

Market Observations

April 16, 2009

Looking for substance over form

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The real deal or just another bear market rally?

In the field of accounting, “Substance over form” is a principle used to ensure that the financial statements reflect the complete, relevant, and accurate picture of the transactions and events. Taking another perspective of this and parlaying this theory over to equity markets, this recent five-week rally by the S&P 500 Index (+26%) and S&P/TSX Composite Index (+22%) has arguably painted a picture of a decent economic recovery. In our opinion, for the market to remain at current levels or perhaps trend even higher, we will need to see this move substantiated in the form of stability in employment figures and corporate earnings. We have recently seen a few economic data points that may support this notion, but it is far too early to tell if this is a sustainable trend. Heading into calendar Q1 earnings season, results and guidance will be closely scrutinized as investors search for evidence to confirm this rally.

Nice bounce from oversold conditions; gains will likely be harder to come by

The markets have clearly demonstrated a tendency to overshoot on both the upside and downside. In late February, both the S&P 500 and the S&P/TSX Composite Index hit new 52-week lows on renewed concerns over the state of the financial sector. The flight to defensives trend was prominent as there were a number of specific concerns surrounding banks and insurers including fear of new capital requirements, potential for dividend cuts, as well as concerns over earnings visibility/stability given the combination of volatile markets and rising loan losses. Volatility and risk aversion trumped rationality and fundamentals causing valuations to reach extremely attractive levels and some dividend yields to soar to all-time highs. All things considered, despite the weak economic outlook, we were of the view that the sell-off was overdone at that time (see our publication “Life Insurance – Where have the premiums gone?” from March 10).

Interestingly, over the past five weeks, there has been a drastic reversal in investor sentiment; financials and energy stocks have made sharp recoveries as capital rotated away from more defensive sectors such as health care and utilities. To be clear, we expected a rebound but certainly not one of this magnitude or pace. North American markets roared back over 20% from oversold levels and the sense of optimism among some investors have clearly turned on the back of a number of catalysts including:

- better-than-expected economic data points released south of the border (ISM indices, consumer confidence, housing starts, retail sales) and in China (loan growth and industrial output);
- a number of financial institutions including Citigroup (C-NYSE), Bank of America (BAC-NYSE), and Barclays (BCS-NYSE) indicating that operations were profitable in January and February;
- better-than-expected earnings at Wells Fargo (WFC-NYSE) as a result of strength in traditional banking businesses, strong capital markets activities, and “exceptionally strong mortgage banking results”;
- changes to mark-to market accounting rules allowing for greater discretion on fair-value accounting;
- possibility of the Securities Exchange Commission reinstating the uptick rule on short sales and/or banning short sales on stocks that have declined by a predetermined percentage;
- some merger and acquisition activities including the merger of Suncor (SU) and Petro-Canada (PCA), the acquisition of Centex Corp. (CTX-NYSE) by Pulte Homes (PHM-NYSE), and the purchase of WellPoint’s (WLP-NYSE) pharmacy

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benefit management unit by Express Scripts (ESRX-NASDAQ);

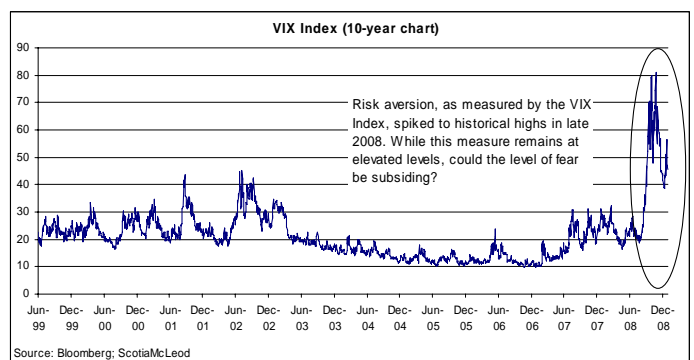
- a fairly positive tone coming out of the G-20 meeting after finance ministers from various nations reiterating their commitment to do "whatever is necessary" to fix the global economy and restore the financial sector;
- Federal Reserve's decision to purchase US\$300 billion of U.S. Treasury Bonds; and,
- more clarity on Treasury's plan for public-private partnerships (PPIP) – a plan designed to remove the uncertainty around "toxic assets" on banks' balance sheet by providing incentives to entice banks to unload toxic securities and to give private investors an attractive reason to buy them.

