LEITH WHEELER INVESTMENT OUTLOOK

Leith Wheeler
INVESTMENT COUNSEL LTD.

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" The Unexpected Will Happen "

- George W Bush, Dec. 1, 2008

George Bush's caution to Barack Obama would also be good counsel to those of us in financial markets. What a year that was! The S&P 500 dropped 52% from its high to low while the TSX dropped 49% and the corporate bond market went "no bid". Several weeks ago the *Globe and Mail's* front page reported that a major Canadian bank just predicted that the market bottom had been reached. While this was considered a newsworthy event by the financial press, some observers will view the report with skepticism. After all, this bank, which was up to its arm pits in Enron and was in deep with asset backed commercial paper, was now predicting the unpredictable - the timing of a market bottom.

The bank's view may prove to be right. In the financial business, predictions are made all the time. Some prove to be correct. Some prove to be early, which is the marketing spin for being wrong. At Leith Wheeler we also have a view on markets, but having failed to predict this financial market collapse, our readers must be somewhat skeptical as to our ability to predict the future. In fact, the developments over the past year have only confirmed our view that attempts to time the market will be unproductive. Whether professional or not, most investors did not see the depths of this decline because the events were, for the most part, unpredictable. The unexpected did happen. Looking ahead, the events that are known are priced into the market and it is the unknown events that will determine the markets' direction.

Our approach is to build diversified portfolios comprised of strong companies that can weather economic storms, that are acquired at sensible prices and that give our clients exposure to long term economic growth. There is no evidence that portfolio results can, over the long term, be enhanced by market timing. Anecdotally, we have seen many investment managers touted as possessing the ability to forecast markets because of a recent success or two, only to miss the next move and be cast aside. The fact is that managers don't live long enough to experience a statistically significant number of market swings required to prove proficiency. On the other hand, stock selection skills can be confirmed statistically because there are many stocks and many decisions in a portfolio. Leith Wheeler has proven stock selection skills and that is the hand we play.

Nevertheless, many of our clients are asking if this decline is something out of the ordinary. Could we be entering a period equivalent to Japan in the 1990s or the depression of the 1930s? Let's look at how this market compares to declines* since 1973:

35 years of Bear Markets plus 1929

Start Date	% Decline S&P 500	Duration Month	Real GDP Decline %	Market Upturn Lead Months
1929	-86%	34 mo	-27.0%	8 mo lead
1973	-48%	22 mo	-3.1%	5 mo lead
1980	-27%	21 mo	-2.2%	4 mo lead
1987	-33%	3 mo	N/A	N/A
1990	-20%	3 mo	-1.3%	5 mo lead
2000	-49%	31 mo	-0.2%	11 mo lag
2007	-52%	14 mo	N/A	N/A

** Market decline of 20% or more. Based on daily close. Source ISI Group, Leith Wheeler*

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As the table shows, this decline, if it is over, will be about equal to the declines of 1973 and 2000 bear markets. However, it feels worse than the 2000 bear market to us. That's because the earlier bear market focused on internet stocks while many value and 'old economy' stocks actually performed quite well. By sidestepping stocks with silly valuations, our investors avoided much of the damage.

However, the decline this time has been widespread and not nearly as kind to value investors. There are a couple of reasons for this difference. One is that a huge divergence in valuation between value stocks and other stocks did not occur at the top of this cycle as it did during the internet bubble. Another factor is that bank and financial stocks, which are a traditional home for value investors, were ravaged as their exposure to bad mortgage loans and impaired securities became apparent. These problems are more pronounced in US financials, but they have also impacted Canadian financial stocks.

In the writer's experience, this decline most resembles the 1973-1974 bear market due to the magnitude and breadth of the two declines. That bear market began in response to rising interest rates and inflation. At that time, the economy was still strong and there were growing labour shortages. In the summer of 1973 a price freeze, universally viewed as a disaster by business, was put into effect in the US. Tight money and rising interest rates caused "disintermediation" at Savings and Loan companies. That meant that interest rates in the market were higher than the law allowed S&Ls to pay. As a result, mortgage financing for residential home buyers dried up. Then, with commodities still in short supply and hoarding taking place, the Arab oil exporters embargoed the United States to gain political leverage. Long line ups formed at gas stations due to lack of supply. The price of oil quadrupled. You couldn't give away a gas guzzler. By the fourth quarter of 1974 inflation had risen to 12% and GDP declined. Unemployment peaked at 8.7% in mid 1975. All this time, an unpopular president was focused on Watergate while the war in Vietnam continued. Stocks fell to extremely low valuation levels. Dividend yields peaked at 5.3% while the yield on long term US Government bonds was just over 8%. The market traded at only 8.6x trailing earnings.

