CROFT 2009

ECONOMIC OUTLOOK & MARKET FORECAST

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Events, dear boy, events

By Richard Croft

As investors, we all attempt to make a profit. That means we expect to get a return *on* our money as well as a return *of* our money over time. That return – and the attendant safety of our principal – will vary according to the degree of risk inherent in our investment choices and the length of time we expect for that return to materialize. The higher the degree of risk, the greater the expected return.

Investors in pre-industrial Europe took great risks on trade. The age of sail was fraught with peril for these investors, who purchased shares of ships and charged their captains with the task of buying scarce goods in distant lands. When these ships returned, often after years of absence, investors reaped fantastic rewards. Their "ship had come in," and their fortunes were made. But frequently, their ships didn't come in, falling prey to calamities both natural and human.

The efforts of these risk takers, always with an eye to the big payoff, evolved in time into the various globe-girdling trading companies whose purpose was to reduce overall risk for investors. In addition to stimulating global trade – and incidentally forming the basis of the great trading empires of the time – they formed the basis for the rebirth of a system of international credit, which had all but disappeared with the extinction of the Knights Templar in the early 14th century.

Today, the scale and technology have changed. The principles have not. Investors still seek the big payoff through globe-girdling trading empires and still seek to minimize risk while maximizing profit. Now, as in all previous eras, investors weigh risks and make plans as carefully as possible in an effort to generate good returns from their investment. That means attempting as far as possible to assess probabilities of future trends.

In times past, that meant factoring in risks that could be quantified to some degree – the threat of pirates or privateers or disruption of trading routes by competing nations – offset by risk-mitigating factors, like the presence of the world's strongest sea power, as in the case of the British Empire through the 18th and 19th centuries. Today it means trying to predict what is

Outlook for 2009	
Canadian GDP	0.7%-1%
BoC rate:	0.75%-1%
Canadian CPI	1%-1.5%
C$	US$0.90
US GDP	0%-0.5%
US fed funds	0%-0.5%
US CPI	0%-0.5%
Gold	US$700-$900/oz.
Oil	US$40-$50/bbl.

most likely to influence the valuation of our portfolios, from factors like interest rates and inflation, to the price of oil and gold.

But the best-laid plans are often derailed by "events, dear boy, events," as British Prime Minister Harold Macmillan famously said when asked what would be most likely to blow government policy off course. The risk of "events" is largely unquantifiable and unpredictable. At the height of its glory in 2000, for example, Nortel Networks Corp. was "King of the World," with a share price at a record high of $112. In January 2009, it declared bankruptcy.

Last year saw the undoing of plenty of other big business names. It also saw the unfolding of "events" on a grand scale. Though some very few voices in the wilderness had legitimately predicted an unhappy outcome to the orgy of easy credit since 2002, they were ignored, as naysayers, partypoopers, and assorted sour-grapers always are and always have been. After all, it's tough to be a contrarian in a raging bull market, when even the proverbial taxi driver dispensing investment advice looks like a genius.

We make no claim to being any sort of voice in the wilderness or even coming anywhere close to displaying an IQ over 145. We pretty much muddle along, just like everyone else. However, in our *2008 Economic Outlook and Market Forecast*, we did forecast a recession in the US, and we argued that "rate cuts will come faster and be larger than most investors think." We turned out to be right on both counts, though to be fair, we did not expect the recession to be as severe as it turned out to be. And we did not in our wildest nightmares dream that the US Federal Reserve Board would cut its target for the federal funds rate to…zero.

We also delivered a real clunker, when we argued that one of the reasons a recession would be relatively soft is that "consumers have better access to credit, and financial intermediaries more tools to offset risk." Turns out that very "access" and those precise "tools" were the very factors that brought the global financial system to the edge of the abyss in 2008. In short, our very earnest prognostications – accurate to some degree at least – were overtaken by "events, dear boy, events."

The freeze-up in global credit markets that precipitated both the recession and the bear market in stocks brought some truly white-knuckle moments to even the most cynical and case-hardened veterans of Bay and Wall Streets through the never-to-be-forgotten summer of '08. The collapse of storied investment bank Lehman Brothers Holdings LP rocked the global financial system to its foundations, but it was just the tip of the iceberg. To prevent those foundations from crumbling to dust, central banks around the world followed the Fed's lead and raised the floodgates, letting a tidal wave of liquidity inundate the global financial markets. At first, to no avail, it seemed, as confidence collapsed in tandem with some of the world's largest banks.

By the fourth quarter of 2008, central bank and government treasury interventions in financial markets around the world had reached an unprecedented level. The US Federal Reserve Board slashed the target for its key federal funds rate to between 0% and 0.25% in December, while the Bank of Canada cut its target overnight lending rate to 1.50%. In mid-January, the BoC delivered another 50 basis point rate cut, to a record low 1.0%

The loosening of monetary reins around the world was accompanied by a host of aggressive fiscal moves, including loans and loan guarantees of the unmarketable debt of troubled institutions, outright equity purchases, and other forms of stimulus.

The TED spread, which measures the difference between the three-month London Interbank Offered Rate (LIBOR) and the rate on three-month Treasury bills, narrowed from 3.53% at the end of September, its highest level in 25 years, to less nerve-wracking 1.12% by mid-January. The narrowing TED spread gave markets some hope that aggressive monetary and fiscal activity by governments was beginning to restore some confidence in the credit markets. However, the yield on three-month US Treasury bills still hovered near zero, while three-month Canadian T-bills traded to yield 0.83% at the close of the year – and indication that return *of* capital still trumped return *on* capital as an overriding objective in financial markets.

