Quadrant
ASSET MANAGEMENT

2009 Q1 Market Commentary

Is the Glass Half Full?

Summary

Market movements of March may have signalled a positive change in direction for many investors; others remain sceptical. We know that credit conditions have eased over the past several months and they continue to improve as the interbank (TED) spread and corporate bond spreads continue to slowly narrow; but they are still high relative to their long-term average. Market volatility, as measured by the VIX, is down to half of its fall high, but still above its historical average. Price to earnings ratios are low by historical standards but have been lower during other recessions. It appears that the financial system is starting to show signs of stabilizing thanks to massive injections of capital and guarantees by governments. The most difficult days may be behind us.

Spring?

Spring is usually a time of renewal and optimism. After months of negativity, some encouraging economic signs are causing commentators and the media to state that the glass is beginning to look half full. The stock markets, as of late, seem to have caught onto this sense of optimism as well. March started off with declines, but then:

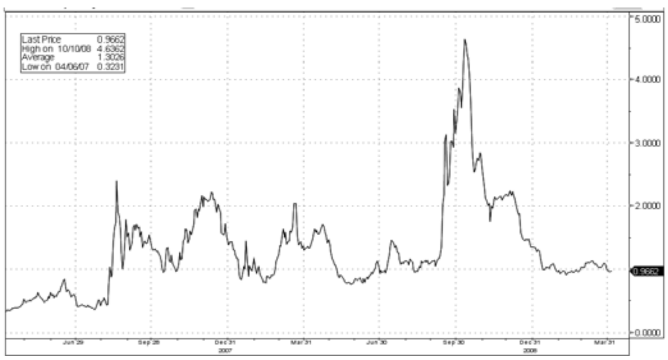
- On March 9, a seemingly innocent Wall Street Journal story about how a memo from the CEO to employees at Citigroup mentioned that the bank was on track to an expected quarterly profit of $8.3 billion, the best performance since Q3 2007, started a spark in the equity markets. On March 12, Bank of America said, “me too!” and declared that January and February were profitable and that no more help from the US government was required.

- For the rest of March, the markets rallied, with the S&P 500 up 8.4% in Canadian dollars and Toronto’s S&P/TSX index up 7.8%.

But is it really spring for the economy and the markets? US Fed Chairman Ben Bernanke recently said on 60 Minutes that he sees, “green shoots” in the economy. Will the green shoots take root or will they wither away?

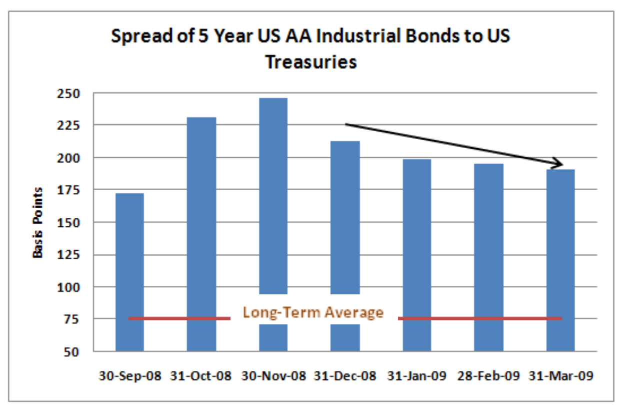
Let’s examine a few economic indicators and market levels. Many believe that it was the credit crunch, precipitated by a housing bubble, that initiated a decline in the markets last year. Before the economy can get moving again, we believe credit must be more accessible and the housing sector should at least stabilize.

Credit



For there to be any lasting recovery in global equity markets, credit markets must continue to recover. We have seen a reduction in the TED spread – the difference in interest rates between inter-bank loans and short-term US Treasury bills. In general, the greater the spread, the greater the perceived credit risks of the banks. Normally this spread is between 40 and 60 basis points. In October, on the heels of the collapse of Lehman Brothers, this spread reached a high of 465 basis points[1]. The TED spread has been declining lately and is now at about 96 basis points. While this is still higher than its historical norm, the trend is downward.

Corporate bonds have a higher yield than government bonds. This reflects the fact that corporate bonds are riskier than government bonds, which are generally considered to be default free. The spread between corporate and government bonds is an indicator of the risk of default. Any new corporate bond issue would have to pay a rate of interest that reflects the spread. In October and November, this spread widened to levels higher than the Great Depression. However, since then, there has been a reduction in the difference between the two bond yields. Before there can be a fully sustainable stock market recovery, corporate bond spreads have to reduce further so that corporations can borrow at a lower rate and investors will be more attracted to equities than high corporate yields. Credit is thawing slowly, partly because there is greater fear of defaults with the turndown of economic activity. While still not back to their historical norms, again the trend is positive.



