RBC Asset Management®

CAPITAL MARKETS UPDATE
A BREAK IN NEGATIVE FEEDBACK LOOPS?

Last weekend, the process of deleveraging the global banking system intensified, forcing Merrill Lynch into a merger with Bank of America, a bailout of AIG and Lehman Brothers into bankruptcy. Morgan Stanley and Goldman Sachs, the last major independent U.S. dealers still standing, were tested as their access to funding was questioned. The point of maximum stress arrived Tuesday night. Losses on Lehman Brothers commercial paper caused the Reserve Primary Fund to “break the buck” on its $60 billion money market fund, and ultimately close. Wednesday, U.S. money market funds were hit with $90 billion in redemptions, several big players announced the closure of funds, and stocks of State Street and other money managers plunged as much as 58%.

As the contagion that began in the residential mortgage market way back in August of 2007 had now spread to the safest pool of savings, the Fed, U.S. Treasury and, apparently, Congress, drew a line last night. Rather than deal with crises individually while keeping markets functioning with regular and massive injections of liquidity, three important initiatives were announced. First, the federal government is considering a facility along the lines of Resolution Trust, the workout scheme created in 1989 to limit the fallout from the failed U.S. Savings & Loan industry. Second, the Federal Reserve will provide insurance for certain types of money market funds, effectively guaranteeing their net asset value and, third, the SEC will ban short selling for a period of 10 to 30 days. In our view, these three steps represent the circuit breaker that has been missing. *Negative feedback loops that allowed losses to rebound through markets and the economy over the past year should now be broken.*

RISKS STILL LURK, BUT…

The implications of last night’s package are considerable. First, though, we want to remember that risks still lurk. At the epicentre of the crisis is residential real estate, and the correction there hasn’t ended. Still, a large part of the adjustment is likely behind, as a 16% fall has moved existing house prices toward levels consistent with incomes (Exhibit 1). Defaults on subprime loans may finally have peaked (Exhibit 2), mortgage rates have dropped considerably and the availability of funding has expanded since the federal government took control of Fannie Mae and Freddie Mac two weeks ago. But the crisis won’t surely be over until house prices stabilize.

Exhibit 1

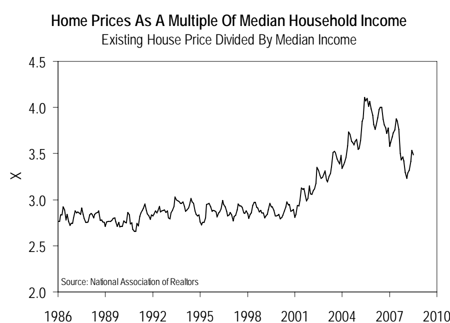
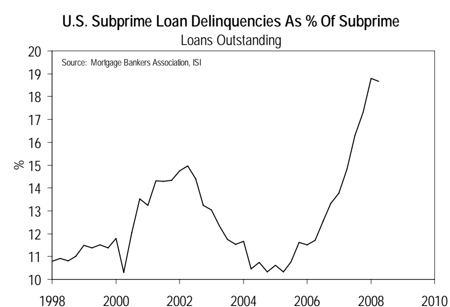


Exhibit 2

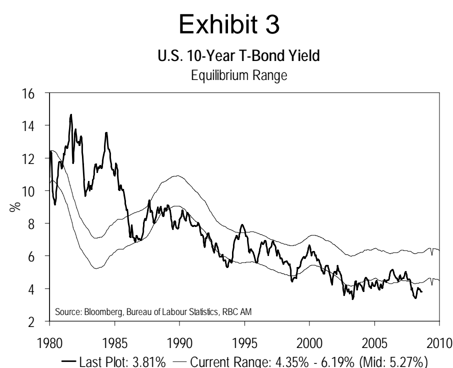


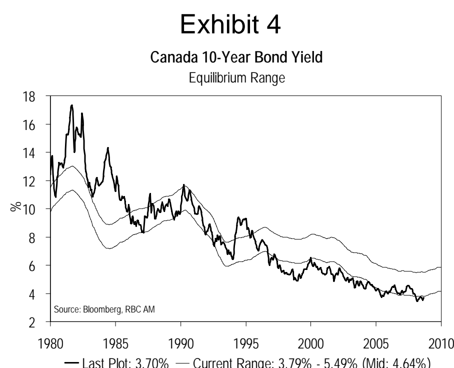
…THE ECONOMY SHOULD REGAIN MOMENTUM BY MID-2009