While the factors causing the declines were different in 1973 from those in 2008, the market sentiment was similar. People were very worried then that the economy was out of control, that corporate earnings were suspect, that leadership was missing and that things would invariably get worse, not better. Long before there was evidence of a turn in the economy, the stock market began to rise.

Descriptions of conditions leading to the market high in the late summer of 1929 have some eerie similarities to this cycle's peak. The US had enjoyed a seven year expansion. Money was relatively easy and there was a boom in housing, capital investment, autos and appliances. Unemployment fell to less than 2%. The market had more than doubled from 1926 to September 1929 and speculation was rampant, much of it fed with borrowed money. Writers describe the mood of the time as a feeling that "the country had found the secret of permanent prosperity".

By November 1929 the market had fallen about 35% from its highs. But despite a strong rally in 1930, the market was not ready to recover and dropped further to bottom in 1932 with a total decline of 86%. Are there parallels to today? Yes there are. The boom, euphoria, and use of leverage are present, but to a lesser degree in this cycle. This time, the "secret to wealth" was housing more than stocks. Leverage was used beyond reason in that sector. However, leverage was also overused in the stock market this cycle by hedge funds, private equity vehicles and through the use of derivatives and futures. In the late 1920s, many new trusts were formed to invest in stocks. The public purchased these blind pools with virtually no disclosure. They, in turn, bought stocks which also had poor disclosure. The blind invested in the blind. The parallel this cycle is the hedge fund. Many institutional and private investors poured money into hedge funds without any idea how the money would be used or how much leverage would be applied. When the history of the current bear market is written, the forced selling by hedge funds and other investors responding to margin calls will likely be seen as a major reason for the speed and size of the decline just as it was in the 1929 decline.

There are also some important differences that explain why what started out as a normal business cycle contraction in 1929 turned into a major depression, destroyed so much market value, saw mortgage defaults rise to 30% and unemployment reach 25%. While there were many factors at work, probably the most significant was that deposit taking banks were allowed to fail. Over the first two years following the start of the bear market, 5,096 banks in the US were unable to meet their depositors' demands for funds and went under. Half of these banks were in communities with a population of less than 1000 people. The failure of the local bank undermined confidence and destroyed purchasing power across the US. This is not happening today. While the investment bank Lehman Bros. was allowed to fail, it did not affect depositors. Today, unlike 1929, monetary authorities guarantee deposits. They have lowered interest rates, purchased securities to increase bank reserves and have purchased bank equity all to ensure that banks remain solid and are able to make loans.

There are other significant differences between this cycle and the 1930s including an economy less dependant on agriculture, exchange rates that float and are not pegged to gold and a better understanding of the role of fiscal policy today.

In the 1930s, about 25% of the labour force was employed in agriculture. The collapse in agricultural prices resulted in banks calling loans to farmers. It wasn't until 1933 that government agencies were established to take over mortgages, reduce interest rates and postpone payments by farmers. The economy has much less exposure to commodity prices today due to the larger role of the government and service sectors and growth of manufacturing. There was no unemployment insurance and little in the way of other "safety nets" that are in place today.

Fixed exchange rates, the norm of the time, required monetary policy to be focused on maintaining the exchange rate rather than economic growth. With the exchange rate fixed and central banks having agreed to provide gold upon demand, deflationary measures were required when demand for foreign currency exceeded supply. The tool kit to accomplish this included increasing interest rates, imposing tariffs on imports or applying exchange controls. In the early 1930s, international trade collapsed as these tools were used extensively. Today, exchange rates float freely and, while it may involve some uncertainty to importers and exporters, it allows for quick adjustments to changing conditions. The recent drop in the Canadian dollar, for example, will cushion the economic blow to many Canadian businesses.

Attitudes have also changed since 1929. In "The Great Crash", which is J.K. Galbraith's account of the times, he marvels at how wrong economists and business leaders were. In the early 1930s the general pronouncement from business leaders, economists and government officials was that "the economy is fundamentally sound". The last politician to try that in 2008 lost his presidential bid. The broadly held view in the early 1930s was that sound fiscal management required a balanced budget. That is exactly what was achieved in 1930 despite the economic collapse. After 1930, fiscal policy turned somewhat more stimulative but the deficits were too small in relation to GDP to have a significant positive effect on growth.

