Market Overview: Non-Financials are Oversold

While we have never been believers that the month of the year should dictate whether or not you buy stocks (fundamentals should), it would appear that the month of September and the TSX Index are not the best of friends this year. In fact the TSX has not been performing well since its 2008 closing high of 15,073 on June 18. Declines of the past week or so have been particularly dramatic, leaving investors to wonder "what's going on?" We provide a table showing the performance of the TSX Index by sector since the June 18 year high, the beginning of September and on a year to date basis below:

S&P/TSX Point Contribution to September 9, 2008

	Since Jun 18		Since Sep 2		Year to Date	
	Points	%	Points	%	Points	%
S&P/TSX (% of index)	-2926.37		-1152.78		-1686.30	
Energy (29.0%)	-1404.01	48.0%	-515.61	44.7%	-339.51	20.1%
Materials (15.7%)	-984.95	33.7%	-390.43	33.9%	-452.16	26.8%
Financials (30.3%)	-196.70	6.7%	-41.12	3.6%	-409.23	24.3%
Technology (5.1%)	-190.99	6.5%	-99.04	8.6%	-109.53	6.5%
Industrials (5.7%)	-63.30	2.2%	-56.61	4.9%	-52.55	3.1%
Consumer Discretionary (4.2%)	-28.22	1.0%	-11.97	1.0%	-163.03	9.7%
Utilities (1.6%)	-26.04	0.9%	-11.96	1.0%	-16.51	1.0%
Telecommunications (5.4%)	-21.89	0.7%	-18.70	1.6%	-96.53	5.7%
Consumer Staples (2.6%)	-5.83	0.2%	-3.69	0.3%	-22.76	1.3%
Health Care (0.4%)	-4.45	0.2%	-3.65	0.3%	-24.48	1.5%
	Index down 19.4%		Index down 8.4%		Index down 12.2%	

We won't attribute all of the weakness over the past three months or the past week to one reason alone as there have been numerous catalysts causing investors to sell. Although not exhaustive, we highlight some of the more prevalent reasons below.

1) GLOBAL ECONOMIC SLOWDOWN

More attributable to weakness seen over the past three months is the fact more evidence has emerged indicating that global growth is slowing. While the U.S. has stolen many of the economic weakness headlines in 2008, and rightfully so, it is other parts of the world that have entered the spotlight since June. European countries such as Germany and Great Britain along with Asian countries such as Japan have been slowing, while China's growth has been brought into question with the passing of the Olympic Games. Such signs and signals tend to wave red flags around commodities as investors question whether demand will be strong going forward. As they concluded that demand could come under pressure, commodity related stocks have found more willing sellers than buyers.

2) U.S. DOLLAR STRENGTH = COMMODITY WEAKNESS

With other economies showing signs of weakness relative to the U.S., the U.S. trade weighted dollar index has actually done quite well since mid July, rising from about 72 to almost 80 or 11% in 2 months. As most investors are aware, commodities are priced in U.S. dollars. Therefore, when the U.S. dollar weakens, it takes more U.S. dollars to buy a barrel or pound or ounce of a commodity. The reverse is also true when the U.S. dollar strengthens which is exactly what has happened. A strengthening dollar requires fewer U.S. dollars to buy that same commodity and therefore commodity prices fall. As you can see in the performance chart we have provided by sector, the Energy and Materials sectors make up 44.7% of the TSX index. When commodity prices fall, you're bound see the TSX index come under pressure.

3) HEDGE FUND SELLING/FORCED LIQUIDATION

The emergence and growth of hedge funds this decade has made them very influential at times in moving the market. The weakness of commodity prices in August actually resulted in some hedge funds closing their doors as losses were substantial. In order to pay out investors and wind down funds, positions have been thrown into the market and sold at whatever price available. This increase in selling has put a lot of pressure on commodity related stocks in September and has likely resulted in further selling as investors speculate that other hedge funds could fail and be forced to liquidate. The influence of hedge funds is accentuated by their levered investments which punish investors more severely when those investments are off-side.

