



EQUITY RESEARCH

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INVESTMENT STRATEGY

2009 Outlook & Portfolio Strategy

Calm after the storm may lead to modest upside for equities

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Index Levels

TSX	8564.93
TSX Venture	718.80
DJIA	8804.83
S&P 500	896.47
Nasdaq Composite	1558.08
MSCI World Index	221.02
Risk Metrics	
VIX	53.08
TED Spread	1.82%
FAIL [®]	96.45

Prices and levels as at noon PST on December 16, 2008

Interest Rates & Commodity Prices

Canada T-Bill (90 days)	0.85%
US T-Bill (90 days)	0.03%
Canada 10-year Govt.	2.98%
US 10-year Treasury	2.36%
Canada 30-year Govt.	3.70%
US 30-year Treasury	2.86%
CRB Index	226.85
Spot Gold	US\$852.24
Crude Oil (Feb.)	US\$46.73
Canadian Dollar	82.47 US cents
USD/Euro	1.3972
USD/JPY	89.39

Source: Bloomberg

Summary

- Our view is that a return to lower volatility and improved risk appetite which we expect in 2009 may lead to modest upside for global equities from current levels.
- Our analysis of bottom-up earnings estimates for the TSX Composite and the S&P 500 indicates that earnings forecasts may still be too optimistic, against the backdrop of an accelerating economic slowdown.
- Our end-2009 estimate for the TSX, based on an 11x multiple applied to our 2009 earnings estimate of \$885, is 10,000. For the S&P 500, based on a 12.5x multiple applied to our 2009 earnings estimate of \$75.50, our end-2009 estimate is 950.
- Equity valuations are attractive at current levels, relative to historical norms and also in relation to other asset classes such as bonds (especially US government paper). The 3.25% dividend yield on the S&P 500 exceeds the current yield of 2.36% on US 10-year Treasuries for the first time in decades.
- We expect financial markets to remain unsettled in the near term, and begin recovering in the second half of 2009. Accordingly, our recommended asset allocation is as follows – Stocks 45%, Bonds 30% and Cash 25%.

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Back from the brink

At their nadir last month, global equity markets had collectively lost \$32 trillion or 50% of their value this year. This gives 2008 the dubious distinction of being the year in which the biggest erosion of wealth has ever occurred on a worldwide basis.

Much of this wealth destruction has occurred over the past three months, a period when the global financial system seemed to be teetering on the brink of collapse on more than one occasion. At the time of writing, concerns about a catastrophic financial meltdown have receded considerably. The focus now is on the extent of the economic damage wrought by the 17-month long credit crunch.

This has been such an exceptionally tumultuous year that we believe next year will seem becalmed in comparison. It would be imprudent to expect a massive rebound given the extent of the damage that has already been inflicted on investor sentiment and economic prospects. **However, our view is that a return to lower volatility and improved risk appetite which we expect in 2009 may lead to modest upside for global equities from current levels.**

Canadian indexes brought down to earth by plunging commodities

Plunging commodity prices triggered a precipitous decline in the TSX Composite, which had defied gravity by reaching a new record in June despite an increasingly murky outlook for global economic growth. The TSX-Venture index – down 80% YTD in US dollar terms – is one of the worst performers globally this year due to the combination of tumbling commodity prices and an extremely challenging financing environment for early-stage companies. As Figure 1 shows, the TSX this year displayed a closer correlation with global equities (using the MSCI World Index as a proxy) and US equity indexes, than it did with commodity prices. In the following section, we analyze the impact of some of these variables on the TSX.

Figure 1: S&P/TSX Correlation Matrix – 2008 YTD

Security	SPTSX	SPX	INDU	MXWD	CRB	CL1	CADUSD	DXY	VIX	.FAIL
SPTSX	1.000	0.801	0.768	0.835	0.539	0.493	0.542	-0.265	-0.664	-0.475
SPX	0.801	1.000	0.990	0.846	0.360	0.290	0.547	-0.051	-0.848	-0.671
INDU	0.768	0.990	1.000	0.829	0.320	0.262	0.541	-0.035	-0.836	-0.659
MXWD	0.835	0.846	0.829	1.000	0.572	0.480	0.657	-0.363	-0.743	-0.567
CRB	0.539	0.360	0.320	0.572	1.000	0.813	0.571	-0.657	-0.370	-0.277
CL1	0.493	0.290	0.262	0.480	0.813	1.000	0.479	-0.519	-0.243	-0.182
CADUSD	0.542	0.547	0.541	0.657	0.571	0.479	1.000	-0.559	-0.467	-0.327
DXY	-0.265	-0.051	-0.035	-0.363	-0.657	-0.519	-0.559	1.000	0.008	-0.077
VIX	-0.664	-0.848	-0.836	-0.743	-0.370	-0.243	-0.467	0.008	1.000	0.821
.FAIL	-0.475	-0.671	-0.659	-0.567	-0.277	-0.182	-0.327	-0.077	0.821	1.000

