

PERSPECTIVES

An exclusive report from TD Waterhouse Private Investment Counsel Inc.

Market Correction or Return of the Bear?

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From early May through June 13, stock markets took a beating, with Canada's S&P/TSX Composite Index ("S&P Composite") falling about 13% from its peak while the American S&P 500 Index ("S&P 500") slipped a more modest 7%. Overseas, the smaller emerging markets dropped a stomach-churning 25%. For investors used to solid, consistent returns in recent years, all this has come as a rude awakening and for those who recall the bear market of 2000 – 2002, some painful memories have re-surfaced. Global stock markets staged a modest recovery from their June 13 lows, leading investors to ask what's going on, are we going to see a repeat of the long, deep downturn we witnessed earlier this decade and what does this mean for their portfolios.

In the Beginning . . .

Global stock market weakness has its origin in the era of extraordinarily low interest rates seen earlier this decade. After the events of 9-11, the U.S. Federal Reserve ("the Fed") was concerned about the possibility of a deep recession and deflation – an outright decline in prices generally accompanied by severe economic weakness. To ward off this possibility, the Fed cut its benchmark Fed Funds rate to 1%, the lowest level seen in generations

(see Chart 1). These exceptionally low interest rates, which were imitated by central banks around the world, naturally stimulated demand for credit. After all, who didn't want to borrow money at rates that were essentially zero after netting out inflation?

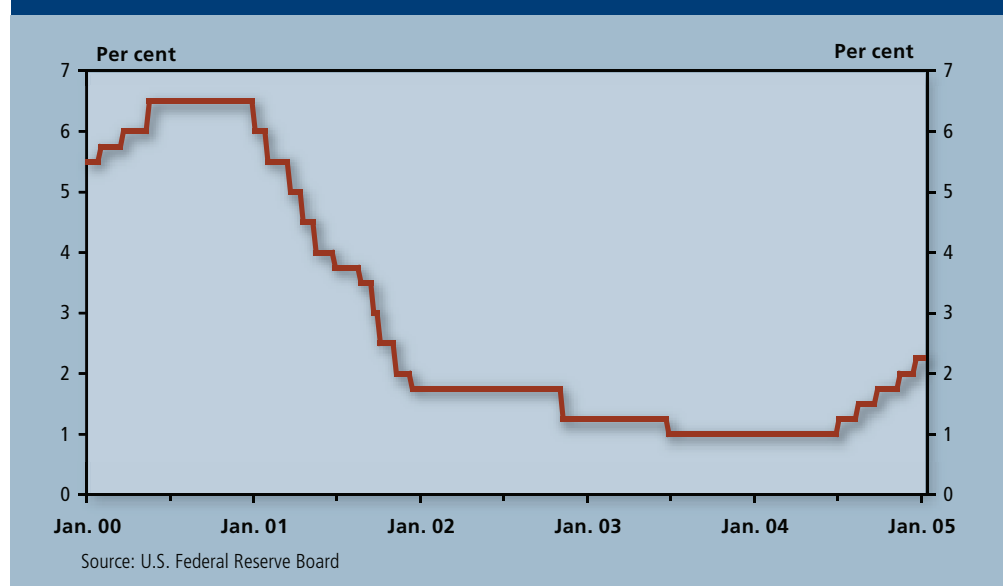
This loose credit did its job, warding off both recession and deflation, while ushering in a period of synchronized global growth. At the same time, all the cash injected into the financial system – "liquidity" in finance parlance – due to ultra-low interest rates, created what

in the stock market and commodities plus weakness in U.S. residential real estate all reflect some deflating of this "liquidity bubble".

Three Factors Behind the Market Decline

Three related factors have recently played out in the markets around the globe. **First**, short-term U.S. interest rates have risen, we have a close-to-flat yield curve (see Chart 2) and short-term rates will likely edge higher.

Chart 1 - U.S. Federal Funds Rate



Alan Greenspan referred to as "asset price inflation" of real estate, some financial assets and commodities. As we'll explain below, **the recent decline**

