

# Investing in Challenging Markets

## Summer 2008 Update

Over the past 18 months, the U.S. housing correction has morphed into a full blown housing recession and what began as an issue with subprime mortgages has worked its way through the financial system to the domestic and now broader global economy. The notion that economic growth in emerging markets can decouple from developed markets is being put to the test.

The credit crisis is showing few signs of abating. In fact, it may be set to worsen as financial institutions struggle to raise new capital. With risks in the financial system mounting, investors now demand higher interest rates on new borrowing that could reduce banks' willingness to extend new loans to both consumer and business. If that proves to be the case, it will only further aggravate the slowdown in North American and European economies. Investors should be prepared for continued volatility in financial markets and their portfolios in the months ahead.

### Where are things headed?

- **The economy** - Expectations for a v-shaped recovery in economic activity and corporate profitability have given way to what is likely to be an extended period of economic malaise. The pace at which the slowdown in the U.S. economy has spread to other G7 nations is unsettling. German GDP, which accounts for about 30% of Europe's output, contracted in the second quarter for the first time since 2004. Much of the Eurozone now appears headed for recession. The Japanese economy shrank last quarter for the first time in six years and hopes for economic and financial decoupling are beginning to fade as emerging markets including Brazil, Russia, India and China (BRIC) are also exhibiting weakness. Given Canada's reliance on exports, it has also been caught in the downdraft. Cracks are beginning to form on a number of fronts including employment. The Canadian consumer is more cash strapped with household expenses taking an increasingly larger bite out of disposable income. While the excesses in the Canadian housing market never neared the proportions of the U.S., a modest build up of inventory is likely to cool gains in home prices through the end of the year. Scotia Economics is forecasting Canadian Real GDP of 1.1% in 2008 rebounding modestly to 1.6% in 2009.
- **Interest rates** – Lower inflation globally should give central banks greater scope to lower interest rates to stimulate growth. The U.S. Federal Reserve (The Fed) is expected to lower its funds rate a further 75 basis points (a basis point is 1/100<sup>th</sup> of one percent) to 1.25% by the first quarter of next year in order to address a number of risks to the U.S. economy. The Bank of Canada (The BoC) is also expected to cut its overnight rate by 50 basis points to 2.50%. The European Central Bank's (The ECB) next move remains a question mark as they continue to view inflations as a significant threat. The ECB has the sole mandate of maintaining price stability.
- **Currency** – The trade-weighted U.S. dollar appears to have found a near-term bottom. One of the key developments in currency markets has been the rapid deteriorating in growth figures out

of Europe, in particular Germany. Interest rate futures are now suggesting the ECB's next move will be to lower interest rates. Another major development has been the steady decline in the price of crude oil, which is expected to take the pressure off headline inflation. Scotia's currency strategist believes these bullish developments could continue to underpin strength in the U.S. dollar in months ahead.

- **Equities** – Analysts' earnings expectations for 2009 are still too high and will be revised lower. This should keep downward pressure on stock prices in the months ahead. From a thematic perspective, we maintain our defensive orientation that favours consumer staples, utilities, and telecom investments, but would use volatility to establish or build interest in emerging markets and natural resource stocks. We believe emerging markets represent an attractive long-term investment proposition for our clients. Emerging markets have provided the highest real returns for investors over the past decade. Simply put: the superior economic growth should lead to superior returns for investors. We believe structural supply issues remain that will ultimately limit declines in commodity prices. When economic growth begins to recover, rising commodity prices will once again take centre stage. For this reason, from a longer-term perspective, we are inclined to accumulate shares of mining, energy and fertilizer stocks on extended periods of weakness.
- **Fixed income** – The investment climate for fixed income is positive with expectations for further interest rate cuts and yield curve steepening. Bond markets have continued to perform on a consistent basis throughout the year. Fears of increasing future inflation due to rising commodity prices were the catalyst for the run up in the index during the first quarter of 2008. However, real returns have been in decline during the second quarter as commodity price pressures have dissipated. With lower benchmark rates, Scotia Economics is also forecasting short-term bond yields in the U.S. to continue to decline from current levels over the next six months. Longer term bond yields, however, are forecast to remain at current levels into 2009 before rising over the balance of the year. Benchmark 2-year Canada yields are expected to fall towards the 2.4% level while the 5-year yield is expected to rise to 3.25%, the 10-year and long bond yield are expected to be 3.50% and 4.10% respectively in the first quarter of 2009.

## What do you do now?

In volatile times like these it is important to **stick with your long-term plan, and maintain a diversified portfolio that meets your risk tolerance.**

- Ongoing weakness in equity markets represents an excellent opportunity for long-term investors to dollar-cost average into core positions, whether stocks, mutual funds, or exchange-traded funds (ETFs). The economy will eventually turn and the equity market will ultimately move to new highs, it always has. The stock market is a discounting mechanism and will begin to rebound before an actual turn in the economy is evident. We encourage clients to look at our Guided Portfolios for investment ideas. To conclude, we believe the Canadian financial services sector is better positioned to weather the ongoing credit crunch and economic downturn and recommend our clients maintain a home bias.

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