



Research

Portfolio Strategy & Quantitative Research

The 2007/2008 Crisis

Challenging Conventional Views

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“War is Economics Pursued by Other Means”

-Raymond Devoe

“Economics is War Pursued by Other Means”



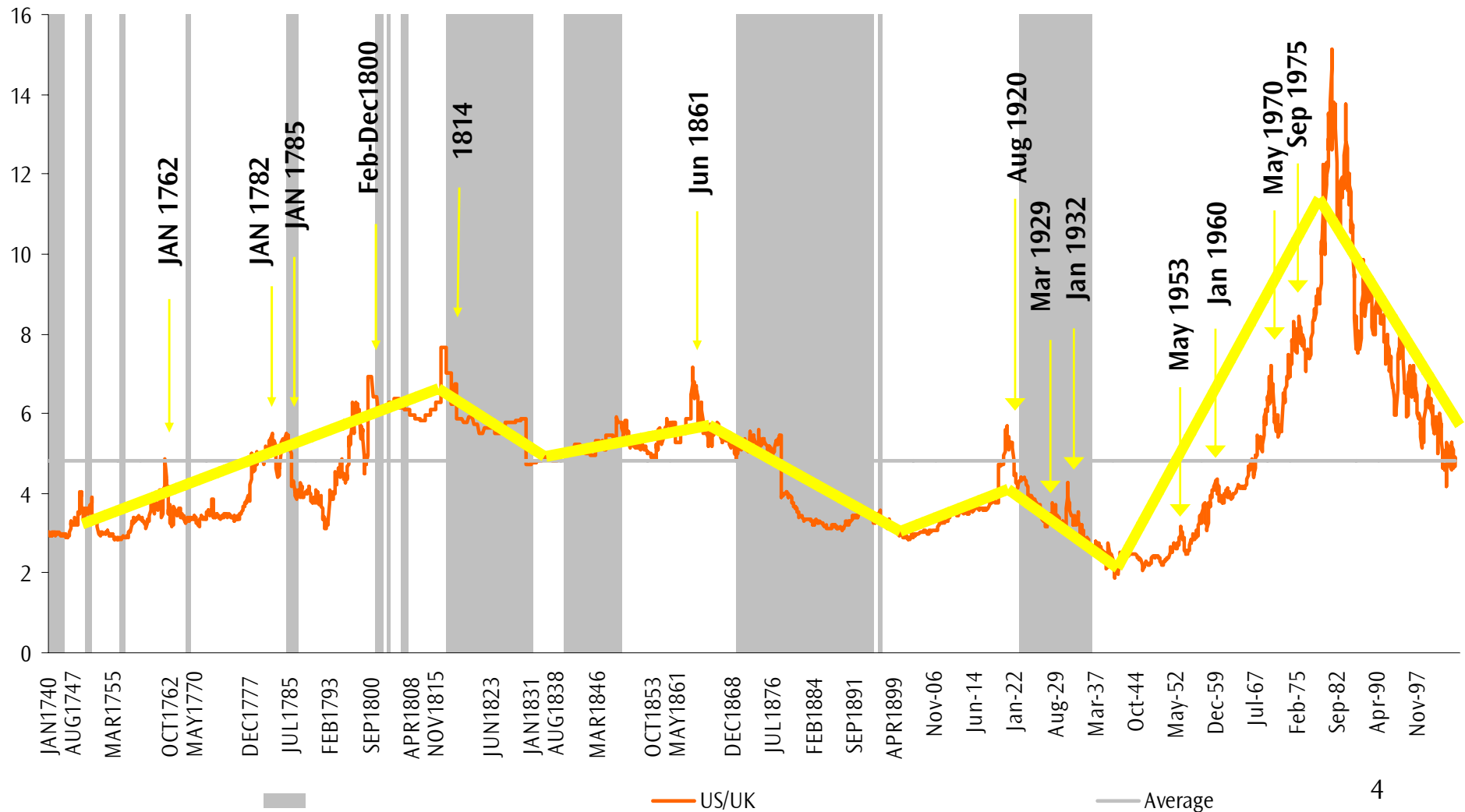
DEBT RISK

Debt Risk

1. Record U.S. Government: $\frac{\text{Debt}}{\text{GDP}}$
2. Record Consumer Debt :
2/3 of Economic Growth Due to Consumer
“Self-restraint from spending, but , not yet!”
3. Record Current Account Deficit

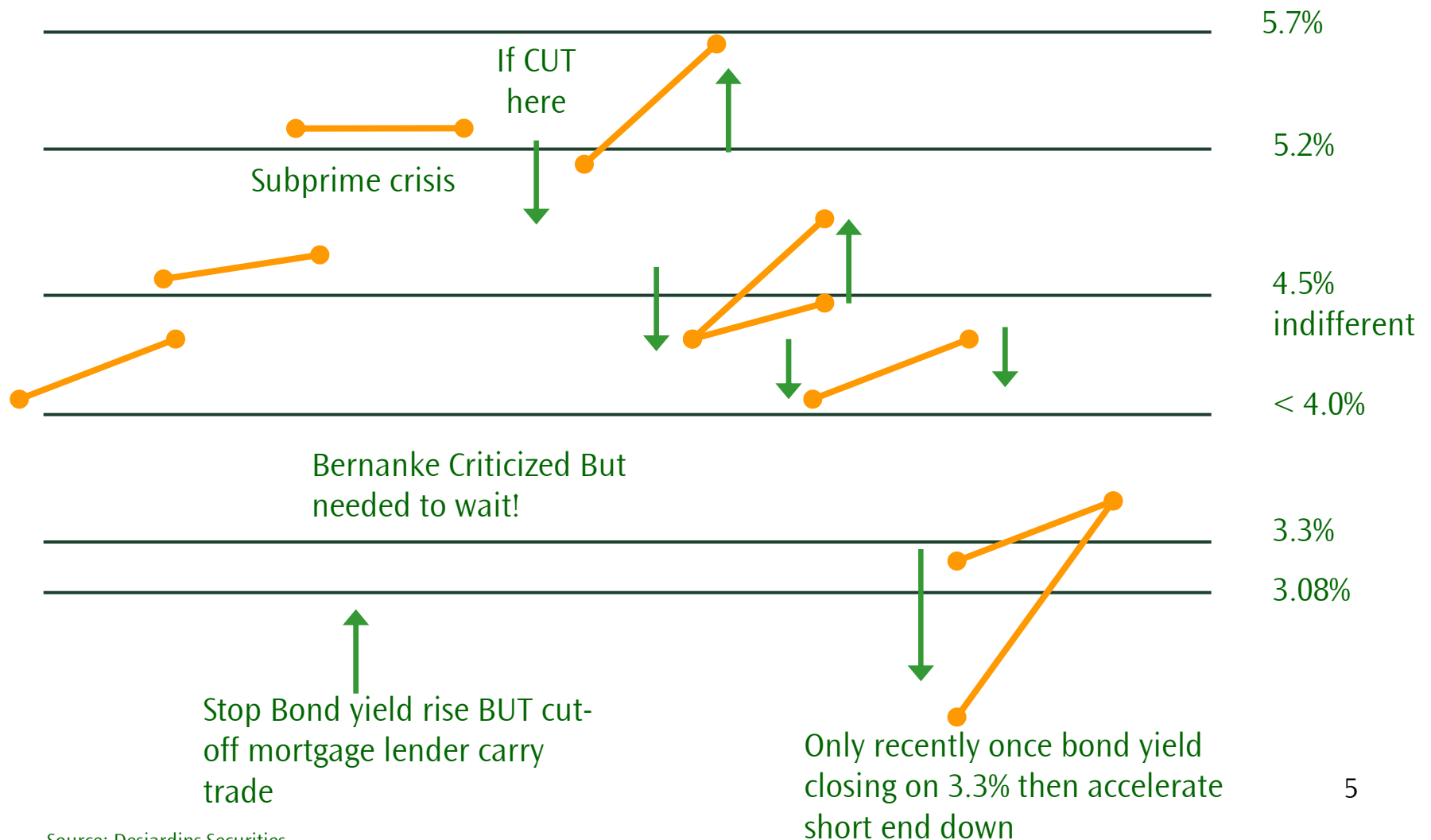
**CONCLUSION: CANNOT INFLATE AWAY DEBT AND
DEFLATION IS NOT AN OPTION**

250 years of United States Interest Rates (10 Yr Bond Yields)

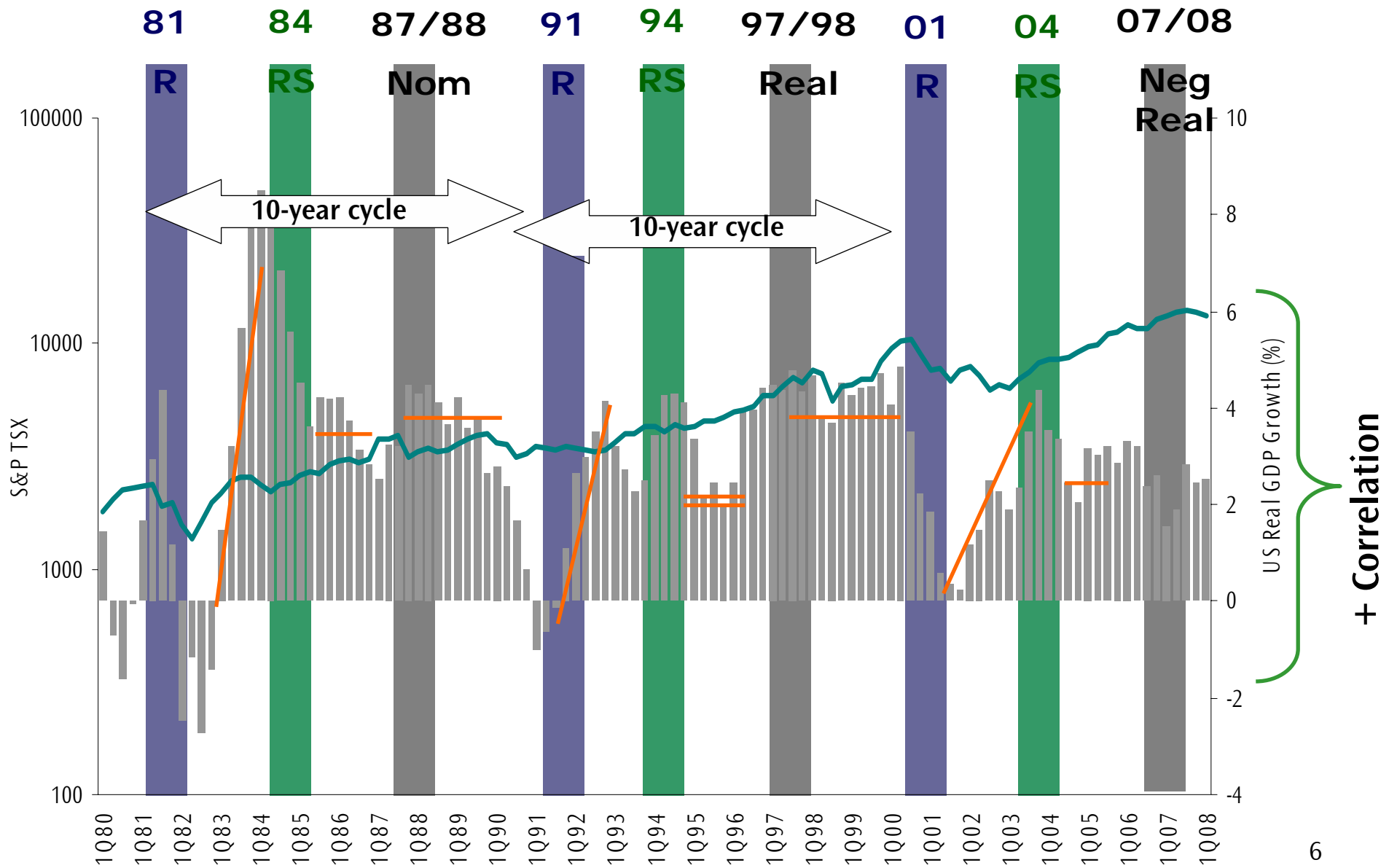


Source: Desjardins Securities, Global Insight

Stock Market & Real Estate Crash : What Triggered it?



