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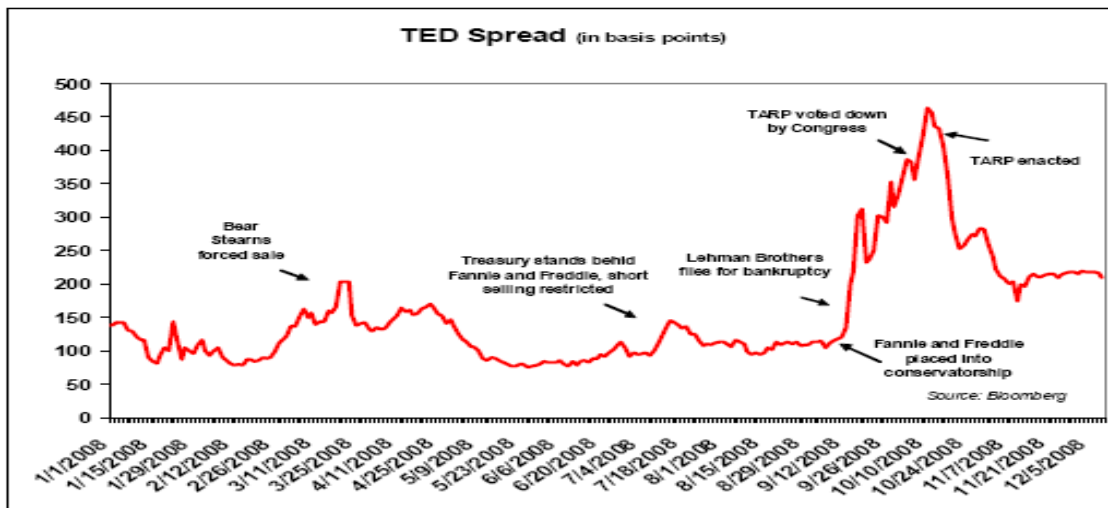
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Wednesday, January 14th, 2009

Year End 2008

2008 was a year to remember. The Toronto Stock Exchange had its worst calendar year ever; 33%, including dividends. The Dow Industrials' total return, -32% in U.S. dollars was its worse since 1933 and its 3rd worse ever. The broader S&P 500 lost -37% in U.S.\$, its worse year since 1937 and also its 3rd worse ever. The MSCI World Index's -42% was the worst yearly performance since the Index started in 1970. These last 3 were mitigated by a 22% rise in the U.S. dollar against the Canadian.

