

Thursday, January 7, 2010

## **Year End 2009**

### **The Lost Decade**

Goodbye to the ‘Noughties’, the stock markets’ worst decade in nearly two centuries. Measured in Canadian dollars the MSCI World Stock Market Index lost 5% per year since Dec. 31, 1999, while the S&P 500 lost 4% per year including dividends (-0.9% per year in U.S. dollars), compared to average annual returns over 10% in the past century and 18% per year in the 1990s. Thanks to energy and mines, the Canadian stock market had a much better decade, with compound annual returns of 5.6% including dividends. The ‘00s under-performance is payback for the massive gains in the salad days of the late 1990s. Mean reversion reared its ugly head.

The decade began with the pop of the 1990s tech bubble’s hot air. Then came the defining moment of the decade: the terrorist attacks of 9-11. In the U.S.A., Federal Reserve Chairman Alan Greenspan dropped interest rates to 1% in 2003, starting the bubble in the credit markets. Securitized lending boomed the next year. The personal savings rate went negative in 2005. Home prices peaked in 2006. The subprime credit meltdown began in 2007, setting up the storied bankruptcies and massive government bailouts of 2008 and 2009. And we had entered what Barron’s Alan Abelson calls ‘a new age of anxiety’.

In The ‘00s: Goodbye (at Last) to the Decade from Hell, (Nov. 24, 2009) Time’s Andy Serwer called the first 10 years of this century “the most dispiriting and disillusioning decade Americans have lived through in the post-World War II era.” Investors should be glad the “Loss Decade” (Business Week, Dec. 1, 2009) is over.

### **The Year That Was**

2009 was a remarkable year. On March 10, 2009, the S&P 500 was already down 25% for the year. If the year had ended then, after 45 days, it would have been the 9<sup>th</sup> worst year the index had ever had. But then the next nine months saw one of the most terrific stock market rallies of the past 75 years, with the S&P 500 up 65% (in U.S.\$) since March 10<sup>th</sup>. Stocks that had been the most brutalized in the crash, (that were lower quality, riskier), led the stock market rally from early March on, making it difficult to match the performance of the stock indices.

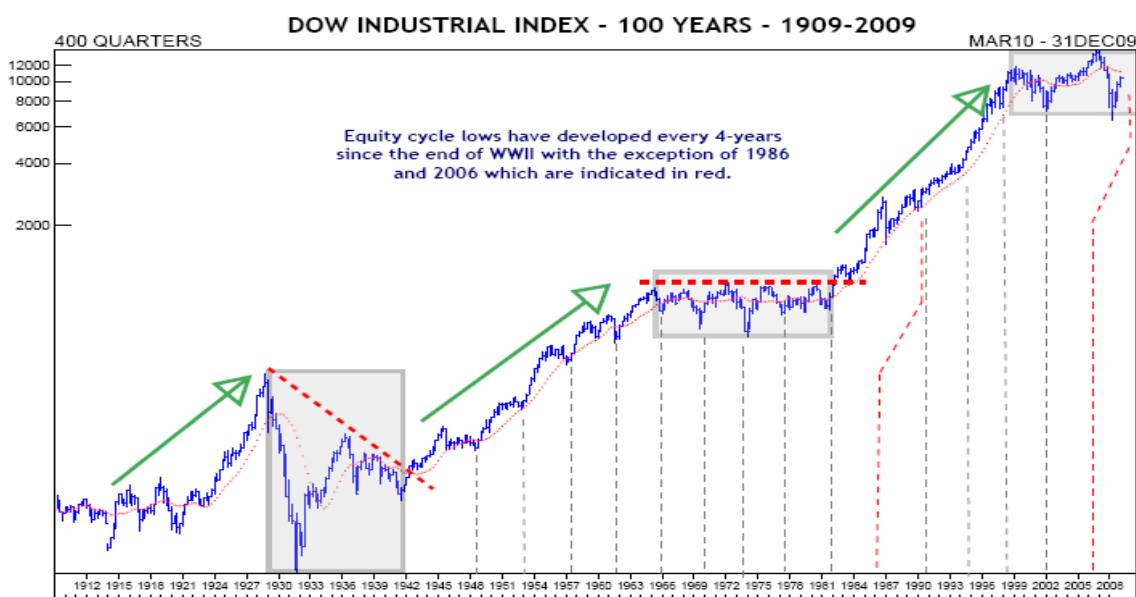
The Canadian stock market (the S&P/TSX Composite Total Return Index) was up 35.1% in 2009 after being down 33% in 2008. (Don't think that leaves it even. It is still down 10%, including dividends, over two years. As a further aside, a high-flying mutual fund that was up 85% in 2009 but down 85% in 2008 is now about 27% of what it was two years ago.) More spectacularly, but also more typically of stock markets around the world, the MSCI World Index, up 27% in 2009, was down 42% in 2008 and is now 26% below 2008's beginning.

Early in 2009, during the worst of the credit crisis, less liquid bonds, such as municipals and corporates, yielded much more than federal government bonds. Those yield premiums had largely dissipated by year-end, in part because central bankers were uncharacteristically unambiguous in their resolve to keep short-term interest rates at unnaturally low levels. For instance, Matt Carney, Governor of the Bank of Canada, in June shockingly virtually promised to keep the Bank rate at 0.25% until at least mid-2010. The guarantee of almost no return from so called risk-free notes and growing assurance that the world financial system was not inexorably melting down set-off a pursuit of yield that erupted last spring and gathered steam all year. Individuals, still leery of stocks, poured money into bond funds, especially those mutual funds specializing in corporate bonds. For example, a senior two and a half-year Royal Bank bond now yields a meagre 1.85%, only 0.20% more than a two year Government of Canada bond.

A growing appetite for corporate risk, and a growing realization that the huge increases in government borrowing was increasing sovereign risk (for example, recently Dubai, Ireland and Greece bore credit rating downgrades), led to sharp declines in long-term government bond prices. In 2009 the long Canada bond returned -6.2% (its yield rose from 3.5% to 4.1%. In the U.S. the 30 year Treasury bond lost 30.1% (down 39.7% in \$Cdn.).

## The Here and Now

Before briefly discussing the present, here is some historical perspective. From time to time I have reprinted a version of this 100-year chart of the Dow Jones Industrial Average, from RBC's Trend and Cycle. It shows that after multi-decade advances like those of the 1940's-50's and 80's-90's there have been long consolidations (shaded areas). It also shows that since World War II there have been stock market lows roughly every four years, with the exception of 1986 (followed by a crash 1987) and 2006 (followed by a crash in 2008). It illustrates that there is a precedence for a long period of a flat stock market.



Source: RBC Capital Markets, Trend & Cycle

So, with safe fixed-income investments offering miniscule yields, and with hopefully the economy and corporate profits gradually improving, I think we will see a shift from bonds into dividend paying stocks where there is a prospect of higher yields, capital gains and dividend growth. Aging baby boomers and their increasing needs for reliable investment income should add to this trend. There were some signs of this late in 2009 as, for instance, pipeline, utilities and staple stocks started to do better. I consider them to be “having it both ways” kinds of stocks. They should offer at least some degree of protection on a relative strength basis if the stock market sells off this year but should go up somewhat if the stock market does.

**Have a Happy New Year**

Sincerely,  
George Stedman, CFA  
Portfolio Manager

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