

Third Quarter Review

Rocking the Boat

Turmoil hit financial markets this past summer as continued weakness in the U.S. housing market escalated into a full-blown “credit crisis”, which briefly rattled global financial markets. The potential for trouble started several years ago when the combination of rock-bottom U.S. interest rates, a hot housing market and very aggressive mortgage-lending practices set up conditions for a “perfect storm”. Back then, variable rate mortgages were sold to higher-risk or “subprime” borrowers at low introductory “teaser” rates - in many cases with little or no money down. **The assumption was interest rates would stay low and housing prices would continue to rise.** Neither happened. Instead, many of these mortgages are coming up for renewal now at significantly higher interest rates and large numbers of homeowners simply cannot afford the higher financing costs. Not surprisingly, foreclosures have risen significantly in many areas of the U.S., putting further downward pressure on real estate prices and increasing the possibility of a consumer-led economic slowdown.

This “Main Street” event became a “Wall Street” crisis last July, when it became apparent that many of these bad mortgages had been “bundled up” and sold globally to financial institutions who had then used them as collateral to back other debt obligations. Panic spread as lenders scrambled to figure out their exposure. The huge asset-backed commercial paper market virtually dried up overnight, threatening the short-term financing needs of companies around the world.

During times like this, we rely on central banks to restore confidence and stabilize financial shocks through **quick action in credit markets**. In this case, the U.S. Federal Reserve stood in and immediately lowered interest rates on overnight loans to other banks. In September, they reduced the fed funds rate by ½% as well. Here at home, the Bank of Canada held back on raising rates in September, after a ¼% increase in July, providing further stability to financial markets. The net effect for investors was a somewhat wild ride during the quarter. Most major equity markets had declined by over 10% between mid-July and mid-August before **they rallied back to end September modestly higher** in local currency terms.

Of course, there's more to this story. Fallout from the U.S. real estate market and resulting lower interest rates sent the **U.S. greenback into a freefall** against other currencies. It declined to an all-time low against the Euro and fell to parity with the loonie for the first time since the mid-1970s. Overall, the Canadian dollar advanced almost 7% over the quarter and almost 15% year-to-date, overwhelming otherwise positive U.S. equity returns when expressed in Canadian dollars.

In the fixed income arena, high-quality bonds did their job by providing a safe haven from the volatility of equity markets. As the expectation in Canada changed from one of rising interest rates to a more accommodative environment, bond prices rose modestly. The short-term bond index advanced approximately 2%.

Following are the returns for the major indices for the period ended September 30, 2007:

	3 rd quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (SCM 30-Day T Bill)	1.1	4.3	3.5	3.1	3.7
Canadian Bonds (SCM Short Term Bond)	1.8	3.2	3.6	4.2	5.2
Canadian Stocks (S&P/TSX Comp.)	2.0	22.8	20.2	20.4	9.1
U.S. Stocks (S&P500)	-4.4	4.0	4.7	5.2	3.1
Non-North American Dev. Stocks (EAFE)	-4.7	9.0	11.2	10.0	2.5
Emerging Markets Stocks (MS Emerging)	7.0	41.3	30.4	26.7	8.3

All returns in Canadian dollars. Source: SS&C Technologies and PalTrak

Fourth Quarter Outlook

Calmer Waters

Market participants are now focusing on third-quarter earnings results and looking for signs that the monetary policy of the past two months has been effective. Third quarter earnings are expected to be somewhat weak in the wake of the subprime storm, but to resume their **double-digit growth trend** in the fourth quarter. Upcoming economic releases will also garner close attention as investors watch to see if additional central bank easing will be required. It would not be surprising to see more volatility in stock markets until we have more answers. Nevertheless, investors have reasons to expect that the “credit crisis” of the summer was not a harbinger of things to come for several reasons:

The Federal Reserve “The Fed” - The Fed proved its mettle in August by clearly demonstrating its ability to stabilize overnight credit markets. Further, the Board’s unanimous decision to lower

the Fed fund’s rate by ½% on September 18th was more aggressive than many expected. Investors took comfort that any further evidence of economic fallout would result in a similar strong response. Moreover, with the Fed funds rate currently at 4¾%, there is ample room to maneuver.

Interest Rates - Although rates have increased worldwide over the past two years, they are **not high by historical standards**. Five-year government bonds are 4% to 5% in many developed countries, giving little restriction to economic growth. By way of example, with corporate profits growing at almost 10%, entrepreneurs and corporations can do very well with borrowed money. If interest rates were to decline from here, their potential profits would increase.

Economic Growth - World economic growth is in high gear. It would take a considerable shock to the overall system to throw it off course. The financial securities specifically linked to the subprime mortgage debacle make up **1/3 of 1% of all U.S.-dollar financial assets**. In addition, the U.S. economy as measured by GDP represents about 27% of the world economy. To put that in perspective, the European Union represents over 30% and the Pacific Rim countries about 20%. Even if a U.S. slowdown were to unfold, in the diversified global context, economic strength elsewhere would mitigate against such U.S. weakness.

Valuations - Stock prices remain low by historical measures and

there is inevitably a point where the attraction of corporate profits outweighs pessimism and stock prices rebound to their fair value.

Currencies – Currency movements serve as a policing mechanism among countries. A declining currency boosts profits for exporting companies and also increases earnings for domestic companies with foreign operations. The reverse is true in countries with rising currencies. The recent decline of the U.S. dollar, for instance, means many U.S. companies will receive a meaningful jump in earnings, as over 50% of revenues from the S&P500 companies are derived from international operations. Longer term, **U.S. companies will become more competitive internationally**.

A Final Note on the Canadian Dollar

The Canadian dollar has rocketed through parity with the U.S. dollar, trading recently at \$1.02 U.S. This is partly due to the weakness in the U.S. dollar, which is down relative to many currencies, but also the Canadian economy is strong and that has translated into a strong loonie vis à vis most major currencies.

Sound portfolio management practices include reducing risk through equity representation in a broad basket of stock and currency markets. We don't have to rewind very far back in time (2002!) to recall when the Canadian currency was one of the **least desirable** ones to hold. Long term investors should mostly ignore short-term currency fluctuations (even dramatic ones) and take solace in the fact that currency movements become muted over time. The following chart illustrates this well. The chart reflects the annualized percentage change for each currency relative to the Canadian dollar over the past one, five and twenty year periods.

Period	U.S. Dollar	U.K. Pound	Japanese Yen	Euro (Mark)	Swiss Franc	Average
1 Year	-12.2	-2.6	-8.3	0.2	-4.3	-5.4
5 Years	-9.8	-4.0	-7.9	-2.0	-4.5	-5.6
20 Years	-1.4	-0.2	-0.2	0.1	0.0	-0.3

Period Ended Sept 30, 2007
Source: Dimensional Fund Advisors Inc.