Outlook for 2009

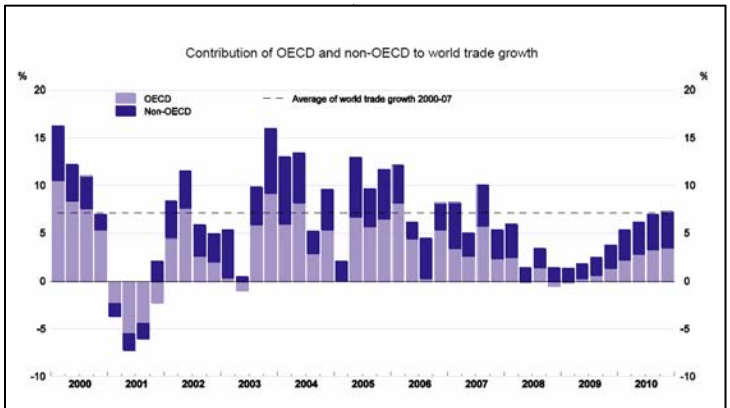
The US officially dropped into a recession in December 2007 and has been there ever since. The difference between this recession and the 2000-02 recession is that this one is a result of a steep decline in consumer activity. Such recessions tend to be much deeper and longer than recessions originating with a decline in business investment.

US household spending declined in the third quarter of 2008, for the first time after 18 years of positive growth. The combination of shrinking real estate wealth and tightening credit extinguished consumers' appetite for spending, while spurring a renewed interest in personal financial probity, including paying down debt and saving more. The US savings rate actually climbed from below zero, where it had sat for the past few years, to 2.8% in November 2008.

This may be useful for the US government, as demand for government bonds will help keep yields low and let the government borrow at low rates to fund its near trillion-dollar stimulus packages. However, it's not such good news for global trade.

Already, emerging markets are feeling the pinch of declining exports as US consumers snap their wallets shut and pull out those dusty piggybanks. Global trade has dropped sharply as combined exports and imports from the US fell 18% from July to November 2008. Trade declines cascaded through the global economy through the fourth quarter as the repercussions of the credit crunch hit consumers worldwide.

World trade growth to remain weak in 2009



Note: Change relative to previous quarter at an annualised rate.
Source: OECD Economic Outlook 84 database.

It is very unlikely that any of this will come to an end much before the final quarter of 2009. The 30-nation Organisation for Economic Co-operation and Development (OECD), which accounts for 50% of the world economy, predicts a net contraction of 0.4% in gross domestic product (GDP) in 2009 for the group.

And although emerging economies – especially those in Asia – have been the drivers of global growth these past few years, that enviable position has eroded considerably, owing to the interlocked nature of the global economy – which, incidentally, has also laid to rest the peculiar myth of global decoupling that was making the rounds last year. Still, emerging markets are expected to post positive economic growth through 2009, fueled largely by growing domestic demand and liberal doses of fiscal stimulus.

Overall, then, the global economy, weighed down by stagnant growth in the developed nations, is unlikely to grow by more than about 1.5% in 2009.

US GDP growth between 0% and 0.5% in ’09

The US economy continued to contract through the fourth quarter, as consumer confidence hit a record low in December on increasing worries about the labor market and business conditions. Through 2008, the US economy lost a total of 2.6 million jobs. The US housing market also stayed on the downward track through the quarter, as October home prices fell 2.2% in the month, for an 18% annualized decline, the steepest drops on record.

“The US is in the midst of a vicious, consumer-led recession that hasn’t yet bottomed out.”

An aggressive policy of monetary easing by the US Federal Reserve Board saw the target for the federal funds rate cut to a record low of between 0% and 0.25% in December, as 91-day Treasury bills were priced to yield close to 0%. Aggressive moves to guarantee or extend loans to financial institutions, including mortgage giants Fannie Mae and Freddie Mac, were supplemented by the implementation of a US$700 billion government bailout program called the Troubled Asset Relief Program (TARP) to provide recapitalization of impaired balance sheets through direct equity purchases. Additional rescue funding in the fourth quarter came in the form of a US$17 billion loan package for the troubled domestic carmakers.

The major US equity indexes closed the year deep in the red as price-earnings multiples continued to shrink on downwardly revised earnings estimates through the fourth quarter. The Dow Jones Industrial Average ended the fourth quarter with a 19% decline and closed the year with a 34% loss. The S&P 500 Composite Index lost 23% in the fourth quarter, ending the year with an overall 38% decline.

The US is in the midst of vicious, consumer-led recession that hasn’t yet bottomed out. The housing market meltdown continued into the fourth quarter with no letup in sight. Without all that leveraged real estate wealth to sustain consumption, consumer spending will remain very weak through most of 2009. That means the US recession, which began in December 2007, is on track to produce negative GDP growth for at least the first two quarters of 2009. We believe the recession will begin to ease in the third quarter (though data won’t be available to validate that prediction until the fourth quarter).

We say this simply because the massive injections of liquidity by central banks and gargantuan spending by governments will put a floor under the economic slide. It will do this mainly by thawing credit markets, the first signs of which we are already seeing in the contraction of the TED Spread.

However, consumers won’t begin spending again until that credit thaw spreads further into the economy and until we see some stability in house prices. Although long-term US mortgage rates dropped to a record low in early January, with 30-year mortgages a 5.01%, the housing market continued to slide unimpeded. The 20-city benchmark Case-Shiller index of housing prices indicates that as of the end of October 2008 home prices had fallen 21%, as the index posted declining prices for 27 consecutive months. This dismal story is also likely to continue well into 2009, as foreclosures, already up a record 81% year over year in 2008, continue to rise, against a backdrop of unemployment that we expect to expand to between 9% and 10% by the end of 2009.

It's not a pretty picture. And it has become clear that the banking crisis is far from resolved. In mid-January, Bank of America got an emergency bailout of $20 billion from TARP. Basically, the government purchased that amount in 8% preferreds, after the banking giant announced a fourth-quarter loss of US$1.79 billion and complained bitterly that it couldn't really digest Countrywide Financial and Merrill Lynch after all. The company still managed a $4 billion profit in 2008, but posted more than US$10 billion in capital losses and $27 billion in credit card costs. In addition to the US$20 billion equity position, the government also guaranteed US$118 billion of BoA's losses.

Meanwhile, Citigroup Inc. reported a loss of US$8.29 billion in the fourth quarter, and announced plans to break itself up into two businesses, saying it wants to focus on core businesses. Too bad they didn't adjust that focus a couple of years ago. Some US$300 billion of Citi's assets are already guaranteed by the US government.