The copious amount of positive news provided a much needed jump to an arguably oversold market. That said, in our view, we are now approaching a precarious level in the market from both a technical and fundamental perspective. The point we would like to emphasize is not that the recent run was entirely unwarranted, but more so that, even if it is the case that we have established a bottom, any further torque will likely require the support of firm economic statistics and corporate earnings.

How much more legs beyond 900 points for the S&P 500 Index?

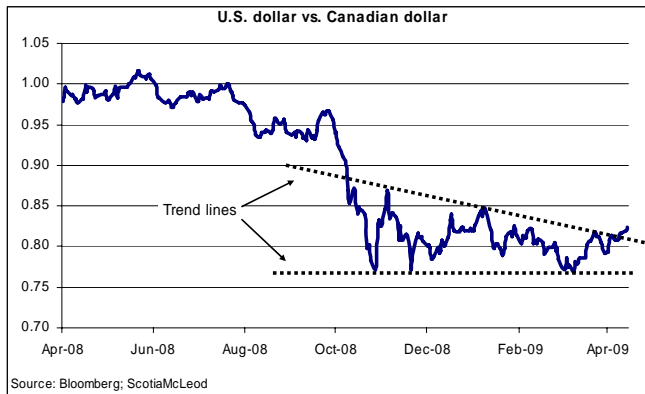
Market performance has been resilient the last several weeks and there remain a number of potentially positive developments in the market including:

- The VIX Index, a widely followed measure of the implied volatility of S&P 500 index options, continues to ease over the past several weeks after hitting a high of 79.1 in October 2008. This index is often monitored as a measure of risk aversion (the higher the number, the more nervous/fearful the market is) and has historically traded closer to the range of 10 to 20 under more normal market conditions. The VIX Index currently stands at 36.2, just below the level set during the January 2009 rally of 36.9. If this measure continues to ease, it could be a positive indication that risk tolerance is gradually, albeit potentially slowly, returning to normalcy and the cost of capital for most companies is progressively reverting to more traditional levels.

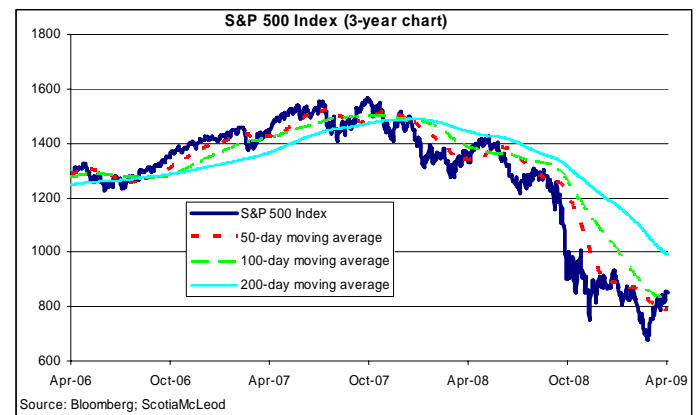
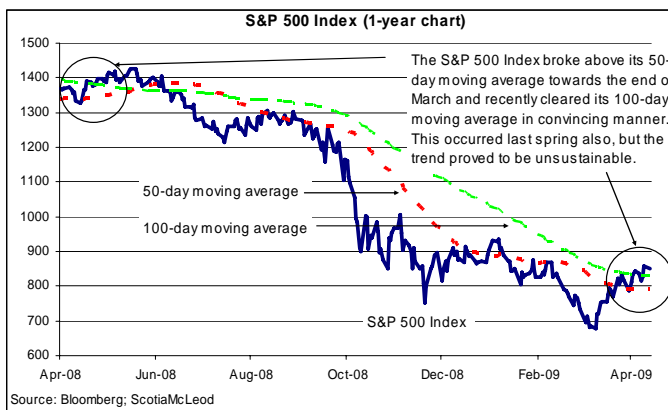


- Related to the decline in volatility of the equities markets, such a scenario could result in some downward pressure on the U.S. dollar as investors unwind some of their "flight-to-safety" positions in U.S. Treasuries. This has positive implications for the market, particularly commodities and the related stocks. Essentially, many commodities are priced in U.S. dollars and a weakening greenback increases demand for commodities. The offset to this is that the outlook for economies in other regions such as Japan and U.K. continue to deteriorate, thereby making the U.S. dollar slightly more attractive on a relative basis. Therefore, in the near term, we expect some softness in the greenback but not necessarily a material collapse. Longer-term, we continue to believe that the U.S. dollar may be vulnerable given that they have spent trillions of dollars on bailouts and stimulus programs.