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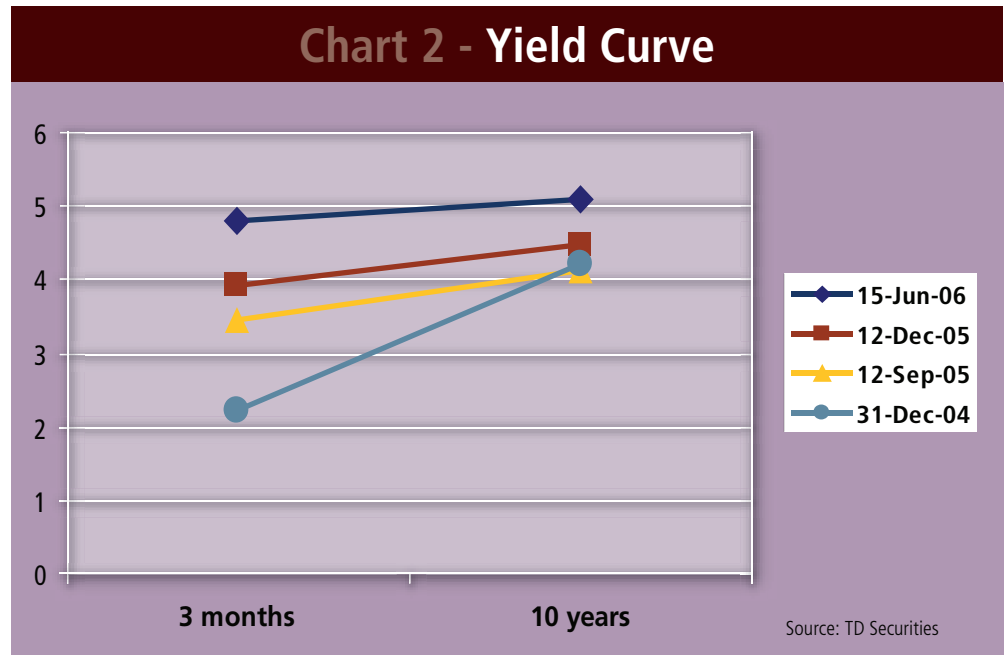
Readers of our sister publication, *Investment Outlook*, may recall that we have discussed the implications of a flattening yield curve on several occasions over the past few years. The resultant, tighter credit conditions portend a slowing U.S. economy, which will adversely affect corporate profits.

Second, the credit-sensitive U.S. housing sector, which has been a driving force in the U.S. economy in recent years, is feeling the effects of tighter credit and is showing pronounced weakness. Impending weakness in U.S. residential real estate was one of the key concerns cited in this January's issue of *Investment Outlook*.

Third, commodity prices, after a strong advance, have corrected in anticipation of lower demand resulting from the imminent slowdown in the U.S. economy and the ripple effect around the globe.

What's Happened to Date

The sharpest stock market declines have been registered by the emerging markets, found chiefly in Asia, Latin America and Eastern Europe, which lost a quarter of their value in the recent five-week sell-off. While **client portfolios typically have little or no exposure to this volatile area,** understanding what's happened is instructive. During periods of ample credit and rapid growth, such as that experienced in recent years, investors develop an appetite for risk and pour money into the more volatile emerging markets. When credit tightens and growth slows, as cited above, these same markets are hardest hit.



Closer to home and as mentioned earlier, the Canadian and U.S. stock markets fell about 13% and 7%, respectively, from their peaks reached in early May and are down slightly on the year to date at the time of writing. Leading the decline on both sides of the border have been the more cyclical stocks – those that would suffer most from a slowdown in the economy. **Since we generally construct client portfolios to be more defensive in nature and not as susceptible to the ups and downs of the economy, your portfolios have been less volatile than North American markets as a whole.** In the U.S., there has been a notable rotation of leadership from the smaller companies' shares (small-caps) to the higher calibre large-caps – witness the small-cap Russell 2000 Index decline of 12% versus the S&P 500's 7% slide. **Since your portfolios' U.S. content is underweight small-caps and overweight defensive, large-**

caps, this has proven beneficial for you.

Correction or Bear ????

A stock market correction is generally looked upon as a decline in stock prices of 10% or more but which does not signal a fundamental change in an upward trend in stock prices, referred to as a bull market. A bear market implies a deeper drop in stock prices sufficient to represent a change in the market's direction. Are we, as some investors have asked, on the cusp of another long, deep bear market like that from 2000 – 2002? Let's look at a few key indicators.

First, let's examine valuations, then and now, as represented by Price: Earnings (P:E) multiples. In mid-2000, P:E multiples of the S&P/TSX Composite and S&P 500 were about 30X compared with 15-17X today, depending on whether you choose to measure trailing, current or forecast earnings.

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Either way, **stocks are much less expensive today, as measured by their P:E multiples, than they were in 2000** (see Chart 3) and current P:E multiples are not excessive by any standard.

The P:E multiple is a valid measure of valuation but should not be looked at in isolation. It is important to also look at competing fixed income investments, most commonly illustrated by the 10-year bond yield. As depicted in Chart 4, Canadian and U.S. bond yields today are considerably lower than they were six years ago, in June 2000. In Canada, the 10-year bond yield was 5.86% and is now 4.40% while in the U.S. the 10-year Treasury bond had a yield of 6.10% in June 2000 compared with 5.10% today. So, **not only are stocks cheaper today but they also**

represent good value versus competing fixed-income investments.

To put these two measures of value in context, we can employ the Fed Model, so called as it was popularized as a measure of relative value by Alan Greenspan in 1997. In short, it compares the earnings yield (the inverse of the P:E multiple) of the stock market with the yield of the 10-year bond. Historically, the two are close and if the earnings yield of stocks falls well below the bond yield then stocks are expensive. Conversely, a higher earnings yield signals good value in the stock market. As show in Chart 5, **even if we use the more conservative earnings yield that reflects a P:E multiple of 17X earnings, stocks are both better value than they were in 2000 and,**

more importantly, solid value today.

