent? No, not necessarily – because as the pendulum swings from one extreme to the other it typically overshoots on both sides, so we could (and likely will) see more downside in US housing prices – but the numbers are certainly more encouraging now than they were a few years, or even a few months ago.

To further the 'less bad' theory, we've now seen that TED spreads have come in (meaning banks are beginning to trust one another again), the VIX (measure of volatility or uncertainty in markets) is still high but has dropped considerably, and major economic indicators such as the Baltic dry freight index and the ISM numbers are showing signs of potential bottoms. In addition, insider buying on the stock markets has shot up (always a good sign when the 'Brass' of a company feels that their stocks are undervalued and are buying their own shares), merger and acquisition activity is heating up (another good sign when companies feel that other companies are undervalued and look to acquire them), and equity issues are once again coming to market (confidence is being restored).

Remember that the data you hear in the news will continue to be bad for some time yet, primarily because most numbers are reported year over year (so logically it takes time for them to turn up), but further magnified by the media's desire to glamorize and over exaggerate bad news (sells more newspapers). BUT remember that stock markets are forward looking discounting mechanisms, and 'less bad' can be very good for stock markets…

Below is a chart of the S&P500 before, during, and after the crash during the great depression. Notice the period of time in which stocks gained 118% as GDP growth went from -21% to -16% to -8% to -0.5%. Remember that these are all still negative growth numbers…negative growth is not good…it's bad…it's just 'less bad'…



On that note, a lot of people are asking "is this the next great depression??" My answer is simple...no one can be certain, but I sincerely doubt it. Look at the differences between then and now…

Professional Wealth Management

Is this another Great Depression in the making?

Then	Now
Interest rates and taxes raised throughout 1930's	0% interest rate policy and quantitative easing
Hoover focuses on balanced budgets	Huge deficit spending in order to stimulate growth
No Regulator preventing "run" on banks	Deposit Guarantees
No unemployment insurance or health care	Unemployment insurance and pseudo-guaranteed health care
Rising protectionism resulting in trade war and a near complete collapse in global trade	Some early signs of protectionism
Massive drought in the Mississippi Valley	It continues to rain

RBC Dominion Securities

RBC Dominion Securities

And yet, stock prices have sold off (to this point) almost in lock-step with the sell off experienced during the early stages of the great depression.

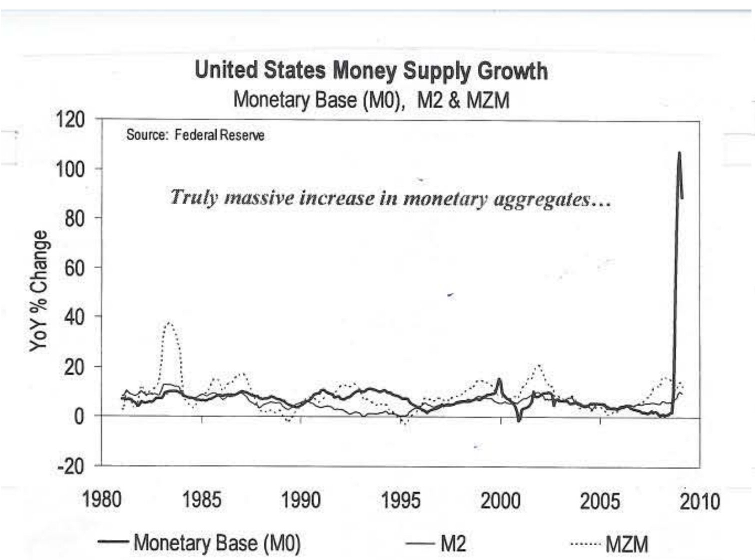
The next question I get is "well if not the great depression, then what about Japan's lost decade??" Again…can't be certain, but in hindsight Japan's primary errors were lack of speed and lack of size in responding. The US took their cues from these miscues and implemented the exact opposite response. Theirs' has thus far been truly massive and incredibly quick. It took Japan 5 years to reach a zero interest rate policy – it took the United States 15 months. Japan was slow in implementing a fiscal stimulus package. The US quickly announced that they will be spending hundreds of billions of dollars. Will it work? Who knows. But perhaps we can look to China to draw some comparisons.

