Chris Horan, Financial Advisor

Across the Valley

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Assante Capital Management Ltd. – Member CIPF
#3401-130 Adelaide Street West   Toronto, ON M5H 3P5

Website: www.chrishoran.ca
Email: choran@assante.com
Phone: 416-216-6532

Chris has a BA in Economics from UBC, and a business degree from Western (now Ivey MBA). Before joining Assante in 1992 he was Treasury Manager for a Fortune 50 firm where one of his responsibilities was Chair of the Investment Committee of the $65 million pension fund.

Chris provides financial planning, investment planning and full implementation services to about 100 families.

For more information, please call (416) 216-6532 or email at choran@assante.com

October 2008 has been the worst month for stock prices in 20 years (ironically since October 1987), with spectacular price declines averaging 17% across global markets. No equity market sector and no country was spared. The only asset class to have anywhere near a positive return was bonds.

So far, none of my clients have lost their nerve and done anything precipitous. I am truly and deeply grateful for your cool under fire. I am grateful because I remain completely confident that the crisis is beginning to ease and prices will recover, and go on to new heights, as they always have. Stay calm, hold your ground, and the storm will pass.

I ride with my clients in 2 important ways. Your money is managed the same way my own money is. Secondly, my revenue is asset-based fees, so my income is highly sensitive to declines in your portfolio. And I am my 9th largest client. No armchair quarterbacking here.

The Current Situation

As this is written there is a huge economic tug of war going on. On one side, consumer confidence is at extreme lows from the shocks of the US banking nightmare. This damaged confidence could result in a sharp contraction in economic activity as spending and investment decisions are delayed.

On the other side are very powerful positive economic forces from low interest rates (below zero after inflation), oil prices fallen by half, a strong global economy, and excellent corporate financial health (outside banking).

The situation is extremely complex and uncertain, and predictions are difficult, as Mark Twain said, 'Especially about the future'.

My view remains that the markets are oversold and the bad news economic scenario is now priced in. The forces behind global economic growth will eventually overwhelm the fear and uncertainty, possibly sooner than we think, and the world economy will carry on. Most importantly, the markets will begin to recover long before the economy.

Point of Maximum Pessimism

Just as prices are highest when the prevailing mood is euphorically optimistic, prices are lowest when the mood is despondently negative. This is the case today.

The reason experienced investors remain confident when pessimism is widespread is because our experience has taught us that markets tend to reverse after a big decline and move upward. This confidence can appear misplaced to our Stone Age brains, which are hard-wired to simply extrapolate trends.

Bargains, by definition, exist when prices are low. Experienced investors know that prices are low only when things look bleak. So the same way a pilot has to stay cool in an in-flight emergency, an investment pro has to buy when things look bad. Dan Bubis, manager of the CI Canadian Investment Fund said to me once "Did you want me to wait until the price went up before I bought it?"

There have been 11 bear markets (>20%) since WWII in the broad US stock market, according to Market Analysis & Research Group. The average drop is 33% and the average duration is 17 months. The biggest declines were 48% and 49% in 73-74 and 01-03. As of November 28th the S&P 500 was down 52% from its high of October 2007. It is not bold to see that this is close to the bottom.

I do not know if the next 1000 points in the markets will be up or down, but it is highly likely that the bad news is baked in to current prices, and, like John Templeton in the last newsletter, I will bet anyone in the room that a year from now the markets are significantly higher than they are today.

Tax Free Savings Accounts (TFSAs)

The TFSAs we mentioned in our last newsletter are generating a lot of interest. They will become available in January 2009.

The $5,000 contribution room accumulates over time so there is no deadline for contributions.

If you would like more information or want the paperwork to open an account, please contact Barb McKenzie at (416) 646-3836 or by email at bmckenzie@assante.com

Five Classic Signals

The saying goes that 'Nobody rings a bell' at a market bottom. No two bear markets are ever the same, but some things are exactly the same. Here are 5 classic signals.

