

Dave's Diary

August 2008

The rule is that financial operations do not lend themselves to innovation. What is recurrently so described and celebrated is, without exception, a small variation on an established design, one that owes its distinctive character to the aforementioned brevity of financial memory. The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version. All financial innovation involves, in one form or another, the creation of debt, secured to a greater or lesser adequacy by real assets.

– John Kenneth Galbraith

The wisdom of John Kenneth Galbraith, Canada's most eminent contribution to the study of economics, reminds us that, despite the consistent “Sky is Falling” proclamations of the business media, investors are not in uncharted waters. The world as reflected in equity markets will continue to unfold in much the same cyclical pattern it always has – rampaging bullishness followed by volatility-induced incredulity followed in turn by a period of retrenchment and risk aversion. Pinpointing the market's current progress along this bull/bust continuum is extremely problematic at present - the negative effects of the ongoing credit crisis are weighed daily against the positive influence of continued, rapid economic growth in the emerging markets of Asia and Latin America. With the outcome of this tug of war uncertain, we favour a balanced, risk-conscious portfolio strategy with positioning designed to benefit from current positive trends while also protecting profits generated from the strong five-year track record of Canadian equity markets.

Slowing Economies Ahead

Market strategists with the strongest long term track records have always followed the maxim that successful investing is “ a probability game, not a certainty game”, recognizing the pitfalls of inflexible, over-confident investment strategies. The challenge for investors then is to position portfolios for the most probable future market environment as suggested by the trends of recent data.

The most verifiably predictable change in the current global investing environment is the virtual certainty of slower global economic growth for the remainder of 2008 and into 2009. Ironically, the credit crisis which so clearly had its origins in the over-reaching debt issuance of US financial companies, is having greater adverse effects on the economies of the European Union and the UK than on the S&P 500. Nonetheless, the extreme scarcity of credit availability in the United States, which prevents not only a bottoming of the \$25 trillion US housing market but also growth-oriented investment by corporations of all sizes, is resulting in a rapid downsizing in estimates for future North American economic growth. Domestically, slowing exports to the U.S. resulted in the Ministry of Finance recently slashing 2008 Canadian economic growth estimates from 1.7% to 1.1%.

BRICs and Mortar

If the slowdown is increasingly apparent in the developed world, its potential effects on the emerging economies of Asia, Eastern Europe and Latin America are less clear. Projections as to the future course of the Chinese economy are now more difficult in the wake of widespread pre-Olympics industrial shutdowns which, at least temporarily, have depressed economic output. For Asia overall, the risks to future prosperity have been focused on inflationary pressures caused by rampant economic expansion.

The best case scenario in the months ahead would involve slower import demand from developed economies mitigating Asian inflation pressures (without slowing economic growth significantly), allowing the region to continue its 10%-plus economic growth rates. Importantly for Canadians, this outcome would ensure continued outsized demand for basic materials, the trend which has supported Canadian markets to dramatic effect since mid-2003.

Avoiding The Round Trip

In preparing portfolios for the future, Canadians must first realize their extreme good fortune in the recent past. For the five years ending July 31, 2008, the S&P/TSX Composite index has outperformed the MSCI World index by 11.13% per year and the S&P 500 by 15.33% per year. In Canadian dollar terms, this means that an investor in the Canadian benchmark turned \$100,000 into \$169,495 for the period, \$43,000 more than an investor in the global benchmark and \$62,168 more than S&P 500 investors. The magnitude and longevity of this outperformance is unprecedented in the post-war era. To state that Canadians have "had it good" relative to our global counterparts is a massive understatement. With this in mind, our portfolio strategy suggestions are designed in part to defend the profits garnered from strong domestic markets. The goal is to benefit from existing positive market trends while simultaneously avoiding a "round trip" for investments most likely to be negatively affected by slowing global economic growth.

Portfolio Strategy: Begin the De-Risking Process

It is entirely reasonable for Canadian investors to position portfolios for a post-Olympics reflation of the Chinese economy with subsequent strength in energy and resource investments. At the same time, respecting that global economic growth is slowing, it is also reasonable – bordering on necessary - for investors to move a portion of their assets to non-cyclical, stable growth market sectors to protect the profits generated by the strong equity markets of recent years.

Any cursory glance at market history reinforces the lesson that Canada's current outperformance of global markets, which may well extend into 2009, will not continue in perpetuity. The tree will not grow to the sky, and it is not "different this time". Canadian investors who have internalized the global equity trends of the past five years, believing them a New Paradigm and taking Canada's position as the #1 performing global equity market for granted, are the most at risk of major disappointment (and portfolio losses).

Investors positioned to benefit from current trends while simultaneously reducing cyclical risks are most likely to outperform in the less certain economic environments indicated for 2009 and beyond.

Feel free to contact me any time to discuss the ways your portfolio is designed to accommodate these global economic considerations.

Best regards,

Dave Hagenow

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