Both Citi and Bank of America are "too big to fail." Apparently, they're also too big to manage properly. Both are destined to be carved up and sold off piecemeal. This will not be a good year for the remaining big banks.

The mess at America's two biggest banking institutions is bad enough. But according to a January report by Goldman Sachs, the loan loss situation is about to get a whole lot worse. Losses from delinquent residential mortgages, it says, could hit US$1.1 trillion as the housing market continues to sink. But bad debt from commercial and consumer loans could add another US$1 trillion to the pile. Only half of the total US$2.1 trillion in loss has been recognized, according to Goldman.

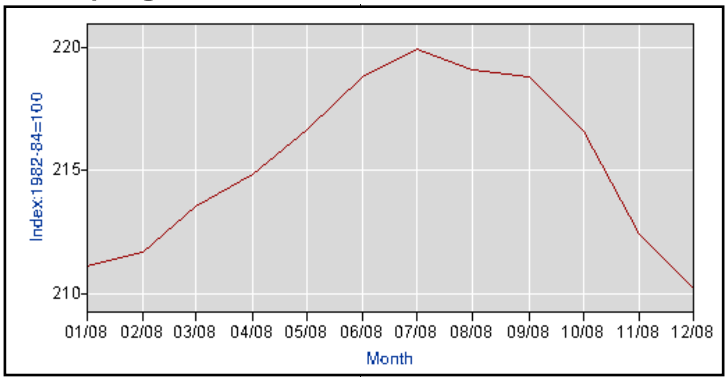
Federal Reserve Board Chairman Ben Bernanke wants the remaining US$350 billion of the TARP funds to be used for propping up the tottering financial system by buying or guaranteeing more of banks' toxic debt. "Fiscal actions are unlikely to promote a lasting recovery unless they are accompanied by strong measures to further stabilize and strengthen the financial system," he said.

The Fed has already cut the target for its benchmark federal funds rate effectively to zero. Much of what's driving central bankers to distraction is the alarming decline in the general level of consumer prices. More than anything else, central bankers want to avoid a scenario where a secular deflationary trend takes hold. So December's 0.7% monthly decline in US consumer prices caused much furrowing of brows down at the Fed. It was the third consecutive monthly decline in the general level of prices. For 2008 in total, prices rose only 0.1%, the lowest increase in consumer prices since 1954. Reflecting a real weakness in global demand, producer prices also fell for the fifth con-

"The Fed has already cut the target for its benchmark federal funds rate effectively to zero."

secutive month in December, dropping a seasonally adjusted 1.9%, and were down 0.9% year over year.

US CPI plunges



Source: US Dept. of Labor, Bureau of Labor Statistics, All urban consumers

US policy is now to avoid deflation at any cost. Many observers are nervously looking back at the Japanese experience of the '90s, but we believe the odds of a Japanese-style deflation are low. Unlike Japanese policy of the time, the US is currently pulling out all the fiscal and monetary stops, putting trillions of dollars of fiscal stimulus into the economy, forcing a restructuring of failing banks, marking nonperforming assets to cost, recognizing losses, and recapitalizing. That's diametrically opposite to what happened in Japan, which allowed continuation of zombie businesses for political reasons, with the resulting deflationary, no-growth lost decade.

The Fed's next objective is to push long rates down, with the objective of easing rates right along the curve. As a result, we do not expect US policy rates to rise at all through 2009, and probably not until after the decline in the CPI has decisively ended going into 2010.

Even then, we do not see a big risk of inflation getting out of control. The wage-price spiral that blind-sided monetary authorities in the '70s will not become a problem owing to huge productivity improvements in the intervening decades, which have kept inflation in check.

In addition, one big difference now is that a significant amount of capacity that is now idled can be brought back online before inflation becomes a problem. This gives monetary authorities time to react. We don't believe any such reaction will become necessary for at least 18 to 24 months.

We believe US unemployment will continue to rise through 2009 as the recession deepens. Unemployment is no longer a lagging indicator, because businesses are now very quick to cut costs and overheads. As a coincident indicator, then, unemployment data give us immediate insight into economic activity. With 2.6 million jobs already eliminated in 2008, and another 2 million expected to disappear through 2009, we expect the US unemployment rate to peak between 9% and 10% by the end of the year or in early 2010.

Counterintuitively, however, unemployment rates continue to rise for several months after a recession has bottomed. And we believe this will be the case with the current downturn as well. The vast amounts of "stimulus" will flow through to the economy this year. And although much of it will be used to pay down debt and to save, there will be at least some visible effect on consumer demand, starting in the third quarter. The American consumer is incredibly resilient, and with stimulus cheques in hand will also begin to feel confident enough to begin borrowing again, as bank credit thaws out.

Falling global trade is shrinking the US trade deficit, as oil prices declined and US imports fell more than exports in the fourth quarter of 2008. US productivity is likely to support export growth over the next year or two, and a weaker dollar will reduce the trade deficit considerably.

This year will mark the inflection point for both the economy and the markets. For 2009 as a whole, then, we expect US GDP to stop shrinking in the first half, showing a return to growth in the second half, with annual growth flatlining at zero, or in the best case, perhaps eking out half a percent expansion. The dollar will weaken against the euro and British pound, as it becomes more apparent that the deleveraging process is winding down. Interest rates are likely to remain unchanged for 2009, and inflation will be a non-issue until 2010 at the earliest.

Canada catches a cold

The Canadian stock market continued to decline in the fourth quarter of 2008, pressured by falling commodity prices, weakness in the financial sector, and declining earnings estimates. The 0.1% monthly decline in Canadian gross domestic product in October signaled that the Canadian economy was likely to see an overall contraction in the fourth quarter as the recession in the US begins to bite. Aggressive action by the Bank of Canada saw the target for the key overnight rate drop to 1.5%, as it sought to mitigate the effects of the declining housing sector and a severe slowdown in manufacturing activity, particularly in the hard-pressed automotive industry.

S&P/TSX Composite Index

Source: Yahoo Inc.