Source: Bloomberg, Global Securities Research

TSX Drivers

- **Global Growth and Commodity Prices**

Escalating concerns about slowing global economic growth have led to a 37% decline in the CRB index this year (Figure 2), while the index has plunged 52% from its peak in July. Crude oil is down 54% YTD and has tumbled 70% from its record high, also reached in July.

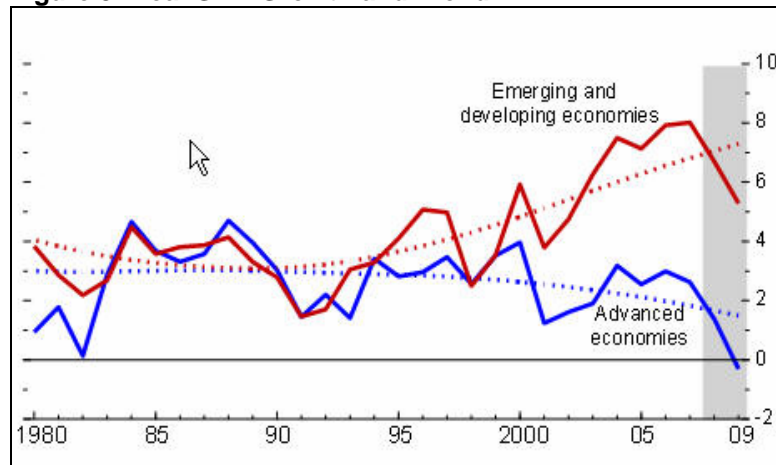
Figure 2: TSX vs CRB and Crude Oil - YTD



Source: Bloomberg, Global Securities Research

In its World Economic Outlook Update released last month, the IMF forecast world growth will slow to 2.2% in 2009, from an estimated 3.7% in 2008. The downturn is expected to be led by the advanced economies (Figure 3), with the forecast 0.25% contraction in the group in 2009 being the first annual one during the postwar period. Emerging and developing economies are forecast to grow at a slower pace of 5.1% in 2009, led by China and India, whose growth rates are forecast at 8.5% and 6.3% respectively in 2009.

Figure 3: Real GDP Growth and Trend



Source: IMF World Economic Outlook Update, November 2008

We expect commodity prices to remain soft in the first half of 2009, before rebounding – albeit modestly – in the second half.

- **The Canadian and US economies**

To all intents and purposes, the Canadian economy seems to be in a recession, while the US economy is officially in one. The gravity of the situation is underscored by the Bank of Canada's decision earlier this month to lower its benchmark target for the overnight rate by three-quarters of a percentage point to 1.50%, citing significant deterioration in the outlook for the world economy and a global recession that will be broader and deeper than previously anticipated. In its Monetary Policy Report released in October, the Bank had projected average real GDP growth for Canada of 0.6% for both 2008 and 2009, and 3.4% in 2010. **Given the weakness in recent economic data releases, we expect those forecasts to be revised lower in the months ahead.**

On December 1, the National Bureau of Economic Research (NBER) confirmed that the US economy entered a recession exactly a year ago. This is the first US economic contraction since 2001, and is already the longest in a quarter-century. Recent data have been nothing short of abysmal. US employers slashed over 500,000 jobs in November, bringing job losses this year close to 2 million, while sales at US retailers last month declined the most in almost four decades, and mortgage delinquencies and foreclosures are at record highs. The IMF forecasts the US economy will contract 0.7% in 2009, after growing 1.4% in 2008. With the economic outlook having weakened further since its October 29 meeting, the Federal Reserve today established a target range for the federal funds rate of zero to 0.25%.

- **Corporate Earnings**

Our analysis of bottom-up earnings estimates for the TSX Composite and the S&P 500 indicates that earnings forecasts may still be too optimistic, against the backdrop of an accelerating economic slowdown.