4) THE CREDIT CRUNCH JUST KEEPS ON CHUGGING ALONG

Those investors that thought the bailout of Bear Stearns was a sign the worst was over in the credit markets have been sorely mistaken. The credit environment continues to be a challenge and U.S. financials have been through another couple of scares including the fears of further failures leading up to quarterly results in July and recent speculation that Lehman Brothers (LEH) may be the next large financial institution to shut its doors. Combine that with the recent bailout of Freddie Mac and Fannie Mae by the U.S. government, thus indicating that all is not well in the U.S. housing and mortgage market, and you've got a nice recipe for financial weakness. While this factor has been more influential in the United States, we certainly have seen Canadian banks come under pressure at times due to credit related events and news.

5) GOOD OLD FASHIONED PANIC SELLING

When investors see the magnitude of this past week's declines their first reaction is to get out to avoid further losses. While perhaps such emotions may not have moved the market to massive degree, they certainly created more sellers in the market place.

Now that we've identified some of the catalysts, let me share my thoughts on what we're thinking about them from a Canadian equity market perspective.

1) GLOBAL ECONOMIC SLOWDOWN

The U.S. economy has been struggling for some time. Is it really a surprise that Canada, Europe, Asia and the emerging markets are following suit? Absolutely not. Those investors that thought certain economies, such as China, would be completely immune from the slowdown of the world's largest economy (25% of world GDP) come to realize that the influence of the U.S. economy is widespread even during times of economic weakness. Yes, places such as China will still continue to grow, but to become immune is another story. We don't think that investors are surprised that other economies are showing signs of weakness, but we do believe those same investors are likely surprised by the speed at which the slowdown has occurred. The negative headlines which seem to come out on a daily basis from Europe are certainly dampening growth and commodity demand expectations. However, we would point out that even though emerging markets are likely to post lower growth numbers this year that absolute growth levels posted will still be decent. Sure, China will not exceed the 11.9% GDP growth rate posted in 2007, but 8% growth in a country of 1.3 billion people is nothing to frown at either. We also dismiss the conclusion that the Chinese economy will slow down now that the Olympics have come and gone. The multi-year growth and investment in China has not been due to the hosting of a sporting event alone as China is bigger than the Olympics. What we've witnessed is not a cyclical change, but a generational change and therefore we believe growth and investment in that country should continue for some time to come.

2) U.S. DOLLAR STRENGTH = COMMODITY WEAKNESS

Yes, economies outside of the United States have slowed as of late which may make the U.S. dollar look more attractive on a relative basis, but we question how much better and whether or not the recent strength has been over done. We also question whether or not the U.S. is going to be able to get its economy back on track sooner than later. All indications would lead us to conclude that the U.S. economy still has many obstacles to over come and the U.S. dollar is in for a tough fight if it intends to continue its upward trend. Is the U.S. dollar really looking that good these days? The currency of a country which is having one of the worst real estate downturns in decades, where housing prices continue to fall, where delinquencies continue to rise, and where housing inventories continue to climb? The currency of a country which will post a budget deficit of at least $400 billion this year, excluding the impact of Freddie Mac and Fannie Mae? And the currency of a country where the U.S. consumer has cut back on spending and has been responsible for at least 75% of aggregate demand? We're not convinced and wouldn't be surprised if we see the U.S. dollar give back some of its recent gains before economic conditions eventually improve. If such a retreat occurs it will only help resource stocks and thus the TSX regain lost ground. One of the most commonly asked questions in 2008 is whether or not the U.S. is in recession. Our response is that such a question is irrelevant at this stage when it comes to making investment decisions. The economic data speaks for itself. If it looks awful, smells awful or tastes awful….chances are, it's awful.