The broader economy faces its greatest test over the coming two quarters as the fiscal stimulus package runs out, booming exports come up against slowing economies offshore and the lagged effects of the credit crunch bite. It's likely that GDP growth will stall in the closing quarter of 2008 and remain negative for the first quarter of 2009. By the spring, though, the full power of prior reductions in the fed funds rate will be at work. If the initiatives announced today and those put in place over the past months are successful in restoring confidence and unclogging the credit pipeline, the economy should be gaining momentum as the summer approaches. Importantly, firmer growth should be accompanied by low inflation.

YIELDS ARE TOO LOW…

U.S. T-bond yields broke 3.25% on Tuesday and then spiked to current levels near 3.75%. Although the drop in energy prices and flagging economy sparked the latest rally in bonds, we have to believe that a large part of the drop in yields is the flip side of panic in the stock market. Those seeking the safe haven of government bonds should consider the risk of normalization in risk premiums as the credit crunch eases. Exhibit 3 plots the 10-year T-bond yield against its equilibrium range. In past cycles, as recession ultimately gave way to growth, investors began to seek out the better returns that come with risk. Yields moved from beneath the band to its midpoint or above, sometimes slowly, sometimes quickly. A similar move today would push 10-year T-bond yields to 5.25%. We look for a 10-year T-bond of 4.50% by this time next year. For Canada (Exhibit 4), we forecast 10-year government yields at 4.25%.





…AND STOCKS SHOW SIGNIFICANT UPSIDE POTENTIAL

Stocks are down a lot, and valuations are compelling. Our fair value model for the S&P 500 (Exhibit 5) shows that the index pierced the lower reach of its equilibrium channel Wednesday before its sharp snapback over the past 24 hours. Our fair value composite for global markets (Exhibit 6) shows the major indices have fallen 24% beneath equilibrium, approaching levels similar to those at the end of the Tech Wreck.

Our analysis of returns through the post-war era shows that the best periods to buy stocks are those where inflation holds below its long-term average of 4.2% *and* stocks rest below the band's midpoint. Periods where these twin conditions are satisfied are relatively rare – only 32% of months since 1960. But during these periods, 12-month gains averaged 13%, the incidence of positive returns was 85.4% and, even when the short odds came up, the biggest 12-month loss was only 13.8%. Exhibit 7 tests a strategy of buying the S&P 500 in the first month that the index fell below fair value during a time of low inflation. Three months later, returns are positive

for 5 of 9 cycles. The incidence of rising markets shifts considerably higher to 7 of the 9 cycles after 6 and 9 months. One year following, markets are in positive territory in 8 of the 9 cycles with average gains of 23.6%, with the single losing cycle almost breaking even at -1.5%. Importantly, the economy was mired in recession during two of those cycles.

Exhibit 5

Exhibit 6

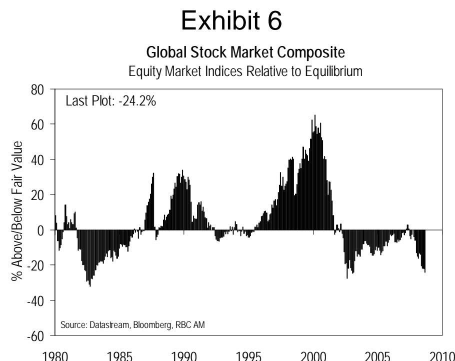


Exhibit 7

Returns from 1st Month S&P 500 Falls Below Fair Value & Inflation Below Long-term Average

