October 2008 – The Market in Review

Many of the problems that became manifest during the third quarter continued to have a major impact on financial markets during the month of October. Housing prices continue to fall, particularly in many parts of the U.S. and in Britain, further exascerbating the issues with bank balance sheets as increasing numbers of homeowners in these countries find themselves with negative home equity. Banks are still not willing to lend to each other (a necessary condition for the recovery of the financial sector) and are very slow to provide credit even to their most creditworthy customers. The economic news continues to worsen globally, as expectations now are for a significant global slowdown/recession and a number of corporations have begun to announce reductions in their workforce. Consumers are feeling the pinch (reduced wealth due to falling house prices and shrinking investment portfolios plus less certainty regarding their job security) and have largely stopped spending on discretionary items, thus worsening the economic slowdown. The U.S. government's \$700 billion Troubled Asset Relief Program (TARP) was passed by Congress in early October and money has already been provided from this fund to a number of financial institutions and other corporations (the Big Three car companies are the latest supplicants). In the U.K., a similar major pool of capital was made available to British financial institutions and ultimately resulted in the "nationalization" of the Royal Bank of Scotland and HBOS. Most commentators are not expecting a significant improvement in global economic conditions in the near term. The G20 countries appear prepared to move aggressively to stem the crisis, using both monetary and fiscal policy tools.

A factor that has become increasingly evident in the investment market behaviour over the last few months is the significant deleveraging and redemption activity that is occurring in hedge funds. In principle, hedge funds "short" investments they believe will perform poorly (i.e., they sell securities they do not own) and use the cash from those transactions to buy investments they believe will perform well. This creates leverage (i.e., a dollar of investment is used more than once within the investment portfolio) and hedge funds attempt to manage the degree of leverage in their portfolio to maintain a certain "risk" profile. As the riskiness of markets has increased markedly, hedge funds are forced to reduce the degree of leverage in order to maintain their desired risk profile. This means that they need to sell the investments they like in order to cover their short positions. Redemption requests from investors create a similar impact (selling attractive investments to cover short positions). This likely explains part of why the stocks of high quality companies have performed so poorly during recent months (as these are the securities that hedge funds are often selling). It may also explain some of the precipitous drop in commodity prices.

The credit crunch and continued lack of liquidity available for corporate lending (from banks and investors) continued to cause a rapid increase in the spread between yields on corporate bonds (at all maturities) and federal government bonds around the world. Corporate spreads are now at their widest level since the 1930s and are particularly wide for bank bonds. In Canada, the flight to quality has also hurt spreads on provincials bonds. This resulted in negative returns for bond indices during the month of October, particularly for longer maturity bonds. It also meant that investment managers who owned more credit exposure than the Index experienced very poor results.

Equity markets globally experienced a second month of horrendous results; the past two months represent the worst two consecutive months of equity market performance since 1932. Day-to-day market volatility is at unheard of levels, with most markets experiencing movements of at least 5% during more than 50% of the trading days in October. Commodity prices (oil, natural gas, metals) continued to fall during the month. On a global basis, the October equity market decline was led by the Materials, Financial and Industrial sectors; in Canada, Energy and Information Technology (i.e., RIM and Nortel) also posted weak results. The emerging markets continued to be the worst place in which to invest, particularly if the investment was in commodity based companies. For the Canadian investor, returns were significantly impacted by the weakening Canadian dollar, as the Canadian index return of -17% was far worse than the return of the MSCI World Index which returned -7% for Canadian investors (vs. -16% in local currency terms). The Consumer Staples and Health Care sectors continued to be the places of relative safety in the global indices, again posting small positive results for Canadian investors.

Many institutional investment managers are beginning to speak of the tremendous "bargains" that are becoming available. Bond managers note that current credit spreads, although largely driven upward by lack of liquidity, are now at levels that would normally imply a high probability of bankruptcy; if one can select bonds of companies with little risk of bankruptcy, returns over the next few years could be very strong (as yields return to normal levels). On the equity side, managers note that they are now able to buy many of the world's best companies at prices well below anything they have previously seen. While not suggesting that the current "bear" market is finished (as economic news continues to worsen), long-term investors, such as pension funds, have a tremendous opportunity to upgrade the overall quality of their investment portfolios with the expectation that this should help their performance during the next cycle.