

# PERSPECTIVES

A REPORT FOR CLIENTS OF TD PRIVATE CLIENT GROUP - PRIVATE INVESTMENT COUNSEL

## Investors' Summertime Blues

Even as they head off on vacation this Summer, many investors feel a little down in the dumps, courtesy of the stock market. While one set of headlines trumpets the solid economic recovery taking place, another chronicles the sickening slide of equity markets in recent months. What's going on and what are the implications for financial markets and, most importantly, your portfolio?

### The Economy & Stock Markets Disconnect

Amid the understandable gloom that prevailed in the wake of the September 11th tragedy were promising signs for a stock market recovery: low interest rates, loose monetary policy and record high cash on the sidelines. Right on cue, stocks worldwide rallied, posting solid gains in the final quarter of 2001. From there, however, it's been all downhill with stocks making little progress in the first quarter and falling sharply in the three months ending June 30th. To be specific, Canada's TSX Index fell 8.60% in the second quarter while in the U.S., the S&P 500 incurred one of its sharpest losses in recent years, dropping 17.48%, expressed in Canadian dollars.

Meanwhile, the economic news has been upbeat. North American economies have grown at a rapid rate in 2002 to date. The manufacturing sector is on the mend, housing sales are strong and both consumer and business confidence has improved. At the same time, jobs have been created at a record rate in Canada and new U.S. jobless claims just fell to a new 15-month low.

So, if the economic numbers are good and the outlook positive, why have stocks been going down and the market's bottom proving so elusive? The answer is that the stock market and the economy have become disconnected, with the economy's good news, both current and prospective, not being reflected in equity prices. There have been two overriding reasons for this.

### 1. The Enron Effect

The decline of Houston-based Enron and a series of similar episodes in recent months have combined to severely undermine investor confidence.

Accounting revelations and misdeeds by some corporate executives have left investors feeling that misrepresentations are pervasive and wondering who they can trust.

Believing stocks are now riskier than they once thought, investors have responded by attaching a higher risk premium to equity ownership. In addition, questionable accounting practices have made investors skeptical about both the quality of corporate earnings and the likelihood of those earnings improving in the second half of this year as had been anticipated.

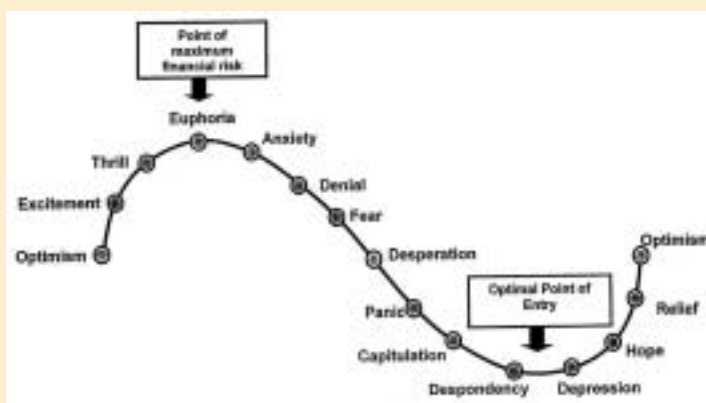
Put another way, investors have become unwilling to pay as much to be shareholders and participate in a company's earnings, the quantity and quality of which they doubt. As a result, the share prices investors are prepared to pay, relative to those companies' earnings (commonly known as the Price:Earnings Ratio or P:E Ratio) have fallen.

### 2. Telecom & IT Shares Meltdown

A disproportionate share of North American stock markets' decline can be attributed to the sharp drop in the prices of many telecom and tech sector share prices. In short, telephone companies built more capacity than is currently needed and prices for telecom services have fallen faster than demand is rising. Similarly, most technology companies have suffered from softer demand as a result of weaker corporate capital expenditures.

While the telecom and IT sectors account for about 20% of the U.S. stock market, they have accounted for most of the headlines, further worsening investor sentiment.

