

Q3 2009 – The Market in Review

While it appears that the recession is officially over in many parts of the world (the Governor of the Bank of Canada declared the recession in Canada over in June), this does not mean that the world is out of the economic woods. Unemployment continues to be at very high levels in most countries and continues to increase in a number of regions. World trade is down over 20% year-on-year, industrial production remains substantially negative compared to last year and most economies are operating well below capacity. For the first time in 70 years, we are seeing retail price deflation on a global basis, as consumers and corporations attempt to pay down staggering debt loads and repair their balance sheets – U.S. consumer savings rates are at their highest level in decades. The prospect of consumer-led economic growth appears bleak in much of the developed world. At present, the recovery and the potential for growth have been government-financed, a situation that is only a short-term palliative solution. According to OECD estimates, fiscal deficits of its member nations as a percentage of gross domestic product (GDP) have risen from 1.4% in 2007 to 7.7% in 2009 and an estimated 8.8% in 2010. In Canada, our projected deficits of 4.8% and 5.5% for 2009/10 respectively look good both relative to the average and particularly relative to the United States (10.2% and 11.2%) and the United Kingdom (12.8% and 14.0%). In addition, Canada's total debt as a percentage of GDP began the crisis at a much lower level than the other OECD members. Combined with our lack of significant banking problems, Canada may indeed prove to be more resilient than many of our peers.

Bill Priest of Epoch Investments provides a very useful framework for understanding this economic crisis and determining where the OECD stands in getting out of the problem. He views the crisis as involving three problems: a liquidity problem, a solvency problem and a recession problem. The liquidity problem (the complete lock-up of the credit markets) has passed, as evidenced by the behaviour of the Treasury Eurodollar (TED) spread, a proxy for the cost of interbank lending. TED spreads typically range between 25 and 50 basis points (bps), but increased to the 100 to 200 bps range from August 2007 to August 2008 and to 460 bps last fall. TED spreads are now around 19 bps. The solvency problem relates to the write-offs of financial assets, estimated by the International Monetary Fund to total \$4 trillion. To date, roughly \$3 trillion in write-offs have been recognized with the remaining amount likely relating to commercial real estate and non-performing loans of many varieties. We, therefore, may be through the worst of the solvency problem. While the recession has likely ended, this does not mean that significant real growth is necessarily in the short term horizon. Mr. Priest suggests that, in order for real growth to occur in developed economies, there must be a transition from government stimulus to private sector growth, with private sector employment growing and those who are employed receiving higher incomes. In other words, stimulus spending must create private sector employment opportunities and earnings growth for businesses. By these criteria, growth is still a fair distance away in many countries and thus a sustainable recovery remains in the future.

The bond market currently reflects little expectation of price inflation in the short to medium term, as the yields on 10 year Canada bonds are at 3.31% as at September 30. Canadian corporate bond spreads (the difference between the yield on a corporate bond and a comparable term Treasury) have narrowed very aggressively from their high of 6.55% on an A-rated 5 year corporate bond to 1.23% at September 30 – while this is still somewhat higher than normal, the degree of future narrowing will be limited. Corporate bond spreads in other countries (relative to that country's federal government bond) also continued to narrow during the third quarter, following aggressive narrowing during the second quarter. For example, in the U.K., corporate bond spreads (A-rated bonds) hit a high of 7.22% in late March; they have since narrowed to 4.53% at June 30 and 3.01% on September 30 – note that these are still well above normal spreads of 75 to 125 bps. In the U.K., this meant that corporate bonds outperformed their government counterparts by 5.5% for the quarter. For foreign corporate bonds, the expected future return continues to be high relative to that for their Canadian counterparts. The DEX Universe Bond Index posted a return of 2.7% over the quarter and has a return of 5.6% for the year-to-date.

The equity market rally continued through the third quarter, although it continues to be led by those companies that were on the verge of bankruptcy earlier this year (a number of whom received government bailouts). This is evidenced by the fact that the best performing sector over the quarter was the Financial sector (with a return of 23% relative to the next best sector at 16%), the sector that was most subject to government bailout. In general, the defensive sectors (Health Care, Utilities, Telecoms) were the worst performing sectors over the quarter. The Canadian market posted a very strong quarter, with the S&P/TSX Composite gaining 10.6%, for a year-to-date return of 30%. In the global equity markets, much of the story for the Canadian investor was the continued strengthening of the Canadian dollar relative to most global currencies – it rose 8% against the US dollar, 4% against the Euro and 11% against the pound sterling. This meant that, although the MSCI World Index (local currency) posted a return of 15% for the quarter and 20% year-to-date, the return for the unhedged Canadian investor was reduced to 9% for both periods. As befits a market that is anticipating economic recovery, the best performing sectors (other than Financials) have been the economically sensitive sectors (Industrials, Materials and Information Technology).