SPECIAL BULLETIN

THE PRIVATE
Wealth Manager

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Year-In-Review

As we begin 2010, I want to wish you and your family all the best. I hope that you were able to enjoy some quality time with your family over the holidays. Hopefully didn't eat too much turkey and already break your New Year's Resolutions.

With another year in the books, as is the annual ritual, it is time to reflect. 2009 was a truly remarkable year in so many ways and a few pages undoubtedly does not do it proper justice. That said, we'll give it our best shot, so let's take a look in the rearview mirror and reflect on the year that was.

As the market opened on March 10th, 2009, the S&P 500 was already down 25% for the year. Had the year ended right then and there, this would have marked the 9th worst year the index had ever had and the year was only 45 trading days old! As with most turning points in the market that had occurred abruptly over the past century, historians will debate for years to come that which caused the seemingly inexorable slide toward zero to suddenly reverse course. While the following list undoubtedly leaves out some of the potential explanations, here are some likely rationales:

- **Evidence that the big U.S. banks were getting turned around:** on March 10th, Vikram Pandit, CEO of Citigroup, sent a memo to employees indicating that the bank had generated nearly $20 billion of revenue in the first two months of the year, which was the most in any two month period for the bank since 2007. The news caught nearly everyone by surprise, as it was assumed that the large U.S. banks were heading toward disaster and yet if Citi, perhaps the worst off of all the big banks, could be generating huge revenues, then the situation may not be as dire as feared. On March 9th, Citi would close at $1.05 per share, but by the end of the week it would be up more than 70%, while the bank sector in general would rise more 35% for the week (the Big 6 Canadian banks would rise an average of 19% for the week).
- **U.S. policymakers get their act together:** For the first couple of months of the Obama Administration, things appeared rather feeble. Messages were crossed and the ultimate linchpin of Mr. Obama's financial plan – Treasury Secretary Tim Geithner – appeared ill-equipped for the job. But armed with a $787 billion stimulus package that had been enacted the month before, Obama, Geithner and the rest of the administration went to work rebuilding confidence. The key for

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investors seemed to be the idea that policymakers stood ready to do whatever it took to bail out the system and while doubts seemed to abound in the early months of the year, for whatever reason this feeling began to shift in the middle of March.

- **Green shoots begins to take root:** The global economy fell off a cliff in the fall and winter of 2008/09. But led by the Chinese, who put in place a $500 billion stimulus package late in 2008, evidence began to surface that the data was beginning to turn. It was not necessarily a case of growth actually occurring, but rather the data had started to turn less bad, as the rate of decline began to slow ("less bad" would become the most uttered phrase of the early part of the year). While it would be some months before the U.S. and most of the Old World economies would actually see positive data points, emerging Asia, led by China and India, reestablished a growth platform in the late months of winter, which became somewhat of a beacon for the rest of the world. On the night of March 15th on 60 Minutes, Ben Bernanke would utter his famous "green shoots" musing and this would quickly supplant "less bad", as the most abused phrase of the year (only to be replaced later in the year with "he did what?" in reference to a now infamous golfer).
- **Europe gets it act together:** The world was on the brink in no small part because the problems in Eastern Europe were spiraling out of control. Gross domestic production in places such as Ukraine, Poland and Latvia had plummeted more than 10%, while Western European banks were on the hook for hundreds of billions of dollars in potentially bad loans. A cascade of failures seemed a possibility and there were real doubts as to whether or not the major Western European nations were willing or able to extend a lifeline to their rapidly collapsing neighbours. But then they did. The IMF held an emergency meeting and the major economies of Europe pledged to extend billions in aid and the crisis was averted (at least for a period of time).
- **Just because:** Perhaps the last share sold at 666 on the S&P was the last share that needed to be dumped before there were only buyers left in the market. Perhaps a bear somewhere decided that he or she had made enough money and decided to cover a short, which caused a bunch of other shorts to cover and we were off to the races. Perhaps the episode of House the night before in which a patient had an illness that caused him to say whatever he felt no matter whom it might hurt tickled investors' funny bones and they came in the next day determined to own stocks. The point is, the market may have stopped going down simply because it was done going down.

Regardless of the cause or causes, it was off to the races and what would ensue over the next nine months would go down as one of the most terrific rallies of the past 75 years. Along the way, there were several things to add fuel to the fire, including:

- **A change to FASB accounting rules:** This one has all the signs of something that may come back to bite us, but on March 16th, the Financial Accounting Standards Board (FASB) proposed changing the rules of mark-to-market accounting in instances in which the market in question is unsteady or inactive. Three weeks later, FASB enacted the rule change, which proved to be big boon to many banks, as they carried hundreds of billions of assets on the balance sheet, which at the time lacked a steady or active market. Under the old rules, these instruments would have had to be valued at fair market value (which was very depressed), but under the new regime, these instruments could be marked-to-model, which allowed for a much more generous valuation range. Almost instantly, many banks went from badly capitalized to well capitalized, which led to …
- **The pay back of TARP:** The Troubled Asset Relief Program (TARP) was enacted in less than a fortnight in October of 2008. Most banks had no choice but to participate, as the U.S. government made it clear that whether you wanted to or not, you wanted to. While TARP likely helped to bring many banks back from the brink, giving them much needed capital when there was little capital available, it proved to be an intrusion for many, as direct government investment meant playing by the government's rules. With the change in the FASB rules and the huge recovery in revenue and profits (a product of bountiful spread businesses), many TARP participants led by the likes of Goldman Sachs and Morgan Stanley were able to pay back their funds much sooner than most people thought, signaling the growing strength of the banking sector.
- **The orderly bankruptcy of General Motors**: In 1953, Charles Wilson, then President of GM (he would soon become U.S. Secretary of Defense), uttered the famous phrase "what's good for General Motors is good for the country." Of course, it is hard to imagine that Mr. Wilson would envision that 56 years later, GM would be dying a rapid death under the weight of runaway health care and pension expenses and years of failed products. GM had so much debt and still employed so many people that it was frightening to think what a disorderly collapse of the automaker would mean. To put it in perspective, GM employed more than 250,000 people directly at the time of its seemingly imminent collapse and another million or so indirectly through its supplier relationships. For weeks, bondholders, the UAW and the government went back and forth on the bankruptcy of GM and at the end, it was eventful in how utterly uneventful it was. GM simply reorganized and carried on. Whether it will return to the bankruptcy courts in the years to come remains an open question (most Chapter 11 filers eventually return as so called "Chapter 22" filers), but removing the GM overhang with nary a ripple would at the very least not stand in the way of the market's upward climb.
- **An unexpected earnings renaissance:** Just when it looked like the market was flagging a bit in July, an unexpected recovery in corporate earnings drove shares higher. While top line growth proved elusive, intensive cost cutting helped to drive margin expansion and the dire forecasts of analysts proved unfounded. This recovery continued into the third quarter and this time