RATE SHOCKS NOT RECESSIONS at 1/3 & 2/3 for 10 year cycles



Source: Desjardins Securities, Global Insight

TIGHTEN UNTIL SOMETHING BREAKS

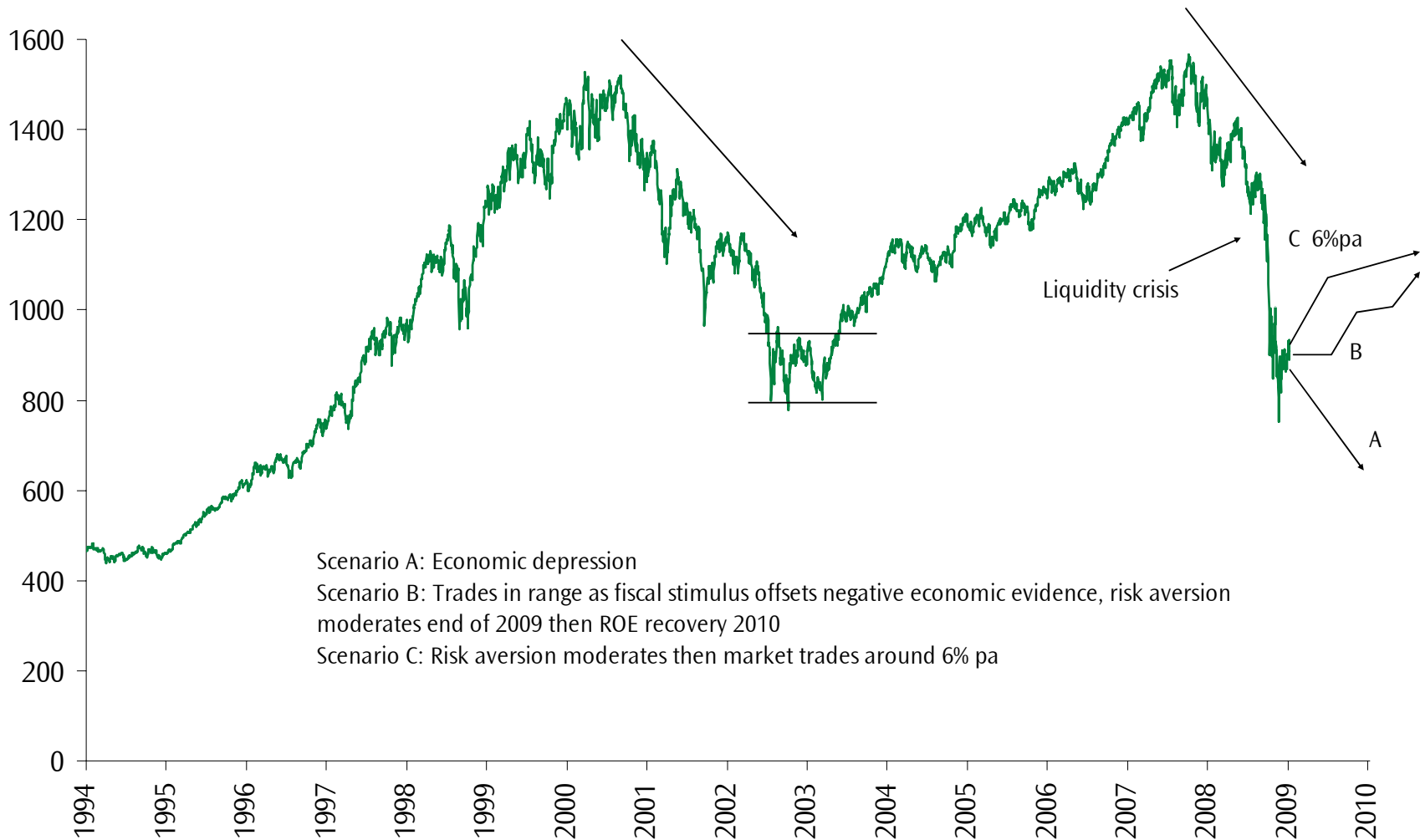


Source: Desjardins Securities, Global Insight

Recent market fundamentals compared with March 2003

	Recent	March 2003
10-year US bond yield (%)	2.05 (down from 4.00)	3.08 (down from 4.00)
US T-bill rate (%)	0.02	1.00
S&P 500 operating ROE (bottom-up weighted average) (%)	21.8	20.8
P/E (operating) (x)	14.2	23.0
P/BV (x)	2.9	4.4
P/BV five-year average (x)	4.0	7.68
P/BV vs five-year average (x)	0.72	0.57

Three most likely scenarios for S&P 500



Scenario A: Economic depression
Scenario B: Trades in range as fiscal stimulus offsets negative economic evidence, risk aversion moderates end of 2009 then ROE recovery 2010
Scenario C: Risk aversion moderates then market trades around 6% pa

THE 'SHADOW BANKING SYSTEM'



Financial Panic when:

1. Financial institutions REFUSE TO LEND to consumers

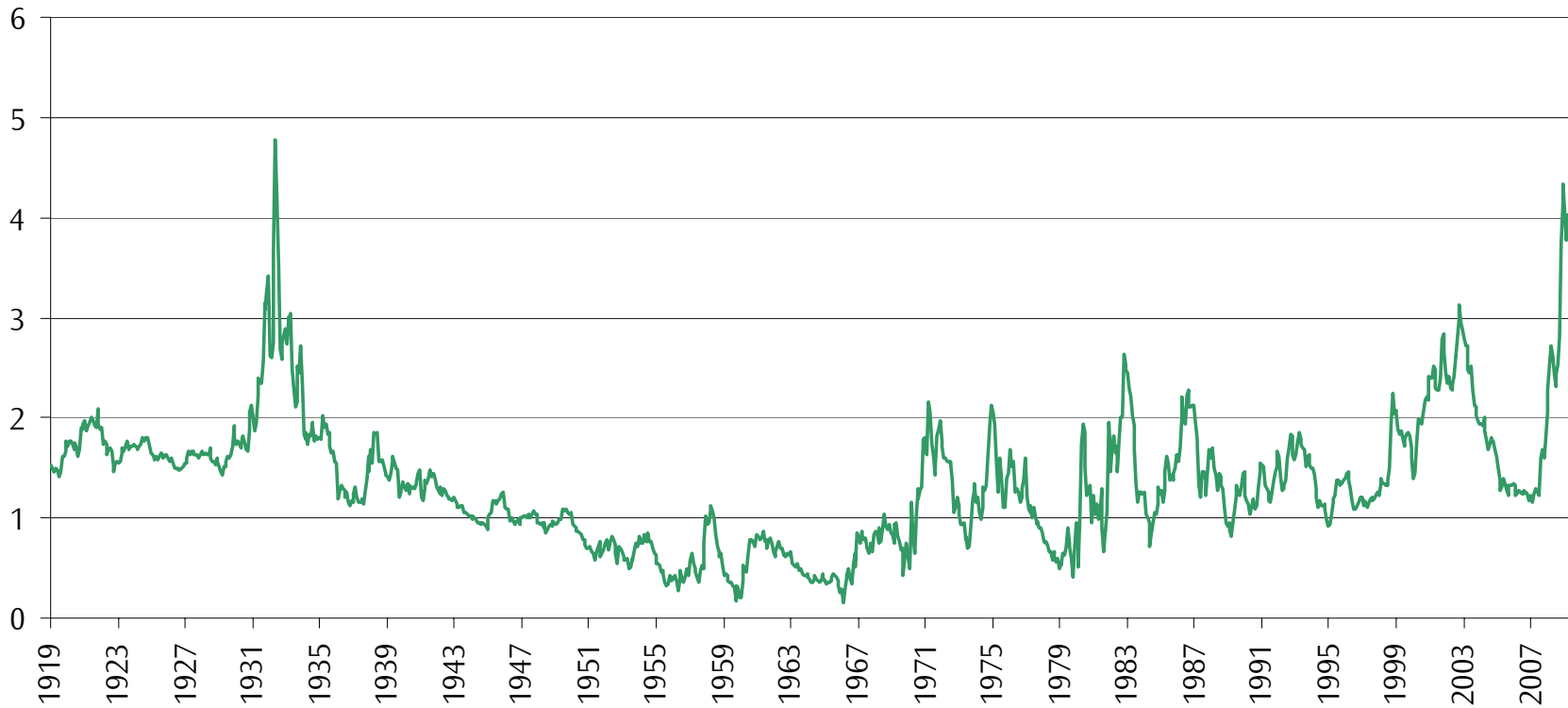
And/or

2. Each other

And/or

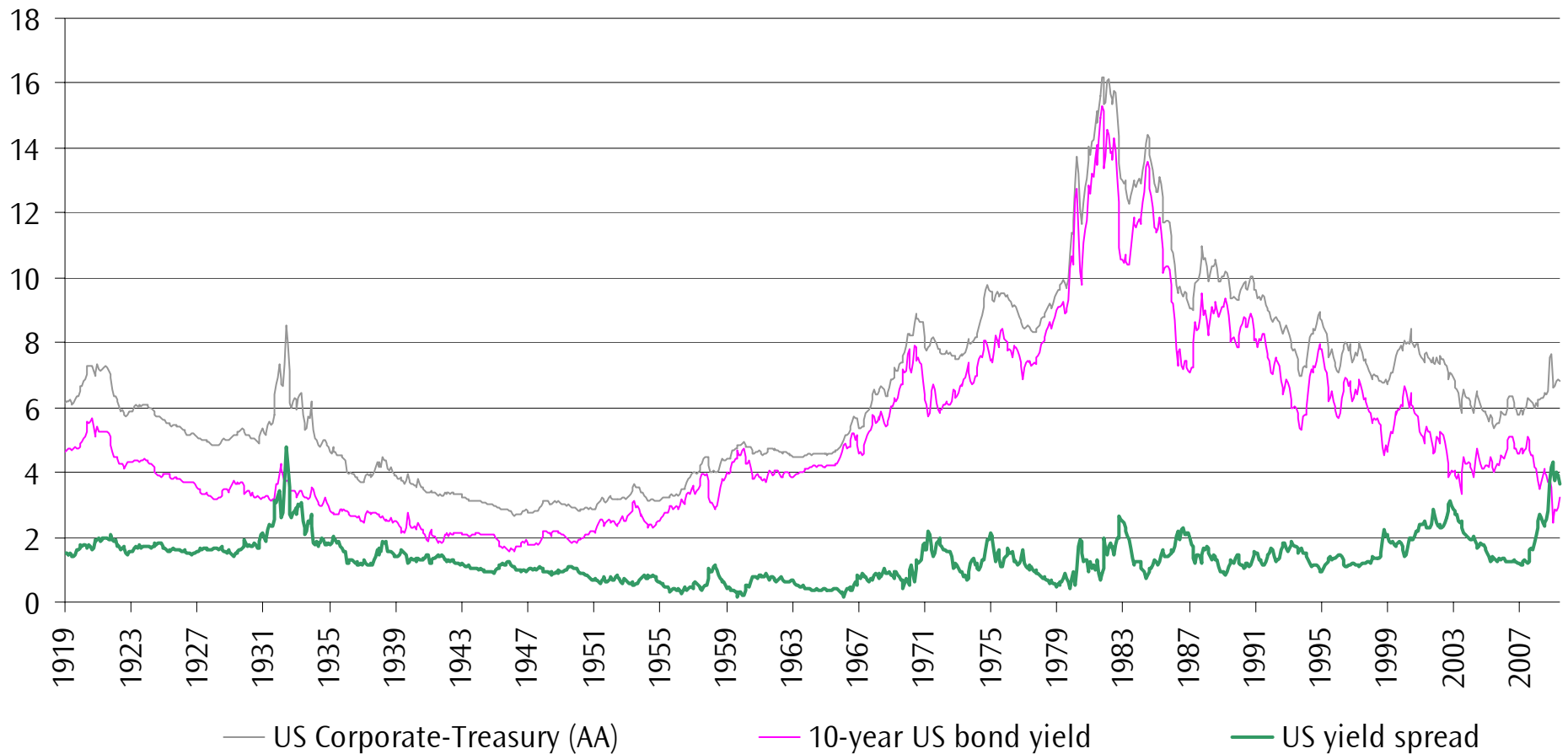
3. Consumers REFUSE TO BORROW to such an extent that economic system may suddenly become INHERENTLY UNSTABLE

US yield spread: AA corporate – 10yr US bond yields



Source: Desjardins Securities, Global Insight, Global Financial Data

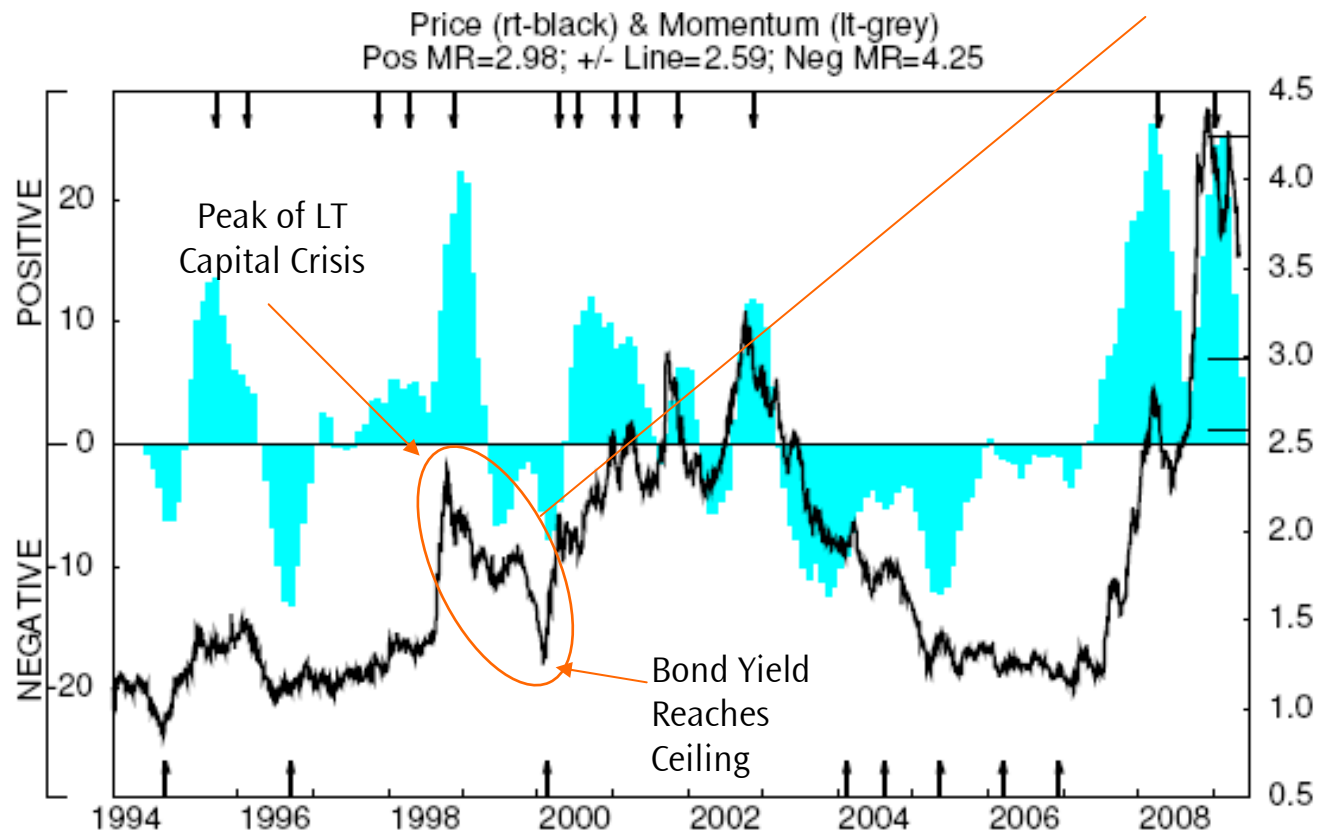
US yield spread: AA corporate & 10yr US bond yields



Source: Desjardins Securities, Global Insight, Global Financial Data

US yield spread: AA corporate - 10yr US bond yields (as of 13May09)

Fed easing causes narrowing of spreads
largely due to rising treasury bond yields not
falling corporate bond yields



150 Year history of US stock market declines of 20% or greater

From	To	% Decline	Duration (months)	6-month rebound	12-month rebound	
Jan - 1853	Oct - 1857	-64.55	57	41.03	38.46	Fail Ohio Life cause European Repatriation
Apr - 1858	Nov - 1859	-22.95	19	25.54	40.43	
Nov - 1860	Jul - 1861	-32.43	8	14.00	40.00	
May - 1864	Apr - 1865	-25.67	11	10.75	4.45	
Jun - 1872	Jun - 1877	-47.24	60	18.64	25.00	Part of Long Depression 1870/1873
Jul - 1881	Jan - 1885	-35.54	42	5.19	22.64	
Jun - 1887	Dec - 1890	-22.03	42	5.43	17.61	
Sep - 1892	Aug - 1896	-32.21	47	9.71	24.67	1893-1896 Depression, Rail failures
Oct - 1902	Oct - 1903	-29.27	12	6.07	23.80	
Oct - 1906	Nov - 1907	-37.69	13	22.08	41.28	1907 Bankers Panic, Capital Repatriation, post SF earthquake, trust busting
Jan - 1910	Oct - 1914	-35.65	57	22.81	37.90	
Dec - 1916	Dec - 1917	-33.40	12	10.90	16.44	
Nov - 1919	Jun - 1921	-33.62	19	14.55	30.76	
Sep - 1929	Nov - 1929	-34.03	2	17.09	-20.77	
Apr - 1930	Jun - 1932	-82.36	26	55.40	146.31	
Sep - 1932	Feb - 1933	-32.58	5	96.21	90.20	Excessive inventories, EMERGING NATION Stock market crash, 1931 currency devaluation & UK gold reserve volatility, The Great Depression
Feb - 1934	Mar - 1935	-24.24	13	36.90	76.34	
Mar - 1937	Mar - 1938	-53.03	12	44.00	29.18	
Jan - 1939	Apr - 1942	-42.02	39	22.98	51.31	
Jun - 1946	Feb - 1948	-26.98	20	14.03	4.41	
Jan - 1962	Jun - 1962	-23.48	5	15.25	26.70	
Dec - 1968	Jun - 1970	-32.90	18	26.72	37.10	
Jan - 1973	Sep - 1974	-46.18	20	31.19	32.00	1973 Oil embargo
Dec - 1980	Jul - 1982	-23.79	19	35.68	51.80	
Sep - 1987	Nov - 1987	-30.17	2	13.83	18.84	
Sep - 2000	Sep - 2002	-46.28	24	4.04	22.16	Info tech bubble bursts
Nov - 2007	Jan - 2009	-43.52	14			Bank lending not pegged to gold reserve today
Average		-36.81	22.89	23.85	35.73	
Median		-33.40	19.00	17.87	29.97	

Source: Desjardins Securities

Past Panics

Panic of 1870

- Four-year Crash & Severe monetary Crisis
- Origin European building boom, land speculation
- Mortgage mania even using un-built homes as collateral
- US emerges as very low cost when producers compared with Europe & Russia
- Largest wheat importer UK shifts demand to UK and European Crash occurs 1873
- European Banking collapse, economic growth estimates far too aggressive
- Interbank lending rates soar & UK financial institutions hoard capital as they wait to see which European banks will collapse due to mortgage crisis

1873

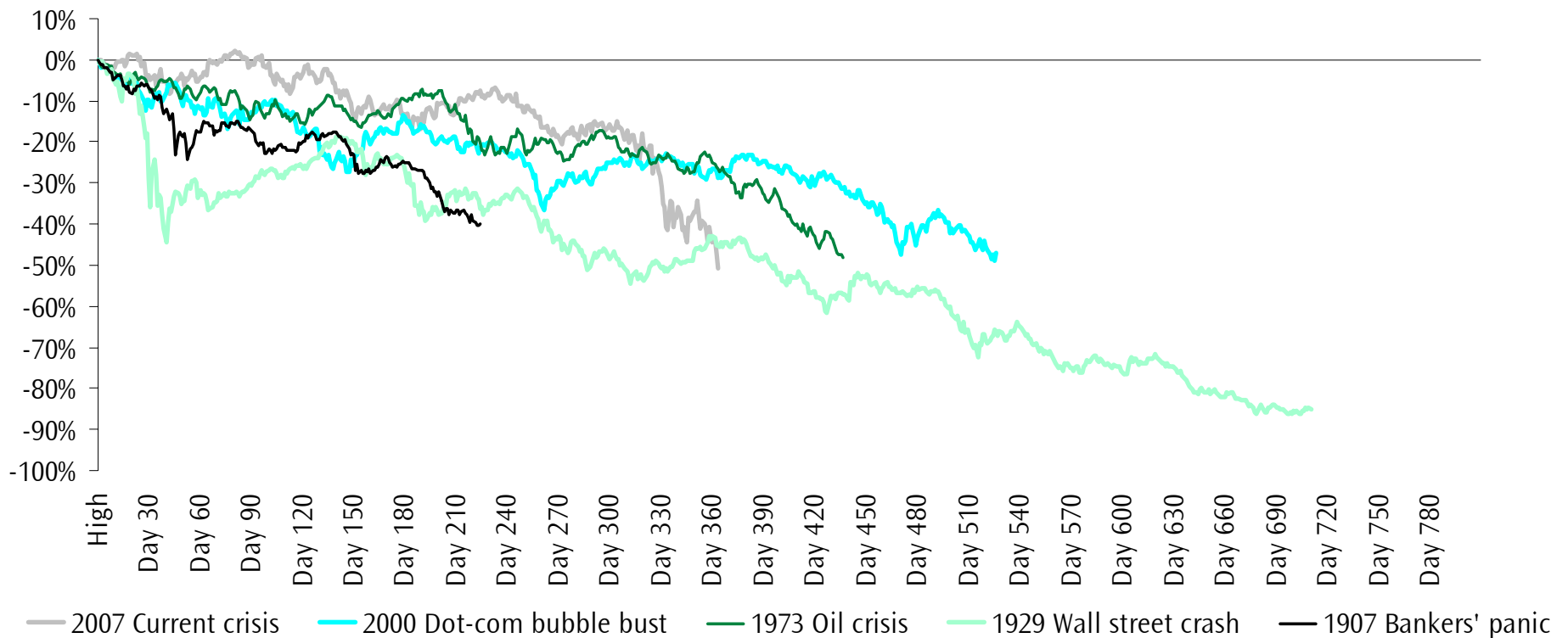
- US banking crisis follows and railroads collapse
- complicated financial instruments not honored that had “Guaranteed” returns but not well understood
- Rail roads resorted to short-term borrowing and then short rates soared; Jay Cooke Bankrupt
- PANIC LASTS FOUR YEARS IN US & SIX YEARS IN EUROPE

