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Third Quarter 2009

One year after the severest financial crisis since the Depression and, in the midst of the great recession, seems a good time to reminisce. I recently mailed you a rather lengthy article from The New Yorker, "Eight Days," by James B. Stewart. I found it to be a thrilling history of the "most important week in American financial history since the Great Depression", Sept. 12-19, 2008. My overwhelming impression from Stewart's behind the scenes account is that the worlds' leading policy makers (Henry Paulson, Ben Bernanke and Timothy Geithner) didn't have a clue. No wonder it was so terrifying. (Stewart describes one scene which is just going to have to be in the movie: After an emergency meeting on whether the government would or could save Lehman Brothers, Treasury Secretary Henry Paulson is asked about A.I.G. His reply: "Why, what's wrong at A.I.G?" The government bailed out the global insurance giant 3 days later.)

One year ago the tumultuous month of October gave the first indications of the depth of the credit crisis brought on by the Lehman Brothers collapse a month earlier. RBC DS gathered these tidbits:

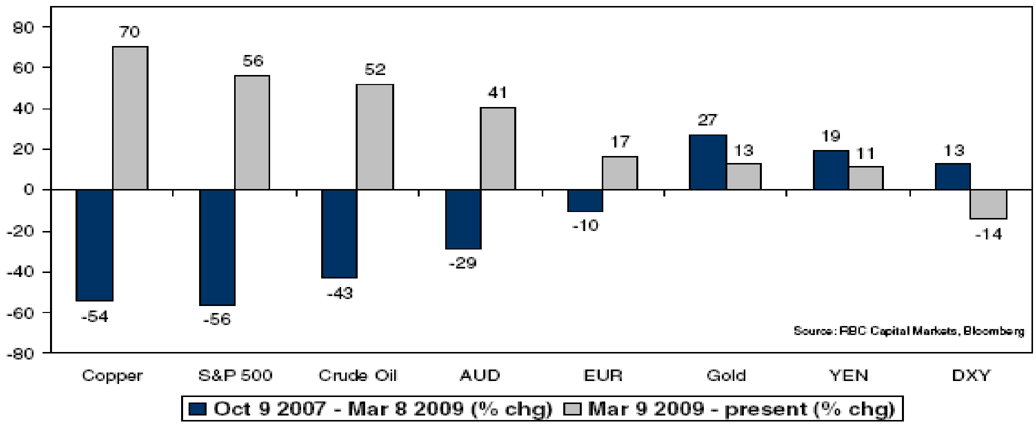
- From start to finish, the S&P 500 would lose nearly 17%, making it the ninth worst month since 1930, but even this masked the intense volatility that prevailed for the month.
- The market moved an average of 4% on a daily basis for the month, with four separate sessions in which declines exceeded 5%, including the gut wrenching day when the House of Representatives voted down TARP live on [TV].
- Over a span of 10 days (10/1 to 10/10), the S&P 500 would lose 30%, falling from 1,166 to 899.
- In between the collapse, the S&P 500 actually generated its two biggest single day percentage gains in 76 years (11.6% on 10/13 and 10.8% on 10/28)

One year later the economic fallout from the financial crisis is plain. The U.S. recession is the longest and deepest in 80 years. The seven U.S. recessions since the Second World War lasted 10 months on average. This one began in December 2007 and may have ended this summer, after some 20 months. The U.S. unemployment rate has had its fastest rise ever from under 5% in 2007 to almost 10% today, according to the September employment report published by the U.S. Bureau of Labor Statistics. The unemployment rate has only stayed below 10% because the participation rate declined sharply. The all-in (U6) employment rate, which includes disaffected and part-time workers that would like to be full-time, now sits at 17%, which is the highest level in the history of the data series. The work week is down to 33 hours, a post World War II low. This does not augur well for future employment rates as companies are likely to increase their employees' hours before hiring new ones.