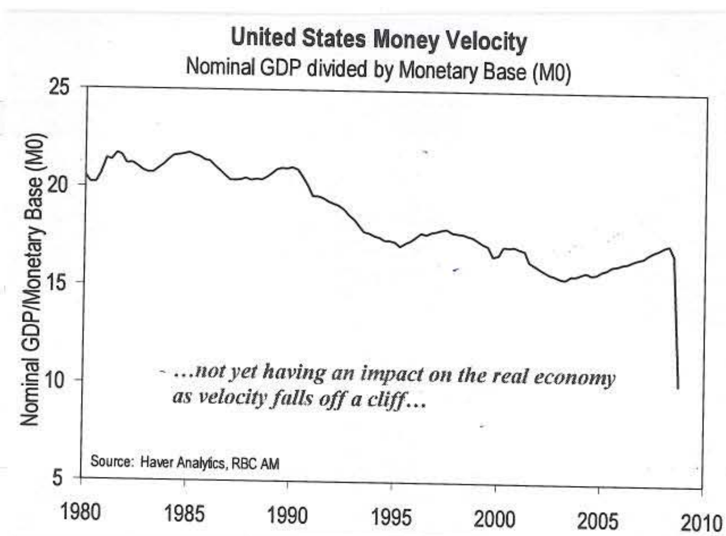
The Chinese stock market 'crashed' earlier than the North American and Global stock markets did (down approximately 65% in 2008), the Chinese government quickly threw everything but the kitchen sink at the problem by way of fiscal stimulus (see numbers below) and guess what…it appears to be working. Their latest GDP growth numbers showed a 6.6% growth in GDP (even as exports to the US have fallen off a cliff) and their stock market is up approximately 40% year to date!

FISCAL STIMULUS:

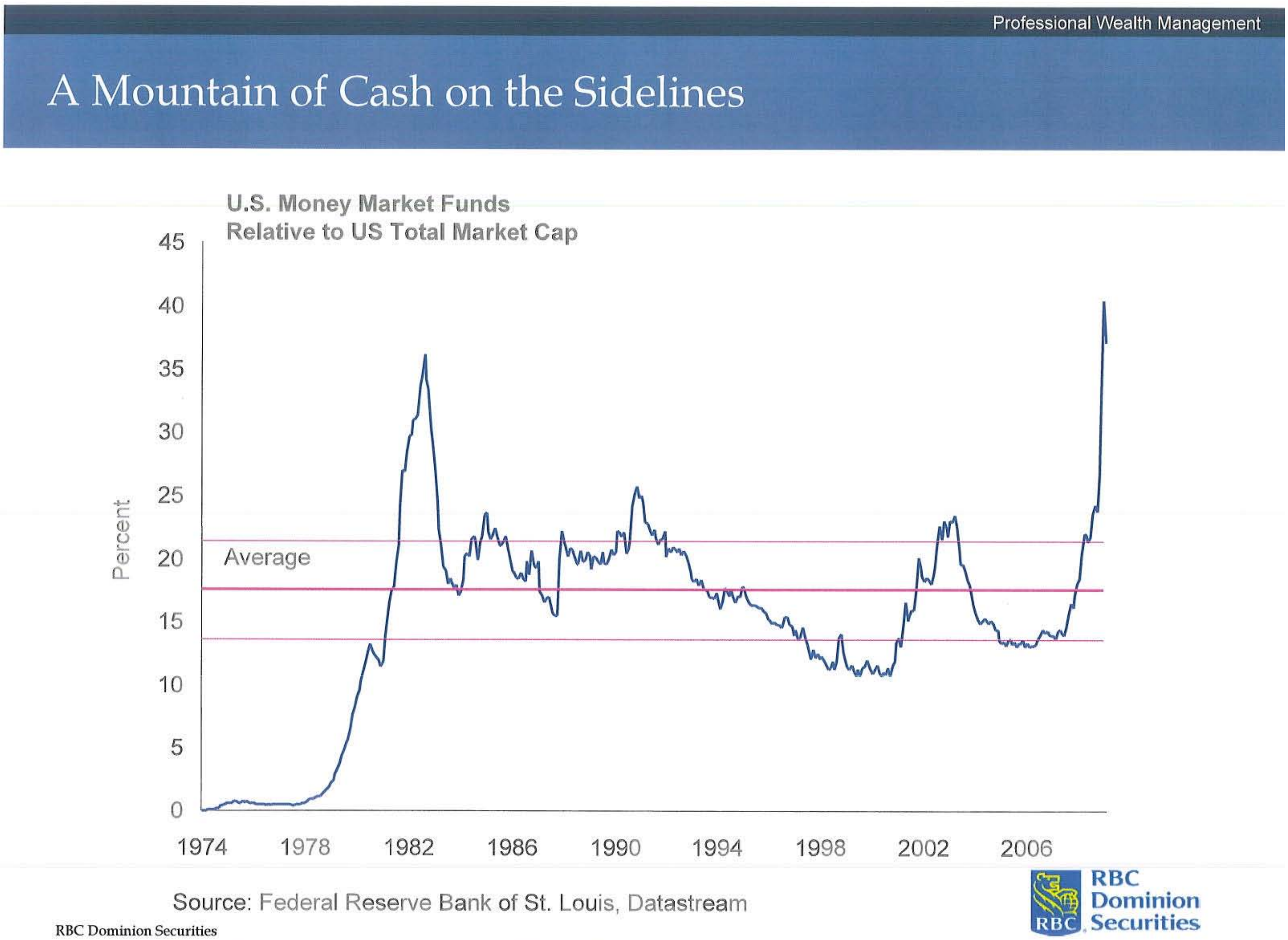
	$	% GDP
China	$ 586 billion	14.0%
US	$ 787 billion	5.5%
UK	$ 50 billion	2.5%
India	$ 26 billion	2.4%
Canada	$ 34 billion	2.0%
Japan	$ 85 billion	1.7%
Eurozone	$ 260 billion	1.5%
Germany	$ 39 billion	1.3%
TOTAL	$2292 billion	2.8%