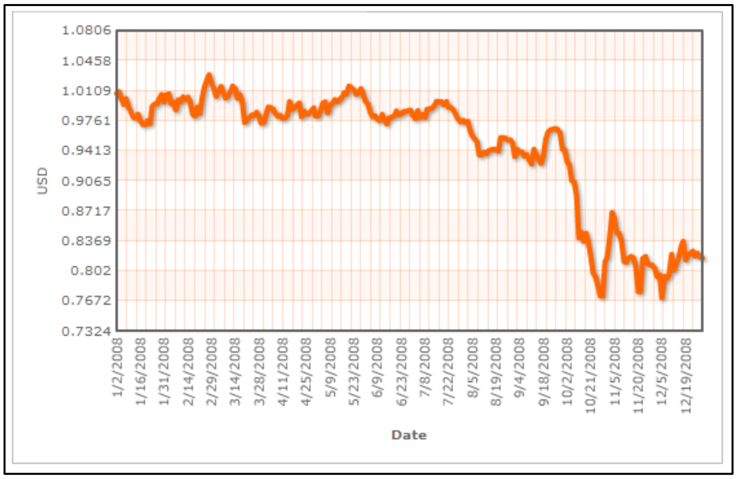
In the fourth quarter, the S&P/TSX Composite Index declined 24%, and closed the year with an overall 35% annual loss. However, the index's peak-to-trough loss from its June high of over 15,000 was a dramatic 48% as it fell to as low as 7,724 on Nov. 20. Since that low, the index rallied 16% to close the year at 8,897.

The heaviest downward pressure on the Canadian market came from resource and financial stocks, which make up about three quarters of the index's market capitalization. The plummeting price of crude oil and base metals drove the energy, mining, and materials sectors to new lows, while the global credit crisis continued to wreak havoc on the financial sector.

Canada cannot escape the fallout from the US recession, simply because about one third of Canada's economy depends on exports to the US. In addition, with global trade shrinking drastically (see the chart on Page 4), non-US trade also declined significantly in 2008. With the deepening global economic downturn, Canadian exports dropped 6.8% in November 2008, while imports fell 4.8% as domestic demand eroded, shrinking the trade surplus to $1.3 billion, an 11-year low. Despite a decline in the Canadian dollar against the US dollar, this is likely to worsen through 2009, with export volumes shrinking as external demand contracts, and commodity prices – especially oil – remain suppressed. Central Canada's manufacturing heartland will be hit particularly hard as the big three US carmakers struggle for survival and protectionist tendencies resurface in the Democratic-majority US Congress.

The Canadian dollar should see some strength against the US dollar through 2009, as global appetite for greenbacks wanes. We expect the loonie to firm up

Canadian dollar – 2008 (in US$)



Source: indexmundi.com

to the US$0.90 range by the end of 2009.

Though Canada's economy is inextricably linked to the US and to the level of commodity prices, Canada is not as badly off economically as either the US or the eurozone. Canada was one of the few nations to enter this crisis with a fiscal surplus, a balanced monetary policy, and a well-capitalized banking sector. This left both the Bank of Canada and the government a powerful arsenal of fiscal and monetary tools to counter the effects of the credit crisis and the recession. In Canada's response to the crisis, there is no real sense that the disciplined measures being undertaken by the government and its central bank to provide stimulus and financial liquidity are somehow a panic-stricken "last resort," as they are in the US.

Unlike previous recession cycles, most notably in 1990, Canada's monetary policy is now working to stimulate demand, as the BoC's target overnight rate has been cut to 1.0% from 4.75% in December 2007. With wages growing at more than 4% and core inflation still in positive territory, Canada is unlikely to see price deflation anytime soon. However, the BoC has room to cut, should it become necessary.

At this point, we do not expect the Bank of Canada to begin tightening rates until clear evidence has emerged that domestic demand is once again growing. This is not likely to happen until the US recession has bottomed out sometime in the middle of this year. Even then, the Bank of Canada is unlikely to jeopardize any nascent economic recovery with a tightening of the monetary screws. The BoC has typically been more rigorous in maintaining price stability than the Fed, because of its inflation-band targeting mandate. We believe that it will continue to do so, and have no doubt that it will act when inflation emerges again.

We believe that the BoC rate will therefore fall 50 to 75 basis points from its 1.5% level at the beginning of the year, and remain in the range of 0.75% to 1% pending the resolution of the credit crunch and signs that the US recession is bottoming.

This is crucial because the unemployment rate has risen along with decimation in the manufacturing sector. However, the combination of already-in-process monetary easing and a federal budget that proposed significant stimulus measures (albeit at the cost of a fiscal deficit) will support domestic demand sufficiently that the unemployment rate through 2009 will be contained to a maximum 7.5% to 8%.

With Canadian monetary and fiscal policy well positioned to cushion the impact of further declines in the external sector, we think that there will be no net contraction in Canadian GDP for 2009 as a whole. There's more than a 50% risk that the economy will slip into mild technical recession (that is, two consecutive quarters of negative growth) early in the year, but the BoC's expansionist monetary policy will go a long way to supporting domestic demand, setting the stage for weak growth in the second half as government stimulus kicks in through 2009.

In summary, we therefore expect Canadian GDP for 2009 to grow at a rate of no more than 0.7% to 1%. Accordingly, inflation will remain tame through 2009 at between 1% and 1.5%, while the BoC rate is unlikely to exceed 1% before 2010, staying at 0.75% through the first half of this year.

