

Making sense of the markets

(as at October 16, 2008)

THE BIRTH OF THE MARKET ECONOMY was rooted in the evolution of a banking system that enabled capital to flow over long distances in order to facilitate trade. Capital flowed across those long distances because of trust. Economies and markets are in essence founded on trust – trust in your counter-party on transactions and trust in the functioning of the system. Over the past month, this trust has been severely stressed. At its worst, we are hearing of cargos trapped in ports around the world as sellers no longer trust buyers' letters of credit; they no longer trust the banking system. While no one view of these markets can encompass the full picture, here are some recent thoughts from Sentry Select's perspective.

We are told that the current market environment is the result of the excesses of a global credit crisis, associated with sub-prime mortgages in the U.S. It has clearly moved beyond this. The crisis initially affected major financial institutions in the U.S. and has since grown to a broader global scale. The credit crunch was initially concentrated in real estate but has since spread throughout the economy. Credit has seized.

Hopefully we saw a climax in the crisis of confidence on Friday, October 10th. The U.S. market collapsed on the open, then rallied, re-tested the opening low at 2:00 p.m. and, in the last hour of trading, lifted 11% before giving up some of those gains. Over that weekend, we read of high-profile CEOs of major U.S. companies being forced to involuntarily sell their holdings as a result of margin calls. On Thursday, October 16th, there was a second test of lows of October 10th; the day ended with a strong rally into the close, again a 10% swing over one-trading day. It would be nice to say we are seeing a capitulation selling climax. We will only know with the passage of time. Leverage is being unwound but we do not know where we are in the process.

While we primarily invest in Canada, our comments will be on the U.S. market. As the old axiom goes: when New York is closed, Toronto doesn't know what to do.

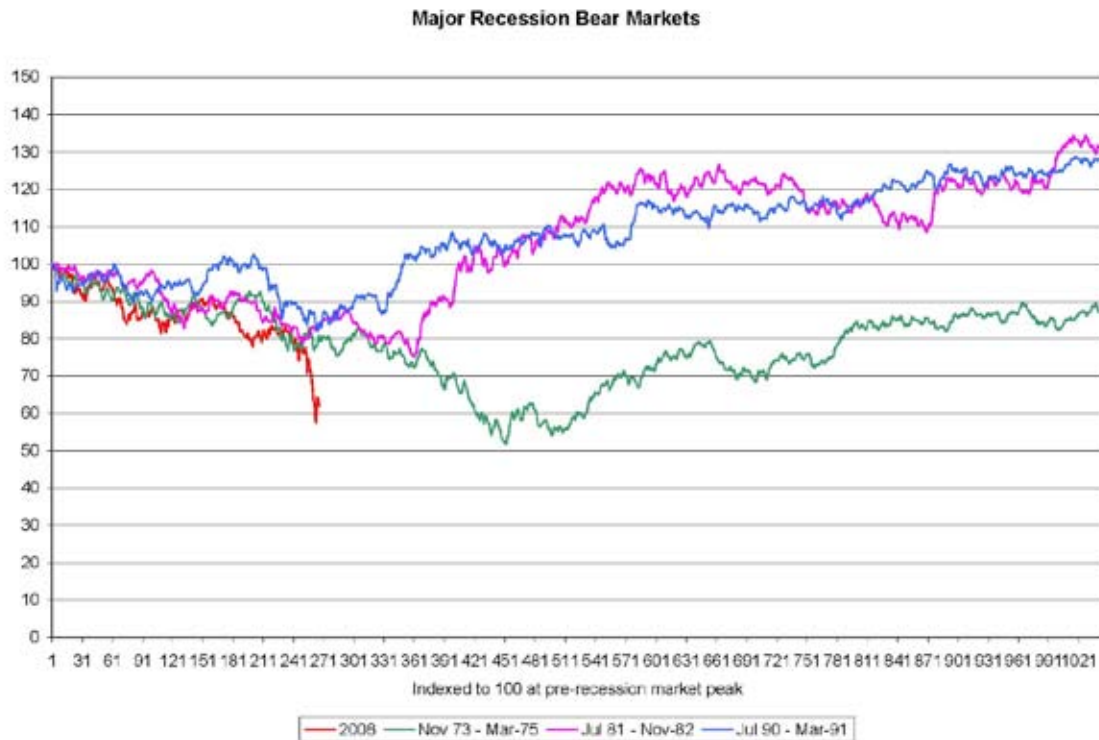
So where are we today?