"So if the US is printing all kinds of money and spending like crazy will this be inflationary??" As Maarten Jansen said in his recent presentation at our Client Appreciation event in Saskatoon last week, "I sure hope so, because that means it's working!" The first chart below shows the incredibly massive increase in money supply in the US. The reason we haven't seen any of this taking effect yet, is because the money isn't moving…the next chart shows money velocity in the US – it has fallen off a cliff as financial institutions and the American consumer alike shore up their balance sheets. But at some point, you have to believe that the massive wheels of capitalism and free-flowing credit will lubricate once again, and this enormous stimulus will in fact re-inflate the economy. Personally, I doubt that it'll happen as quickly or as severely as some might fear, but I do believe that inflation will happen – and I hope it does.

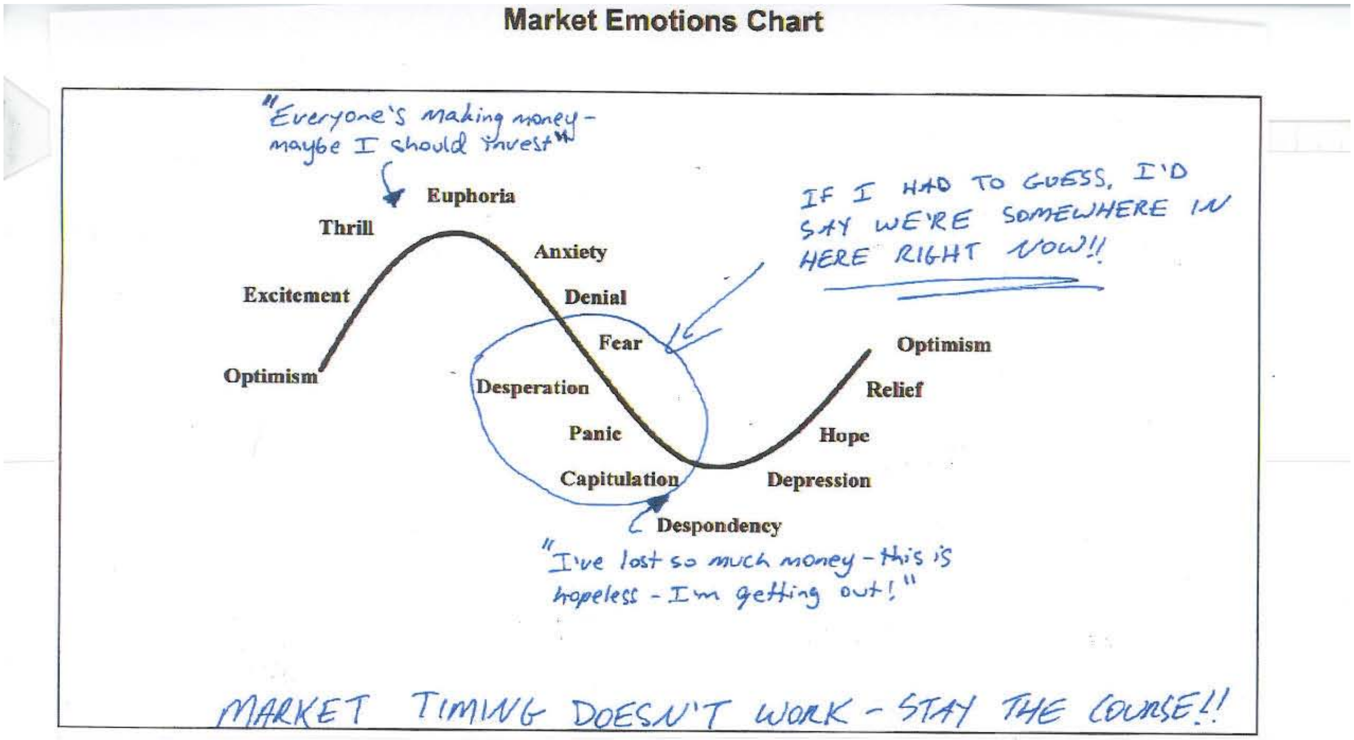




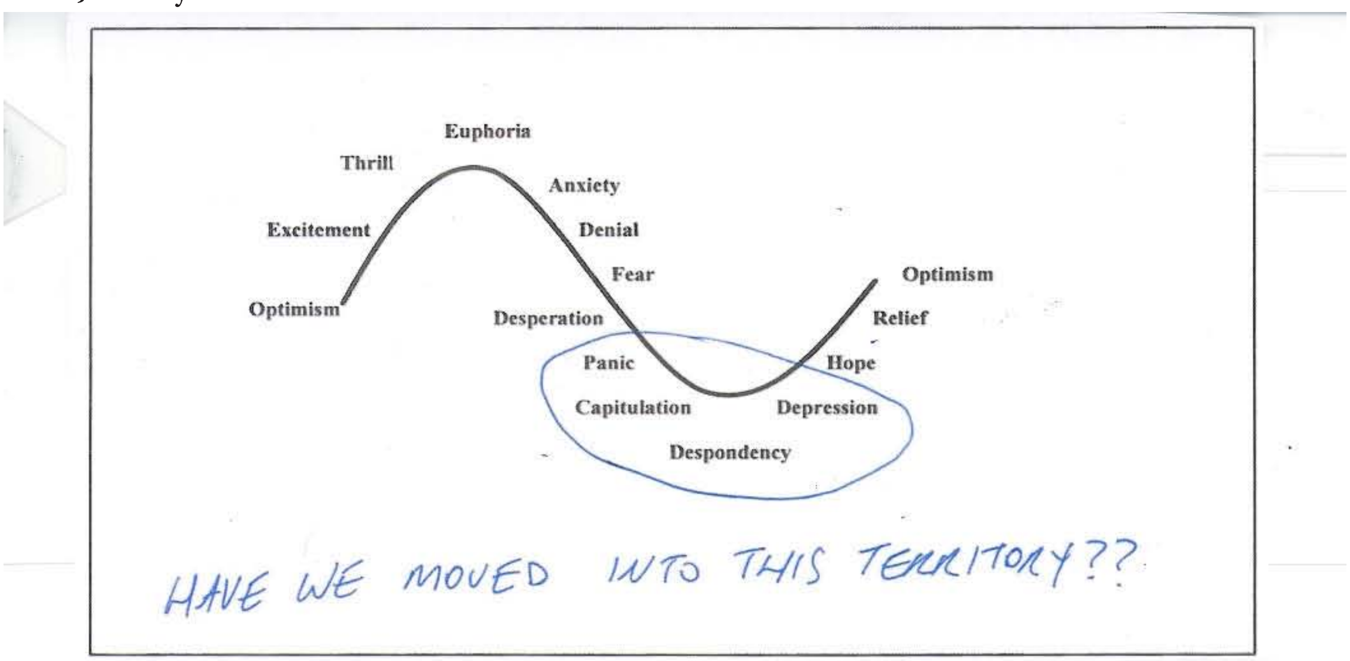
And once inflation happens, I doubt that many investors will be satisfied with having their entire portfolios in money markets, GICs and government bonds receiving close to no interest (remember that we're in as low of an interest rate environment globally as we've ever seen). Below is a chart showing the amount of cash on the sidelines as a percentage of total US market cap; a large percentage indeed. So what do you do if you can't get a decent interest rate in fixed income instruments and inflation threatens to erode the purchasing power of your dollars? Historically, stocks have been one of the only asset classes that have provided positive inflation-adjusted real returns over time. So if a good chunk of this money fears inflation and looks to the stock markets, you'd have to think that that would help bid up equity prices.