Past Panics

Panic 1870 LONG DEPRESSION OPPORTUNITIES

- Gilded age of Industrial Concentration
- Largest manufacturing entities had relatively stable revenues & guaranteed contracts yet huge pricing leverage with railroads
- smaller capital dependent industrial firms in crisis
- 25% unemployment in cities
- Civil unrest, extreme worker distress led to anti-Semitism

History of market declines



1920's/30's

1990's/2000+

Debtor nation reserve
currency military
superpower



UK



US

Vs.

Vs.

Emerging nation
domestic deflation
export superpower



US

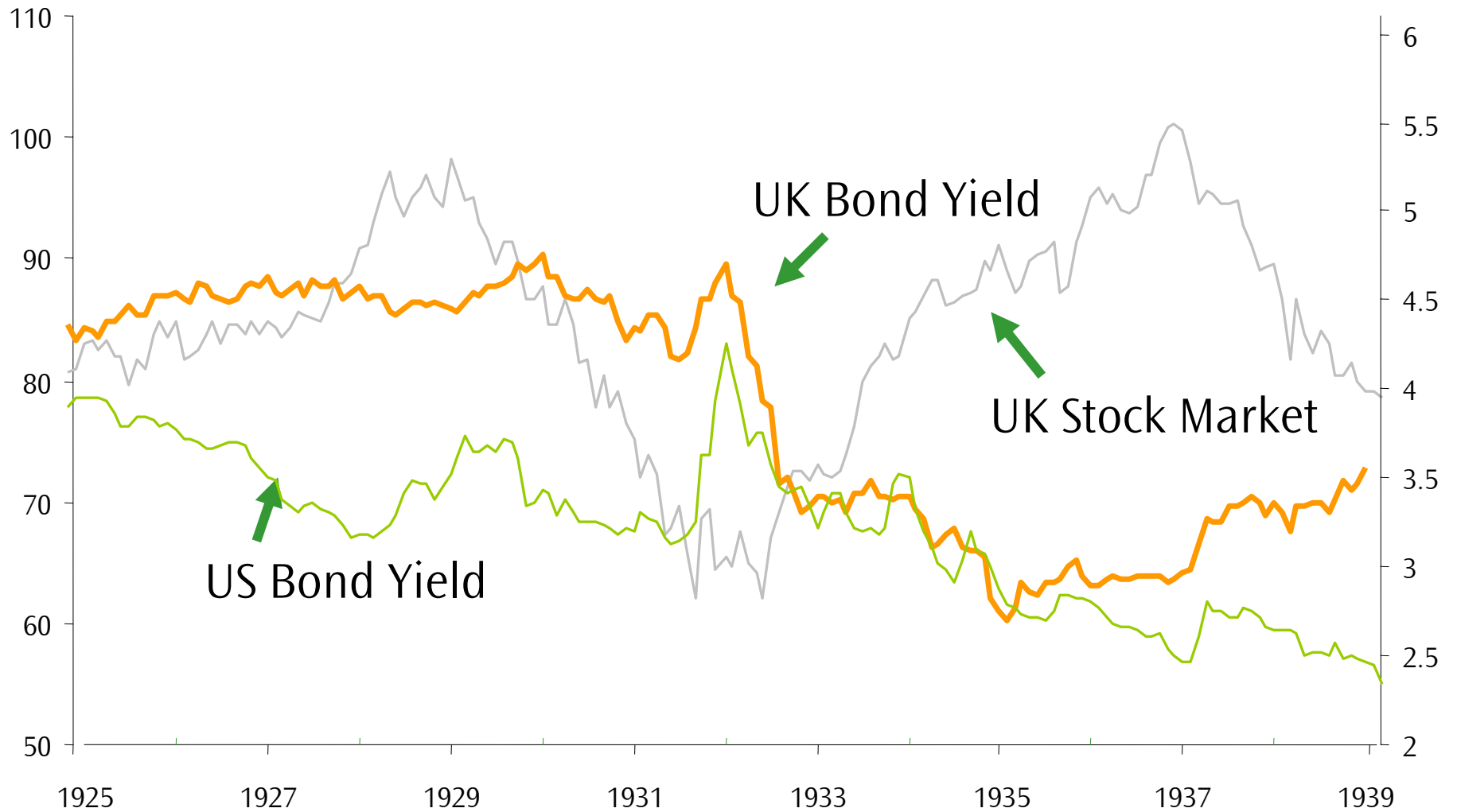
Asia

Similarities Between Past & Present Reserve Currency Countries (U.K. 1930's & U.S. 1990's)

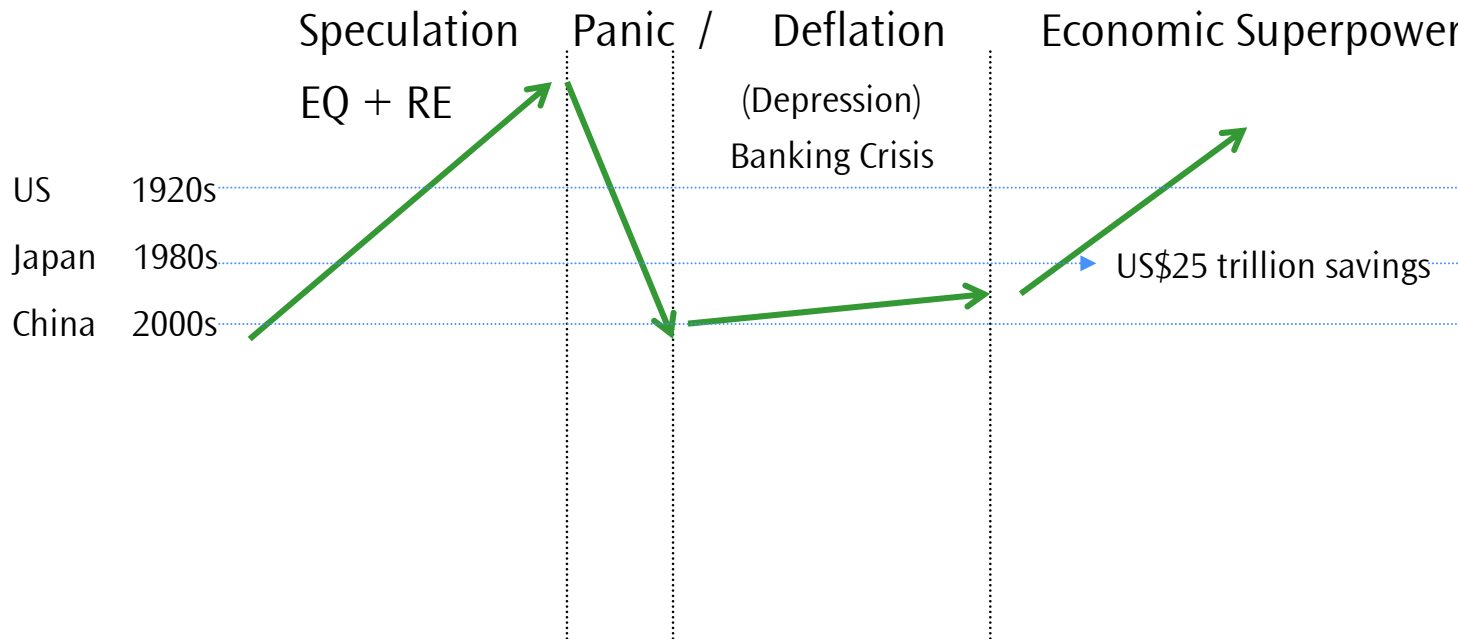
1. Record Government Debt/GDP
2. Record Consumer Debt
3. Record Current Account Deficit
4. Reserve Currency Status
5. Invaded Iraq in order to “Establish A Democracy”

Langs Observation “An unsophisticated forecaster uses statistics as a drunken man uses lampposts for support rather than for illumination”