[1] The source for all data and graphs, unless otherwise noted, is Bloomberg.

Housing

The US housing sector still has a long recovery ahead of it. Median house prices have fallen about 29% since their peak in July 2006. The housing market was quite buoyant during the middle part of this decade as too easily obtained credit pushed up home prices across the US. Economic downturn, sub-prime mortgage resets, squeezed speculators and homeowners who hold more mortgage debt than the value of the underlying home have all increased the number of sellers into a market with fewer buyers. Some buyers have taken advantage of the lowest median home prices in almost a decade. In February, home prices unexpectedly *increased* for the first time in several months. While one month of data does not a trend make, two and a half years after the peak price and with buyers starting to appear in the housing market, it bodes well that the median home price will start to stabilize over the next several months. As of the end of February, the median US house price was $165,400, compared to its peak of $230,000 in July 2006.

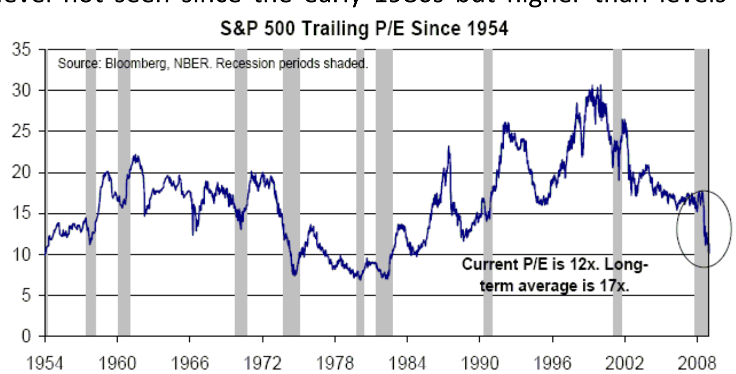
The inventory of unsold homes (including condominiums) in the US has been declining, coming off its peak in the 3rd quarter of last year. At the end of February, there were 3.8 million unsold homes in the US versus a long-term average of 2.8 million homes. Part of this decline is seasonal as there are usually fewer homes for sale during the winter months. While home inventories may not be approaching the long-term average anytime soon, inventory levels are set to decline as new buyers are entering the housing market, new home construction has been very weak over the past two years and government led efforts to help keep mortgage holders from defaulting or walking away from their homes start to ramp up.

Market Indicators

As credit conditions appear to be clearing and housing may be stabilizing, what is the current market view of these events and the economy as a whole? Will the March rally have legs to stand on and become the start of a market recovery, or will this be a bear market rally? Let's consider a couple of indicators.

A way to measure the mood of the market is through the VIX index. Often called the "fear index," it is a measure of the implied volatility that the market is pricing into near expiry call and put options of the S&P 500. Values over 30 have generally been considered to be bearish. Last October and November, the VIX peaked at over 80, but it is now down to half that level. The March rally in the markets declined the VIX by several points but it kept the index at current levels due to positive volatility. Still higher than average and still technically "bearish," this index is settling at about 40 for the time being.

Traditionally, investment managers look at broad market indicators of value such as price-to-earnings, price-to-book value and price to cash flow ratios to gauge whether or not the stock market is fairly valued. The price-to-earnings ratio (P/E), in its most widely used form, takes the current price of a stock or index and divides it by the last four quarters of earnings. The earnings can be "as reported" earnings or the more stable operating earnings, which ignore one-time, non-recurring events. In essence, P/E is the price multiple you have to pay today for a year's worth of core earnings. And since earnings usually go up, due to increased profits, the forward looking P/E ratio, based on the estimated earnings over 12 months in the future, is usually less than the historical P/E ratio. The current P/E for the S&P 500 is at 12x using historical operating earnings, a level not seen since the early 1980s but higher than levels during the 1979 to 1980 recession. The long-term historical average trailing P/E for the S&P 500 is about 17x. Stock valuations appear to be low and there may be more upside than downside. But, there could still be more downside to come and P/E valuations could dip into the single digits as they did in the early 1980s.