In October I put the following graphic in my Random Comments…

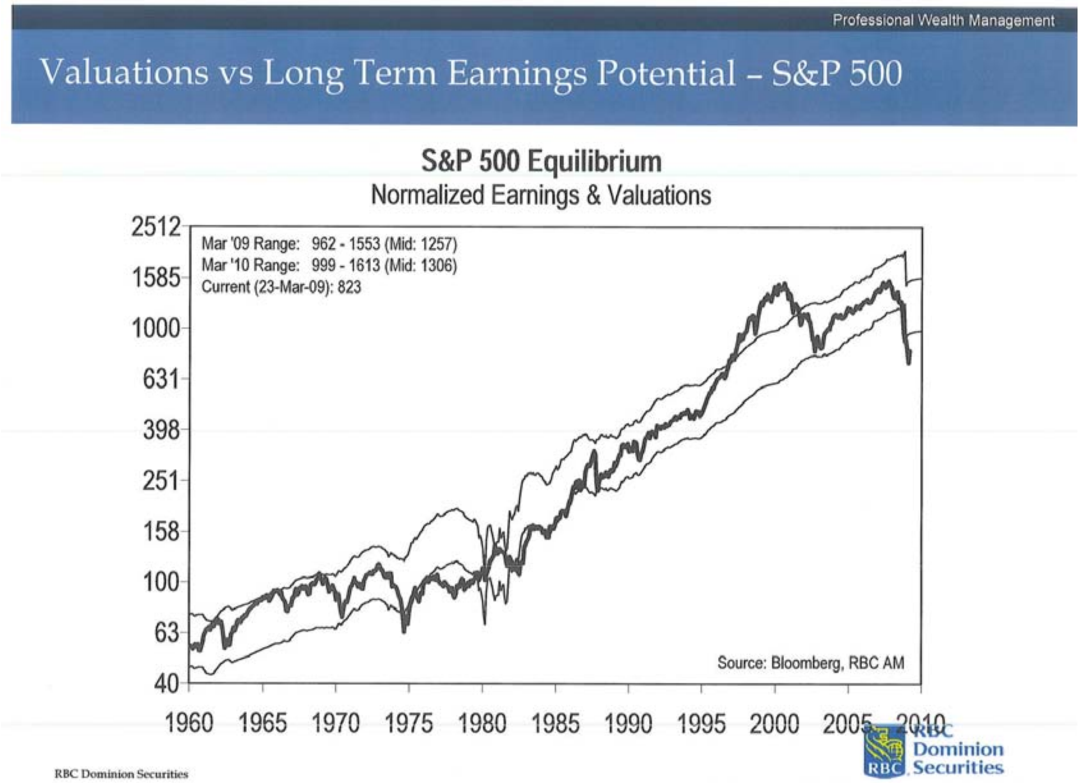


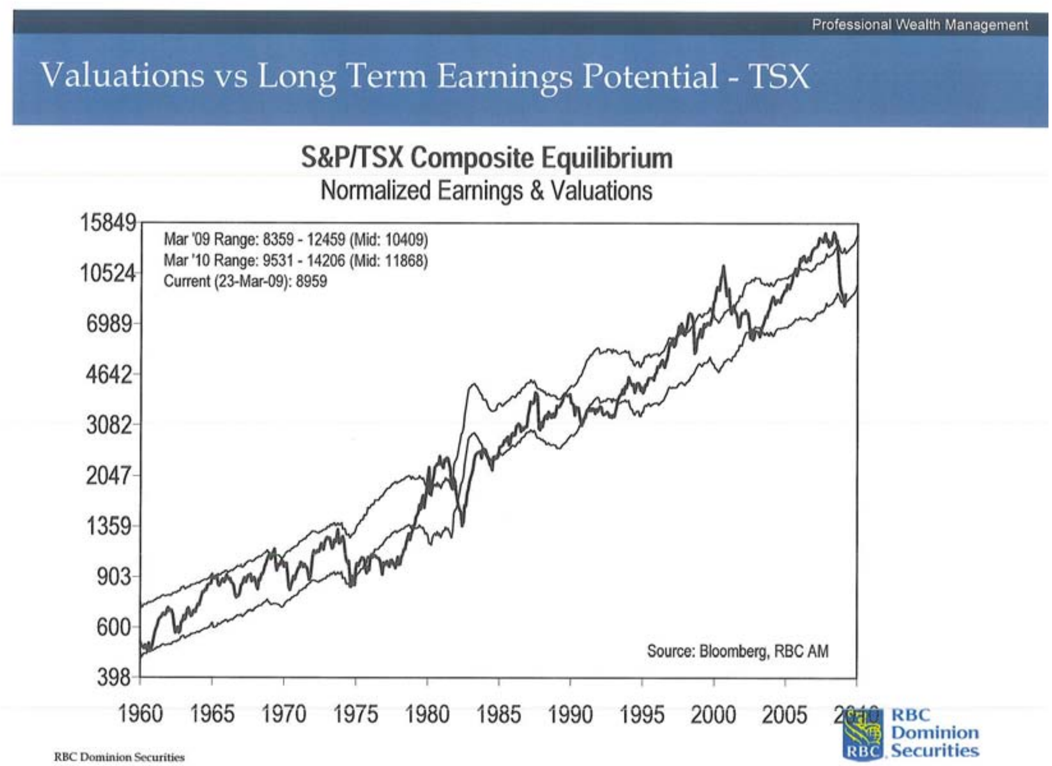
In late January I used this one…



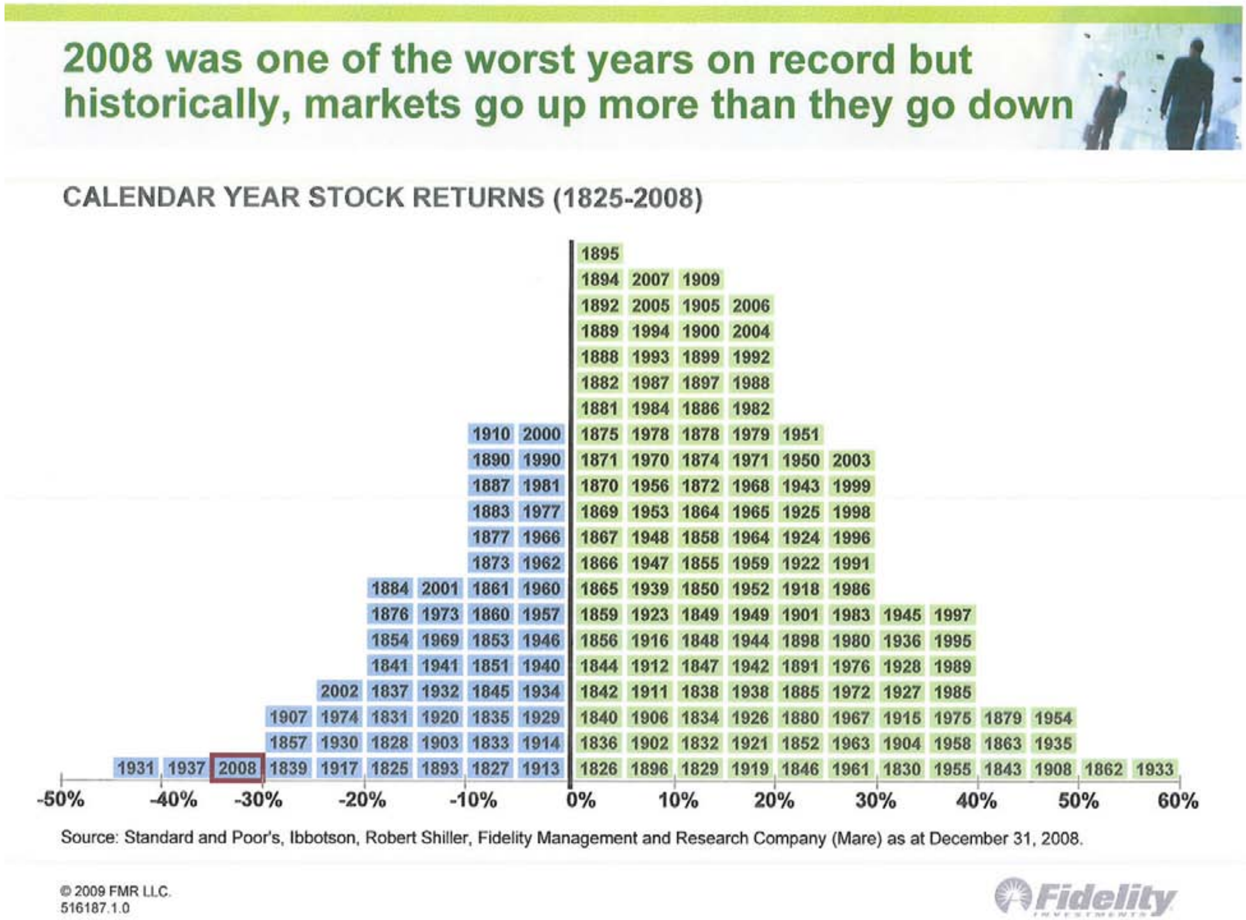
Where do you think we're at now? That's a bit of a trick question, because I don't know the answer (no one does), but I deal with investors emotions daily (both clients and professional money managers), and if I had to guess I'd say we're just now finally starting to see some signs of hope. I'm not