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First Quarter 2009

The economy fell off a cliff after the U.S. Treasury decided to allow Lehman Brothers to fail last September. The U.S. economy (GDP) contracted at an annualized rate of -6.3% in the 4th quarter of 2008. This was the worst rate of decline since the 1930's and the economy was probably pretty much as bad in the 1st quarter of 2009. In all the recessions since World War II, the U.S GDP never shrank more than -2.9% (1981-82). If sustained for 12-months, the -6.3% would be the worst since the 1930's.

References to the 1930's abound today; this recession is now 15 months long, second to 1974-75's 16 months, which was next worse to the 1930's 48 months. Corporate profits in the U.S. are now in their worst successive negative earnings growth streak, at 7 consecutive quarterly earnings declines, since the Great Depression's 12 quarters from 1930-1932.

But we've never seen a policy response like this one either. John Maynard Keynes wrote of the 'paradox of thrift': if everyone saves money in a recession, aggregate demand will fall which will in turn lower total savings. Governments are trying to fill the gap left by the shocked US consumer. Unprecedented monetary policy measures, such as quantitative easing (buying bonds directly to lower interest rates) is being coupled with unprecedented fiscal policy of ambitious spending and tax cuts that are on a level far beyond the norm.

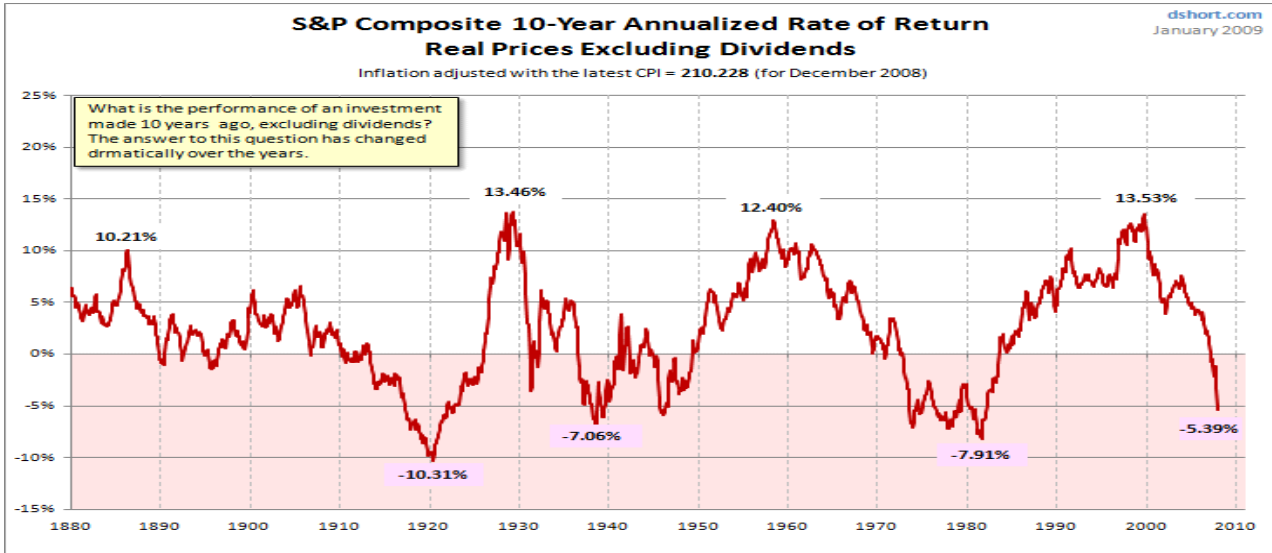
Monetary and fiscal policy work with an exasperating lag. In the first quarter of 2009, the S&P 500 (U.S. blue chips) had the distinction of posting its biggest ongoing loss ever on a quarterly basis. The index fell 11% in U.S. dollars, its 6th quarterly drop in a row, for a total 47.7% decline over the period. The Dow Jones Industrial Average lost 12.5% in the first quarter, its worst first quarter since 1939, but gained 7.9% in the month of March. The stock market rally that began March 9th was, as of last week, the best since, you guessed it, the 1930's (1938). Optimistically, the market may be sensing if not an economic improvement then a moderation in the rate of decline.

This past winter car sales were selling slower than the rate at which cars rust. Total registered vehicles divided by the annual sales rate was 23.9 years, the highest ever, which is unsustainably bad.

The epicentre of this economic mess is residential real estate. The single idea that got us into this mess is what Warren Buffett described as the great assumption that house prices always rise on average, because they always had. This simple fallacy made possible all the silly lending (CDO's and ABS's, etc.) and silly buying of unaffordable homes.