Gold: the ultimate hedge

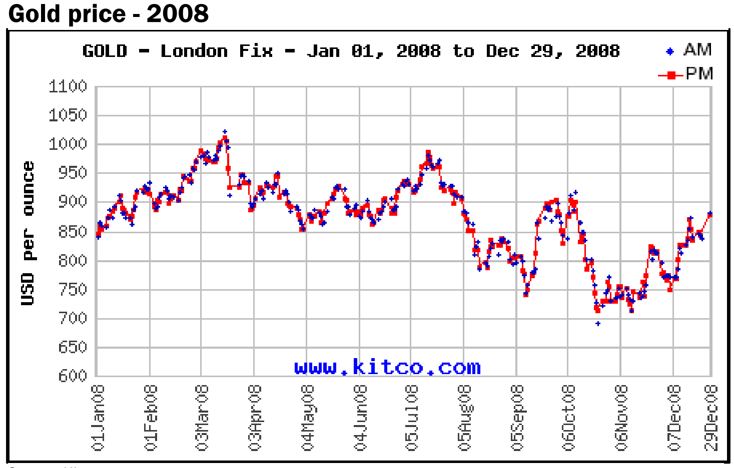
Through 2008, gold at least proved its worth as a crisis hedge. It once again blew away the myth the yellow metal has become obsolete as a store of value or as a proxy for fiat money. In fact, gold was just about the only asset to gain value in 2008, closing the year at US$869 per ounce, up 5.5% for the year. True, it spiked to over US$1,000 early in 2008 on the collapse of Lehman Brothers, but dropped back to US$709 in November, in counterpoint to the rising US dollar, as the danger of a systemic financial collapse subsided.

Prices for most commodities will continue to be soft in 2009, particularly base metals and forestry products, as global demand is likely to remain weak for most of the year. Gold, however, is likely to see some strength in the year, for one very simple reason: reflation. The Fed has already cut its policy rate to zero. thrown the discount window wide open, and expanded its balance sheet to unheard of levels. Money supply has skyrocketed. The entire financial system is awash with liquidity, which very soon will have the desired effect of thawing out credit markets again.

Next, Obama and the Democratic Congress will throw trillions more into the economy (following hard on the heels of the Bush administration's US$750 TARP bailout).

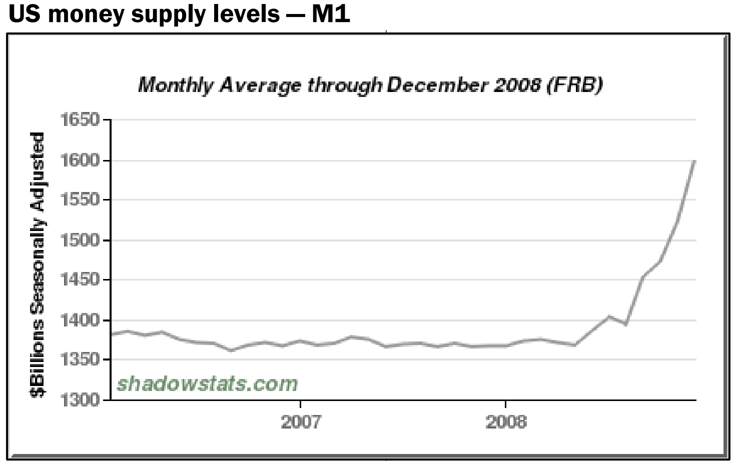
As noted above, all of this should set the stage for economic recovery starting sometime after the second half of this year. But it will also set the stage for growing inflationary pressure. And that's bullish for gold, which remains the most sensitive of all barometers for changes in inflationary pressure.

Gold price - 2008



Source: Kitco

US money supply levels — M1



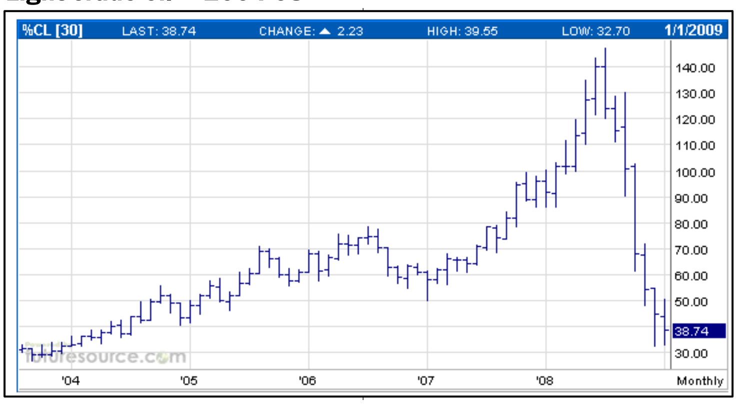
Source: shadowstats.com

Currently gold is discounting a currency crisis, and has no big impetus to rise. However, because the trend of the US dollar will be down as the dust starts to settle, and we see investors leaving US Treasuries, there's a 60%-70% probability that gold will trade in a range between US$700 and US$900 for the balance of 2009. Given the increasingly fragile geopolitical situation (see "Oil" below), and a faster-than-expected devaluation of the greenback this year, there's a 20%-30% chance that gold could spike back over US$1,000, perhaps as high as US$1,500. That probability increases going into 2010, as inflation begins to seep into the economy again.

Oil: declining demand

After spiking to a record high above US$147 a barrel last July, crude oil went into free-fall and fell US$100 per barrel, ending the year with a 54% annual decline. Two key factors contributed to the bursting of the oil bubble. First, hedge fund liquidation of large speculative futures positions, triggered by the credit crunch, brought to an end the momentum-driven price surge through the first half of 2008. Second, and more important from a fundamentals standpoint, demand faded rapidly as US consumers faced a sudden loss of leveraged real estate wealth through the collapse of the subprime mortgage market and resulting global credit crunch. US vehicle sales plunged 50% from the June peak in gasoline prices, and Detroit's big three carmakers just as rapidly fell into near bankruptcy.

Light crude oil — 2004-08



Source: CTVglobemedia

In the same way the rising price of crude oil was said to be like a "tax" on the consumer, the price plunge has erased that "tax" and freed up about US$200 billion for US consumers to spend on other things – like paying down debt.

The Organization of Petroleum Exporting Countries, the oil cartel otherwise known as Opec that produces about 40% of the world's oil, has attempted to curtail production to arrest the price free-fall. So far, to no avail. The global recession is suppressing demand everywhere, and Opec has little control over downside price moves. Opec's production cuts are unlikely to stanch global supply significantly, owing to the long history of cheating among member states, and to the continuing revenue needs of non-Opec emerging-market oil producers (like Russia), which rely on oil revenues for growth.

The International Energy Agency forecasts that global oil demand will drop this year and next, the first such two-year decline in 26 years. The US Energy Department predicts that Opec's spare capacity is expected to rise to four million barrels per day, while supplies balloon. In mid-January, US stockpiles at the country's main delivery hub in Cushing, Oklahoma, were at record highs.