**Chart 1**  
**The Cycle of Investor Sentiment**



Source: Westcore Funds/Denver Investment Advisor LLC

### The Lessons of History

The assorted scandals and attendant fall in the stock market have generated some lurid headlines and comparisons with past periods, notably the Great Depression, Japan's economic bubble of the late 80's and the bear market of the 1970's. Let's address each in turn:

**The Great Depression** -- If the S&P 500 declines for a third consecutive year, in calendar 2002, it will mark the first time this has happened in peacetime since the 1930's. This is

where the similarities end. During the Depression, industrial production and business investment were cut by more than half, real (inflation-adjusted) interest rates rose dramatically, deflation was rampant and bank failures were widespread. In the current cycle, production and investment have slipped much more modestly, real interest rates are low, prices relatively stable and accommodative monetary policies leave the banking sector far less vulnerable. **In brief, we do not believe we are entering a latter day Depression.**

**Japan's Bubble Economy of the Eighties** -- The current bear market, which has been longer and deeper than usual, has sparked comparisons with Japan's overheated economy of the late 80's and the ensuing stock market decline, that saw Japanese prices fall over 70%. While a reasonable comparison can be drawn with the meltdown of the NASDAQ, which also approximated 70%, parallels with our economy and broader stock markets are limited.

1. Valuations of Japanese stocks at their peak in 1989 were 3 - 4 times those of the major North American indices at their top in early 2000.
2. The Japanese government made critical errors in the 90's, simultaneously raising its VAT, or Value Added Tax, and implementing restrictive monetary policies. In contrast, both monetary and fiscal policies have been accommodative in North America.
3. Japan's banking system was left to flounder in the 90's; we have no such issue. **Therefore, this does not appear to be Japan re-visited.**

**The Seventies' Bear Market** -- In 1973 and 1974, the U.S. endured a deep bear market, precipitated in part by sharply higher energy prices plus resultant inflation and high interest rates. Many stocks made little headway over the next half-dozen years and did not recoup their losses until the eighties. While it is accurate to state that many of the current generation's former high fliers from the tech sector will not soon (if ever) return to their former heights, that is where the parallels end. In the late seventies, high interest rates, caused by high inflation, systematically lowered the P:E multiples investors would pay for stocks. Today, we face no such problem as we are in an era of relatively low inflation and interest rates. So, we don't think we are doomed to repeat history.

## Financial Markets Outlook

As outlined above, the Enron Factor has had a debilitating effect on investor morale and we believe has largely caused the disconnection between the strong economy and weak equity markets. Investors are almost uniformly pessimistic and their feelings of despondency are those more closely associated with a market bottom than top (*see Chart 1 on page 1*). What will remedy that disconnection and stock prices? In brief, we believe that investors will respond to higher corporate earnings which we expect to see in the coming months as the economy's strength has a positive impact on companies' bottom line.

It is worth noting that the U.S. Federal Reserve's Stock Valuation Model, which compares stock and bond values, currently suggests equity prices are as undervalued today as on only a few other occasions dating back to the early 1980's. While no indicator should be looked upon in isolation, the implications are favourable. (*See table below*)

Federal Reserve Stock Valuation Model	
Points of Extreme Undervaluation	...Followed by Stock Market Rallies
1980	Stocks extremely undervalued. Uptrend commences and continues through Summer of 1987.
1993 - Late 1994	Stocks generally undervalued and touch bottom in response to Federal Reserve tightening. Strong rally ensues.
Autumn 1998	Stocks reach low ebb in the wake of Asian currency crisis. Uptrend resumes thereafter.
Autumn 2001	Equity markets hit low post-Sept.11. Fourth quarter rally ensues.
Summer 2002	Stock valuations record post-September 2001 lows in response to accounting and corporate irregularities.

## Your Portfolio -- What Lies Ahead

Private Investment Counsel clients' stock portfolios have generally fared much better than the underlying markets over the past several years. We have sought out value and emphasized holdings in such defensive sectors as energy and finance while underweighting the telecom and IT sectors. As we look ahead, we are maintaining our slight overweight in stocks and emphasis on companies with solid sales and earnings growth, trading at reasonable prices. In markets beyond North America, our largest holdings remain in Europe where valuations and the currency are most attractive. ***We believe your portfolio of high quality, well-diversified investments is well positioned to take advantage of the opportunities that lie ahead.***

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