The Government Steps In

Since this crisis began, governments around the world have stepped in to save or takeover financial institutions, stabilize the housing sector, try to thaw lending and stimulate the economy. The leader in these efforts has been the United States. The size of the US intervention is staggering: as of April 1, $12.9 *trillion* has been committed with only $2.5 trillion spent. To help put that in perspective, $12.9 trillion is about equal to the annual GDP (ie., the total value of all goods and services produced in one year) of China and Japan. It is also equal to 1.33x the total value of all US companies trading on stock exchanges (market cap) and it is the equivalent of giving each man, woman and child living in the United States $42,460. If laid end to end, 12.9 trillion $1 bills would stretch to the moon and back 5 times.

Over the last several months, those who watch the news or read the newspapers would have learned many new abbreviations and terms – TARP, TALF, Term Auction Facility, conservatorship, etc. The US government currently has 19 different programs to assist financial service companies like AIG, Citigroup, Fannie Mae and automakers General Motors and Chrysler. Here is a summary of their commitments as prepared by the New York Times:

US Government Programs			
	Program	Committed	Spent
Investment Activities	Investing in troubled companies and purchasing assets	$7.7 trillion	$1.4 trillion
Lending Activities	Accepting illiquid or "bad" collateral in return for loans and US Treasury bills	$2.3 trillion	$680 billion
Insurer Activities	Backing loans and commitments for companies	$2.1 trillion	$340 billion
Economic Stimulus	American Recovery and Reinvestment Act	$787 billion	$12.8 billion[2]
Total		$12.9 trillion	$2.5 trillion

[2]Spending is just starting. See www.recovery.gov for more information.

So far, only about $1 out of $5 committed has been spent. It appears that some of these commitments, like the insurer activities, may not be necessary and may not cost the US government any money at all. Other programs, like the American Recovery and Reinvestment Act, are still in their very early stages. There are some early encouraging economic signs emerging yet only a fraction of the pledged dollars of the US government has been injected into the financial system and economy. The full impact of Uncle Sam's intervention has not been felt yet. When more money flows through the financial and economic systems the pace of recovery should gain momentum. Perhaps, as important, these actions will help restore consumer confidence.

Quantitative Easing

As a further measure to stimulate the economy and reduce spreads, the US government has now turned to an additional program called quantitative easing. Other governments are following suit. Quantitative easing is the process where the central bank purchases securities in the market to increase the money supply. These securities are US Treasury bonds, mortgage backed securities and corporate bonds. The Federal Reserve plans to acquire as much as $300 billion over the six-month program. A willing buyer with (essentially) unlimited cash will push longer term bond prices up and the yields down. It is expected that these lower yields will in turn lower mortgage rates and borrowing cost for governments and corporations. The sellers of those securities receive cash which they will then hopefully spend in the economy. If the seller happens to be a bank, then the bank can lend out a multiple of this new cash to borrowers. Quantitative easing does have some dangers. First, some of the assets that are being bought by the central bank may default, in which case the loss is ultimately picked up by the taxpayer. Second, aggressive quantitative easing may result in inflation and a loss of confidence in the currency. Already, China, holder of about $1 trillion of US Treasury assets, has expressed its concern over the long-term stability of the US dollar.

Quadrant's Actions

Quadrant is continuously analyzing what is happening with respect to market movements and economic data. Among the actions we are taking are:

- Dynamically hedging the US equity portfolios (pooled funds) to counter currency swings. The US dollar has been the main beneficiary of the 'flight to quality assets' over the past six months. As investors seek higher returns and with the rising US deficit, the US currency could decline, causing US dollar based assets to fall in value. Hedging will guard against unwelcome currency movements.
- Rebalancing to target asset mixes.

- Investment manager monitoring. Quadrant believes that active equity managers are better positioned to take advantage of market opportunities than a passive strategy.
- Asset allocation analysis to ensure your comfort with your asset mix and risk tolerance
- Financial independence analysis to ensure that your wealth planning goals stay on track.

Looking forward, the funds authorized under the $787 billion stimulus law are just starting to flow. Those funds will soon be trickling through the economy – in the form of reduced taxes and government program spending. Quantitative easing will put additional liquidity (cash) into the economy as well as help lower spreads. Overall, the results for the moment are still somewhat mixed. It is perhaps too early to say that the glass is half full, but like spring, there are some encouraging signs.

Sincerely,

Quadrant Asset Management

MP/MS/RI