1. The sickening declines have brought US stock prices back to where they bottomed in 2003 after the crash of the technology stocks, and the same level as 1998 after Russia defaulted and the Far East currencies collapsed.

   This 10-year return of zero (excluding dividends) in the broad US stock market is a blue moon, having happened only 2 other times this *century*: 1920 and 1974. (Even in 1937 the 10 year return was 5%.) according to a study by Yale School of Management. Following each of these periods, the 10-year return from US stocks went on a 20-year upcycle peaking at over 20% per year.

2. The news media is a contrary indicator. Eyes glued to the rearview mirror, Business Week's famous headline 'The End of Equities?' marked the bottom of the great bear market in 1982.

In 1999 value investor Warren Buffet appeared on the cover of Business Week with the caption 'Yesterday's Man?' almost exactly as the tech stock hare reached its zenith vs. the value stock tortoise.

Now? The October 15th cover of Time, exquisitely timed to coincide with the October 10th market low, was a picture of a Depression soup line headlined 'The New Hard Times'.

Always a barometer (and driver) of public anxiety, the major media's use of the word 'depression' in economy-related articles rises and falls in perfect negative correlation to markets. Previous peaks in the 'depression index' occurred in 1998 (Asia/Russia crisis), in 2002/3 (tech crash), and the previous granddaddy, the 1987 market crash. In October 2008 the 'D index' surpassed the 87 peak as reported in the *Economist*.

Each of these 'depression peaks' corresponds perfectly with major market bottoms – precisely the best time to be buying stocks for at least the following decade.

3. Individual investors (possibly aided by salespeople with no sense of history, value, or courage) redeemed $8 billion from equity funds in Canada in October, second only to September 08 as the largest redemptions since – you guessed it – the last market bottom in 2003.

   Individual investors, egged on by media hype, stampede for the exits at a market bottom. It's the precise opposite of the 'Buy Low' idea and by far the reason most investors fail miserably. (See 'Investors Behaving Badly' January 2006 www.chrishoran.ca)

4. The VIX options index, about the best indicator of investor fear next to mutual fund redemptions, has been over 40 only once in 18 years. On October 15th the VIX hit an all-time high of 80.

5. With my apologies for repetition, Warren Buffet, a smart investor, recently invested billions of his personal money into US stocks. His comments, published in the Wall Street Journal October 15th, (OK not everything in the paper is stupid) were that US stocks are the best value in 20 years, and talk of long term US economic decline 'makes no sense'.

   As I said before, do you really need to know any more than this?

Nick Murray, long-time industry veteran and commentator said recently: 'Investors stampeding for the exit, VIX at 80, and a soup kitchen on the cover of Time … did you want a buy signal from God Himself?'

The points below address some of the questions on people's minds these days. I am reticent to give them much time, because I believe the markets have included these issues in current prices, but I want to demonstrate that the there is another side to the doomsday scenarios being trumpeted by the news media.

Probably the most important bulwark today to limit the transmission of the financial crisis to the broader economy is confidence. We need confidence in ourselves and in the resilience and adaptability of our free enterprise system. The din of misinformation and negative speculation from the news media is shameless and irresponsible.

This is much more serious than past problems.

No, it isn't. It might have been *potentially* more serious. This crisis threatened the viability of the global financial system, and that took us to the edge of an abyss. But it would have been just as catastrophic if the air travel system had remained frozen after 9/11.

In the 1990's Confederation Trust, Counsel Trust, and Royal Trust (an AAA company) in Canada all blew up because of real estate. The US government had to intervene and liquidate their entire Savings and Loan industry.

In 1987, the markets crashed 22% in a single day- 30% in a month! It was totally shocking. People were certain that the economy was going to follow the stock market into a huge recession. Many people sold out their portfolios, and switched to cash. Hugely expensive mistakes. Yet there was zero economic impact.