And with China, one of the world's biggest oil consumers, also in the midst of a major economic downturn, it doesn't appear that oil demand will perk up anytime soon. This is not to say that it won't *ever* recover. Of course it will, as economic recovery gathers steam through 2010 and demand once again overtakes supply.

But for 2009, we can expect crude oil to trade in the US$40-$50 per barrel range, as the global recession grinds on.

International markets

In international markets, the MSCI Europe, Australasia & Far East (EAFE) Index posted an 20% decline in the fourth quarter, as the index closed out the year with a 12-month loss of 45%. The spreading financial crisis deepened through the year as the credit crunch began to erode real economic activity through Europe and Asia. Both external trade and domestic demand faltered badly across all regions, pushing all economic indicators deep into the red.

With many member nations already in recession through the second and third quarters, the 15-nation eurozone faced increasingly grim economic data through the fourth quarter. Business and consumer confidence indexes have plummeted to their lowest levels in 15 years. And both manufacturing and service purchasing managers indexes for December indicated economic contraction for the eighth consecutive month. Credit conditions remain tight despite an early January rate cut by the European Central Bank to 2.0%. An economic recession and very tight credit conditions in the UK also spurred the Bank of England to cut its key rate by a another 50 basis points, to 1.5%, in January.

MSCI EAFE Index — 2008

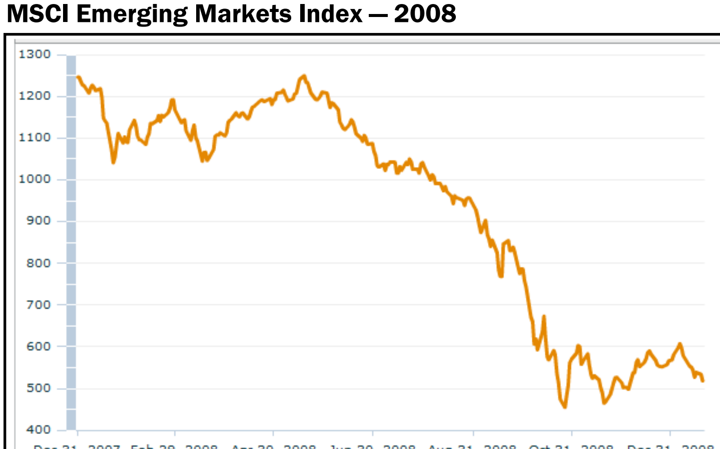
Source: MSCI Barra

With Japan's export-oriented economy in a recession since July, the Bank of Japan had little choice left but to follow the US lead and cut its key policy rate to a near-zero 0.10% in December. Japan seems once again beset by a perfect storm of intractable economic problems, including collapsing exports, the sharpest industrial slowdown since the 1970s, a slumping housing market, weaker consumer spending as wage gains lose momentum, a softening labour market, and tight credit conditions.

Australia's resource-based economy, while not yet in recession, faced powerful headwinds as the global recession began to bite down under. In an effort to mitigate the damage and head off a recession the Reserve Bank of Australia cut its key lending rate by 300 basis points through the year, to a 12-year low of 4.25%. And the government announced a pre-Christmas stimulus package of A$10 billion. However, domestic demand and business activity have slowed to a crawl, owing to slumping demand for key commodities from China.

The MSCI Emerging Markets (EM) Index ended the year down 54%, following a 28% decline in the fourth quarter. With statistics showing the 30 developed nations comprising the OECD on track for a recession, emerging nations have been hard-pressed to avoid the fallout of collapsing demand on their export-dependent economies. A financial vice consisting of rising borrowing costs and sliding currencies on one side and slowing economic output and collapsing stock markets on the other forced many emerging nations to seek emergency loans from the International Monetary Fund through the second half of the year.

MSCI Emerging Markets Index — 2008



Source: MSCI Barra

Any thought of global decoupling was abandoned as emerging nations with large deficits that require foreign financing, such as Hungary and

Pakistan (both of which are components of the MSCI EM Index), faced the possibility of sovereign default. The IMF moved to help developing nations facing liquidity problems weather the financial crisis by easing lending policies that required deep domestic fiscal policy changes. Emerging market countries like Mexico, Brazil, and Eastern European nations without large current account deficits would benefit most from these relaxed rules. Russia, meanwhile, has fallen into recession as it grapples with soft crude oil prices, a mainstay of its recent economic growth.

As the global economic slowdown widened through the third and fourth quarters, emerging Asian giants China and India also began to feel the pinch of slowing exports. Although this was initially partially offset by still-positive domestic demand, capital spending saw significant decline, and unemployment rates rose as export-dependent factories began to close down. China's GDP slowed to an annual 9% in the most recently reported third quarter, down from a peak of 11.9%. An annual rate of 8% is considered the threshold of growth for China.

"For commodity producing emerging nations, the situation is, if anything, even more dire."

With the substantial economic contraction already underway in the OECD developed countries, emerging nations in both Asia and Latin America will see a major deceleration in economic growth through the balance of 2009. Export-dependent Asian nations have already started to experience declines in industrial output, most notably China, which accounts for about 20% of world manufacturing output. China's manufactured goods sector represents 85% of the country's exports and over 30% of its total economic output. China's GDP growth is expected to fall to 7% in 2009, even as the government implements a gigantic stimulus package equal to about 10% of GDP over two years.

Weakness in China's economy affects the entire region, because the Asian economies are so interlocked, and the smaller Asian nations supply nearly half of China's imports as raw materials. Already the impact is noticeable in Taiwan and South Korea, where exports have declined 23% and 18% respectively year over year in 2008.

For commodity producing emerging nations, the situation is, if anything, even more dire, as the commodity price collapse has hit these markets particularly hard. Brazil and Russia (two of the so-called emerging "BRIC" nations, India and China being the other two) rely heavily on commodity exports (sugar and oil in Brazil, oil and gas in Russia). However, the commodity price collapse has seriously weakened exports of oil, causing particular problems for Russia, where net capital outflows reached a record US$130 billion in 2008. The Kremlin has dipped deeply into its gold and currency reserves to prop up the flagging ruble in an attempt to head off civil unrest of the kind that accompanied the ruble's collapse in 1998.