3) HEDGE FUND SELLING/FORCED LIQUIDATION

Without a doubt redemptions and liquidations have had a material impact on the TSX in September, but we can find a silver lining to this weakness and that is that the selling we've seen over the past week is more related to "having" to sell and less related to "wanting" to sell. In other words, all of this selling hasn't occurred because there is something fundamentally wrong with the companies and sectors being sold, it's because the sellers need to get their hands on the proceeds as quickly as possible. It's just like someone selling a house as soon as possible in order to fund the purchase of a new one. You don't care as much about the price you receive as long as you can get the highest price possible in the time constraints provided. So what does this mean for Canadian investors? If the selling was solely related to fundamentals we'd be far more nervous than we are right now, but since it's forced selling we're quite convinced that recent weakness has done nothing but create a great buying opportunity especially amongst commodity related names.

4) THE CREDIT CRUNCH JUST KEEPS ON CHUGGING ALONG

The credit crunch is now over a year old. It was started by sub prime mortgages but has spread into other areas of the financial system. We've had three noticeable credit related selloffs in the equity markets and we wouldn't be surprised to see more. Why? Because if credit concerns can be tied to the U.S. real estate market and if that market has done nothing but fall, then it's very hard to make the argument that the financial sector should grow while underlying assets and securities struggle. Is the credit crunch going to disappear any time soon? Well we're already a year in and still haven't really restored faith in the credit environment or seen any signs of stability in the U.S. real estate market. We find it very difficult, especially in the current economic environment, to get excited about financials as long as growth slows, real estate prices fall, and the U.S government bails out financial institutions. What we will concede though is that Canadian banks are in a much better financial position than their U.S. or global counterparts which is evidenced by the fact that their share prices have outperformed their global peers since the credit crisis began. At the same time, even though they pay a nice dividend, we remind investors that banks are economically sensitive and thus will continue to find their operating environment difficult in the short term.

5) GOOD OLD FASHIONED PANIC SELLING

Panic selling is just like forced selling…it's not the result of a fundamental conclusion but more a result of an impulse reaction. I found a great quote in some of my reading this week from a strategist at Citigroup who said "emotion's your enemy, not your friend". We couldn't agree more. It's recent pull backs like we've seen in September that remind us that we need to keep our focus on long term financial goals and less on short term news and noise. Long terms plans should not necessarily change just because the market is working against you in the short term. Ignoring the short term and focusing long term is one of the most difficult skills an investor can develop; however, such an ability is necessary to help set and meet the goals of a long term financial plan. The winners of panic selling are usually not those who sell their positions, but those that buy them for the long term.

So what should you take away from our discussion above?

- Recent TSX Index weakness has been predominantly commodity related.
- Economies around the world are going to continue to show signs of weakness, and the U.S. isn't going to improve any time soon.
- U.S. dollar strength has contributed to short term commodity price weakness, but the outlook for the Greenback is such that recent gains could be given back and commodity prices could get some support in the future.
- The credit crunch is here for a while yet. Accept it and move on.
- Non-fundamental selling is painful in the short term but opportunistic for long term investors. "Emotion's your enemy, not your friend".

With all this in mind we have come to the conclusion that recent TSX weakness has been over done and that commodity related equities are over sold. The weakness of September has created a long term buying opportunity. While some may question the timing of this call (is it too soon?) we will concede that we will never be able to time the bottom of this downturn considering the volatility we've witnessed thus far. If we happen to time it well I'll be the first to admit that the exact timing was more a function of luck than skill. But what's important here is that from a valuation perspective commodity related stocks and stocks in other sectors that sold off in sympathy with the broader market offer long term value. Although further short term downside is a distinct possibility, we believe long term investors will look back on September 2008 as one of the better buying opportunities of the year.

To discuss these opportunities and how they may benefit your portfolio, please contact your ScotiaMcLeod Wealth Advisor.

- ***Gareth Watson, CFA*** *– Associate Director Portfolio Advisory Group*

ScotiaMcLeod™

The author(s) of the report own(s) securities of the following companies.
None.

The supervisors of the Portfolio Advisory Group own securities of the following companies.
None.

ScotiaMcLeod™