

# BF&M Investment Matters



## GLOBAL OUTLOOK

### CONTINUED GOVERNMENT INTERVENTION IN THE FINANCIAL SYSTEM

Governments are buying back their bonds to provide stimulus.

### U.S. DOLLAR TO STRENGTHEN

Due to flight to safety and poor outlook in Europe and Japan.

### BUYING OPPORTUNITY IN EQUITIES AND CORPORATE BONDS

Investors who can tolerate short term volatility should consider buying.

### MARKET VOLATILITY TO REMAIN HIGH “Wall of Worry”

### PROTECTIONIST VIEW MAY HAMPER GLOBAL GROWTH

New regulations and banking models after the credit crisis may hamper global access to capital and thus global growth.

### DIVERSIFICATION BENEFITS TO RE-EMERGE

As flight to quality assets retreats and as valuations improve.

Financial Market Review - December 31\*, 2008 to March 31\*, 2009

## Where to Look for Signs of Recovery?

Conventional methods for assessing the markets have not been useful in this recession. The peculiar nature of this bear market and its origins limits the traditional kit of tools used to value the equity markets. Traditional indicators have been “murky” at best. History may not be a good guide either due to the nature and cause of this downturn. Previous downturns were mostly the result of a downturn in the business cycle while this one is the result of a broken financial system.

### Conventional Tests Won’t Work

The Price to Earnings (P/E) ratio has historically proven to be a good guide, ranging from 8 times earnings during market bottoms to 25 times earnings during their peaks. However with earnings likely to decline and corporate profitability sliding due to a slow down in consumer spending this may not be the best indicator of a market recovery. A stock trading at a low P/E currently may merely be signaling lower earning prospects. After a downward revision is announced, the P/E ratio will rise due to the mathematics of lower earnings.

Monetary policy or the control of interest rates has also been a strong indicator in the past. The U.S. Federal Reserve would lower rates as the economy slowed in order to boost the economy through lower lending rates. Investors would anticipate stronger profits in the future and begin to buy. However the Fed has cut rates ten times since August 2007, effectively leaving the rate at zero, with minimal impact. With no more scope for rate cuts, rate changes will not be a good litmus test.

Another measure is “cash on the sidelines” which consists of monies in

money market funds or savings accounts. Generally the higher the level of cash on the sidelines versus the amount in the equity market, the bigger impact it can have on the equity markets once the money was reinvested. Currently there is a tremendous amount of cash on the sidelines. Yet the job and housing markets remain weak with the U.S. households struggling to pay down debt. Potential investors may turn into net savers. This means they will keep the funds in cash or pay down bills rather than invest and move the money into stocks.

### Where Are the Signals?

So where do we look for signs of a recovery? The bond market would be the first area, in particular the corporate debt market. There needs to be a decline in interest rates on debt that corporations must pay before the recovery will be on solid footing. The borrowing rates rise when banks and other institutions deem lending to corporations a risky bet. Thus, the more risky the company the higher the rate of interest charged. Interest rates on corporate bonds are at levels not seen since the great depression. Though rates did narrow somewhat in the 4th quarter of 2008, they have increased marginally in the 1st quarter of 2009. This is a signal all is not yet well in the financial markets.

The banking system is the second area. For banks to be in a better position to lend, the so called ‘toxic assets’ or failed mortgage backed securities need to be removed from the banks’ balance sheets. This will provide for a more solid foundation. This will fortify the reserve capital base for the banks. Lending activity will grease the wheels of the financial system and get it rolling again.

Lastly the regulators will be

evaluating the solvency of banks based on stress-tests to measure their ability to withstand varying economic and market scenarios. If the banks can withstand these tests the investing public will likely be more confident the state of the financial system is sound.

### Economic & Market Outlook

Improvement in any one of the above mentioned factors could provide a base for the equity markets to rally further and on a sustained basis.

Until the rally in the equity markets are based on sound economic fundamentals particularly in the U.S., we could continue to see volatility in prices. There could be sharp market rallies followed by declines to previous lows as traders lock in their gains. On the downside, traders will then try to profit by selling the market short further increasing the selling pressure. As a consequence of the traders market, expected returns on equities in the short term may be less than their historical average of eight to twelve percent.

The stock markets have rallied significantly since the low on March 9<sup>th</sup>. Some regions have shown signs of progress and are positive YTD. There needs to be signs that the global economy is on sound-footing to sustain a robust rally.

Four things need to take place:

- 1) stabilization in lending practices
- 2) stabilization of home prices
- 3) stabilization in employment
- 4) a steady increase in industrial production

Point one is critical to jumpstarting the recovery process. Corporate demand for goods and services will not improve unless their access to lending improves, so that they can increase production and in turn expand their orders.

Point three is pivotal to switch the focus from the producers to the consumers. The consumer demand side can not improve until employment stabilizes and people have a sense of security.

### Market Outlook

We advise investors to slowly add to

their equity holdings during the remainder of the year, by directing new contributions into equities. We also recommend an increase in their existing balance allocation into corporate bonds. Due to their undervaluation and resultant high yields, they could provide equity like returns with less risk in the near term.

It is impossible to predict the exact end of a bear market. At the current prices, investments should provide high enough returns versus the down-side risk so that it is worth partaking if you have a medium/longer-term investment horizon.



Past performance is no guarantee of future returns

Sources: Wall Street Journal, Bloomberg LLP, Morningstar, Business Week

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INDEX / CURRENCY	VALUE	U.S. DOLLAR 2009 YTD
S&P 500	831.59	(11.67%)
Dow Jones Industrial Average	7,818.47	(13.3%)
Nasdaq	1,614.48	(3.07%)
Toronto Stock Exchange	9,105.56	(6.16%)
Brazil Bovespa	44,433.15	8.60%
S&P Europe 350	733.66	(15.90%)
UK FTSE 100	3,916.61	(13.09%)
Japan Nikkei 225	8,711.33	(16.16%)
Hong Kong Hang Seng	15,285.89	(5.64%)
Australia S&P/ASX 200	3,677.40	(5.33%)
Euro	1.325	(5.16%)
Pound	1.432	(1.85%)
Yen	98.96	(8.41%)
CRB Commodity Index	220.40	(3.98%)