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- The spate of mergers in recent weeks is perhaps a sign of companies seeking bargains in a market with attractive valuation/acquisition opportunities. It is reassuring to see buyers surface at current levels and to see management as well as board of directors committed to driving shareholder value in this climate. Despite this recent trend, however, we continue to stress that investors need to be mindful of the economic and credit environment we are working under; tight credit conditions, extreme focus on balance sheets, conservative and prudent growth aspirations, are certainly not conducive to a significant number of mergers and acquisitions. Unlike '06 and '07, this is certainly not an environment that warrants investing based on the 'take-out potential' of a company.
- The S&P 500 Index broke above its 50-day moving average towards the end of March and recently cleared its 100-day moving average in convincing manner on Thursday, April 9. Short-term investors, particularly programs and technical traders, will likely view this as a positive. We caution that we also witnessed this occurrence last spring, but the trend was short-lived as the market fell back below those moving averages in June 2008. It will be interesting to see if there are enough buyers at the 100-day moving average (currently ~828) this time around for it to become a level of support for equity markets. For longer-term investors, it is worth noting that Scotia Capital's Portfolio Strategist Vincent Delisle has recently become more constructive on equities but continues to wait for the 50-day moving average to cross the 200-day moving average before recommending an asset allocation with maximum equity exposure.



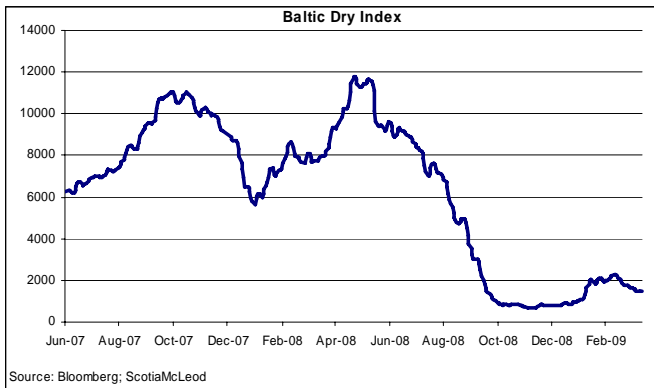
- Based on historical data, the overall equity markets often experience a spring time rally, followed by a trend of "sell in May and go away." Further fuelled by oversold conditions leading into March this year, an abundance of cash on the sidelines, and short-covering activity, the market has gained tremendous traction. The psychology and momentum behind this trend and seasonality should not be underestimated.

Slightly more constructive, but lets take things one step at a time

We recognize that market conditions now are better than they were in the fall of last year with slight improvements in credit markets, and increasing investor appetite for various preferred share and common share issues – even though it may come at a higher price for the issuers. Also, we do not doubt that the factors listed above can continue to drive the market higher. However, there are a few items that preclude us from taking a more bullish stance in the near term:

- From a fundamental perspective, as previously published by our colleague Paul Danesi on March 24, “First quarter earnings and Q1 GDP are both likely to be a wake-up call for analysts and their overly optimistic earnings estimates. With more than 95% of companies in the S&P 500 having reported Q4 financial results, operating earnings declined nearly 70% year-over-year to an abysmal \$5.55. Earnings for the full year were U\$49.50. The current bottom-up consensus estimate for S&P 500 earnings for 2009 is U\$63.00, implying growth of 27% year-over-year. Given current economic conditions, we would be surprised to see any earnings growth whatsoever in 2009. Lower business activity and foreign currency losses are likely to be large headwinds for U.S. multinationals. The offsetting benefits of cost cutting initiatives will have a lagged effect as they take time to implement. The one wild card is bank earnings. Citigroup, Bank of America, and JPMorgan have all suggested they are having a decent quarter. The S&P 500 is trading at 16.6 times trailing earnings. What multiple will investors be willing to pay for earnings of U\$40 or U\$45?” In the context of these estimates and valuation multiples, an argument can be made that there remains some lofty expectations in the market place and even if the market were to show some modest earnings growth, we are near levels that reflect full value for the S&P 500 Index.
- While certain housing and economic numbers have been better-than-expected and have shown some signs of modest deceleration in the rate of decline, we believe it may be a bit premature to mark this as the start of an upturn in the markets. Sparing you the repetitive explanation and details of the housing collapse and the deleveraging process, as well as its implications on consumer spending that represents 70% of U.S. GDP, we would simply highlight that: i) a few data points do not make a trend; ii) deceleration does not mean that stabilization or better yet, a recovery, is on the horizon; and, iii) a significant amount of capital has been removed from the system in this deleveraging process, a great deal of wealth has been destroyed, and a lot more time will be required to restore investor confidence.
- The Baltic Dry Index is a number issued daily by the London-based Baltic Exchange and provides an assessment of the price of moving the major raw materials by sea. The index is often observed by investors as an indication of economic activity. In December 2008, the index fell to 663 points, reaching its lowest level in more than two decades and indicating that supply of shipping capacity far outweighed shipping demand. The index recovered through January and February, reaching a recent high of 2298, but has subsequently fallen again to current levels of approximately 1492. It would be helpful to see upward momentum in the Baltic Dry Index to confirm this rally in equities and commodities.

