Quadrant
ASSET MANAGEMENT

2008 Q4 Market Commentary

February 2009

Welcome to the Quadrant quarterly commentary for the fourth quarter of 2008. We are pleased to present to you an article by Dr. Michael Benarroch on the global financial crisis. He presents us with a condensed summary of the year that just passed and offers his outlook for 2009. Our second article focuses on bonds. Since this crisis began, bonds have been perceived as a "safe haven" by many investors. We examine the markets in 1994, where after a period of low and stable interest rates, the Federal Reserve started raising rates and look at similarities in today's bond environment. Quadrant continues to affirm that bonds are an important asset class for investors but should be placed in the context of a balanced portfolio that is well diversified. On page five there are brief comments on changes to RRIF withdrawals, the new Tax Free Savings Account (TFSA) and tax information.

The Global Financial Crisis: One Economist's View of the World

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The current financial crisis and economic recession have raised concerns about the stability of the financial system not only within Canada and the United States, but across the world. What began as a crisis in the United States housing market quickly spread to both the US financial sector and global markets at a pace never experienced before in the history of the world. In the past year, stock markets across the globe have fallen in value by 30% to 75% and the five largest investment banks in the United States ceased to exist. As investors across the world have watched their wealth decline in value, consumer confidence has plummeted driving many of the world's major economies into recession (Real GDP in Canada is now predicted to decline by between -1.0% and -1.5% in 2009). Sixteen years of continuous economic growth and unprecedented expansion in stock values quickly came to an end.

One of the most surprising features of this crisis has been the extreme volatility experienced by many markets. Not only have the prices of stocks dropped dramatically, but the prices of most commodities have fallen, including crude oil from over $140 US a barrel to below $40 US, whereas the value of the Canadian dollar, which hovered around $1 US for the past two years, fell to below $0.80 in a matter of weeks. The reason this is so surprising is that one would have expected such volatility to occur hand in hand with a dramatic drop in economic growth and rise in unemployment or dramatic changes in either supply or demand. Growth in 2008 however, was still positive in most countries of the world, though

many countries did experience a decline in GDP in the last quarter of 2008. Moreover, while unemployment rose in the United States in 2008, employment in Canada, Europe and other parts of the world held steady.

The key to understanding the depth of this crisis lies within the United States mortgage market and the impact of globalization. In 2001 approximately 5% of all US mortgages were so called sub-prime (high-risk) mortgages. Between 2001 and 2006 however, this number grew to over 20%. These mortgages were financed through the issue of newly formed mortgage backed financial securities. The new financial securities were purchased by investors and institutions across the world. As the US housing market collapsed and the securities lost value, the US investment banks and a number of European banks quickly ran out of capital. The US housing crisis spread throughout the world. With all the G-20 countries experiencing a similar credit crunch, there were no markets to offset the negative impact of the crisis. As a result, global markets reacted in a similar fashion thereby compounding the depths of the crisis. If anyone doubted the extent of globalization prior to 2008, this financial crisis has taught us how closely the world is now connected.

While central banks across the world have intervened to try and stem the crisis by lowering interest rates (in the United States the Fed Funds now stands at 0 to 0.25% whereas in Canada it is 1%) and injecting liquidity into the market, the crisis persists, tight credit markets have severely impaired the effectiveness of these monetary interventions. What started as a crisis in the United States housing market has now crept into the real economy. Most developed countries are now in recession and the prospects for a quick recovery, first predicted at the start of the crisis, are unlikely. With little liquidity in the market, a low tolerance on the part of lending institutions to take any additional risk and extremely low consumer confidence, traditional monetary policy has failed to have the desired effect on the economy.

This has left governments with little choice but to stimulate the economy through fiscal spending. While Europe, Japan and China have reacted quickly to the crisis with financial stimulus packages, Canada and the US have been slower to react. Canada was mired in a political conflict that brought the government to a standstill at the end of 2008, while the United States waited for a new administration to take power. Moreover, economic forecasts have been uniformly downgraded by all major economic organizations, including federal governments, the World Bank, IMF etc. In light of these factors, and with a continued slowdown in the US housing market, economists now expect the recession to last through the middle of 2009 and possibly through to the end of 2009.

With interest rates however, remaining low through the first half of 2009 and large fiscal stimulus packages being introduced in both Canada and the United States, we should begin to see some positive effects by the third quarter of 2009. In North America, much will depend on the extent, speed and effectiveness of the fiscal stimulus measures currently being implemented. If the new government spending and tax cuts can have a more immediate effect on employment, the recovery should take hold. At risk however is that that the stimulus packages will have come too late and may have little impact in

the short run. Further, if tight credit conditions persist through all of 2009, the global recession is likely to continue beyond this year regardless of the level of government spending.

While the speed of the crisis took all pundits by surprise one can only hope that the recovery will be just as swift.