In the U.S., there has been a housing recession for over 18 months, a consumer recession for a number of months and likely a manufacturing recession that started in the third quarter. The latest data suggests that the recession has broadened to encompass the economy as a whole. There continues to be a credit problem that will adversely affect economic growth for the next couple of years as excess leverage is unwound out of the system. This will impact earnings growth rates and valuations for growth-oriented stocks. We would expect defensive sectors and income securities to outperform in a slow growth economy. In bear markets, dividends and balance sheets matter. In recessions, own the companies that produce the products necessary to the functioning of day-to-day life.

What does history tell us?

There have been a lot of comments in the press that “this market sell-off is unprecedented.” This is factually incorrect. While the circumstances of each bear market may be different, the behaviour doesn’t change. Rolling panics eventually subside and, in time, recovery takes hold.

Let’s take a look at past bear markets and see where we might be, relative to major recessionary bear markets of the post-war era. Each bear is indexed to 100 at the pre-recession market peak and is plotted for a four-year period (1,046 week days). The 2008 bear market is plotted in red.



November 1973 to March 1975 recession

The 1973 to 1975 recession lasted two years and was rooted in the oil embargo by the Organization of Petroleum Exporting Countries (OPEC). P/E multiples collapsed as inflation ran from 3.5% to 11.5%. The inflation brought wage and price controls and rising unemployment. The market bottomed in October 1974 (day 451) with a peak to trough loss of 48%. October unemployment was 6.0% up from 4.6% a year earlier. By May 1975 (around day 625 on the chart), the U.S. unemployment rate was 9.0%. We are at day 266 of this bear market and have declined 90% as far as the 1973 bear.

It is worth considering some of the external events that were happening then. Like today, there was war in the Middle East. As a result, oil was being used as a tactical weapon to damage the western economies and cut their support for Israel. At the same time, the U.S. was dealing with the renewal of the Vietnam War. Saigon fell in April 1975 and the U.S. forces were evacuated. The economy bottomed in the first quarter of 1975. It was a time of social unrest.

There was a crisis in housing as well as a crisis in banking. Between 1973 and 1976, 40 U.S. banks with assets of \$6.6 billion were closed by the Federal Deposit Insurance Corporation (FDIC). The largest closure was Franklin National with assets of \$3.7 billion. (Source: FDIC) Rising unemployment leads to loan defaults and declining housing starts.

July 1981 to November 1982 recession

The 1981 to 1982 recession was also rooted in inflation; restrictive monetary policy was introduced to finally solve the inflation spiral. The Fed Funds Rate peaked at 20% in June 1981, leading to a peak in unemployment of 10.8% in the fourth quarter of 1982. The market bottomed in August 1982 with a peak-to-trough loss of 25%. Earnings bottomed a year later with a peak-to-trough decline of around 20%. By the time earnings had bottomed, the market had recovered by 60%.

There was also a crisis in banking that was rooted in the U.S. housing market. Between 1981 and 1984, 364 U.S. banks with assets of \$124.7 billion were closed by the FDIC. The largest closure was Continental Illinois in May 1984 with assets of \$40 billion. On Friday, October 17th, a total of 71,600 U.S. housing starts were announced. They were at the lowest levels for September in 27 years. September 1981 housing starts troughed at 84,100; September 1974 was 98,300. Low housing starts are not a leading indicator; they are co-incident with recession.

