

# PERSPECTIVES

An exclusive quarterly report from TD Waterhouse® Private Investment Counsel Inc.<sup>1</sup>

## Financial Market Volatility and Your Portfolio

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Financial markets' recent rollercoaster ride, characterized by unnerving ups and downs, has many investors reaching for the Graviol to calm their motion sickness. What's going on and why, where do we stand and what likely lies ahead?

### What's Happened Lately

Chart 1 illustrates the rise in stock market volatility over the past year. The CBOE (Chicago Board Options Exchange) Volatility Index (VIX) measures the sharp increase in U.S. stock market gyrations, with the index more than doubling from its lows of May 2007. This pattern has been repeated in stock markets around the world, including Canada, so your imagination hasn't been working overtime. There really has been much more volatility of late.

Why the stomach-churning roller coaster ride? The underlying cause has been the sharp slowdown in economic growth precipitated by the sub-prime lending issue and the impact on credit markets (For background information see the August 2007 issue of Perspectives and the Fall 2007 edition of Investment Outlook). Major banks in the U.S., Europe and to a lesser extent Canada have absorbed close to \$200 billion USD in write-offs caused by this crisis and their shares have paid the price. To illustrate, U.S. bank shares fell 37.54% in the year ending February 29, 2008. While much of that decline was in shares of regional banks and lenders devoted purely to mortgage lending, two groups not represented in your portfolios, the slide of U.S. banking shares has reflected both the pain inflicted to date and fear of what might lie ahead.

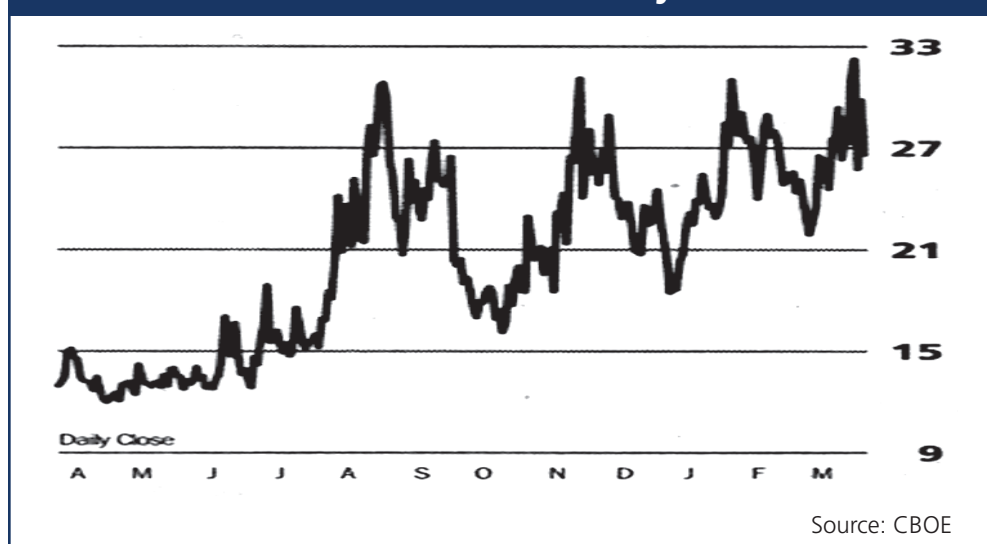
Raw fear, cited above, has been a major ingredient in financial markets' recent instability. In the long run, financial markets are rational but at their extremes, emotions rule. Near market peaks, this emotion translates into greed and in declining markets, fear rules as investors anticipate the worst and become more risk averse.

### Where Markets Stand

Investors' fear and resulting aversion to risk has caused a classic flight to quality – sale of more volatile assets and purchase of what are perceived as safe havens. This is exemplified by the bidding up of Government of Canada bond prices to the point the 10-year issue now yields a modest 3.5%. After netting out inflation of about 2%, the real yield, after inflation, is 1.5%, which fearful investors have been willing to accept due to their concern about possible losses in other investments.

