

Dave's Diary

November 2008

The 2008 Market Meltdown: Outlook and Strategy

After an already tough summer, global market conditions this fall have gone from bad to worse. While the problems in the credit markets have been known about for over a year now, they have not been well understood and thusly the course of events over the past several months has not been predictable.

By now most of the details surrounding the current situation have been well covered in the financial press, if perhaps in a somewhat disjointed fashion. By way of concise recap, the situation we have today is the result of an economic "bubble". In 2000 we had a bubble in technology stock valuations which burst between 2000 and 2002. The current bubble is not a stock valuation bubble but a *credit* bubble. Over much of this decade the lending practices of financial institutions in the U.S. (and to a lesser extent in other countries) became increasingly lax by historical standards and debt issuance had grown to an all time high. This was especially pronounced in the residential real estate market with significant growth in the issuance of "sub-prime" mortgages, which were essentially mortgages made to individuals who were not good credit risks. Still, the ability of lenders to securitize such contracts into structured investment vehicles and sell them to third parties took much of their own liability away and seemed to present a green light for lending institutions to issue mortgages to almost anyone who applied.

Where the problem became a global one instead of just a U.S. based one was in the fact that much of the sub-prime debt that had been securitized and sold was purchased by overseas investors (primarily financial and other institutions) who were attracted by the higher yields these investments offered. Of course, the booming US real estate market which was being fuelled by these lending practices eventually reached a saturation point and home prices began to fall. This is a normal part of the market cycle, but what was not so normal was the *degree* of residential housing oversupply and how widespread was the exposure to risky loans. As real estate prices started to decline and home buyers began to struggle with their mortgage payments, defaults began to increase the magnitude of the risk exposure on the part of lenders and those who purchased mortgage obligations began to become apparent.

The problems the markets face are essentially two-sided. The first problem, which really came to a head in September, was the impending freeze-up of the global banking system. As a part of their normal functioning, banks around the world lend each other vast sums of money on a short-term basis to meet day-to-day and week-to-week balance sheet needs. This is a vital activity and is analogous to the oil in an engine or the blood supply in a body. Because of the sub-prime mess, banks had essentially stopped lending to each other for fear that they might

not get their money back and/or to make sure they had enough cash on hand to meet their own liquidity needs. To alleviate this, central banks around the world began to step-in as “lenders of last resort” to the commercial banks. It quickly became apparent, however, that this was really only a stop-gap measure that did not address the underlying problem. Seeing the seriousness of this situation, the markets began to sell-off sharply in September. Eventually we got to a point where the US announced a major “bailout” initiative for their banks whereby the US Treasury proposed to buy-out the questionable loans residing on the banks’ balance sheets. This was followed by many other central banks around the world taking similarly supportive measures. Today we are at a place where all interbank lending has essentially been guaranteed by the government in most of the major economies. These are drastic measures and have not come without debate, but at the end of the day these actions were required to avert a depressionary scenario which legislators were quick to understand.

While it wouldn’t be prudent to declare the banking crisis a resolved issue at this time, it seems likely that the worst risk has passed with the government intervention measures that have been taken. This now leads us to the *second* part of the story which is the global economy itself. While one could go into a lot of detail about the economic state of the world currently, the primary issue is that with much tighter credit conditions, lower investment and real estate values, and high levels of personal debt, US and other consumers are not in a position to fuel economic growth with their buying activity anytime soon. How long it takes for the credit bubble to unwind and consumers to be back on solid ground is a matter of debate, but presently there is high analyst consensus that a number of major economies will be in recession for at least part of next year. This sets-up an uncertain and challenging environment for investors in 2009.

Investing in 2009

The unfortunate reality is that at over the past several months most investors – even those with conservatively balanced portfolios – have experienced notable declines in market value. With most of the world’s major stock markets down anywhere between 30-50% on the year, this is not surprising. There are a lot of questions on peoples’ minds right now but I would like present five key “rules” that I believe investors would do well to stick-to as we move forward through next year:

Rule number one – don’t panic. The reduced market values you may be seeing on your statements presently are no more permanent than the much higher ones you saw at the start of the year, and certainly don’t warrant sleepless nights. It’s been said countless times, but *markets are cyclical* – they go up, and then down, and then up again. It will be no different this time around.