“It is not sufficient that I succeed—all others must fail.”
- Genghis Khan



Emerging Economies



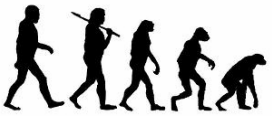
Japan \neq US

Deflation US\$25t Savings vs US\$55t Debt

Japan closer to US in 1930s

US closer to UK in 1930s

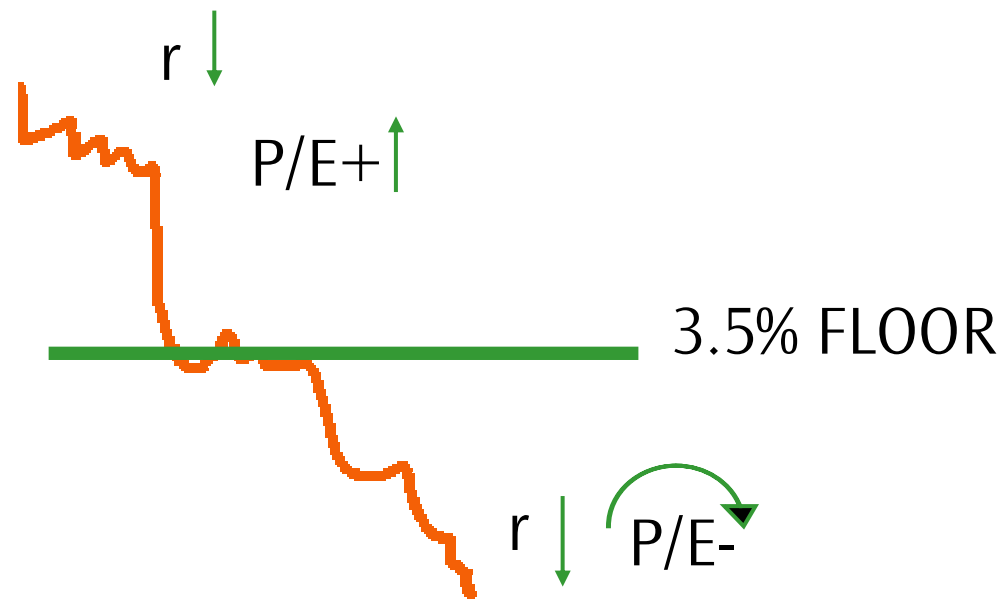
Sweden Currency Devaluation



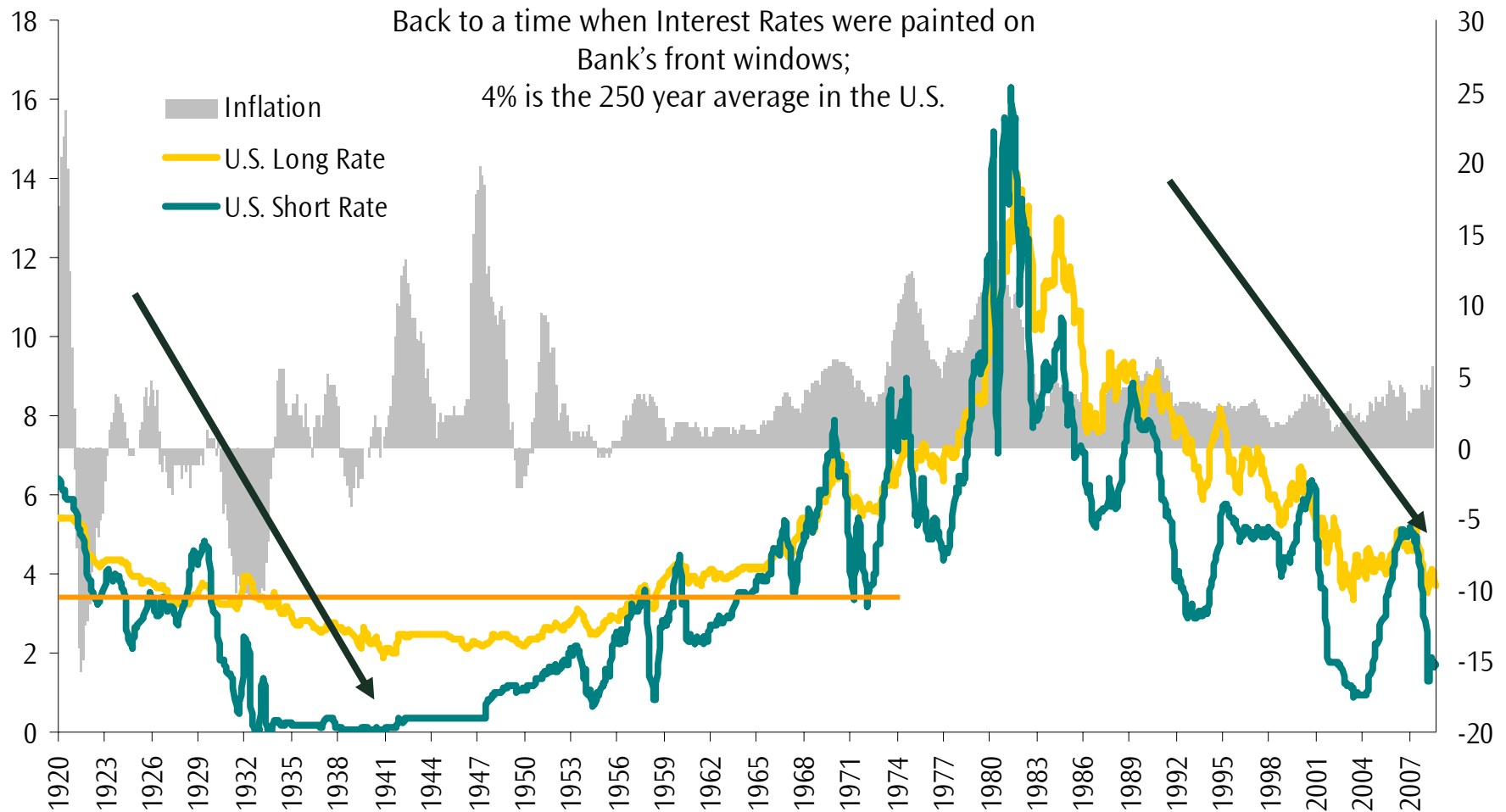
EVOLUTION OF THE CRISIS:

The Positive Correlation and
Its Significant Implications

Positive Correlation



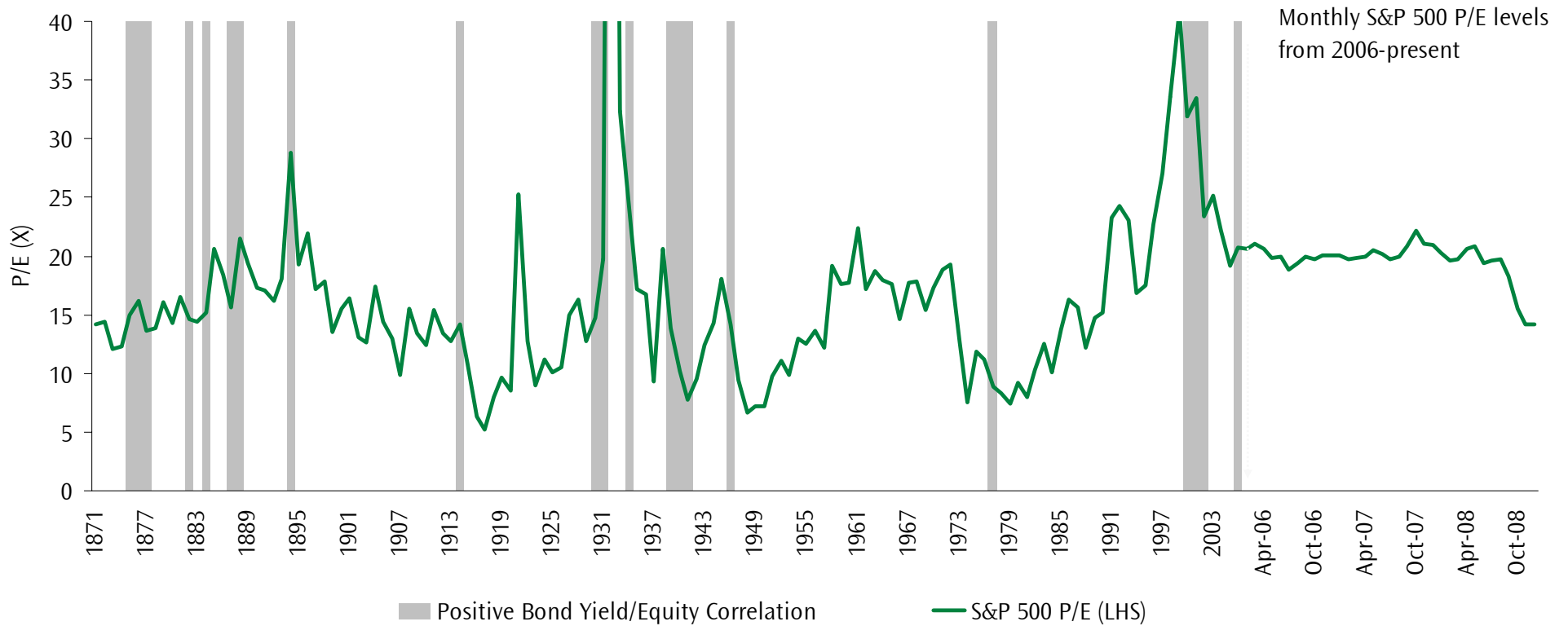
US YIELDS & RATES WHAT IS NORMAL?



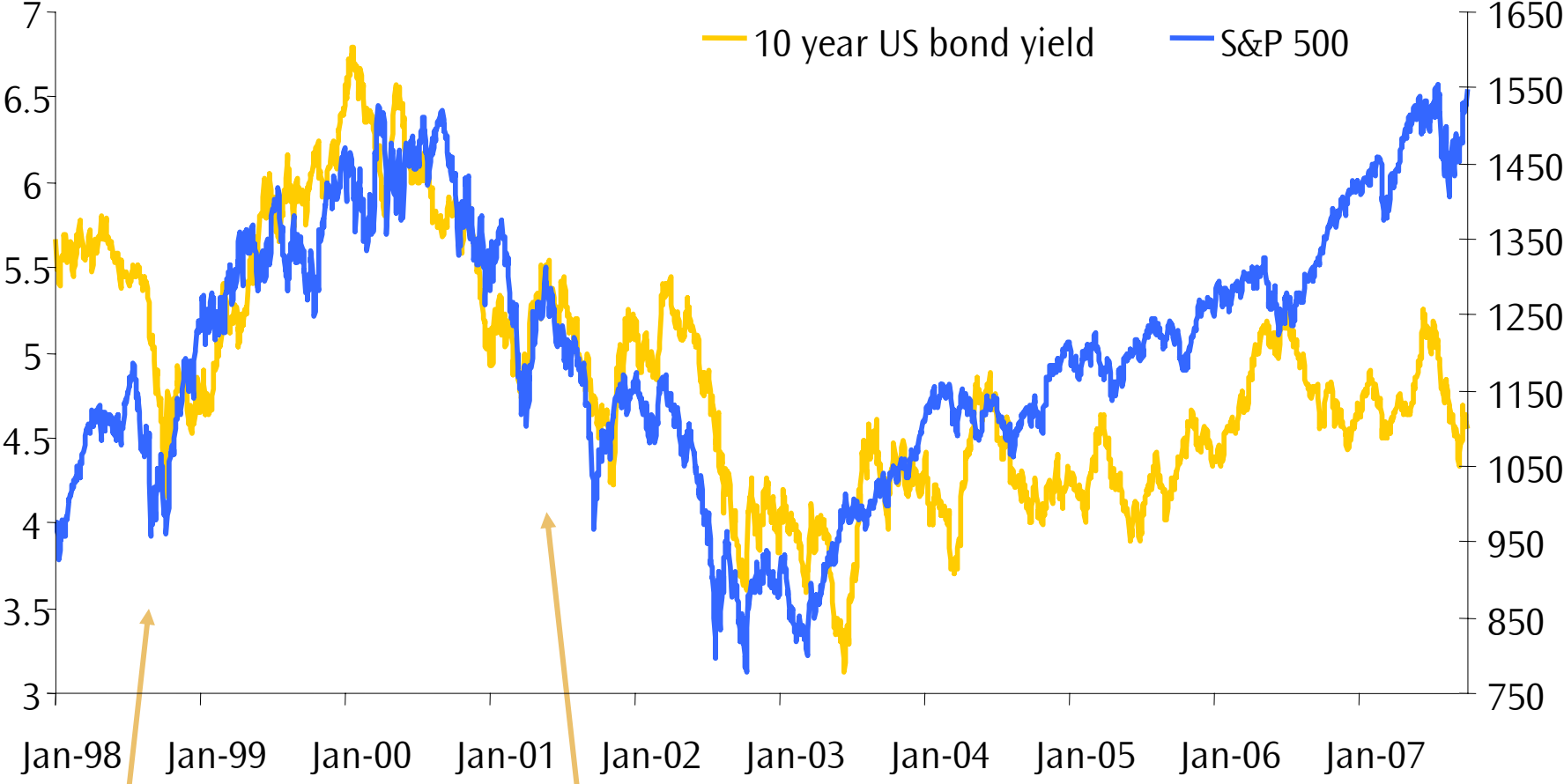
US Inflation



S&P 500 long-term downward P/E trend



THE BAD NEWS: Positive Correlation S&P 500 Price and Bond Yields



Rates fall, stock prices fall anyway

Fed cuts, stock market falls (first in 50 years)