Comparison of the valuation of stocks and bonds illustrates the current situation. Readers of past columns may recall use of what is called the Fed Model to depict relative value of U.S. stocks and bonds. In short, the yield of the U.S. Treasury 10-Year Bond is compared to the earnings yield of stocks (corporate earnings divided by share

Chart 1 - CBOE Volatility Index



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prices). Normally, these two measures are close and extreme divergences often mark inflection points in the market. Chart 2 records a current 10-Year Bond Yield of about 3.5% versus an earnings yield of around 6%, a very wide spread comparable to that in Canada. This suggests stocks are less expensive than government bonds. While it is probable that government bond yields will rise when the flight to quality reverses and the earnings yield could slip, narrowing this spread, valuations support stocks at this point.

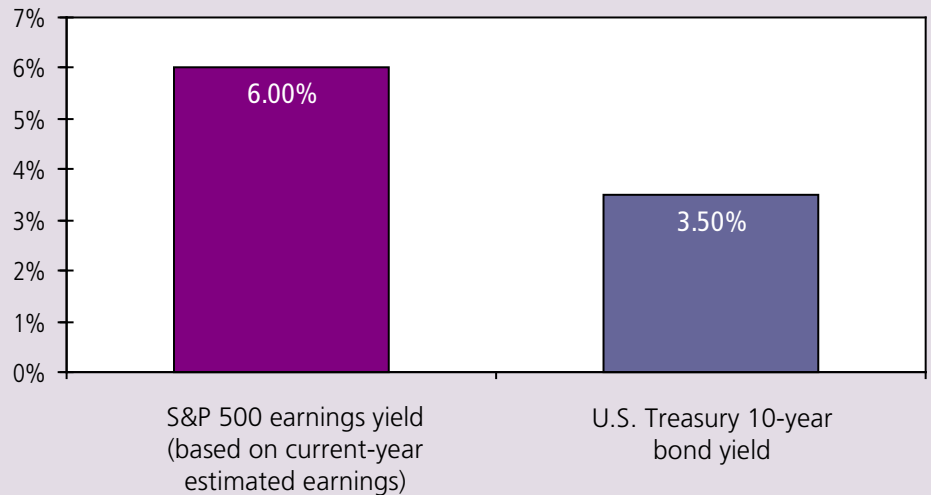
Importantly, American monetary policy is now quite stimulative. The U.S. central bank, the Federal Reserve, has been cutting its benchmark short-term rate, the Federal Funds Rate, since last Fall from 5.25% to the present 2.25%, with the likelihood of further cuts to come. This reduction in short-term interest rates should make those rates considerably lower than long-term (e.g. 10-year) bond yields and should be beneficial for both the American banking system and financial markets in general. This “steepening of the yield curve” is depicted in Chart 3 and its impact should become evident later this year. At the same time, the U.S. Government’s tax rebates, designed to stimulate the economy, will be in the hands of consumers around mid-year and should have a positive effect.

Some other indicators are worth noting. Investor sentiment surveys, which gauge whether investors are positively or negatively disposed toward the stock market, are often useful as they typically represent good contrary indicators. Right now, these surveys display extremely negative sentiment, a positive indicator, not seen since the U.S. market lows of early 2003.

Meanwhile, corporate officers (often referred to as “insiders”) are currently strong net purchasers of their own

### Chart 2 - Stocks represent good value versus bonds

Our estimated S&P 500 earnings yield implies a P:E multiple of 16.6 times estimated '08 earnings. This multiple reflects a more cautious view of U.S. earnings than that of analysts' consensus, which is probably too optimistic.



Source: TD Securities

companies' shares. This is worth noting as they are often in a good position to determine the prospects for their companies' shares.

In addition, money market fund holdings are at very high levels in the U.S. and American money managers are collectively overweight cash; both indicate latent buying power that will be employed in future.

### Your Portfolio

At the moment, client portfolios are, in aggregate, slightly overweight equities, holding more stocks than bonds and cash equivalents. For example, a middle-of-the-road balanced portfolio would have an equity weight of 53%, with bonds and money market holdings making up the balance. This compares with an equity weight of roughly 58% several years ago, which we pared back reflecting a more cautious outlook. This call was early but has proven beneficial over the past year. We are maintaining this

allocation for now as we believe stocks should outperform bonds, but not by a margin that would justify a major overweight in equities.

