

Sporting Contests Have Two Halves

What a week this has been! Currently, governments around the world are trying to alleviate liquidity problems in the first half of this economic environment. The halves of this sporting contest can be separated into liquidity concerns in banks and a slowdown in the economy.

Government bailouts and arranged marriages of financial institutions have rescued the stock market from total collapse. Although a negative 20% return in the S&P/TSX Composite Index in October is not what we would have hoped for, it could have been much worse. Fortunately, the increase in deposit insurance and in some cases complete protection by global governments has prevented a bank run. These measures have ensured individuals are not hiding their money in coffee cans in the backyard. This would have created a liquidity crunch in the banking system which would have been catastrophic.

The speedy response by global governments to protect bank deposits, reduce interest rates simultaneously and inject funds in the globe's lending organizations help to increase the liquidity in the market. Interest rates in Canada and the United States are expected to continue their descent. A reduction in interest rates is anticipated to lower the costs to financial institutions. Eventually money should flow to companies who will spend and aid in reducing the depth of the economic slowdown. The problem again is interest rates have been coming down for a year in North America and market declines have continued. The lower interest rates have not been passed along to the lender's customers.

The most controversial move has been the passing of legislation by US Congress to buy back "toxic assets" as they are now referred. The \$700 billion package was to buy assets back from institutions for cash. This is still a possibility; however, the US government has been using that money instead to inject capital into financial institutions. \$125 billion has been targeted to nine US institutions so far. Europe has

also performed this trick through preferred and common shares. The belief was buying "toxic assets" assisted by removing them from bank balance sheets, but this does not fix the balance sheet of a lending institution. Capital injections strengthen the banks and allow them to lend at their usual ratio of \$10 in loans for every \$1 in capital. Some institutions used a model of \$30 in loans for every \$1 in capital, but those firms now only exist in history books. The capital injections into US institutions can be used to acquire competitors, shore up their balance sheet, or even avoid necessary cost-cutting. The problem with the injection and why we believe the first half of this contest is not completed is there are no requirements for these institutions to lend more. As an example, Jamie Dimon, the Chairman and CEO of JP Morgan, stated on a conference call, "It's clear that the government would like us to use the capital [but] if you are a bank that is filling a hole, you obviously can't do that."

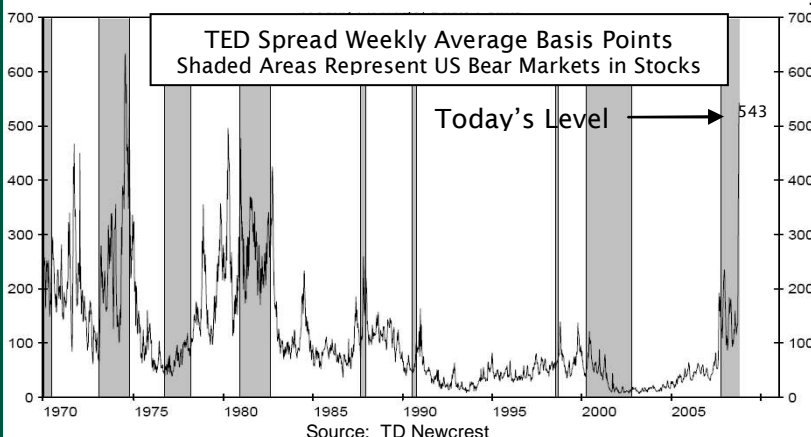
Typically, the TED spread, which is the difference between three month US treasury bills and 3month LIBOR (London Interbank Offered Rate), is used to measure credit risk and liquidity globally. The last time these levels were reached was in the early 70s as displayed in the graph below.

This number has not retreated although many of the measures above have been initiated. Confidence in the system needs to be restored to ease market pressure. The history of the 70s was very volatile and we expect much of the same. We wouldn't count on the sanguine past twenty years to return anytime soon.

What happens in the second half?

Lenders with damaged balance sheets and higher funding costs reduce their lending. The period of low interest rates and credit spreads assisted companies and consumers in their spending. These historic times are over. The second half of this contest will involve higher borrowing costs and reduced economic growth.

Earnings expectations for 2009 in Canada are too high. Although oil and most other commodities are down substantially, many earnings estimates are not pricing in an economic slowdown. We anticipate a large reduction in earnings estimates for many companies in the North American markets. In our analysis, we are looking at past cycles to gauge what earnings expectations are more reasonable in this environment. Some of our names have seen a significant decline and we continue to add to them selectively. The second half will come closer to an end when earnings expectations become more realistic.



Source: TD Newcrest