For the TSX Composite, our analysis indicates that index earnings – based on bottom-up estimates – for 2009 are actually projected to increase marginally (1%-2%) from an estimated \$950 in 2008. An anticipated turnaround in earnings at banks and financial institutions is expected to offset a decline of over 20% in energy group earnings, while profit in the Materials group is forecast to decline marginally.

In our opinion, the turnaround in financial sector earnings may take longer than current projections. With earnings in the heavyweight Energy and Financials sectors – which together constitute close to 60% of the index – under continued pressure in 2009, we are forecasting overall index earnings of \$885 in 2009, a decline of about 7%. Table 1 provides a summary of YTD performance and our forecasted earnings change for the TSX sectors.

Optimism for S&P 500 earnings is even more rampant, with bottom-up estimates calling for a 25% rebound in index earnings after a 19% forecast slump in 2008 (Table 2). The earnings rebound is expected to be led by banks and financial institutions, with significant earnings growth in the consumer staples and discretionary sectors.

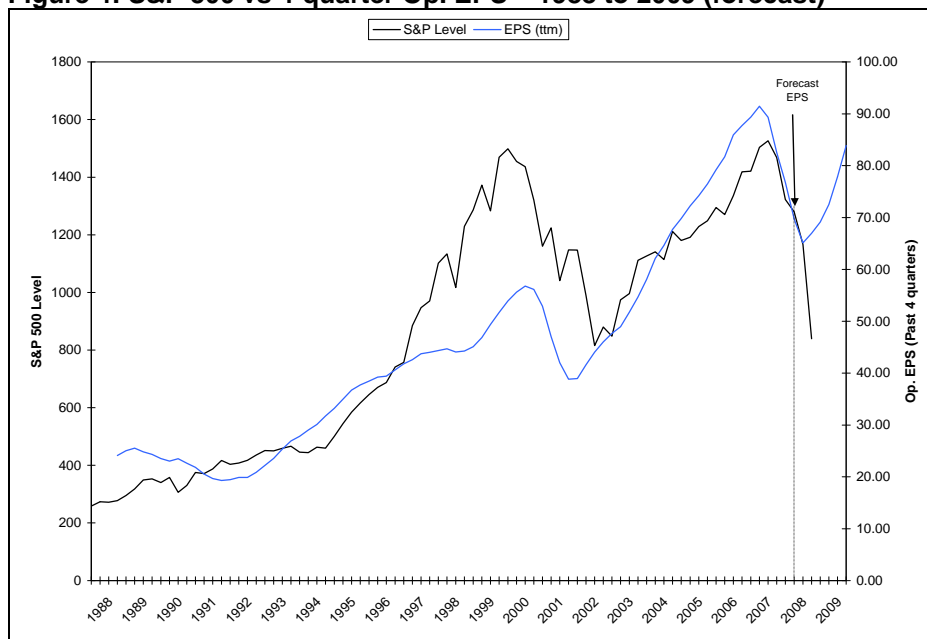
These drivers are forecast to offset a 16% drop in Energy earnings and an 18% slump in Materials sector earnings. In our view, optimism that the second half of 2008 will turn out to be the trough for US corporate earnings (Figure 4) is misplaced. We expect earnings estimates for the S&P 500 to continue to be ratcheted lower in the coming months. We estimate 2009 EPS for the S&P 500 at \$75.50, an increase of 13% from 2008 levels, but down 10% from the current consensus forecast derived from bottom-up estimates.

Table 1: TSX Sector Performance and 2009 Forecast EPS Change

TSX Group	YTD Perform.	Forecast EPS change (%)
Consumer Staples	-13.1%	4.9%
Utilities	-27.8%	-7.8%
Industrials	-30.8%	11.0%
Materials	-32.6%	-5.2%
Health Care	-35.3%	-4.4%
Telecom Services	-35.8%	3.1%
Energy	-36.4%	-21.7%
Consumer Discretionary	-43.4%	-7.1%
Financials	-43.4%	-7.2%
Information Technology	-57.4%	0.3%
TSX	-38.6%	-6.8%

Source: Global Securities Research, Bloomberg

Figure 4: S&P 500 vs 4-quarter Op. EPS – 1988 to 2009 (forecast)