Unemployment is hopefully a lagging indicator and the market appears to be counting on that. Whatever fell the most to the lows of March 9 has risen the most since:

Performance Before and After March 9 Low

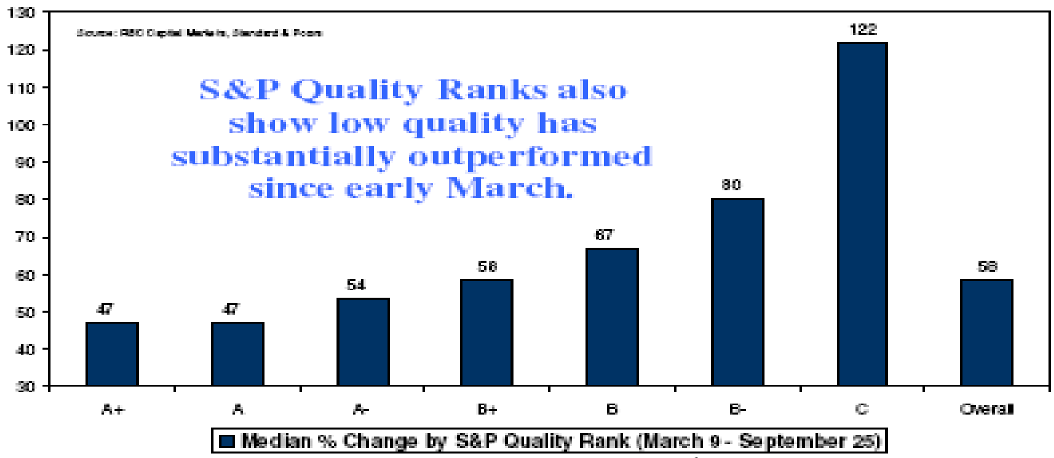
The Bigger they Drop, the Higher they Bounce



Source: RBC Investment Strategy, October 7th, 2009 Pg 6

Since March of this year most assets are up, except the U.S. dollar (DXY on the chart above), which is down, much as the U.S. dollar was about the only thing to go up during the crisis. Also of note is that each asset types' gains since March 9 have by and large been proportional to the size of their respective sell offs leading into the bottom.

Another way to illustrate that the biggest losers have became the biggest winners is by sorting stock gains by their credit ratings:



Source: RBC Investment Strategy Weekly, September 30th, 2009 Pg 4

Stocks with the weakest balance sheets, which last winter appeared to be facing oblivion, have soared since the March 9 lows. It is typical of the early rise in a new bull market that the stocks that had been pummelled bounce hard. What has been unusual is the magnitude of outperformance by the lowest quality stocks.

To illustrate further the embrace of risky assets since March 2009, consider this comparison of the TSX Composite and the MSCI Emerging Markers Fund:

Source: Trend & Cycle "Up and Out?" September 9th, 2009 Pg 1

As go commodities, so go the emerging markets - and Canada as well.

In response to the unprecedented volatility, we've been busy. Throughout the crisis and recovery we've been guided by our fundamental investment policy: the future is uncertain. In the fixed income side of your portfolio a few years ago there was almost nothing but federal and provincial bonds as they yielded only a little less than corporate bonds. Risk was underpriced. Last fall and winter that changed, interest rate spreads widened dramatically and in response we sold liquid government bonds in favour of municipals, GIC's, corporates, even, in some cases preferred shares. Whereas in years past we might have had a government bond maturing every year, now we have a variety of corporate bonds strung into a ladder of different maturity dates. As of this fall the opportunity in corporate bonds had largely passed. Interest rate spreads on corporate bond yields over government bond yields have contracted again. The markets have been to an extent de-risked once more.

Markets are always ahead of fundamentals, so stock prices already reflect an economic recovery, even if we still don't know what month it started. Now that the low-quality stocks have bounced from the March low, we should see a rotation into a fundamental value phase. Some stocks remain inexpensive. We have been buying blue chip companies with sound balance sheets that pay regularly increasing dividends. Investments well-suited to what bond king Bill Gross has coined as the 'new normal' economy of deleveraging, deglobalization and re-regulation.

Sincerely,
George Stedman, CFA
Portfolio Manager

P.S. Please visit us at www.georgestedman.com