saying that it'll be all blue skies and green pastures ahead, but I do believe that the worst of it is likely behind us. I don't know what the next catalyst will be, but chances are that by the time we recognize what it is, we'll be well into the stock market recovery. Ps – the market here in Canada rose by approximately 25% from March 9th – April 17th '09. Is that meaningful longer-term? I don't know yet.

Let's move on then to the idea of "are stocks cheap??" Have a look at the following two charts depicting the fair value bands of where markets should be trading based on normalized earnings and where they currently are (as an aside, notice the sharp drop in fair values reflecting the re-pricing of risk after Lehman's collapse)…





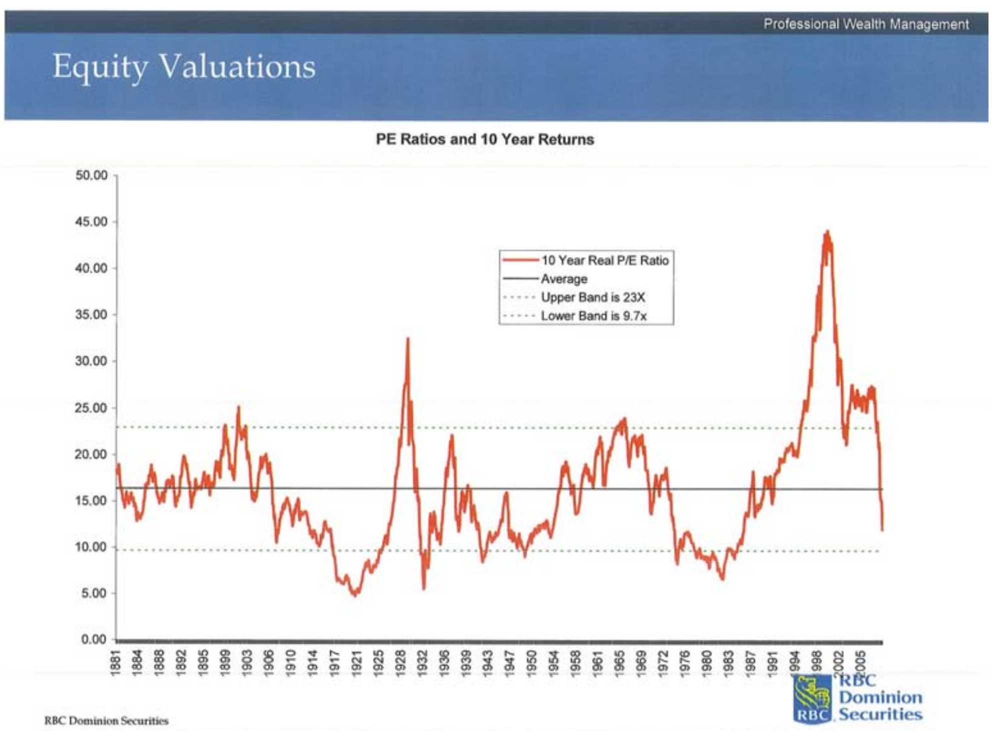
Also, take a look at the following chart from Fidelity. This one is similar to the one I put in my last Random Comments. Have a look at 1931 (way left), then 1932 (not great, but better), then 1933 (way right). Now notice 2008? Where will 2009, 2010, and beyond fall?