One of the lessons learned from the 1930s and from the Japanese experience of the 1990s is that both fiscal and monetary policy must be stimulative when consumers and businesses are attempting to reduce debt. Expansionary monetary policy, which increases bank reserves and the money supply and reduces the cost of borrowing, will help, but it is not very effective when lenders don't want to lend and borrowers don't want to borrow. Recently there has been a surge in the monetary aggregates as the central banks in both Canada and the US inject liquidity. This is quite different than what occurred in the 1930s when the money supply was allowed to shrink. In normal times, the surge in the money supply would be expected to cause inflation. But these are not normal times. The increase in money is being saved and is paying down debt. Economic activity will not increase while this deleveraging is taking place unless spending comes from another source. This is where countercyclical spending by government should come in. Such spending was applied too lightly in the 1930s and too lightly in Japan in the 1990s. It appears that the incoming US administration understands this, and that Canada will be producing an expansionary budget later in January.

Our clients may be surprised that we would endorse deficit spending which might lead to a legacy of debt for our children. Clearly we don't endorse a structural deficit that would continue once deleveraging is complete and the recovery well underway. Government spending should be counter cyclical and surpluses should be run when the economy is strong. Under current conditions however, deficits will reduce the level of unemployment, could provide valuable long term infrastructure assets for the country and will not likely cause inflation.

So, our view is that this bear market, while a big one, is not THE BIG ONE. Monetary policy is expansionary and has been for many months. Fiscal policy in Canada is turning to expansion. In the US, a structural deficit is going to become much more expansionary in the early going of the Obama regime. The policies that are in place or underway will moderate this downturn not exacerbate it. Margin calls and the resulting forced liquidation of stocks have likely run their course. There are large cash reserves in money market funds that earn virtually no net return for their owners. These funds will fuel the demand for stocks once confidence returns. While the corporate bond market continues to suffer from wide yield spreads over government bonds, the valuation of corporate bonds has priced in an expectation of default that would be greater than what was experienced during the depression. At some point, probably when the market gets a sense of the depth of the downturn, investors will move from T-bills offering only fractional returns to higher paying solid corporate issues.

Valuation levels for the equity markets as a whole are exceptional. Admittedly, market valuation tools are blunt instruments. They are blunt enough that they did not signal an overpriced market to us 12 months ago. Nevertheless, they are now at levels that investors see once or twice in a lifetime and indicate the potential for very strong returns. Currently, the Canadian market is trading at about 10x trailing 12 months earnings. The S&P 500 is about 10.5x earnings. Looked at another way, $100 buys about $10 of earnings for an 'earnings yield' of about 10%. Today the difference between the earnings yield on stocks and the yield on T-bills is at levels not seen in Canada since the depths of the 1974 recession. In the US, the earnings yield advantage to stocks exceeds all periods since the beginning of the 1960s. It is a given that earnings will decline next year so a good test would be to use estimated earnings. Applying an earnings haircut of 25% to Canadian companies and 12% to the S&P 500 provides earnings yields of 7.9% for Canadian companies and 7.7% for US stocks. There is still a large spread over T-bill rates. In an absolute sense, the price/earnings ratio for stocks (the inverse of the earnings yield) are at levels not seen since the 1980s. Historically, stocks have produced good returns from these valuation levels.

While earnings may be volatile, dividends tend to be more stable. Current dividend yields are about 4.0% in Canada and 3.1% in the US market. Compared to long term US treasury bonds, the dividend yield on stocks is the highest in half a century. While some dividend cuts can be expected in a recession both the dividend yield on stocks and the yields on corporate debentures are very attractive given government bond yields.

Price to book value is another measure that points to opportunity. On a broad cross section of Canadian stocks, the price/book value (book value is the shareholder equity on company balance sheets) is the lowest we've seen in the 25 year history of our firm. Using the TSX, which is weighted by market capitalization, the price to book index is back to 1980s levels. Likewise, the S&P 500 price to book is down to levels last touched in 1990.

These measures all suggest strong valuation characteristics for the market as a whole, especially with such low rates on government securities. They do not however, say when good things will start to happen or ensure that the bottom has been reached. Neither do we. History shows however, that long before the economic statistics indicate that a recovery is underway, and while the broad consensus is that the economy is a mess, the market will turn. In 9 of the last 11 bear markets the market turned up before the economy (in one case there was no economic recession). While we cannot forecast the timing of a market recovery, we can forecast that there will be a recovery and that the upswing will be met with skepticism. There will be all sorts of things to worry about but markets will rise as they do when bear markets end.

The staff at Leith Wheeler is focused on protecting your capital and making it grow. As owners of the firm we are directly affected by your portfolio results and have every incentive to produce positive returns for you. Our approach has stood the test of time and we are not about to change direction. We thank you for your patience during this time and we believe you can expect a better year in 2009.

Bill Wheeler, CFA
Chairman

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