Indeed, the Russian government is likely to turn increasingly despotic with the re-emergence of Vladimir Putin from behind the scenes as President, followed by growing geopolitical tensions and brinksmanship from the Caucuses to the Baltic and from the Sino-Russian border to the high Arctic.

So for 2009, although emerging economies in general will not descend into contraction, we are unlikely to see a renewed surge of growth until there is a sustained recovery underway in the US. We expect emerging-nation GDP to grow in the 4% to 5% range in 2009. And when it occurs later in 2009 and into 2010, the degree of recovery will be bigger in emerging markets than in developed economies.

Market outlook

Deep interest rate cuts and gargantuan fiscal stimulus are underway just about everywhere around the world. The Bank of Canada cut its target overnight lending rate another 50 basis points on January 20, to a record low 1%. The comparable US rate is zero. The story is the same everywhere, as even the tough-minded European Central Bank has relented enough to cut its rate to the lowest level ever.

But by the end of 2008, equity markets had already discounted the deepening recession and the salutary effects of money printing. In late November, the S&P/TSX Composite Index touched the year's low, at 7,647. By year-end, the index had recovered to 8,987, a 17% advance from the low. The big US indexes, the Dow Jones Industrial Average and the S&P 500 Composite Index, showed the same pattern.

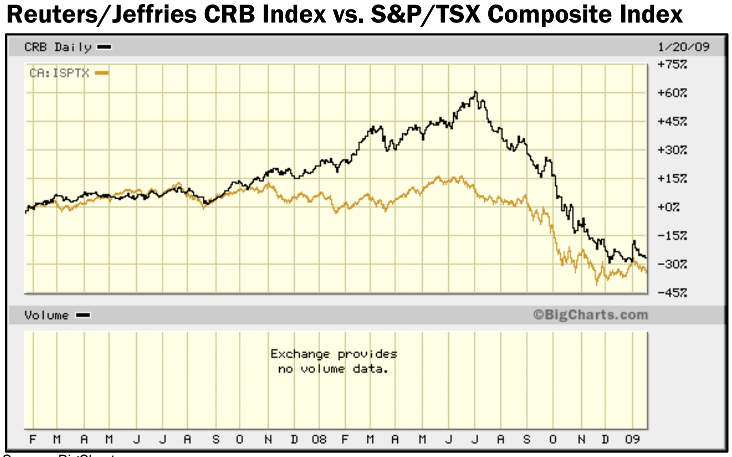
The question is, to what degree have markets possibly overcorrected? The normal trading range for the S&P/TSX may be between 10,000 and 12,000. It's entirely possible that the Toronto benchmark index will rally to that level again this year, for the very reasons that sank in the first place. Let's not forget that the Toronto market is commodity-driven. And commodities, like all markets, tend to swing to extremes. Oil, which was overbought at US$147, now appears to be oversold at close to US$35. Ditto for base metals, such as copper, for example, which closed 2008 at a four-year low.

If, as we expect, economic activity begins to revive in the second half of this year, we should see the beginnings of a rally in commodity prices. And that will revive the Canadian market. Earnings estimates have shrunk dramatically over the past six months, and current valuations may already be pricing in larger earnings downgrades, which may no longer materialize. A number of models are signaling that stocks have become undervalued, including the dividend discount model (1,000 points undervalued) and the Fed model (comparing estimated 12-month earnings yield with corporate bond yield; about 2,000 points undervalued). The Q-ratio developed by James Tobin (dividing a company's market value by the replacement cost of its capital assets) stands at about 0.82 for the TSX – and any reading below 1.0 is considered a "buy."

The other big question concerns timeline. Historically, the S&P/TSX Composite has started to recover about six months before the economy begins to turn around. And because we expect an economic turnaround to begin manifesting in the fourth quarter of the year, the S&P/TSX should begin to rally sometime in the second quarter.

Indeed, the Canadian and US stock markets may have bottomed, as the last drops of both fear and greed have been wrung out of markets. How-

Reuters/Jeffries CRB Index vs. S&P/TSX Composite Index



Source: BigCharts.com

ever, we will need some confirmation in March, when taxpayers begin filing their returns. That will tell us a lot about the depth of the recession.

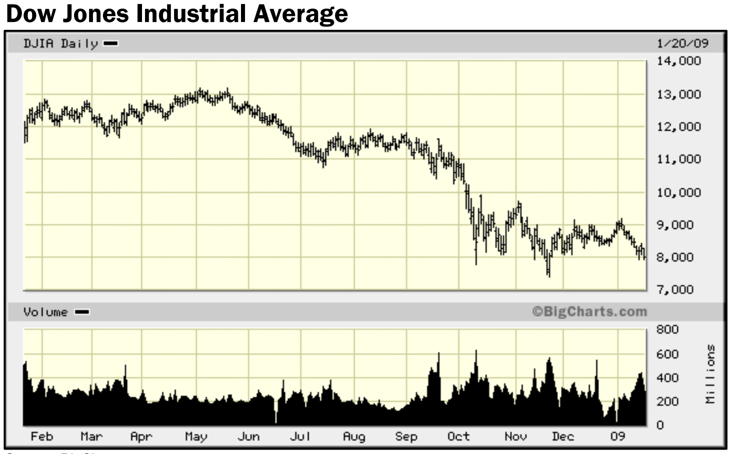
The end of the first quarter will mark the end of the Presidential honeymoon period, and at about the same time, we will get a handle on the costs associated with all those underfunded defined benefit pension plans. That number could be in the trillions, on top of everything else that has been spent to revive this economy. This combination could throw cold water on a rally, which is why we are telling all who will listen to be willing to hedge their bets sometime in March.

After that, when you tie in the massive spending programs, the market's discounting, pricing, and weighing function will increasingly drive performance. A US recovery is expected in the last quarter of 2009, which is when the trillions of dollars of pump priming should filter through to the US consumer.