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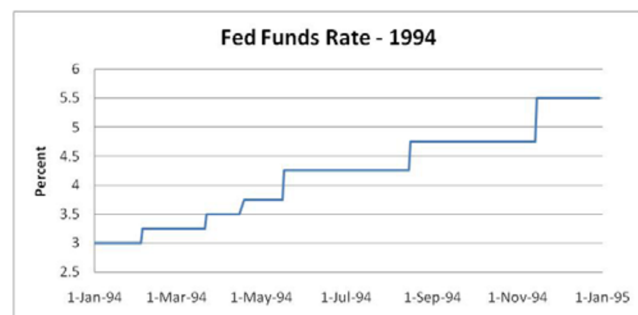
Are Bonds Immune?

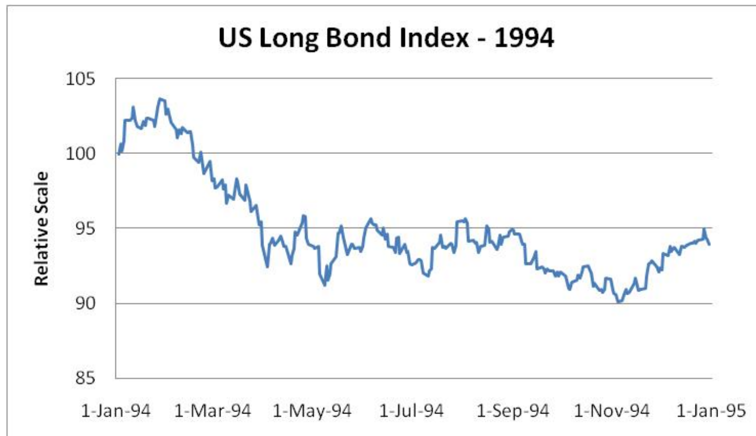
Our last few commentaries have focused on the equity (stocks) portion of the portfolio. While stocks are the main driver of long-term real growth, we thought we would take a look at the other side of your investments – fixed income. In all market situations, Quadrant maintains that the best approach is to have a well-balanced portfolio that is diversified across asset classes, industry sectors, currency and geography.

In the year that just passed, major stock indices around the world experienced declines not seen for decades. Comparisons to the Great Depression of the 1930s were being made on a regular basis. In periods of volatile stock markets, the investing public sometimes turns to fixed income as a "safe haven." Government bonds have held up well – so far. If stocks have the 1930s as their historical low point, modern fixed income has a near equivalent – 1994.

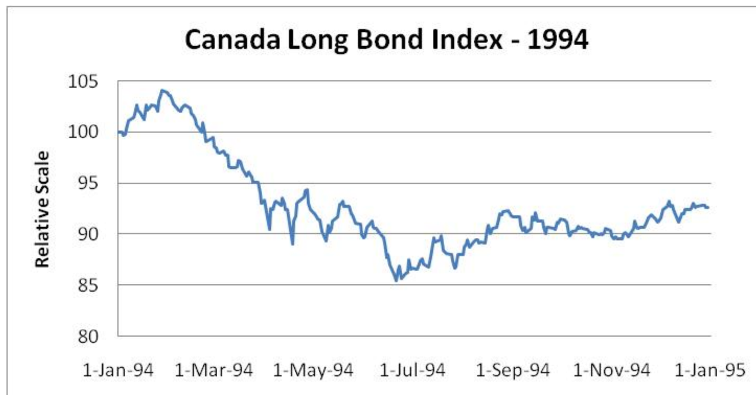
The bond market in 1994 started out harmlessly enough. The US Fed Funds rate was at 3%. The rate had been at this level since September 1992 in order to encourage economic growth after the recession of 1990-1992. Coming out of that recession, it seemed that inflation was finally under control. In 1993, the Consumer Price Index (CPI) increased 2.8% in the US and 1.7% in Canada. With an economic recovery and low inflation expectations, Canadian government bonds returned an impressive 16.4% in 1993, while US Treasuries had a 10.5% return. The Canadian stock market was also strong, posting a 32.6% increase in 1993, thanks to strengthening commodity prices. In the US, the stock market had a 10.1% advance, almost matching the return of the Treasuries. The US economy was expanding, as were the Canadian and European economies. But then, as the winter started to wear, the market mood started to change – worries about inflation started to move into the psychology of the market. The US Federal Reserve raised its Fed Funds rate – moving it up by 25 basis points in February, March, and April. The month of May saw a 50 basis point increase. By the Memorial Day weekend at the end of May, the Fed Funds rate stood at 4.25%, an increase of 1.25% in only three months. But the Federal Reserve didn't stop there – they added another 50 basis points in



August and 75 basis points in November. At the end of 1994, the Fed Funds rate stood at 5.5%, or nearly double the rate at the beginning of the year.



After the initial Federal Reserve decision, bond market participants became concerned that inflation would be coming back. And so, somewhat slowly but steadily, investors demanded higher yields and the prices of bonds declined. The value of US government bonds that matured in ten years or more ('long' bonds) dropped 13% from February to early November. Canadian bond holders fared a little worse, as the price of ten year and longer Government of Canada bonds declined by 18% from top to bottom. There were similar results in Europe. Many bond investors were stunned – they didn't think it was possible to encounter double digit losses on solid, AAA rated government bonds over several months. With the last rate increase of 75 basis points, the market psychology finally changed. There was a strong recovery in the last few weeks of 1994. At the end of the year, the total return on Canadian government long bonds was -7.41% while US government long bonds had a return of -6.71%.



