

## Banking on Regressing to the Mean



John Templeton, the nonagenarian money manager of the Templeton Funds advised investors to buy shares at their point of maximum distress, to benefit long-term from their recovery. Our purpose in showing the US banking chart is to ponder if equity markets have reached the point of “maximum distress”. As much as we like to believe the down days are over, the evidence suggests otherwise. To our eyes, the US bank chart says, “Probably not”, despite the S&P/TSX Composite Index tracking new highs.

The graph is the Philadelphia Bank Index, (BKX). Twenty-four of the largest US banks compose the BKX. The largest position is Wells Fargo. This we own in the Global Equity Fund. Also included are Citigroup, Bank of America, JP Morgan Chase, and Wachovia Corp, a stressed bank much in the news these days.

The graph displays the top last year of 121.2, the credit crunch low of 74.8 in January 2008, and the rebound from that level. The BKX fell 38% from the peak in 2007 to the January 2008 low. In that time Citigroup, once the world’s largest bank, lost 60%, dropping from over \$50 to under \$20 per share. The frenzied trashing of the banks brought about unprecedented salvage actions by the US central bank. The Fed’s cut in interest rates, purchase of secondary securities, and bail out of Bear Sterns brought about the market rebound, we are now enjoying.

Since the end of January, we have seen a kneejerk market response to interest rate reductions. However, the American consumer has not benefited from the rate cuts. The banks in order to re-build their capital have kept

## Pooled Fund - Month End Unit Values

Unit Values	Dec-07*	Mar-08*	May-08
Cdn Balanced	13.72	13.75	14.05
Cdn Small Cap	23.28	21.93	22.60
Cdn Equity Fund	10.37	10.14	10.66
Global Equity Fund	8.96	8.92	8.92
Cdn Income Fund	10.23	10.44	10.39

\* Post distribution

mortgage rates high. The rate cuts have indirectly increased consumer costs by increasing energy prices.

The Bank Index after bouncing off 75 initially and twice more in March and April, rallied and rolled over at progressively lower price levels implying US credit problems are still vexing, despite the actions of the US Fed and US Treasury. In the first week in June, the BKX broke down below the “support” at 75 and touched a new low below 71. The BKX is a gauge of the well-being of the bank, the conduits that finance growth. Corroborating the “action” of the bank stocks, are a number of distressing fundamentals suggesting the January to June rally is just a run in a pending major bear market.

On June the 6th in response to the Dow Jones and TSX’s rallies on the 5th, Chris Finora of TD Newcrest wrote –

*I'd have an easier time solving six sides of the Rubix cube than figuring out this market.*

*We have oil moving higher (sell the market), Lehman on the verge of collapse (sell the market), the Fed indicating that rate cuts are done (sell the market), Old Man Bush thinking about moving on Iran (sell the market), large caps continuing to outperform (versus small caps) (sell the market) and the rally occurred on volume that is thinner than the plot of an average 90201 episode (sell the market).*

*Of course, the market rallied and it rallied hard! Bids were materializing out of thin air and it was enough to close shares up almost 2%. (That was June 5. On June 6, the market erased its gain.)*

In Canada, as at the market top in 2000, we are living in a narrow bull market supported by energy, fertilizers, and smart phones, and they will roll over with the recession unfolding in the US.

Two of the three of Canadian market drivers are the natural result of America's attempt to sustain growth by cutting real interest rates and the value of the dollar. The 2008 dollar depreciation stimulated demand for stores of value – energy, gold, agricultural commodities, to name a few. The bid price for the barrel of oil has increased energy costs to North American consumers, an unintended tax, that has erased any tax rebate and rate cut. The law of unintended consequences is at play.

Beyond Chris Finora's quip, we list the distressing underlying fundamentals that we see crimping bank lending and are unrelieved by the policy actions so far –

- re-emergent widening of interest rates between poor and high quality credits
- chronic credit rating downgrades of banking institutions
- record US mortgage delinquencies and foreclosures
- rising unemployment and inflation cutting consumers' purchasing power

We could run on. The stock market fully recognized the first shock of the credit collapse in January. The second shock is coming from a collapse in consumer and capital spending. The second wave is underway brought about by unsustainable energy prices hitting unsustainable consumer debt.

Policies that sacrifice the saver by cutting rates will not help form a sustainable economic base for future growth. We have reached a point at which lower rates drive commodity prices that ultimately erode the purchasing power of society and corporate profits. Lower share prices will reflect the loss of purchasing power.

We believe John Templeton's point of maximum distress is still to come for US and Canadian stocks. As investors run up share prices from January, they hardly show the fright seen at market bottoms or concern for the financing gap about to stop economic growth. For that, we are well prepared.

## Equity Investing

We have added slightly to established holdings in all funds, where distress has reduced prices. In the Small Cap pool, we have purchased Gennum, Lockerbie & Hole, Empire Company, and Morneau Sobeco. In the Canadian Equity Pool, we bought Emera, Canadian Utilities, and Russel Metals. We have increased the dividend yield on the portfolio. In the Global Pool, we added to AT& T and Singapore Airlines. We have sold or reduced energy and gold shares. We maintain maximum cash reserves.

As to BCE Inc, we await resolution of the petitions before the Supreme Court of Canada. We expect the deal to be consummated, but possibly at a lower price in deference to bondholders.

## Fixed Income Investing

Bond yields have risen a little from their lows. We have added to our corporate bond positions. We recognized that with more credit deterioration corporate yields could rise further. However, we feel the enhanced yield over Canada's, nearly two percent, and concentration on quality and term will support the portfolio value.

Total Return – Capital Gains plus Income (%)						
To May 31, 2008	1 Mo	3 Mo	1Yr	3 Yr	5 Yr	10 Yr
<b>QV Pooled Funds:</b>	%	%	%	%	%	%
Canadian Balanced Fund	1.2	3.5	4.1	8.1	9.7	8.8
Canadian Small Cap	3.7	2.4	-2.1	14.7	21.3	15.5
Canadian Equity Fund	2.8	7.4	1.2	15.6 <sup>+</sup>	18.8 <sup>+</sup>	20.1 <sup>+</sup>
Global Equity Fund	-0.9	5.6	-5.0	-	-	-
Canadian Income Fund	-0.3	0.2	5.6	4.9	5.1	-
* Historic equity returns from the Cdn. Bal. Fund						<sup>8</sup> Yr
<b>Benchmarks:</b>						
Balanced Fund Index	2.2	4.4	5.2	11.1	12.2	7.5
BMO Small Cap Index (unwtd)	4.1	2.0	-11.1	9.3	15.6	6.2
DEX Bond Universe	-0.2	0.3	6.6	4.1	5.2	6.1
S&P/TSX Comp. Index	5.8	9.1	7.4	18.0	19.0	8.8
MS World Index (\$CA)	-0.4	6.4	-12.3	2.1	5.2	-0.2
S&P 500 Index (\$CA)	-0.2	7.3	-13.3	-0.4	2.9	0.3

- Pooled fund returns are gross of management and custodial of fees. Returns over one year are annualized.

- The Balanced Fund Index reflects the total rates of return earned by the DEX 91-Day T-Bill Index (5%), the DEX Bond Universe (45%), the S&P/TSX Composite Index (40%), and the MSCI World Index (CS) (10%)