P/E = stock price/ earnings ratio

1980 – 1999

P/E rises

$$\frac{P}{E}$$

2002 – 2003

P/E falls

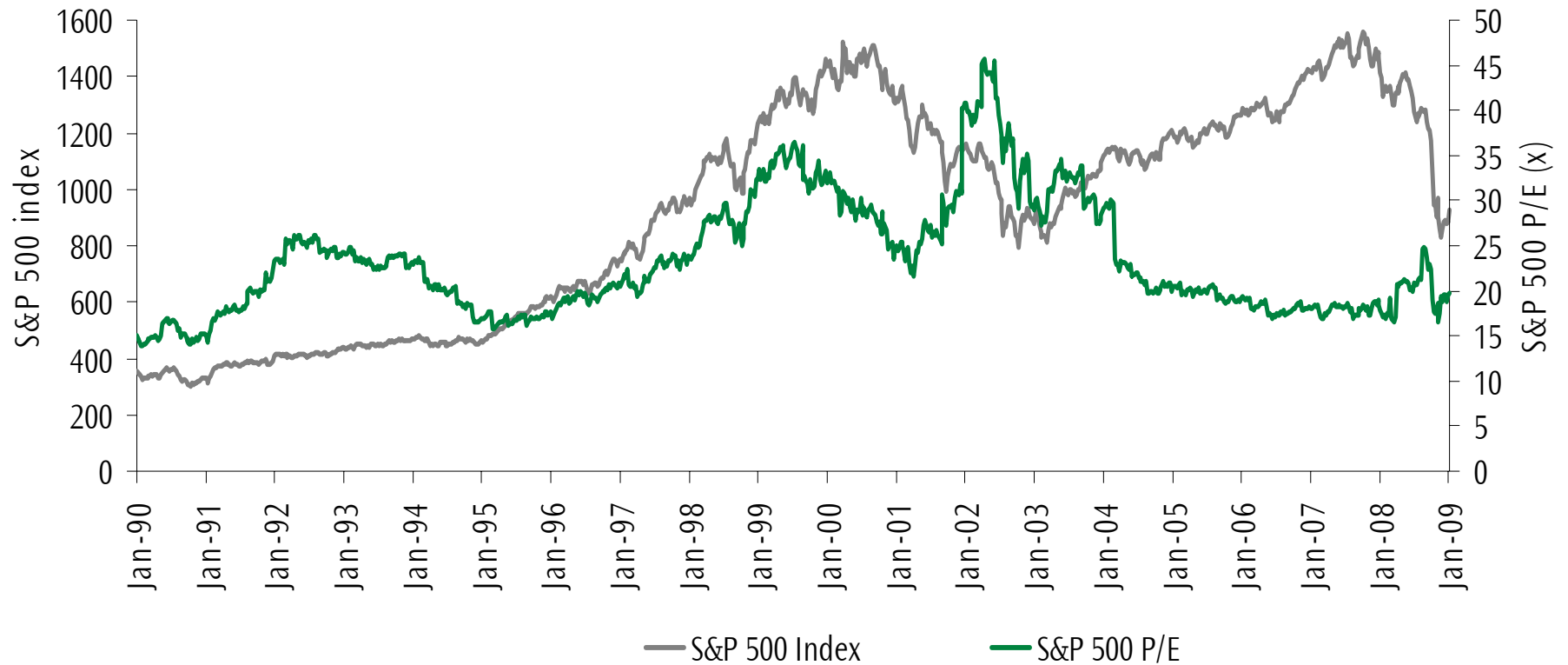
$$\frac{P}{E}$$

2003 – 2007

P/E falls

$$\frac{P}{E}$$

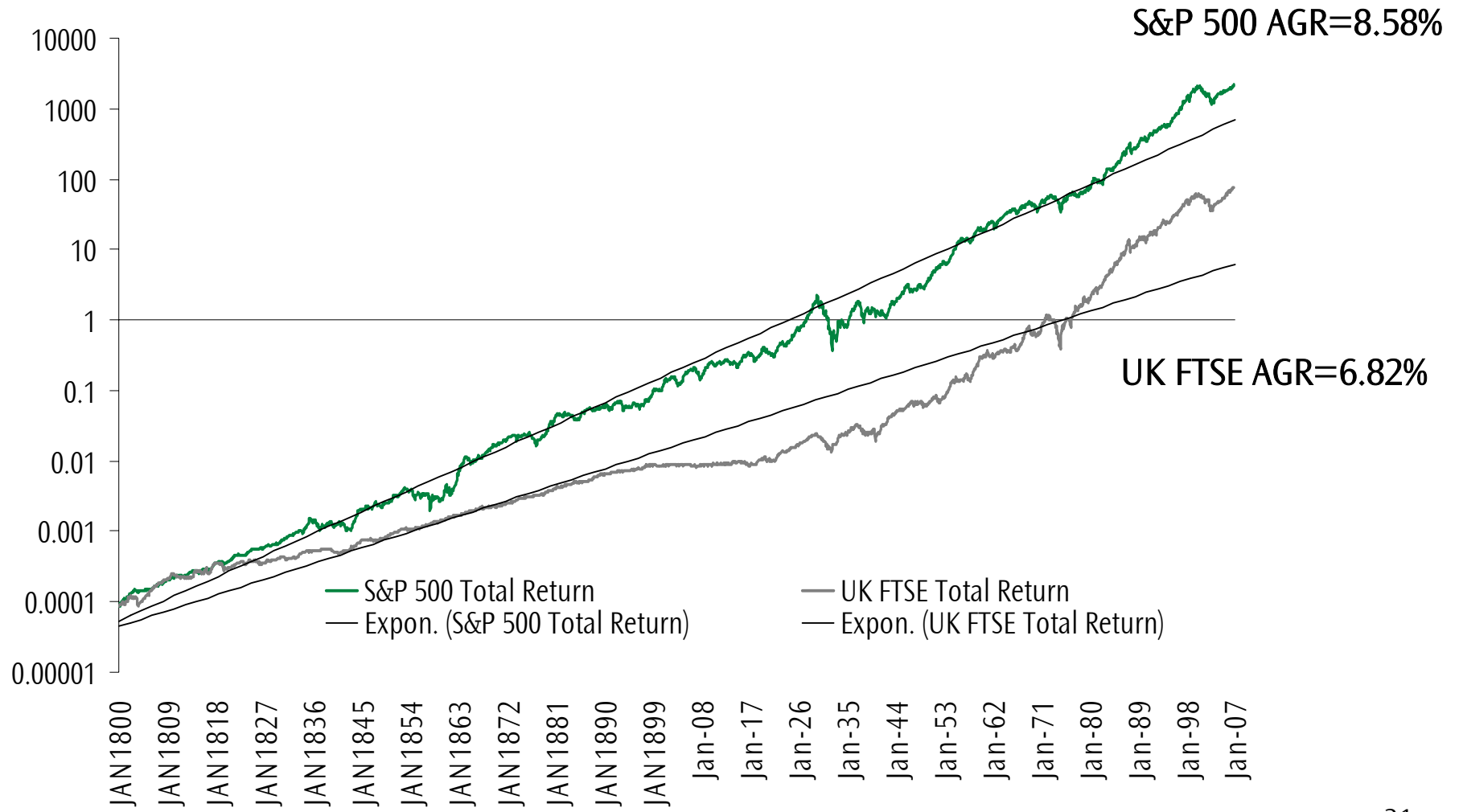
S&P 500 P/E vs S&P 500 index



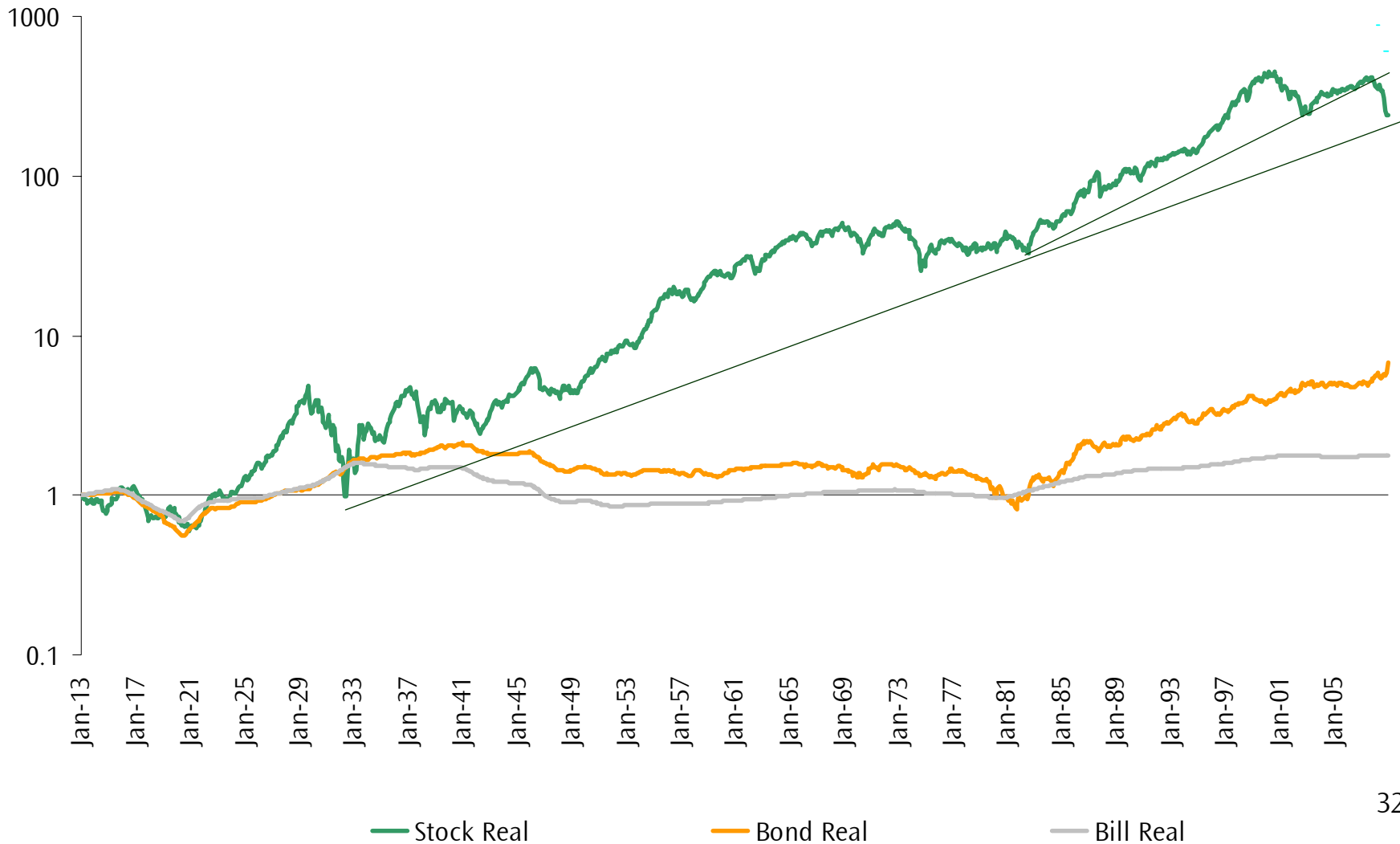
Source: Desjardins Securities, Global Insight