Could bonds be setting up for another 1994-like situation? After the technology stock bubble and the US housing bubble, could there be one more bubble left – a bond bubble? And what is the danger that there will be a similar rise in interest rates? The bubble aspect comes from the 'flight to safety' that occurred in the last six months of 2008. Many individual and institutional investors sold their stocks and hedge funds and clamoured to get into the safe confines of US and Canadian government bills and bonds. New investment money was overwhelmingly placed into short-term fixed income. In short, there is a lot of money that has been put into bills and fixed income. In fact, demand was so great in December that investors were willing to accept a *negative* return on a one month US Treasury bill. All the buying meant that Canadian government bonds were up by 11.8% in 2008.

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Today's Fed Funds rate is not at 3%, but at a variable range of 0% to 0.25%. In the third week of January, the effective rate was 0.05% or five basis points. US long bond rates came within a whisker of 2% during the last two weeks of December. While rates have recovered up to 2.5%, they are still extremely low by historical standards. Canada has had a similar experience. And while the developed world economies are in worse shape than in 1994, and this has translated into these low historical rates, it also means that there is more room for further rate increases.

So, like the beginning of 1994, there are currently low interest rates for bills and bonds. What we are missing are increasing interest rates and deteriorating inflationary expectations. Right now, economists are writing that interest rates will be at the lower end of the spectrum for the foreseeable future as central banks are fighting off the credit crisis and world-wide recession. Governments across the globe are turning on the deficit taps and spending on infrastructure and other major public projects. They are looking to the capital markets to borrow these funds. Investors are currently willing to part with their money at low interest rates. Why? First, as mentioned, government debt is still viewed as a safe place to be. Second, foreign buyers of US debt are still buying as they need a place to put their US dollars generated from exports. China currently has over $689 billion of US Treasuries, almost one-quarter of the over $3 trillion owed by the United States government to people and institutions in other countries. Third, rising inflation is not seen as a threat. In fact, inflation has been falling over the past few months as the recession takes hold. Normally, central bankers are happy when inflation falls, but not this time. They are anxious not to repeat the experience of Japan after their housing bubble burst back in the late 1980s and the country went into deflation. Central bankers and governments are spending and then spending more in order to avoid deflation and to get the economy rolling again.

25% RRIF Re-contributions

Canada Revenue Agency ("CRA") is accepting re-contributions of up to 25% of your 2008 minimum annual RRIF payouts. If you are currently holding a RRIF, LIF, LRIF, or PRIF account through United Financial Corp. (UFC), you would have received correspondence (including the appropriate forms for your signature) from us detailing the amounts you may re-contribute by March 1, 2009 or 30 days after legislation is passed, whichever is later. Any re-contribution will not increase your 2009 minimum RRIF payout, but will replenish your RRIF account and reduce your 2008 taxes.

Tax Free Savings Accounts ("TFSAs")

Any Canadian resident 18 years or older can open a TFSA account and contribute up to $5,000 annually. While the contribution is not tax deductible, none of the investment income (interest, dividends, or capital gains) is taxed, even if you withdraw the funds.

Quadrant will be offering TFSA accounts for all eligible clients in the course of our quarterly meetings with you.

2008 Tax Information

Beginning in October and right through December of 2008, Quadrant examined every taxable account under management in order to identify opportunities for tax loss selling and took action wherever appropriate. The capital losses that were realized may be used to offset capital gains that were realized in 2005, 2006, and 2007 and may be carried forward indefinitely.

You will see the effect of those transactions reflected in your 2008 Tax Packages from UFC.

Sooner or later, the yields on government bills and bonds will rise:

- Eventually, the equity markets will become less volatile and more appealing. Many will leave the "safe haven" of fixed income. Bill and bond yields have to rise and prices fall in order to be competitive.

- Investors, including foreign governments like China and Japan, may no longer be willing to purchase as much US and other government debt. Interest rates will rise and prices will fall in order to attract other investors.

- Expectations in the markets will move from deflation to inflation, thanks to all that government spending. Bill and bond yields will quickly adjust to the new expectations and interest rates will rise, causing prices to fall.

The worst possible combination is that all of the above happen at approximately the same time – and then the bubble could really burst. Quadrant monitors what is happening on the macroeconomic level as well as what is happening with the holdings of the fixed income portfolios. Shorter bond terms (less than five years) offer better defence against rising yields and falling prices, but at a return less than the dividend yield on quality stocks. Our approach to fixed income assets has always been to hold them for liquidity purposes and to smooth out equity volatility. Bonds are part of a well-balanced portfolio. By themselves, they are not the answer for long-term capital growth. Bonds are not immune.

Please feel free to share your thoughts with us – we always appreciate your feedback and comments.

Sincerely,

Quadrant Asset Management

MP/MS/RI

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