In 1981 interest rates went to 20%. Reasonable people with reasonable mortgages renewed at 18% and took a punch to the solar plexus. The TSE 300 (Canadian index of the day) took a year to grind down 49%. *That* was a recession, unlike today's imaginary recession maybe next quarter.

In 1973 the price of oil tripled when the economy was far more sensitive to oil prices. Inflation and unemployment were headed for double digits. The markets took almost 2 years to grind down 48%.
So we have been here before many times. The fear, the thinking that 'this time it's different', the certainty of the media that 'it's going to get worse', is exactly the same.

It looks like we'll have a very bad recession.

We might. And we might not. It appears that the economic data will probably show a sharp contraction in the 4th quarter of 2008. Possibly into 2009 if people read the newspaper. Call that a recession if you like.

But the important thing to remember is that markets look ahead, while economic data and the media look behind at historical data. At this point the markets have fallen so far that a deep recession has already been priced in. This is why the markets go up even as the bad news hits the street. The markets "look across the valley" to the recovery on the other side.

Economic Forces

Two very important things are going on here: first, the world economy was hit fairly hard by oil at $140. This doubling of the price of energy in two years was a huge drag on economic activity and actually led to a first-ever decline in oil consumption in the US. People were actually changing their activity patterns in a real way, and that will show up in the economic data. So of course we're going to see a slowdown.

Second, similar to 9/11 and the October 1987 crash, the sickening fall in share prices has caused firms and people to simply freeze in their tracks. When 5 US investment banks go down at once, of course people are going to defer decisions.

But as soon as the shock wears off, as in both 9/11 and 1987, the economy can carry on.

The main reason cited by economists in forecasting recession is consumer confidence. The question, of course, is whether consumer confidence at 20-year lows (mine is not) will lead to a serious contraction. Confidence is a notoriously poor predictor of economic activity, according to the *Economist*, so it's hard to say. However, given the critical role of consumer confidence in today's situation, the relentless alarm from the media is unfortunately counter-productive. We may even have the first media-induced recession in history.

The financial crisis will lead to a depression like the 30s.

The Great Depression of the 1930's and Japan's Lost Decade of 1990 – 2000 did have roots in asset price booms and banking busts, but the similarities end there. Comparisons to the current situation are tenuous. There is very little chance of either scenario from here:

The depressions of the 30's and in Japan were caused by government policy errors. The money supply was *reduced* in the 30s, and the infamous Smoot-Hawley tariffs cut global trade in half, thereby destroying world economic growth. Japan *raised* interest rates as the property boom crested in 1989, didn't drop them for almost 2 years, and then dithered for 10 years before forcing insolvent banks to merge. In contrast, the US policy response has been immediate and massive.

The Japanese stock and real estate markets began their declines from sky-high valuations: P/E ratios averaged north of 80, and the land under the Emperor's Palace in Tokyo was famously worth more than all the real estate in California. In contrast, stock market valuations were 18 or so in the US in 2007, are now at the low end of their 25-year range, and real estate prices are modest.

Bad News

We all know that the media exaggerates and sensationalizes things to sell newspapers. Headlines such as, 'Should the Prime Minister Panic More About the Economy?' (Financial Post) are only laughingly stupid. Unfortunately, much of the so-called news is not only alarmist, it is simply wrong.

"*Embattled General Motors is running dangerously low on cash, raising the spectre of a spiral into bankruptcy protection and a massive economic disaster as the automaker and its rivals confront the gravest threat they have faced since the Great Depression*" (Globe and Mail)

This sensational sentence hits the big emotional buttons, but the claims are false: Chrysler faced bankruptcy in the early 1980s (and needed Lee Iacocca from Ford and government backing to survive).

And the 'spectre' – of boarded up plants and 100,000 unemployed workers - just isn't in the cards. GM and Chrysler may well seek protection under Chapter 11. The airlines have done it more than once. Some plants would be closed, some model lines dropped, and yes, some people will be out of work.

But GM and Chrysler need to downsize, they won't disappear. There remains a large market for Detroit cars and trucks, and although the market is declining, it will not disappear any time soon.