So with both Canadian and US stock valuations relatively cheap, we see a rally into February, followed by a short-term correction or consolidation period. After that, we have confidence that stocks can sustain a longer-term rally through the second half of the year.

The result will be that by the end of 2009, the S&P/TSX will reach 10,000 at low end (with a 20% probability of reaching 12,000 at the high end). We will not see any significant contraction in volatility until the second half of the year.

Dow Jones Industrial Average



Source: BigCharts.com

S&P 500 Composite Index

Source: BigCharts.com

Given our view that US and Canadian equity indexes bottomed in November, we also believe that the US markets will show signs of recovery well before the US recession ends. That recession is already over a year old, and being of the particularly nasty consumer-led variety, could last another eight months. Equity markets typically begin to recover with a four to six-month lead before the end of a recession, so we could see the major US indexes take flight in the third quarter.

The Dow Jones Industrial Average, like the S&P/TSX, has a high probability of rallying to 10,000 by year-end, given the vast amount of stimulus being injected into the economy, and the heavy discounting of earnings declines that has already occurred. The same would apply to the S&P 500 Composite Index, which has a high probability of ending the year at around the 1,000 level.

Of course, there are some very real risks to these projections. The US economy may languish longer than expected, if consumers hunker down even more and concentrate on saving rather than spending. There's a concern that the Dow Industrials will continue to scrape along the bottom, holding between 7,500 and 8,500.

Beyond that, we need to see the deleveraging process come to an end. We believe that process is now as much as 60% completed. We also need to see the London Interbank Offered Rate (LIBOR) remain down (current 1.12% compared with 3.89% a year ago), yields up, and a sustained lower TED Spread as fear comes out of market. A TED Spread that sustains at historical norms of around 1% will be one of signals that deleveraging is coming to an end and that economic contraction is ending.

TED Spread — 2008

Source: Bloomberg LP

3-month LIBOR (US$)

Source: theFinancial.com

Strategy

Last year was the year of the credit squeeze. Investment performance in virtually every asset class was suppressed primarily by the difficulties being experienced in the credit markets, especially in credit instruments at the heart of the crisis, ranging from asset-backed commercial paper (ABCP) to derivative swaps to plain vanilla government and corporate bonds, as well as preferred shares.

The good news is that funds and investments managed by R.N. Croft Financial Group Inc. (Croft) avoided financially distressed instruments such as ABCP and credit derivatives. The bad news is that regardless of the presumed safety of any credit investment, everything was tarred with the same broad credit-risk brush.

During the course of the fourth quarter of 2008, we held preferred securities of major Canadian banks. In pricing of these securities, the market shifted from its usual focus on interest rate anticipation as the key pricing driver to a near-obsessive concern with business risk. This caused preferreds, which normally trade with volatility similar to bonds (i.e., relatively low), to trade with volatility almost equivalent to their underlying stock. Owing to this shift, our income pool traded down almost 13%, with the key downside impact coming from preferred shares.

The good point – the one we'll have to wait for – is that most of the preferred shares that we own have call features that come due within the next three to five years. If interest rates remain low, preferred issuers will be looking to refinance these preferreds at lower rates. To do so, they must call the preferreds at par value, which for most of our holdings is about 20% to 30% higher than current values. In addition, all these preferreds still pay their dividends, and we continue deploy these cash disbursements into cheaper equities.

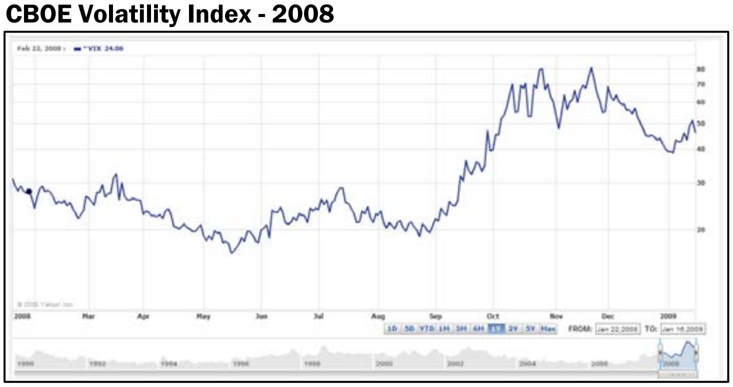
More good news. We should see the income pool respond positively to the flood of fiscal and monetary stimulus being offered up by governments around the world in coming months, which will result in the revaluation of financial sector issues over the course of 2009. We fully expect that our income strategy will outpace bonds significantly during the recovery.

The collapse of credit markets in 2008 hit every equity without discrimination. If it traded on a stock exchange, it was viewed with the same disdain reserved for the hardest hit sectors. Through 2008 and well into the fourth quarter investors' main anxiety was the impact that frozen credit markets would have on bank lending and therefore on the overall economy. It was these worries that influenced market performance and by extension our Equity Pool. We continue aggressively to take advantage of the high option premiums in the market by writing covered calls. Volatility spiked to unusually high levels, pricing options richly and enhancing our premium-income strategy.

The result of our option strategies mitigated the decline in the broader market – cushioning the blow to our Equity Pool by about 3 percentage points.

Because we expect to see volatility through at least the first half of the year, we will continue to write options to generate income and provide some downside protection. We'll consider an option-writing strategy when implied volatility higher than 23, which is the average implied volatility for the S&P 500 Composite as measured by the Chicago Board Options Exchange Volatility Index (VIX) – higher in Canada owing to the effect of commodities. In January, the VIX was still posting readings between 40 and 50, providing excellent option-writing opportunities. However, we expect the index to retreat to norms between 20 and 30, once credit markets thaw, fiscal stimulus kicks in, and the economy shows early signs of growth.

CBOE Volatility Index - 2008



Source: Yahoo Inc.

In summary, then, we expect to see the early beginnings of recovery in 2009, in financial markets and in the economy. But risks aplenty remain – not the least of which is the glacial nature of credit markets. We'll stick to our prognostications for now, and revisit them in three months' time, always with the proviso that we, like everyone, are subject to "events, dear boy, events."■

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