So, comparisons with the year 2000 are not very accurate and it is unlikely we will see anything approaching the deep, protracted bear market witnessed earlier this decade.

The Outlook

The recent global market decline was the first meaningful pullback in well over three years, was overdue and came at a time of seasonal weakness in the May-September period. With the Fed likely to continue tightening in the near term and other central banks following suit, it is not likely stocks will rally in this timeframe.

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Year 2000 versus 2006 - Then and Now

Chart 3

Stocks are much less expensive today...

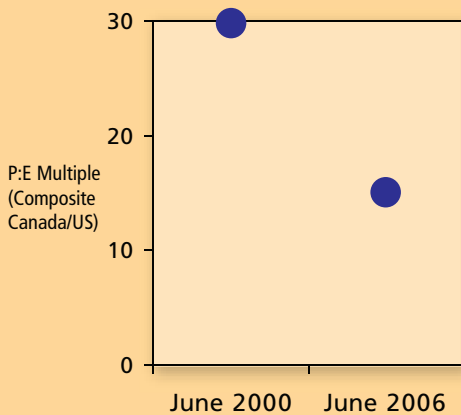


Chart 4

...while bond yields are lower...

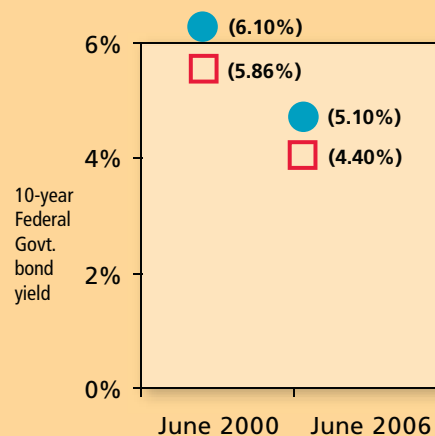
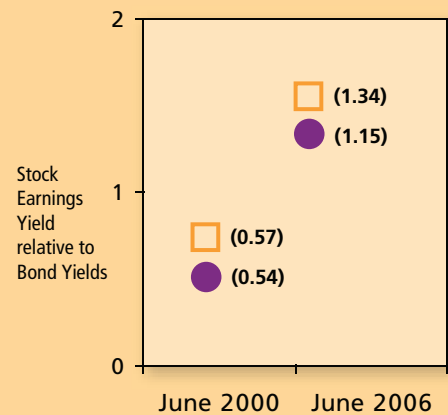


Chart 5

...and stocks represent better value



● U.S. 10-year bond yield
 □ Canadian 10-year bond yield

● S&P 500 Earnings Yield + 10 year Treasury Yield
 □ S&P/TSX Composite Earnings Yield + 10 year Federal Bond Yield

Source: Bloomberg Financial Services

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Instead, we could see some further, relatively modest weakness that would see the TSX Composite and U.S. indices breach their recent lows.

In the medium term, we expect U.S. short-term interest rates will likely plateau in the Fall and probably begin to ease later in the year under the weight of a slowing U.S. economy. This would provide impetus for stronger equity markets in the fourth quarter and we stand by our forecast of positive, single-digit returns in North American stock markets for the year as a whole.

Bond yields will likely decline modestly in the second half of the year and bond prices should rise, reflecting the expected U.S. economic slowdown. This will help offset the nominal returns earned by bond investors in the year to date.

Tightening credit and a slowing U.S. economy should mean a continuing rotation of market leadership into the large, high-calibre, defensive stocks that characterize the U.S. portion of our client portfolios.

There are three major risks to our forecast. **First**, the Fed could increase short-term interest rates sufficiently

to create an inverted yield curve for a period long enough to induce a recession, cut corporate profitability and cause problems for the stock market. **A second**, related issue would be the potential for the difficult U.S. housing market to become decidedly worse. **Third**, a sharp decline in global commodity prices would adversely affect the Canadian stock market. Needless to say, we are monitoring these issues closely. ■

Summary

- A series of pre-emptive measures were taken to safeguard your portfolios against adverse global market conditions (see inset box).
- Notwithstanding the above, June 30 client statements will act as a reminder that financial markets can go down as well as up, with returns earned in this year's first quarter generally erased in the second quarter.
- The summer and early fall may well see continued choppy markets as investors weigh the impact of the Fed's actions.
- We do not believe recent market weakness portends a long, deep bear

market. Instead, we believe the global equity markets are going through a corrective phase and we will likely see firmer markets in the final quarter of the year.

Pre-emptive Measures Taken to Safeguard Your Capital

- ☑ Equity exposure trimmed some time ago to reduce risk.
- ☑ Selective trimming of Canadian, cyclical stock positions.
- ☑ Overweight defensive, large-cap issues among U.S. equity holdings.
- ☑ Underweight U.S. small-caps.
- ☑ Bonds have shorter-than-benchmark term and overweight corporate positions to reduce volatility and increase income.
- ☑ Underweight volatile resource trusts and overweight higher calibre trusts with stable distributions for income.

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