Period Begins	Period Ends	Economic Backdrop	3 Month Return from Beginning	6 Month Return from Beginning	9 Month Return from Beginning	1 Year Return from Beginning	3 Year Return from Beginning (CAGR)	5 Year Return from Beginning (CAGR)	Duration (Months)
Jan-60	Dec-60	Recession	-2.2%	-0.2%	-4.0%	11.1%	6.0%	9.5%	12
May-62	Feb-63		-0.9%	4.4%	7.8%	18.7%	14.0%	6.1%	9
Sep-71	Oct-72		3.8%	9.0%	8.9%	12.4%	-13.5%	1.4%	14
Dec-82	Jan-84		8.8%	19.5%	18.1%	17.3%	14.5%	11.9%	14
Nov-84	May-87		10.8%	15.9%	15.3%	23.6%	12.1%	15.1%	31
Jan-88	Sep-88		1.7%	5.8%	8.5%	15.7%	10.2%	11.3%	9
Aug-91	Mar-95		-5.0%	4.5%	5.1%	4.8%	6.4%	10.5%	44
Jun-02	Sep-03	Recession	-17.6%	-11.1%	-14.3%	-1.5%	20.4%	8.7%	16
Jul-04	May-08		2.6%	7.2%	5.0%	12.0%	9.7%		47
Average			*0.2%*	*6.1%*	*5.6%*	*12.7%*	*8.9%*	*9.3%*	*22*
Median			*1.7%*	*5.8%*	*7.8%*	*12.4%*	*10.2%*	*10.0%*	*14*
Number of Cycles			*9*	*9*	*9*	*9*	*9*	*8*	
Wins			*5*	*7*	*7*	*8*	*8*	*8*	
Losses			*4*	*2*	*2*	*1*	*1*	*0*	
Best			*10.8%*	*19.5%*	*18.1%*	*23.6%*	*20.4%*	*15.1%*	
Worst			*-17.6%*	*-11.1%*	*-14.3%*	*-1.5%*	*-13.5%*	*1.4%*	

All returns not including dividends
Data based on daily close prices
High inflationary environment defined as inflation exceeding 4.2% (long term average inflation since 1960)

Source: RBC AM

Our view has been that, at some point, selling will be exhausted, confidence will gradually be restored and the markets will wander toward their fair values. By mid-week, a variety of technical indicators were signalling an approaching low. The VIX (Exhibit 8), an index of volatility in the options market, spiked to 40 on Wednesday morning, its highest level in 6 years and above those that indicated the lows for the index in 1997 and 2001. Similarly, surveys of market sentiment highlight a preponderance of bearishness. Through July and most of August, Investors Intelligence (Exhibit 9) showed less than 30% of traders were bullish on the outlook for stocks - the kind of pessimism common to market troughs including the Tech Wreck. Price momentum, too, (Exhibit 10) indicates the market is deeply oversold and approaching a turn for the better.

Exhibit 8

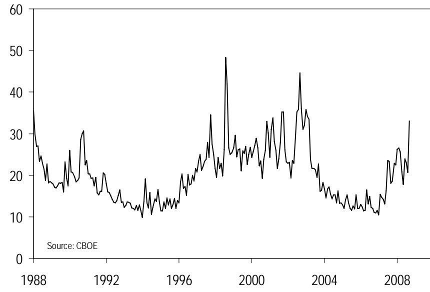


Exhibit 9

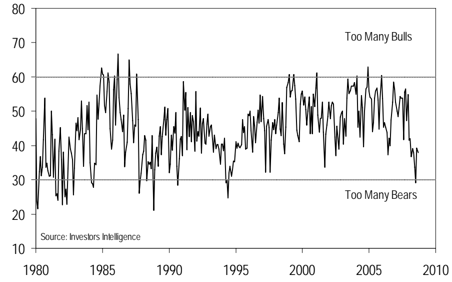
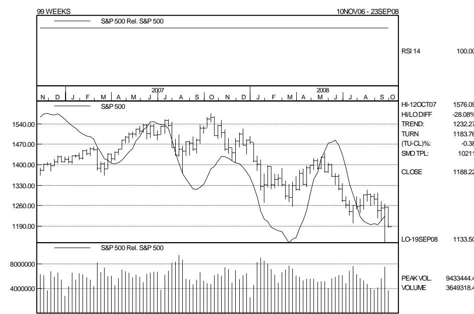


Exhibit 10

S&P 500 COMPOSITE



As negative feedback loops are broken and financial institutions begin to lend once again, we believe that confidence will recover and stock markets will move in the direction of fair value. Attention will shift, and is perhaps already shifting, to valuing stocks on the basis of future earnings potential in a stable and growing economy. More recently, values have reflected a panic. Three weeks ago, we released the fall edition of the *Global Investment Outlook*, a copy of which can be accessed at www.rbcam.com/pdf/Fall_2008_Global_Investment_Outlook.pdf. In it, we detail our forecasts for the economy and capital markets more completely.

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