Rule number two – don't sell everything to cash at this point. Moving equities to cash is a market timing decision and would have been a pretty good one at the start of the summer. Moving heavily in that direction *now* may be tempting but is a recipe for longer-term portfolio damage. It is quite true that the market outlook, even from where we are now, is vague at best, but having come as far down as we have the odds are that the bottom is somewhere near. You may tell yourself that you will come back into the market when we've actually *reached* that bottom, but the problem is that there will be no clear signals. We will know we have bottomed only after the market has sustained *several* percentage points of recovery. Missing those early moves can set-back your own portfolio's recovery by months or years.

Rule number three – rule number two notwithstanding, don't completely ignore your current investment positioning. While it is true that riding the cycle through is generally the best advice, this doesn't mean that adjustments can't be made to help minimize further downside risk and/or improve your positioning for the eventual recovery. I believe that major asset class shifts should be avoided at this time (ie. significantly changing the mix between equities, fixed income, and cash) but the positioning *within* the asset classes can and should be optimized for the conditions that seem to lie ahead.

For those who invest predominantly in mutual funds or other managed investments, the respective fund managers should be using their expertise to make the best possible positioning decisions for you. In such a case, the investor need only be certain that the manager and especially the *mandate* of the funds held continue to be the most appropriate to the investment objective and the market environment.

For those who invest partially or entirely in individual stocks and bonds, the analysis is a little more involved. Assuming that a recession or near-recessionary environment looms in 2009, high-growth stocks are unlikely to be in-favour overall, as corporate earnings growth, by definition, will be sluggish. During recessions consumers curtail their discretionary spending, so companies that make products that people *need* (like razor blades and toothpaste) will probably fare better than those making products people merely *want* (like luxury cars and designer handbags). Further, with little share price appreciation foreseen, investors are apt to prefer dividend and distribution paying investments, the rationale being that it is better to be paid something while waiting for the market to improve than it is merely to wait. With all of this in-mind, blue chip producers of consumer staples and healthcare products, as well as utilities with solid dividend payouts could be among the more favoured stocks. Certain income trusts will also be worth a look in 2009.

While consumers might not be spending next year, it seems clear that governments *will*. And one of the best ways governments can spend to not only stimulate the economy but also create jobs is to put money into *infrastructure*. Those of us who live around the GTA can certainly appreciate the need for upgrades to roads, bridges, and water & sewer infrastructure throughout the area, and the fact is that the US and many countries in Europe and Asia are in

similar situations. There is a true need for massive infrastructure spending throughout the world, and with governments everywhere now resigned to opening their purse strings in an effort to ward off recession, infrastructure is destined to be a primary beneficiary. Investors should do well in the next few years to “follow the money” and look for quality infrastructure plays.

Rule number four – don’t make big bets on where the market bottom is. While most investors’ biggest challenge will be resisting the urge to move *out* of the market at this time, some investors will be tempted to “call the bottom” and put more money *in*. As a long-term strategy this could be an effective move, but unless you have no problem at all with the possibility of taking a potentially painful step backward before taking two steps forward, limit your investment. There are always a lot of variables affecting market direction and right now those variables are as many and as complex as we have ever seen. The markets have been extraordinarily volatile and a few days’ move in one direction or the other is not very telling at this point. Whether the market is truly at attractive valuations right now is really dependent upon what corporate earnings will look like in the months ahead. Certainly the sell-off we have seen to this point has discounted some degree of pullback in earnings, but if those earnings come in weaker than currently expected over the course of the next several months, then there *is* room for the stock markets to move lower. A measured dollar-cost-averaging approach would be more prudent than a large lump-sum investment of extra cash.

Rule number five - try to remember that time is on your side. Many of us are saving for retirement and that is often years away. Current setbacks won’t look like much ten or twenty years from now. For those who are *already* retired or close to doing so, it is important to recognize that the retirement period is often a long one and *also* requires and benefits from a longer-term investment strategy. While in most cases your portfolio positioning should be more conservative than that of younger investors, the same dynamic of riding the market’s ups and downs in pursuit of suitable average rates of return applies. Where an income stream is being drawn from the portfolio, care need only be taken that such withdrawals are met without significantly impeding the portfolio’s ability for recovery.

My Very Best Regards,

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