Within your equity component, we retain a relatively high Canadian weight but below the level of early 2007. While individual client portfolios will differ, Canadian stocks as a percentage of all equities approximated 70% in early 2007, a very high weight that had proven beneficial as both our stock market and currency had been strong performers. We reduced that figure to roughly 60% in order to both reduce the risk of being so highly concentrated in Canada and by inference, the energy and financial sectors, plus take advantage of attractive opportunities elsewhere. This has not proven of benefit to date but we expect this to change as we see a shift into less cyclical sectors and the Canadian Dollar, which has slipped a few cents in 2008 to date, feels further pressure from weakening economic data.

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Your U.S. equity exposure is principally concentrated in shares of the largest companies, the so-called “large caps”, an area we have felt would fare better than smaller companies’ shares, referred to as “small caps.” This has been beneficial as our larger companies’ shares have sharply outperformed small caps over the past 15 months. Nonetheless, the appreciation of the Canadian Dollar has more than offset good stock selection, resulting in negative returns on U.S. stocks, when expressed in Canadian currency. As mentioned above, this will change should the Canadian Dollar weaken in the coming months.

Overseas, the major story has been the sharp fall in emerging markets, an area we have little exposure to and had expressed concern about. China, especially, has been hard hit, declining over 40% from its 2007 peak. As outlined in past columns, our exposure to China is chiefly indirect so Shanghai’s recent market woes have affected you very little.

Among your bonds, we are overweight high quality corporate issues, which have historically outperformed government bonds, in large part due to corporate issues’ higher interest payments to bond holders. This was

not the case in 2007, though we expect corporates’ historical outperformance to re-assert itself later in 2008.

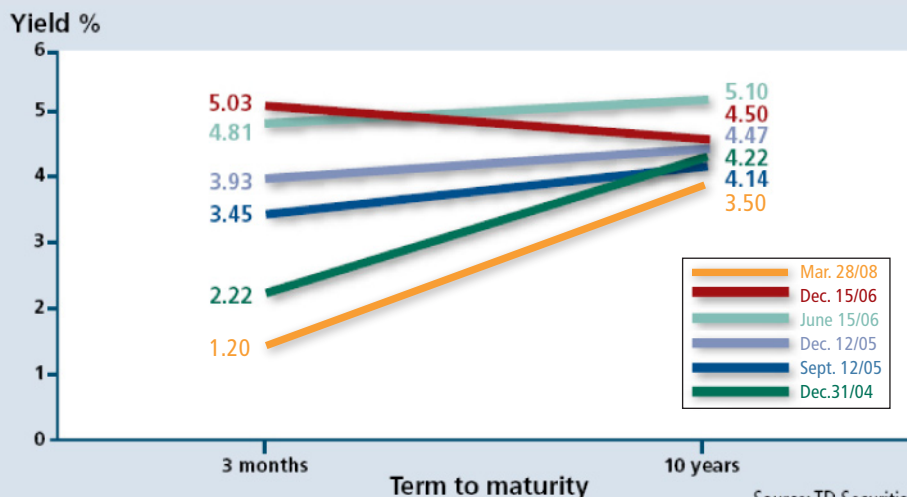
## The Road Ahead

Fear, as mentioned above, has been the dominant emotion driving markets of late and has contributed to escalating volatility. This investor fear has not been without justification as the U.S. credit crisis and housing problems are serious and will be protracted. In our view, stock markets fell in anticipation

of an economic slowdown, are groping for a bottom in the midst of extreme volatility and should begin to recover in anticipation of some improvement in the second half of 2008. Valuations, monetary and fiscal policy in the U.S. and investor sentiment suggest this will be the case.

### Chart 3 - U.S. yield curve steepens

The U.S. yield curve has now steepened, a portent of a pickup in the economy.



Source: TD Securities

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