Source: Global Securities Research, Standard & Poor's

Table 2: S&P 500 Quarterly Operating Earnings

Period	2007-A	2008	% Change	2009-E	% Change
Q1	\$22.39	16.62	-25.8%	\$18.78	13.0%
Q2	\$24.06	17.02	-29.3%	\$20.40	19.9%
Q3	\$20.87	16.26	-22.1%	\$21.59	32.8%
Q4	\$15.22	17.08	12.2%	\$23.08	35.1%
Total	82.54	66.98	-18.9%	83.85	25.2%

Source: Standard & Poor's

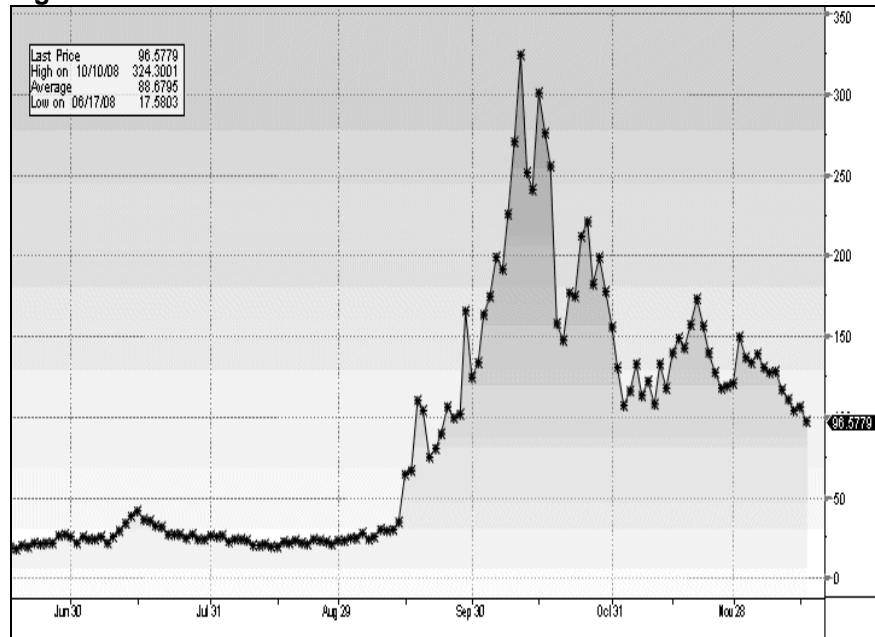
- **Volatility**

Equity markets have been tremendously volatile since September 15, when Lehman Brothers' bankruptcy sent shockwaves through the global financial system. The CBOE Volatility Index (VIX) has had daily swings of at least 4% on as many as 26 days since September 15; volatility of this magnitude was last witnessed in 1933. Since September 15, the average level of the VIX has been 56.50, compared with an average level of 17 in the five years preceding the eruption of the credit crisis in August 2007.

The TED Spread, which measures the difference in yields between three-month US T-Bills and three-month Eurodollar LIBOR, reached a record 4.64% on October 10. Our proprietary Financial Armageddon Indicator Level (FAIL[®]), which combines the VIX and the TED Spread to provide a measure of the concern regarding a global systemic collapse, has been declining steadily since October 10 (Figure 5), when it reached its highest levels since October 1987.

While this degree of volatility represents a natural "overshoot" from the complacency that marked the 2003-2007 bull run, we believe that the risk pendulum has swung too far, to an extreme level of risk aversion. This is manifested in the elevated levels of risk metrics for relatively risky assets such as corporate bonds and options, as well as the massive flight to the perceived safety of US Treasury bills that has sent short-term yields to near-zero. In our opinion, with the floodgates of liquidity wide open globally, investor appetite for risky assets will return to some extent. **As the fear of a systemic financial collapse recedes, we expect volatility and risk spreads to contract significantly from current elevated levels.**

Figure 5: FAIL[®] Indicator



Source: Global Securities Research, Bloomberg

Outlook

The global market rout in 2008, the steepest and broadest in recent memory, has given rise to significant concern that it may portend a long-drawn recession, or perhaps even a Depression.

In our opinion, while the global recession is likely to be longer and deeper than the norm, the concerted measures taken by global central banks may stop the rot from spreading to dangerous levels in 2009.