Source: Desjardins Securities

UK FTSE and S&P 500 Total Return Since 1800

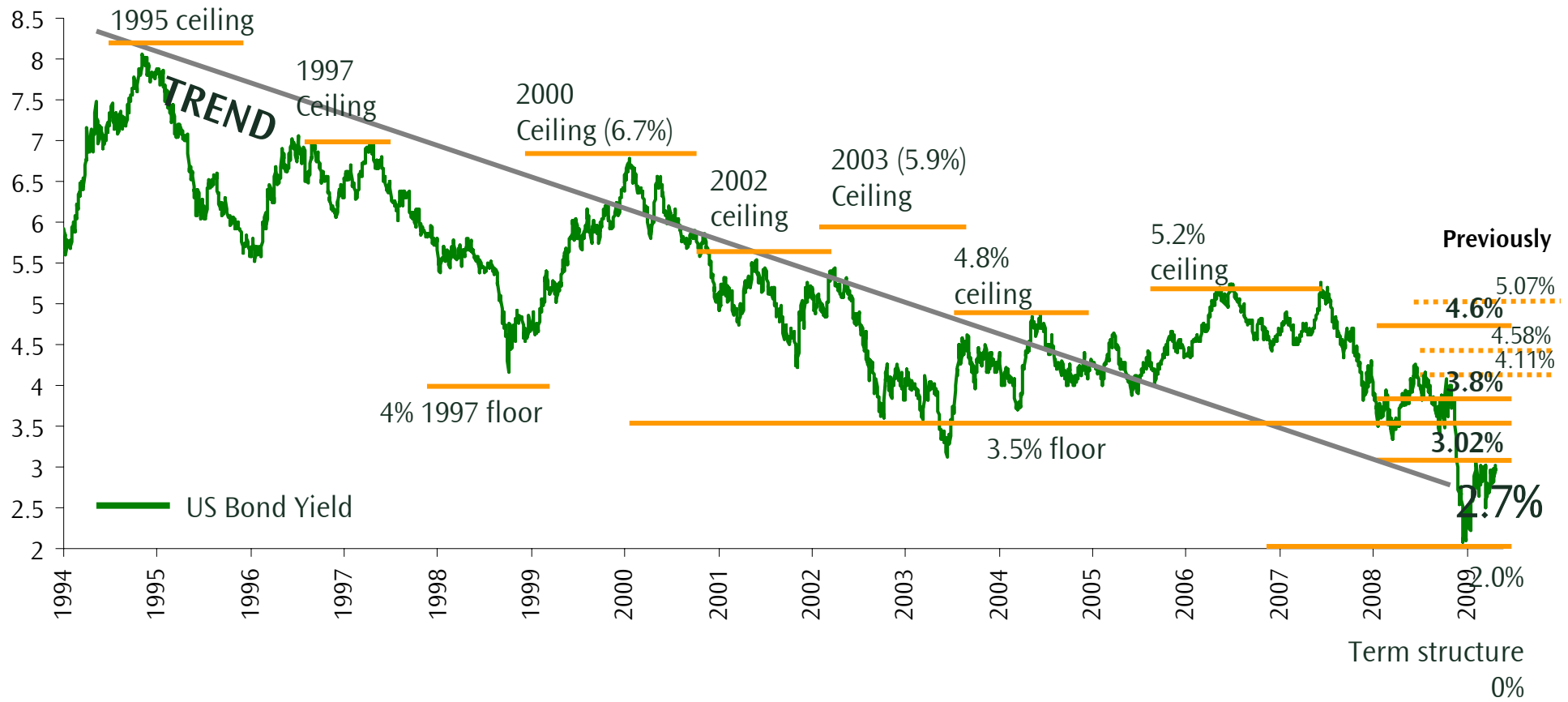


US Asset Classes Real Return



Source: Desjardins Securities

Bond yield levels approach the ceiling as curve is NORMALIZED



Selected US Asset Class Returns

Start	End	S&P 500 Total	S&P 500 AGR	Bond AGR	TBill AGR	CPI AGR	
Jan-22	Oct-29	382.12	22.24	4.78	3.55	-0.03	Inflation
Nov-29	Jan-39	-19.50	-2.32	4.08	0.68	-2.21	Deflation
Jan-42	Jan-46	166.84	27.17	2.93	0.37	4.13	War economy, Inflation
Jan-48	Jan-55	268.21	20.20	1.86	1.35	2.03	Painted rates
Jan-55	Jan-67	263.13	11.26	2.63	3.07	1.74	Steady rise, inflation
Aug-74	Jan-82	119.41	11.05	3.88	8.70	8.97	Hyperinflation
Aug-82	Jun-06	2157.68	13.92	10.01	5.25	3.12	Disinflation

Ceiling & floor – Asset mix switches August 1998 - 2002

	Returns
Buy & Hold Bond Returns	+45.4%
Buy & Hold Equity Returns	-2.5%
50/50 Bond & Equity Split	+21.4%
5 Ceiling/Floor Switches	+96.2%
Since June 2007	
S&P 500	-37.9%
US 10-yr bond return	+47.6%
Relative performance	85.5%

INVESTING STRATEGIES

1. VOLITILITY &
2. YIELD SAFETY

VOLATILITY

	+20%	-20%
1928-39	5	5
Next 60 years	0	2

Do pension fund managers need to be traders?

S&P 500 trading, January 1, 1930 to December 29, 1939

(%)		Sell level									
		1.00	0.98	0.96	0.94	0.92	0.90	0.88	0.86	0.84	0.82
Buy level	1.00	-3.98	0.05	-0.68	-2.65	-5.07	1.28	-0.28	0.36	-0.15	-3.34
	1.02	-0.98	3.57	2.48	1.90	0.87	2.12	2.33	0.82	1.00	-2.17
	1.04	-0.04	1.49	5.19	5.95	3.78	2.39	6.01	2.39	2.11	-0.92
	1.06	0.23	1.95	6.41	5.97	2.65	0.43	2.19	-1.04	-0.37	-2.85
	1.08	3.02	2.82	4.90	6.51	6.42	6.82	3.87	3.09	4.19	2.59
	1.10	0.45	1.02	3.78	1.68	1.76	2.39	-0.05	0.18	2.19	0.94
	1.12	-1.28	1.12	2.94	2.63	-0.27	-0.16	-2.18	0.59	2.39	1.48
	1.14	-0.77	-0.91	0.06	-0.30	-1.13	-3.83	-4.90	-2.66	0.63	0.42
	1.16	1.66	1.62	0.97	2.46	2.58	1.22	0.29	1.77	3.15	-0.64
	1.18	1.64	0.33	0.85	4.22	4.71	4.25	4.18	5.50	5.85	3.04

Source: Desjardins Securities

Yield Safety/Coverage

- 5% yield pickup 1930s – Total Return = -0.5%, Prices = -5.5% pa
 - dividend yield low NOT 1929 but 1936!
1. Reasonable yield ie 2-11%
 - In ie 3-4% interest rate environment; Why not > 18%
 2. Positive ROE level ie > 10%
 3. * Positive ROE change NOT -0.3, -0.5 standard deviations
 4. Safe Operating Earnings Payout Ratio (Canadian Banks) ie Top Quartile Break > 57%
 5. Debt/Cash Flow Coverage; Median = 2.5x; Recall 1870s

2009 targets (as of 6Jan09)

	Recent	Year-end 2009
TSX	9121	11000 ²
Earnings (x) ¹	832	600
P/E (x)	10.9	15.2–18.3
S&P 500	906	1100 ³
Earnings (x)	65	50
P/E (x)	13.9	18.0–22.0
Canadian T-bills (%)	0.80	0.75
Canadian 10-year bond yield (%)	2.90	3.10
US T-bills (%)	0.02	0.50
US 10-year bond yield (%)	2.49	3.00–3.50
WTI oil (US\$/bbl)	43	70–80
Gold (US\$/oz)	844	1,000–1,100
C\$/US\$	0.84	0.90–0.95

¹ Larger decline on reported earnings due to writedowns compared with massive US writedowns but an operating number for the US; ^{2,3} These peaks are trading levels and are likely unsustainable
Source: Desjardins Securities, Bloomberg

Challenging Conventional Views Summary of Observations & Implications

1. BOND MARKET DICTATES:

Problem of too much Government & Consumer Debt

2. MUST PROTECT BOND YIELD TREND & LEVEL while awaiting an energy related technology driven productivity growth breakthrough

3. PLAYING FOR TIME: Bond yield collapse when FED tightens until they break something ie 87/88, 97/98, 07/08



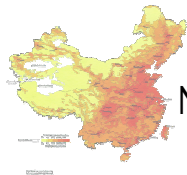
4. BATTLE FOR GLOBAL ECONOMIC & MILITARY LEADERSHIP:

US Debt burdened, Reserve currency vs (ASIA) Export dependent emerging economy

5. NEXT FEW DECADES YUAN CARRY TRADE

(VENDOR FINANCING for 3 billion people):

Need Chinese Banking Crisis or something to drive rates down



Challenging Conventional Views Summary of Observations & Implications (continued...)

6. UNFORTUNATELY, ARTIFICIALLY LOW US RATES REQUIRE:

US Safe Haven Status or US Deflation

7. DEFLATION MEANS DANGEROUSLY WEAK US ECONOMY:

Falling bond yields coincide with falling stock prices (positive correlation)

8. ALL ASSET CLASS RETURNS FALL,

investing strategies change dramatically, Pension fund challenges multiply

9. END OF EQUITY/ECONOMIC CYCLE &

FED INTEREST RATE POLICY defined by bond yield ceilings

10. THE BOND YIELD FLOOR IS EQUALLY DANGEROUS:

Our 2007/08 problems related to trend level being less than floor level !

Challenging Conventional Views Summary of Observations & Implications (continued...)

11. NARROWING CREDIT SPREADS IN LAST 18 MONTHS OF EQUITY CYCLE COINCIDE

with stock market rebound BUT due to rising government bond yields (& +ve stock correlation)

12. VOLATILITY

13. RULES FOR IDENTIFYING SAFE YIELD (dividend coverage)

14. T-18 months (Bond Yield Ceilings):

The emerging China bet & the US\$ bet
Gold & Oil vs Financials (Systemic)

15. UNDERSTANDING THE S&P 500 INDEX REBOUND (4 parts):

Risk Premia Rebound, Lower LT Returns, Higher Volatility, ROE Recovery?