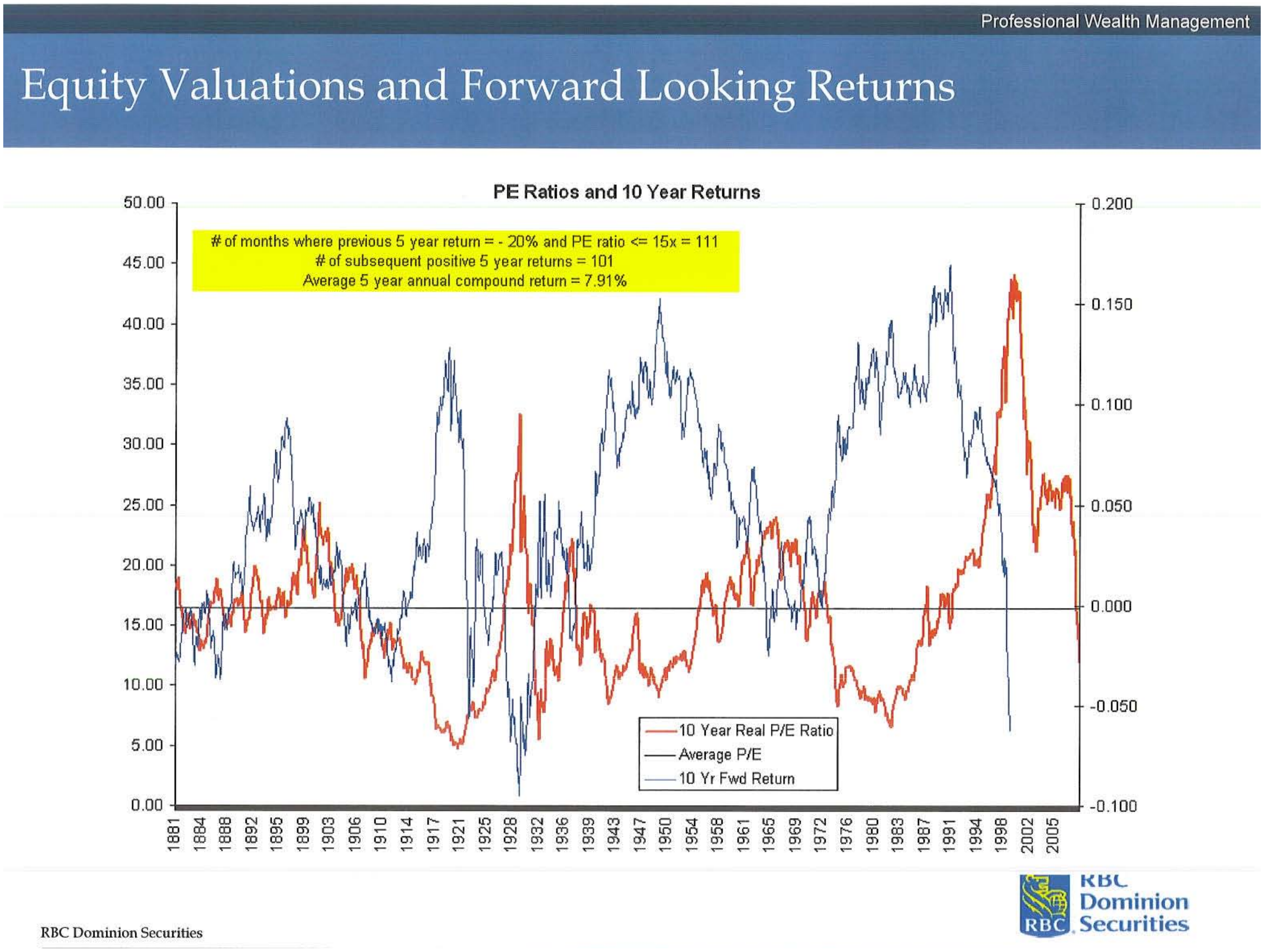
And before I close with the best charts I've come across in the past number of months to help build on the "are stocks cheap" question, I want to briefly touch on the "China factor". I am a big believer that China is redefining the urbanization scale and their growth has the potential to be a major catalyst (if not THE major catalyst) for the next bull market (whenever that may be). Consider that between now and 2025 economists are predicting that Chinese cities will add more than 350 million people (that's the entire population of the United States and 10 times the population of Canada!), there will be more than 200 Chinese cities with more than a million inhabitants in each (in Europe today there are only 35 cities of that size!), there will be up to 50,000 new skyscrapers (the equivalent of about 10 New York's!), there could be up to 170 new mass transit systems (in Europe today there are about 70!) and by 2025 two-thirds of China's citizens will live in cities (that's nearly 1 billion people)!!! And remember that China is not the only emerging market with this sort of trend!