July 1990 to March 1991 recession

The causes of the 1990 recession are less clear than the inflation-era recessions. Analysts have attributed it to a pessimistic consumer, the overhang of accumulated debt and the impact of the Kuwait war on oil prices. What is clear is real estate was a catalyst. The credit contraction that resulted from the Savings and Loan debacle was devastating to the U.S. local banking industry. Between 1988 and 1992, 1,838 banks failed with total assets of \$696 billion. These failures included seven of the top 10 U.S. bank failures. (Source: FDIC)

Despite a clearly stressed banking system and the failure of one of the major investment banks, Drexel Burnham Lambert, the 1990/91 bear market was relatively benign. The market gave up 18%. Earnings did not bottom until May 1992. By the time earnings had bottomed, the market had recovered by 40%.

Current bear market

Oddly enough, the bear market that is most similar to the current one in circumstances is the 1990 bear market. This, too, was rooted in a housing crisis that spilled over to a credit crisis. I have already discussed the U.S. banking crisis in the early 90s; it was in part solved by the formation of the Resolution Trust Corporation in 1989. So far in this banking crisis, 16 U.S. commercial banks with assets of \$350 billion have been closed by the FDIC, including the largest U.S. bank failure to date, Washington Mutual.

But this bear market is much worse than the economic conditions would have predicted. The severity of this bear is clearly due to a forced unwinding of highly levered hedge funds. In that respect, just think Long-Term Capital Management (1998 baby bear market) but on a larger scale. The credit crisis has resulted in forced selling of long-term assets by investors and management due to margin calls.

Since the start of the bear, we have seen a decline of 40% in value together with an earnings decline of almost 40%. Reporting standards initiated as a result of the accounting frauds in the early 2000s are forcing banks to recognize declines in asset values much more rapidly than in the past.

We believe that, while painful, the market needs to consolidate. Bottoms take time to become established. They frequently need to be tested. While we are not yet prepared to say a bottom is in place, we do have a positive sign. Despite the failure of Lehman and the concerns regarding bank stability, in the decline from the July lows, the U.S. financials are outperforming the broad market. This is a pre-condition for a market recovery.

What's next?

Stock markets tend not to be very good predictors of recessions. There are too many tops that occur just as you're about to go into an economic downturn. Stock markets, however, look through the recession and markets tend to bottom relatively early during the physical recession. Stock markets look forward; they always want to move on.

We don't believe investors should wait for an official announcement that we're in a recession. Generally, that announcement arrives after the recession has ended. As well, **if one is waiting for a confirmation that the recession is over before acting, the investment opportunity tends to be missed.**

On average, the announcement that the recession is over happens 15 months after the recession has ended. It's purely academic by the time the economists have given you the 'all clear.'

Don't be late

Earnings bottoms are typically well after the market bottoms. If you look back at the 1990 experience, the market bottomed on October 17th, but it wasn't until May 1992 that we witnessed an earnings bottom. **You had a very nice recovery in price by the time the earnings physically bottomed. This time we may well be having an earnings bottom co-incident with a market bottom. S&P 500 earnings have been quite stable since July.**

It's worth being reminded that it can be very dangerous to be **under-invested at troughs**. While we understand that it's difficult to remain invested or put additional capital to work during turbulent market conditions, the **eventual move off the trough is a very major component of your first phase of a bull market. The recovery from over-sold lows can range from 10% to 30%.** In the first year of a bull market, you can be up 20% to 50%.

While it's difficult to predict a market bottom, the current market environment is producing historically low valuations that we believe have the potential to translate into long-term opportunity for investors. Our portfolios continue to focus on quality assets which we believe possess intrinsic value. They will continue to focus on businesses that possess low debt and strong management teams, continue to generate free cash flow and are expected to maintain viability for many years to come. Brave investors who use a disciplined dollar cost average process over the next year should be well rewarded over the next five years. In the words of Warren Buffet:

"Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now." (New York Times October 16, 2008)

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