The fact is that Detroit pays their workers $60/hr to do a $25/hr job, so their business is declining. They have been far too slow to build the high-quality small cars that people want. The downsizing of Detroit is part of a natural economic evolution, and is not an economic disaster.

Other media errors are more serious. A recent front-page Post article quoted annualized economic data as if it were quarterly, thereby exaggerating it fourfold. It's a great way to turn a soft quarter into a depression. Great copy, but just not true.

Unemployment jumps

NBC said "*The jobless rate zoomed to 14-year high of 6.5% in October as another 240,000 jobs were cut, stark proof the economy is almost certainly in recession*".

Let's ignore the stupidity of saying *stark proof of maybe something*. It's either stark proof or it isn't. In this case it isn't. Zooming implies you went somewhere fast. Except going from 6.1% in September to 6.5% in October is so small it's irrelevant: it is an increase of one person in 200.

OK, but a year before, unemployment was 4.8% according to The Economist, so an increase to 6.5% is actually up 25% - and that's a big increase, right? No, it isn't. A big percentage of a very small number is still a very small number. Last year 95 people in 100 were employed (4 of the 5 were unemployable). This year 93 people in 100 have jobs.

The fact is that unemployment in the US and Canada is near generational lows. The US still has the lowest unemployment of any major economy in the world except Japan (and Japan is a basket case, which shows that unemployment isn't a very important number anyway).

But economists are calling for a recession now.

We may well have one. But I do not want to give this line of thinking much credence because the markets have already priced in a bad news scenario.

It's extremely important to keep in mind that the markets look to the future, they "look across the valley" and they will turn up long before you see recovery in the data.

And the media never stop calling for recession: Time still had recession on its cover in mid-1992, 18 months after that brief and mild recession ended.

What about consumer retrenchment?

Consumer debt levels are not in themselves a problem. Interest rates are low and thus the debt is manageable. Demographically, with the median boomer at 48, it makes sense that debt levels will be high – those are the peak earning years. Yes, consumers will have to borrow less in future. Yes, consumers – and the economy - are at *risk* if interest rates rise sharply. It's a risk. Not a problem.

In the meantime, the US consumer has NOT hit a wall. Consumer loans are *not* all being called for repayment. Debt has not been the primary driver of the US economy by any stretch of the imagination, and so declining debt won't contract the economy. We had very strong economic growth through the 50's and 60's with very little increase in debt, according to the Bank Credit Analyst. While GDP growth is likely to be slower, a leveling (or even reduction) in the rate of debt growth simply does not equate to a decline in GDP.

But House Prices have Fallen

Yes a falling house price will dent your optimism. You might not put a swimming pool on your credit card. But we had a 30% decline in house prices in Toronto in the 90's and the economy was fine. Housing price adjustments tend to occur over time, not all at once. Besides, almost half of US homeowners have no mortgage at all.

End of the US leadership?

The US has squandered (in my opinion) a generation of world moral authority with its ill-conceived invasions of Iraq and Afghanistan. The notion of 'regime change' will surely go down in history as one of the most repugnant concepts in the minds of free thinkers since Lebensraum …

Undoubtedly the greatest contribution of the US to the world is its confidence in economic freedom. Economic freedom and global trade has provided every nickel of prosperity, including the health care enjoyed by billions of people.

Probably the greatest danger to the world economy today is the view that economic freedom is somehow inherently bad and should be fixed. Yes, banking regulations need to be fixed. The securitization and other off-balance sheet shadow-banking activities have to be regulated if they are going to warrant government guarantees (and are large enough to jeopardize the system).

Government's Role in the Crisis

You may not be aware of the role that governments played in the credit crisis. In a summary "Brief History of the Credit Crisis" now available on my website (www.chrishoran.ca), I show that the crisis is a more subtle blend of variables, including government initiatives, than you might have thought.

Your comments and questions are appreciated. Keep them coming please.

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