Now, most of these people are moving to the big cities in search of what we have here in North America – they want internet, TV's, cell phones, cars – all of this requires massive amounts of infrastructure and 'stuff'. By 'stuff' I mean steel, concrete, copper, zinc, oil, gas, uranium, just to name a few. And furthermore, these people will continue to demand better nutrition…which bodes extremely well for agriculture (both inputs and outputs). That being said, you can see why I'm extremely bullish of energy, base metals, raw materials and agriculture at these prices. The demand is not going away, but because it's slowed, and because market prices are so low, it doesn't make economic sense for companies to go out and find new supply right now. You've got to believe that at some point, as demand continues to increase and existing supply is depleted (and since we're not bringing on new supply right now) we'll begin to see shortfalls, prices will rise, and we'll see another run up in commodities. It's simple economics 101 – supply, demand, and the cyclical nature of the industry.

Enough about the 'China Factor' for now. I'll close with two very busy, but very important charts. The first shows the average multiple that the market is willing to pay for one dollar of real earnings (and we all know earnings are volatile so we use the average of the trailing 10-year real earnings). In english, we're trying to find out how much market participants are willing to pay for every dollar of earnings that a company makes? So if Company ABC make one dollar of earnings per share, what am I as an investor willing to pay to own one share of that company? The long-term average is about 16 times earnings. So, if for the past 10 years, a company has made an average of one dollar of earnings per year, the market would (on average) be willing to pay $16 to own a share of that company. If the company has made $2 per share, the market would be willing to pay $32 per share. I apologize for oversimplifying this and beating the proverbial dead horse, but I'm trying to make an incredibly important point, so it's important to understand the data. We see that before the great depression, markets were paying a very high multiple for earnings. We also see that during the peak of the tech bubble in the late 90s and early 2000s, market participants were willing to pay absurd multiples for earnings (over $40 for $1 of earnings)!! We also see that today, market participants are only willing to pay somewhere around $12 for each dollar of earnings. So what do you think…are markets cheap or expensive? Stay with me…I'll build on this concept with the next chart too…



Now this chart is extremely telling…the red line is the same line as in the above chart, showing what the market is willing to pay for a dollar of earnings. The overlaid blue line shows your average annual return over the next ten years had you bought the index at that multiple. This chart does a great job of showing us (quite logically I might add) that if you pay too much for something (a high multiple in this case) you probably won't get great value out of it (returns over the next 10 years in our example). Alternatively, if you get something at bargain prices (low multiples) chances are you'll get better value for your buck going forward (higher returns). So when investors say "who would ever want to invest in the stock market, it hasn't returned a cent in over 10 years" one could very easily reply "yeah, but look at the price you paid if you bought in 10 years ago – one could argue that you significantly overpaid". In contrast, one could argue that top quality companies are "on sale" and provide incredible value for your investment dollar in the here and now. Warren Buffet says "price is what you pay, value is what you get." What will the blue line look like 10 years from now?? What value will you receive??



Finally, a few housekeeping items:

- We're still opening Tax Free Savings Accounts – if you don't have yours set up yet, give us a call.

- I know we just got through RRSP season, but it's time to start thinking about your 2009 contribution. The sooner you make your contribution, the better!

- And most importantly, please take a minute to think about your Family's overall financial picture…we are NOT just stock brokers, we want to ensure that all aspects of your holistic Wealth Management profile are looked after. Is your Financial Plan up to date? Have you had an Insurance Needs Analysis done recently? Have you addressed your Estate concerns? Are you thinking about setting up a Charitable Giving Program? Are you considering selling your business soon? These are just a few Wealth Management areas that we'd be happy to assist you with – at RBC Dominion Securities we have more financial planning experts eager to help than all of our competitors combined! Please give us a call if you'd like to discuss any Financial Planning or Wealth Management issue.

Sincerely,

Dan Hulak