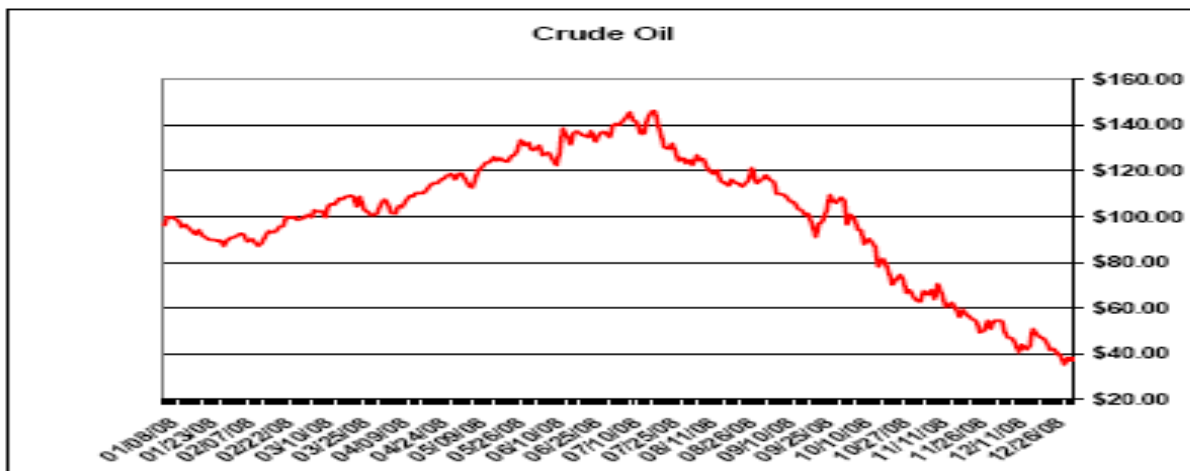
Last year, like 1929, 1974 or 1987, will be remembered for at least a generation. It was the most tumultuous year since the last depression. On January 21 the US Federal Reserve cut interest rates 0.75% but that did not save Bear Stearns which disappeared March 17, ending the 85 year existence of a company that survived the Great Depression without laying off anyone. On July 16, the US Treasury banned the short selling of financial stocks and indicated it would backstop mortgage brokers Fannie Mae and Freddie Mac. On September 7 those two behemoths were put into conservatorship. On Sept. 14 Bank of America bought Merrill Lynch, then on Sept. 15 Lehman Brothers filed for bankruptcy, the largest in U.S. history, ending the company's 158 year history. Goldman Sachs and Morgan Stanley quickly converted into banks and then there were none. All five of the large US investment dealers were gone. When Lehman Bros. failed lenders lost confidence in their counterparties and the TED spread (the rate at which banks will lend to one another over and above the risk free rate) went through the roof. In more normal times the TED spread hovered around 30 to 50 basis points (50 basis points equals ½ percent). When the credit crisis began in the summer of 2007 it moved up to 100 basis points, peaking at 200 basis points when Bear Stearns nearly collapsed. The Lehman Brothers bankruptcy shot the TED spread to over 400 basis points. Credit markets seized up. Only government intervention was able to get the TED spread back to a still high 150 to 200 basis points.



Source: RBC Dominion Securities, The Rooster January 5th, 2009

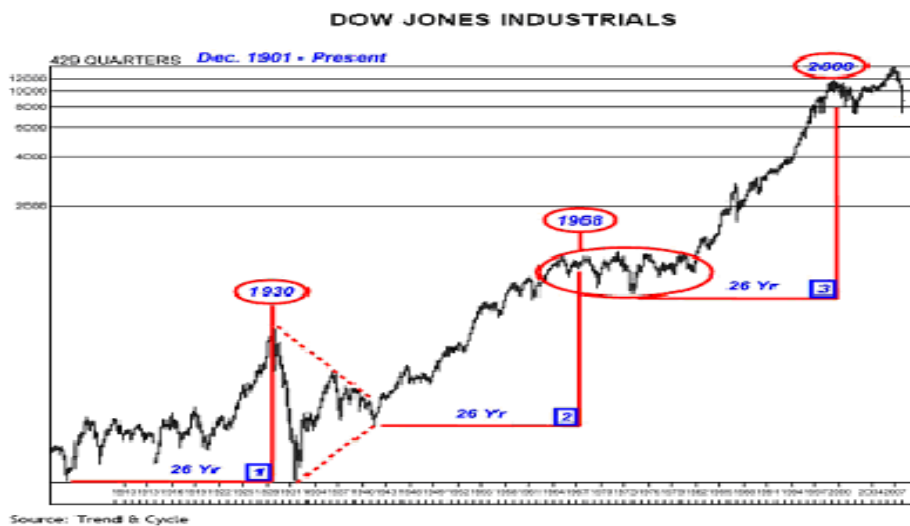
The old joke that is making the rounds again is that now when your bank calls to complain that your cheque bounced because of insufficient funds, you have to ask if it's you or them.

Energy is as important as financials to the Canadian stock market. Remember decoupling and the associated idea that incessant demand from China and India would keep the price of oil rising? By June of 2008 oil was approaching \$150 per barrel, while many other commodities were near all-time highs. Whether because of liquidation by hedge funds or the world wide economic slowdown, the chart below illustrates the incredible reversal in the price of crude oil that took place in 2008.