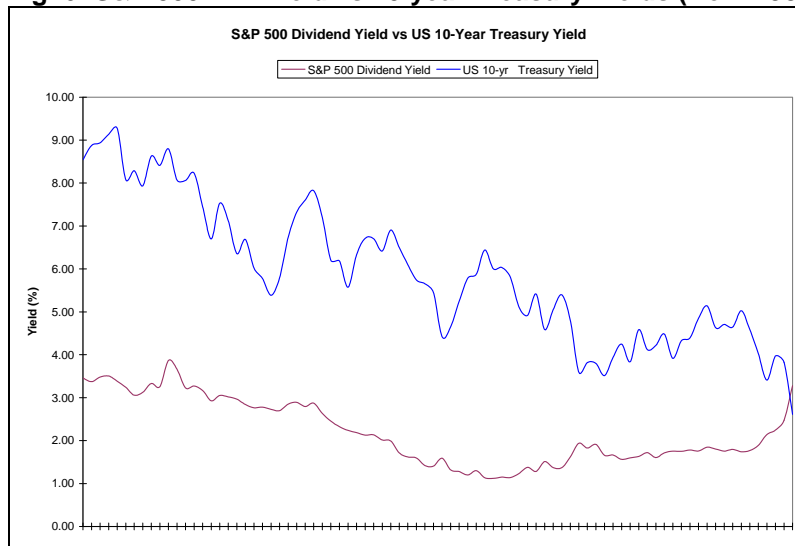
The TSX Composite is currently trading at 9x estimated 2008 earnings of \$950, half the level of its average 18x earnings multiple since 2003. Valuations have compressed due to a number of factors – uncertainty about the extent and length of the slowdown, panic liquidation, the credit crisis and so on. We expect valuations to improve in 2009 (but stay well below the five-year average), as the credit crisis abates and investors have clarity on the likely end of the recession. Accordingly, our end-2009 estimate for the TSX, based on an 11x multiple applied to our 2009 earnings estimate of \$885, is 10,000.

For the S&P 500, based on a 12.5x multiple applied to our 2009 earnings estimate of \$75.50, our end-2009 estimate is 950.

Based on the above, we proffer the following insights with regard to investment portfolios –

1. **Equity valuations are quite attractive:** Equity valuations are attractive at current levels, relative to historical norms and also in relation to other asset classes such as bonds (especially US government paper). As Figure 6 shows, the 3.25% dividend yield on the S&P 500 exceeds the current yield of 2.36% on US 10-year Treasuries for the first time in decades. The TSX Composite has a dividend yield of 4.40%, more than 140 basis points above the 10-year Canadian government bond yield of 2.98%. Equity markets are presently discounting a very gloomy scenario, and if the reality is not as bad as expectations, equities could outperform significantly.

Fig. 6: S&P 500 Div. Yield vs 10-year Treasury Yields (from 1988)



Source: Global Securities Research, Standard & Poor's

2. **We favor Canadian equities over US at this time:** The Canadian economy is in better shape than the US going into this slowdown. As well, we believe there is a growing risk of a significant pullback in the US dollar against major currencies in 2009. Our end-2009 targets imply potential upside of about 17% for the TSX Composite and 6% for the S&P 500, reflecting our view that Canadian equities may outperform their US counterparts next year.
3. **Increased merger activity in the commodity and energy sectors may support stocks:** Barring the odd takeover play, M&A activity has shrunk to a fraction of its size in the glory days of 2007. Nevertheless, we believe that long-term fundamentals justify substantially higher prices for most commodities. In our opinion, suitors from the emerging giants of China and India who share this view are likely to take advantage of this opportunity to acquire commodity assets at a deep discount.
4. **An opportunity to accumulate best-of-breed equities:** Since this selloff has been quite indiscriminate, investors can accumulate best-of-breed blue-chips at reasonable valuations. Numerous companies are trading below the value of their per-share cash holdings.
5. **Acquire a sensible proportion of risky assets:** We believe that the inordinate degree of risk aversion at present has led to a mispricing of risk. As an example, spreads on US corporate bonds versus US government bonds are currently at multi-year highs. We advocate acquiring a sensible proportion of perceived risky assets within a diversified portfolio.
6. **Sectors that may outperform:** We continue to advocate an overall defensive position for investment portfolios. Sectors that we believe may outperform in 2009 include Energy, Utilities and Gold.
7. **Asset Allocation:** We expect financial markets to remain unsettled in the near term, and begin recovering in the second half of 2009. Accordingly, **our recommended asset allocation is as follows – Stocks 45%, Bonds 30% and Cash 25%.**

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