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- Gold is often viewed as a safe haven in volatile times as risk adverse investors believe this commodity represents the ultimate store of value. Using this as a proxy for risk tolerance, it is somewhat surprising to see the price of the bullion essentially unchanged since the start of the rally in equities in March. While we understand the merits of gold as a hedge against inflation, we do not view this as an immediate threat at this stage. Accordingly, this discrepancy perhaps suggests that the price of the bullion is currently overvalued in the near term (which would help substantiate the current rally) or that the stock market has run ahead of underlying fundamentals.
- Fate of automakers may pose some headline risk as the companies work to restructure their operations in an effort to avoid bankruptcy proceedings. It was recently reported by the New York Times that the U.S. Treasury Department is directing General Motors (GM-NYSE) to lay the groundwork for a bankruptcy filing by June 1st. While we perceive this to be a longer-term positive for the market (by structuring healthier, more competitive companies), the near term concerns over job losses and impact on pensions could weigh on the market.

Summary

The five-week rally posted by equity markets worldwide has been impressive as we continue to head through this seasonally strong period for equities. There remains a tremendous amount of positive momentum in the market. However, in the absence of a trend of stabilizing and/or improving economic and earnings data, we believe that the market is quickly approaching fair value (and arguably based on some generous assumptions). Generally speaking, while the environment feels moderately more constructive, there is still a substantial amount of risk in the macro environment given the severity of the economic downturn and we emphasize the need to remain nimble.

Accordingly, we would be reluctant to add to our positions at current levels as we head in to earnings season. In fact, for short-term oriented investors, we believe that the market is gradually trading towards overbought territory and in the face of a potentially stormy earnings period, we would be inclined to start taking profits. For longer term investors, we do not see the need to chase this market as risks are beginning to outweigh potential rewards at current levels. We continue to highlight that even if this is the bottom of the bear market, there is absolutely no guarantee that we are in for a sustainable and material rally (especially given that we are already up 20%+). We could potentially be in for an extended period of range-bound activity and as a result, one strategy we continue to recommend is to focus on dividend paying stocks to enhance income potential.

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Caution Warranted

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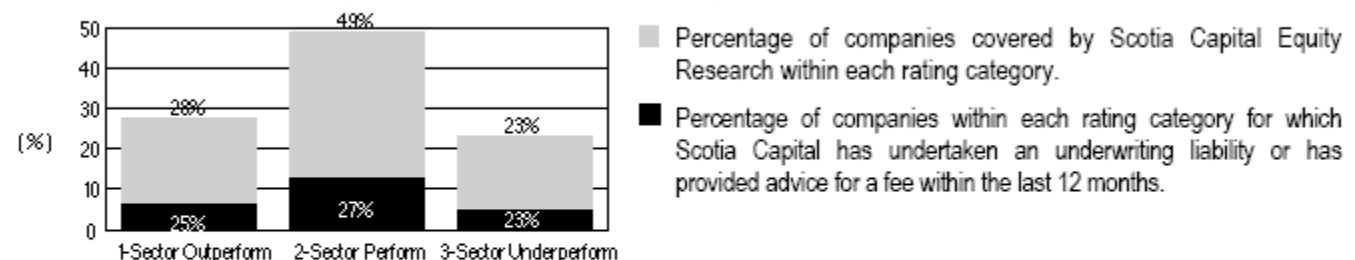
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