Source: RBC Dominion Securities, The Rooster, January 5th, 2009

The rolling 10 year return on the S&P 500 is now negative for the first time since 1941. I've been wondering what to call this, the first decade of the new millennium and with stocks back to where they were in the nineties, the 'noughties' seems right. This isn't the first decade that 'nought' has come from investing in stocks. The speculative peak of the late nineties looks more and more like the speculative peak of the late twenties and sixties. All three speculative peaks were followed by a decade or more of low returns in the stock market:



January 07, 2009

I've been looking for a silver lining for 2008 and my losing 5 kilos in 5 months probably doesn't qualify. One benefit of a depression is Madoffs (pronounced Made-off) are revealed. As Warren Buffett says it is only when the tide goes out that you see who has been swimming naked this time and it isn't a pretty picture. More scams may come to light as what John Kenneth Galbraith in his 1954 classic The Great Crash of 1929 called 'the bezzle' works its way out of the system. Galbraith said that in good times the bezzle grows by a combination of greed and more lax oversight. "One of the uses of depression is the exposure of what auditors fail to find." (<http://blogs.wsj.com/economics/2008/12/19/>)

Every quarter Wall Street creates new jargon. My favourite of 2008 is 'money heaven' as in 'where did Madoff's supposed \$50 billion go?' – Money heaven. 'Where did Satyam's balance sheet assets go?' – Money heaven. (Satyam is India's 3rd largest technology services company. The founder, now arrested, recently confessed that the company's books were faked. Satyam is said to mean 'truth' in Sanskrit but I think it translates better as Enron.)

Another extraordinary thing about 2008 has been the plunge in yields on only government bonds. There is no better measure of the Panic of 2008 than the negative yield on 30 day US Treasury bills that existed at times in October and November. Today under the Federal Reserve's official near zero interest rate policy 30 day T-bills yield pretty much zero. Rather than a risk-free return they offer what James Grant calls "return free risk". Yet, according to the American Association of Individual Investors, Americans are setting aside 42% of their portfolio in cash, the highest ever. (Barron's 01/05/09)

What must count as a silver lining to the crash in stock prices is that for the first time since the 1950's stocks yield more than bonds. Today 10 year U.S Treasuries yield 2.3% (2.7% in Canada) and the 2 year treasury yields 0.81% (1.0% in Canada). The S&P 500 index of the U.S blue chips has a dividend yield of about 3% and the S&P/TSX yields around 4%. The situation in Europe is similar.

There is a tectonic shift going on, to thrift from risk. Deleveraging and higher savings equals less consumption and lower profit margins. In this environment predictable income, in a word yield, is likely to be an enduring investment theme.

I've read that many investors are disillusioned with their advisors because the advisors did not get them out of the path of the bulldozer. (As a measure of the performance of the average Canadian balanced fund, the Globe Canadian Equity Balanced Peer Index lost 22.6% in 2008). I'm sick about not selling all stocks a year or two or ten ago to buy 30 year US treasury bonds (in Canadian dollars a 30 year US treasury bond returned 75% in 2008), but here we are. I never have claimed any ability to dodge crashes. The strategy I've advocated is to maintain a consistently balanced portfolio on the assumption that the future cannot be reliably predicted and my strategy hasn't changed. As a tactical matter it seems we are faced with a dilemma. Stock prices have already plunged and the economy is obviously falling off a cliff. Whether stock prices have already priced in a severe recession or a depression is debatable.

I'm envious but suspicious of advisors who are sure what to do. Recently I've read passionate and well reasoned arguments that: the only thing worth owning is US T-bills because deflation is going to ravage the rest of the world more (for example: www.marketoracle.co.uk/Article7939.html) Or gold is the one and only refuge from hyperinflation (for example: <http://www.bearly.com/pdfFiles/Williams14112008.pdf>)

We'll see and I'll continue to advocate diversification.

Wishing you all good health this year.

Sincerely,
George Stedman, CFA
Portfolio Manager
P.S. Please visit us at www.georgestedman.com