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some revenue growth returned, especially to those firms with significant international and emerging Asia exposure.

- **Interest rates remain low:** While there are many factors that have driven the rally, one that deserves a fair share of credit is the extremely low level of interest rates worldwide. Low interest rates promote risk taking, as the ability to generate returns on lower risk instruments is constrained in a world in which interest rates are very low. Leave rates low for long enough and the likely outcome is that risk-taking is going to occur.

But while there were many reasons for the strong rally, beneath the surface, there were still danger signs that kept 2009 from being an unadulterated success. Among them were:

- **Dubai nearly collapses:** Perhaps no nation personified the excesses of the credit bubble as much as Dubai. A nation with little in terms of oil production in a region that produces billions of barrels of oil, Dubai rose as a playground for the wealthy in the Middle East. Island hotels, ski slopes in the desert and untold investment dollars, Dubai was a veritable rocket ship for much of the decade. However, when it all went wrong with the world in 2007 and 2008, Dubai was inevitably exposed as a nation built on credit in a world in which credit was no longer available. While Abu Dhabi ultimately came to the rescue of Dubai, its near collapse should serve as an indication that while we have come back from the brink, we have not necessarily taken giant steps away from the brink and that problems still abound in the world.

- **Job losses reach frightening levels:** Not since the early 1980s had the United States experienced a jobless rate of greater than 10%. This all changed in 2009, with the unemployment rate hitting a peak of 10.2% in October. But this may not even do the situation a proper justice, as the ranks of those working part-time, but desiring full-time and those who had simply thrown in the towel would swell the ranks of the unemployed to more than 17% or roughly one-in-six Americans. The picture in Canada was not as dire; however, a strong Canadian dollar and a sharp slowdown in cross-border trade continued to devastate the manufacturing sector. The U.S. needs to generate 100,000 jobs just to tread water on employment and some forecasters have posited that it will be half a decade or more before the jobless rate comes even close to prior levels, as consistent monthly prints of 200,000 or more will be needed to make up for the million or so jobs that have been lost.

- **The U.S. dollar declines:** The U.S. dollar made much news during the year, as U.S. policymakers largely ignored what seemed to be the inexorable slide of the greenback. Despite all the headlines, the trade weighted U.S. dollar (DXY) only declined 6% for the year, but investors clearly seemed to fear that trillion-dollar deficits for potentially the next decade would lead to the continued diminution of the dollar. Against this backdrop, the Canadian dollar rose 15% for the year and somewhat painted the Bank of Canada into a corner, as the nascent economic recovery pointed to the potential need for rate hikes in the future, while the strength in the Loonie offset this need. Indeed, repeatedly in its monetary comments, the Bank commented on its discomfort with the strength of the Canadian dollar, although it resisted any more overt intervention measures.

- **Low quality stocks lead the rally:** While the broad market rallied significantly from early March into year end, the primary driver of this performance was so called "lower quality" stocks, which carry significantly more risk. While this was not atypical of this rally, but rather something that occurs quite often when the economy is transitioning from recession to growth, this leadership shift made it difficult for many investors to match the performance of the index.

- **The Democrats lose their momentum:** Following the election of November 2008, the Democrats had seemingly everything going for them. Huge majorities in the House and Senate and a president that had won by a wide margin (at least by today's standards) spoke to the potential for an ambitious agenda of Health Care reform, carbon trading and other nuggets. In late April, this agenda got a big boost when Republican Senator Arlen Specter defected, giving the Democrats a filibuster-proof majority in the Senate. And yet, despite this, the Democrats were remarkably unable to get much done during the year, as more conservative members of their own party held back a more liberal agenda. Against this backdrop, President Obama's popularity plummeted to amongst the lowest ever for a first year president, although the high level of job losses and the view that the fat cats on Wall Street had been bailed out while Joe Six Pack on Main Street had been left to fend for himself became the prevailing wisdom of many.

Okay, now that we've dealt with some of the what and the why, let's take a quick look back at some of the sectors of the TSX:

CONCLUSION

2009 will go down as one of the most remarkable market years on record. It saw one of the worst starts to the year ever recorded and one of the sharpest rallies in 75 years. Many decisions that were made throughout the year will likely have repercussions for years to come, but that will be a discussion for another day. Until then, enjoy the holidays whatever your celebration may be, happy New Year and here's to a quieter, more orderly 2010.

For information on issues discussed in this article, please call us at (416) 956-8888.

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