

## **Towers Perrin Market Review – October 1 to December 31, 2008**

What began as a real estate bubble in the United States, fuelled by very low interest rates and unbelievably lax mortgage lending standards, has developed into a truly global recession. A number of economic commentators believe that this is likely to be the worst recession of the post-war era and could drag on well into 2010. Bill Priest of Epoch Investments in New York has termed this “The Great Recession.” The Governor of the Bank of Canada has recently presented a somewhat less pessimistic view for the Canadian economy, but Canada will not be immune from the impact of this global recession. Central banks around the world have lowered the interest rates at which they lend to banks (e.g., Fed funds rate) to the lowest levels ever in an attempt to inject liquidity into the financial system. Governments (U.S. and Europe) continue to step in to rescue banks, increasing their ownership stake in the banking system in the process and helping them repair their shattered balance sheets. The resumption of normal bank lending behaviour (to their customers and among themselves) is essential to ending the credit crunch that has slowed economies to a standstill. Unfortunately, much of the news for the next while will continue to be negative, as corporations report sharp downturns in revenues/profits and announce lay-offs. Governments of most major countries are introducing massive fiscal stimulus packages in an attempt to stave off the worst elements of the recession and get their economies moving. At this stage, most governments are more worried about deflation than about the possibility of future inflation.

Bond markets continued to be volatile in the fourth quarter. Investors in most countries have continued to flee to the safety of government bonds, driving the yields for sovereign bonds of most countries sharply downward. For example, 30-Year Canada bond yields dropped to 3.45% by December 31, including a 90 basis point drop during the month. Yields on 3-month U.S. Treasury bonds actually fell to negative levels for the first time since 1940, with investors effectively paying for the privilege of owning these bonds. Yield spreads on corporate bonds (over sovereign debt) in most countries are at levels not seen since 1931, reflecting bond investors’ unwillingness to take on any risk at this time. For example, in the U.S., BBB rated corporate debt, which is the lowest level of investment grade debt, is yielding more than 7% in excess of a comparable term to maturity government bond. Spreads are so extreme that they reflect default rates far in excess of those actually experienced during the Great Depression. As governments issue the large amounts of debt necessary to finance their huge fiscal stimulus packages, the rebalancing of supply and demand factors is likely to result in an increase in government bond yields to more normal levels. In addition, market stabilization will ultimately cause corporate bond spreads to return to more normal recessionary levels. This process will produce superior returns for those holding corporate bonds, although it is unclear when this normalization will occur.

Equity markets have experienced some of the worst volatility in history. Over the fourth quarter, the S&P500 experienced 18 days of at least 5% returns (7 up, 11 down); this compares to 17 such days over the previous 53 years. The period from mid-September (the collapse of Lehman Brothers) to mid-November may also prove to be the worst period for global stock market returns in history. Yet, stocks did have a brief rally in December, with fundamental factors again beginning to influence behaviour (i.e., companies with strong balance sheets and good earnings outperformed those of lower quality). The Canadian stock market was one of the worst places to invest, as its performance was worse than that of all major indices including the emerging markets. The Canadian market was led downward by the Energy, Materials and Information Technology sectors and Canadian bank stocks were punished by investors; the Financial, Energy and Materials sectors made up more than 70% of the Canadian market at the beginning of the quarter. In addition, Nortel Networks had such poor performance that it fell below the threshold for inclusion in the S&P/TSX Index and was removed; the company has since filed for bankruptcy protection. Over the quarter, foreign equity indices were driven lower by Information Technology, Materials and Financial stocks, although these sectors make up a much smaller proportion of those indices. For Canadian investors, losses on foreign stock portfolios were mitigated by the sharp weakening of the Canadian dollar against the U.S. dollar, yen and euro. While the scale of equity market volatility seems to be gradually reducing (although still nowhere near normal levels), the prospect of poor corporate earnings reports over the next quarter or two are likely to be a lead weight around the prospects of a near-term recovery of the markets. This is likely to be a period in which the companies you select to own is a more important factor than owning the market as a whole, as differences in corporate performance are likely to be very marked through this recession. From a market point of view, it is important to remember that the stock market tends to rebound in advance of any sign of economy recovery.