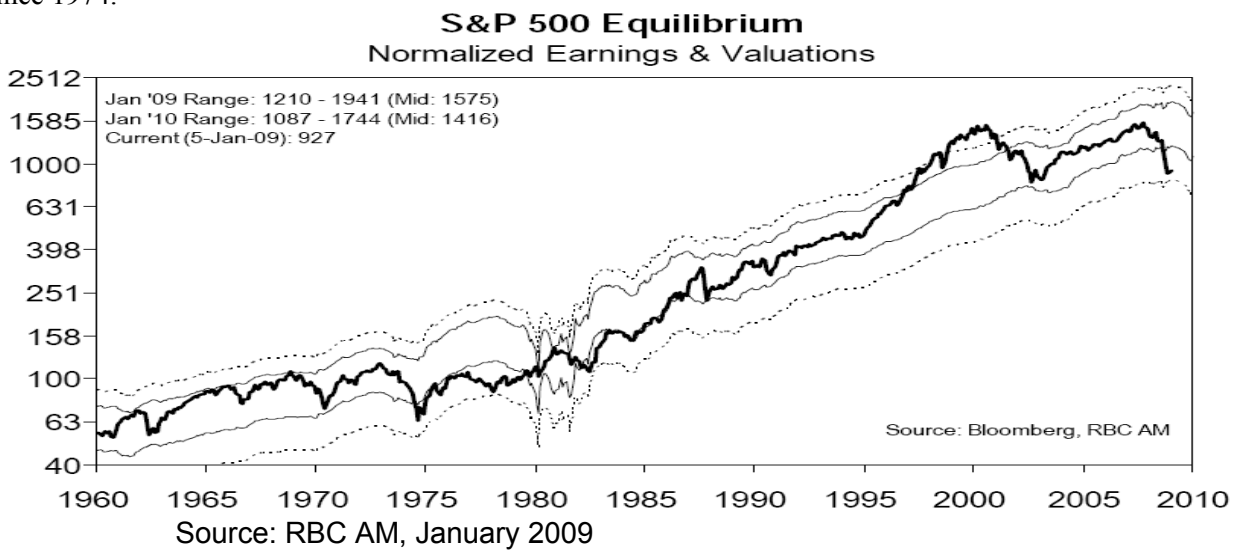
T2 Partners have chronicled the real estate debacle from the beginning and Alan Abelson summarized their latest update in Barron's (04/11) "As for home prices...the unbroken monthly decline since they peaked in July 2006 will continue to make buyers hesitant and sellers desperate, while the 'tsunami of foreclosures' will maintain the huge imbalance of supply over demand... [D]istressed sales account for a formidable 45% of all existing home sales... They expect housing prices to decline 45%-50% from their peak (currently prices are down 32%) before bottoming in mid 2010." T2 Partners' reports are available on the web and are highly recommended.

So the economy stinks. But, so do stock prices. This chart shows the rolling ten-year annualized returns on the S&P 500 for the last 130 years. For only the 4th time rolling ten-year returns are negative, down 5.39% per year (adjusted for inflation and not counting dividends). At the peak of the great stock market bubble in 2000, they were up 13.53% per year.



Source: Yale School of Management, January 2009 <http://dshort.com/charts/SP-10-year-returns.html?SP-Composite-10-year-annualized-real-rate-of-return-exdiv>

This next chart is familiar from Dan Chornous's strategy publications for RBC Asset Management. Based on normalized earnings and valuations, it shows stocks are as far below fair value as they've been since 1974.



Source: RBC AM, January 2009

So far I've tried to make the point that a) the economy stinks because b) the house price bubble has popped and c) stock prices have already gone down like seldom before. This last chart addresses overall value. It is known as the 'Buffett Metric'. Back in 2000 Buffett wrote an article in which he predicted that returns for stocks for the next decade would at best be very low (which I was happy to share with my clients at the time). In 2001, Fortune Magazine first printed this chart which I particularly like because it is so general. They updated it this February (the article is enclosed). It takes the value of all U.S stocks divided by Gross National Product. Buffett wrote in Fortune 2001 "if the percentage relationship falls to the 70% to 80% areas, buying stocks is likely to work very well for you."



Source: Fortune Magazine, "Buffet Metric says it's time to buy", February 4th, 2009, Pg.1

Finally, I want to reference the March 2009 article by Jeremy Grantham, another old timer, which is also enclosed. His title "Reinvesting when Terrified", kind of says it all. Like me, Grantham's worst years professionally were the late 1990's because he (and I) were warning of over priced stocks but everyone else was making money. The S&P 500 was going up 30% a year in those days. Grantham, like Buffett, predicted very low returns for the first decade of this century. In his March piece Grantham argued that stocks are cheap and because we can easily become emotionally paralysed, it is critical to invest based on a plan. In our case our plan is summarized by your Investment Policy Statement and the investment discipline it fosters of gradually buying into declines.

Sincerely,
George Stedman, CFA
Portfolio Manager

P.S. For the first time in years many of you have been receiving annual reports you didn't want. We regret that inconvenience and have taken steps to correct it. Last August the code on your accounts was mistakenly changed to accept shareholder communications. We only noticed in February and have changed it back, but because of the long lead time for corporate mailings that was not in time for this year's Annual Reports season. Again, we are sorry for the trees and for any inconvenience.