Appendix

Global Portfolio System (GPS)

Desjardins Securities Quantitative/Strategy - Microsoft Internet Explorer fourni par Présenté par VMD/Presented by VMD

Re Calculate | Excel Export | Save | Print

Portfolios

Portfolio Options

Global Options

Base FX Rate: Default

Base Weighting: Market

Benchmark: Desjardins Se

Style Weights (click to enable)

Core: 100.0

Trading: 100.0

Screen Options

Core

Weight Calculation

Min/Max Weig...: 0 | 100

Long/Short: Long

Factor Tilts

Tilt Factor: None

Tilt Formula: Aggressive

Rank #1 x

Rank #2 x

Rank #3 x

Rank #4 x

Rank #5 x

Trading

Weight Calculation

Min/Max Weig...: 0 | 100

Long/Short: Long

Factor Tilts

Tilt Factor: None

Tilt Formula: Aggressive

Rank #1 x

Rank #2 x

Rank #3 x

Rank #4 x

Rank #5 x

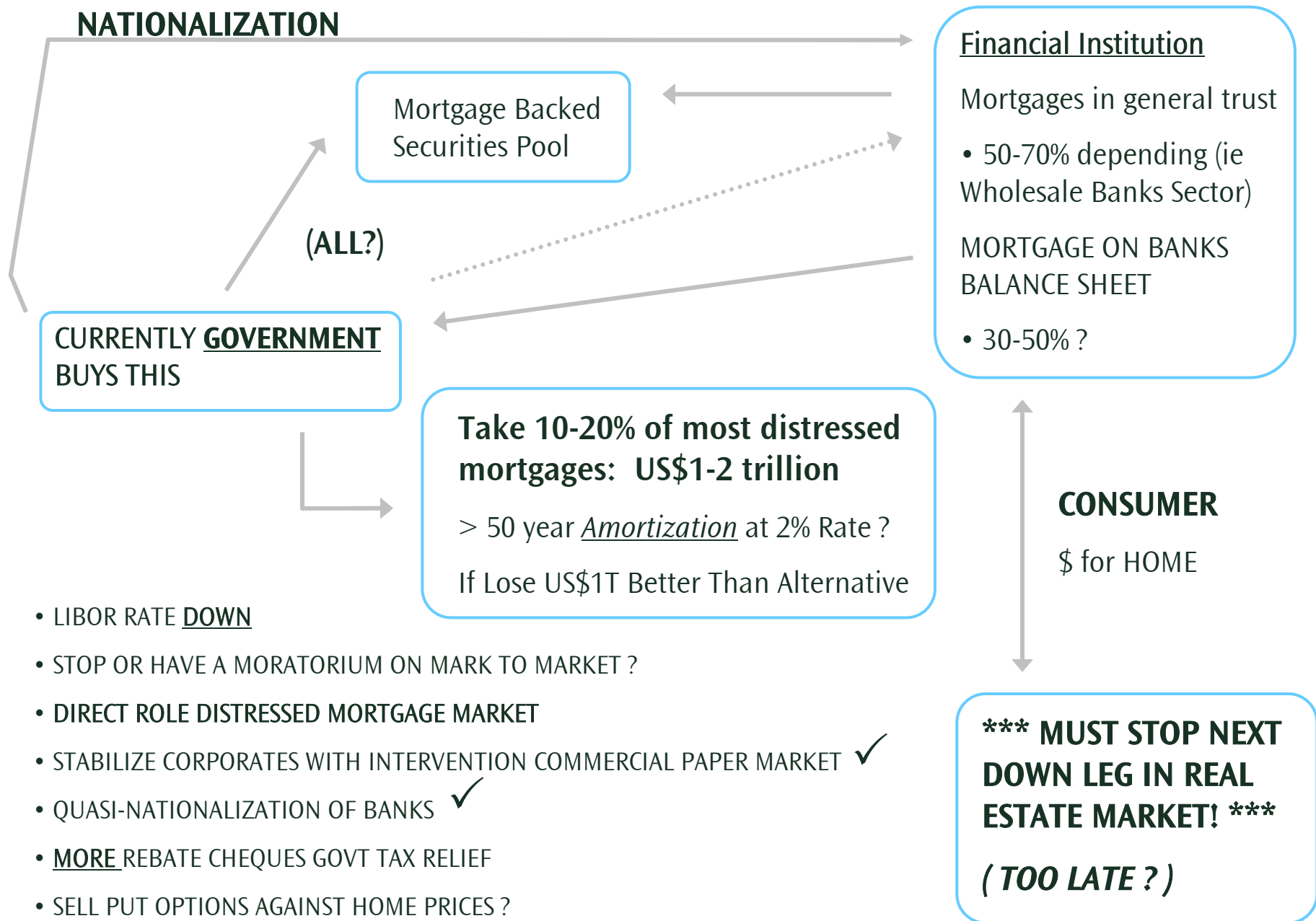
Portfolio Results

Summary | Sector Diversification | Country Exposure | Fundamentals | Fundmntls (Graphs)

		price	abs mom	rel mom	tilt factor	index weight (%)	weight (%)
utilities							
DUK	Duke Energy Corporation	US 28.72	1	4	-	0.22%	1.08%
EIX	Edison International	US 38.32	3	4	-	0.10%	0.51%
CNP	CenterPoint Energy, Inc.	US 12.58	3	3	-	0.03%	0.16%
TE	TECO Energy, Inc.	US 18.64	1	4	-	0.03%	0.16%
CMS	CMS Energy Corporation	US 14.30	3	1	-	0.03%	0.13%
Sum of Portfolio Weights							2.02%
Benchmark desjardins securities north american equity composite Sector Weight							3.17%
financials							
Core (1.31%)							
BNS	The Bank of Nova Scotia	CDN 39.75	5	5	-	0.26%	1.27%
KFS	Kingsway Financial Services Inc.	CDN 20.94	3	3	-	0.01%	0.04%
Trading (3.98%)							
KRB	MBNA Corporation	US 21.42	5	5	-	0.23%	1.10%
BEN	Franklin Resources	US 72.69	3	3	-	0.15%	0.74%
MTB	M&T Bank Corporation	US 104.23	5	5	-	0.10%	0.48%
MEL	Mellon Financial Corp.	US 27.99	5	5	-	0.10%	0.48%
CMA	Comerica Incorporated	US 56.57	5	5	-	0.08%	0.39%
SAFC	SAFECO Corporation	US 54.57	2	2	-	0.06%	0.28%
JP	Jefferson-Pilot Corporation	US 50.11	5	5	-	0.06%	0.28%
MTG	MGIC Investment Corp.	US 63.40	3	3	-	0.05%	0.24%
Sum of Portfolio Weights							5.29%
Benchmark desjardins securities north american equity composite Sector Weight							20.99%
consumer staples							
Core (0.09%)							
ATD.SV.B	Alimentation Couche-Tard Inc.	CDN 19.25	1	1	-	0.02%	0.09%
Trading (8.60%)							
PG	The Procter & Gamble Co.	US 54.39	4	5	-	1.13%	5.49%
WAG	Walgreen Company	US 46.24	4	3	-	0.39%	1.91%
HSY	The Hershey Company	US 64.32	3	3	-	0.10%	0.48%
SWY	Safeway Inc.	US 23.05	3	5	-	0.09%	0.42%
UST	UST Inc.	US 45.42	3	3	-	0.06%	0.30%
Sum of Portfolio Weights							8.69%
Benchmark desjardins securities north american equity composite Sector Weight							10.33%
telecom svcs							
FON	Sprint Corporation	US 24.93	4	3	-	0.29%	1.41%
AT	Alltel Corporation	US 61.00	2	5	-	0.15%	0.75%

Done | Local intranet

Source: Desjardins Securities

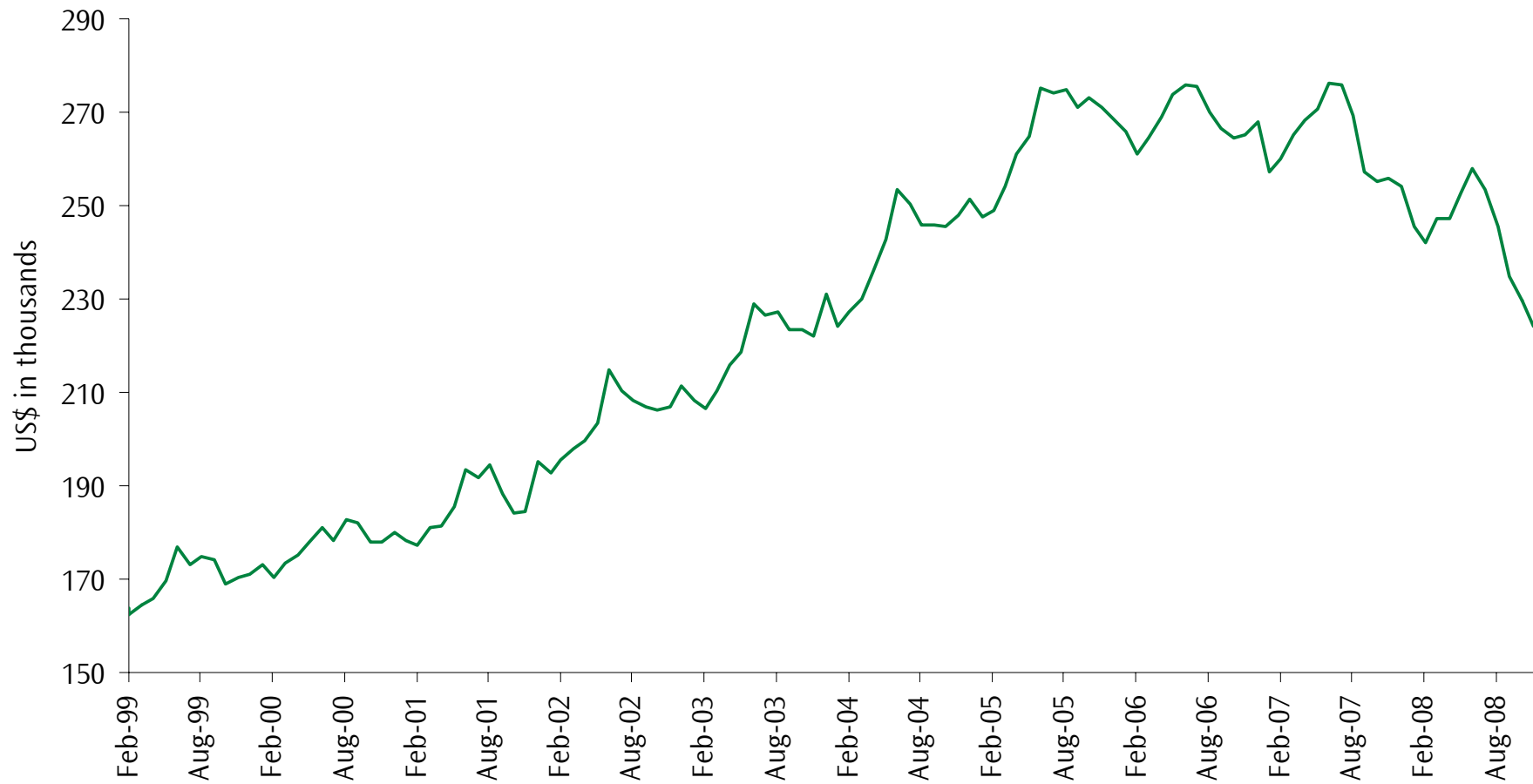


DECLINE

IN

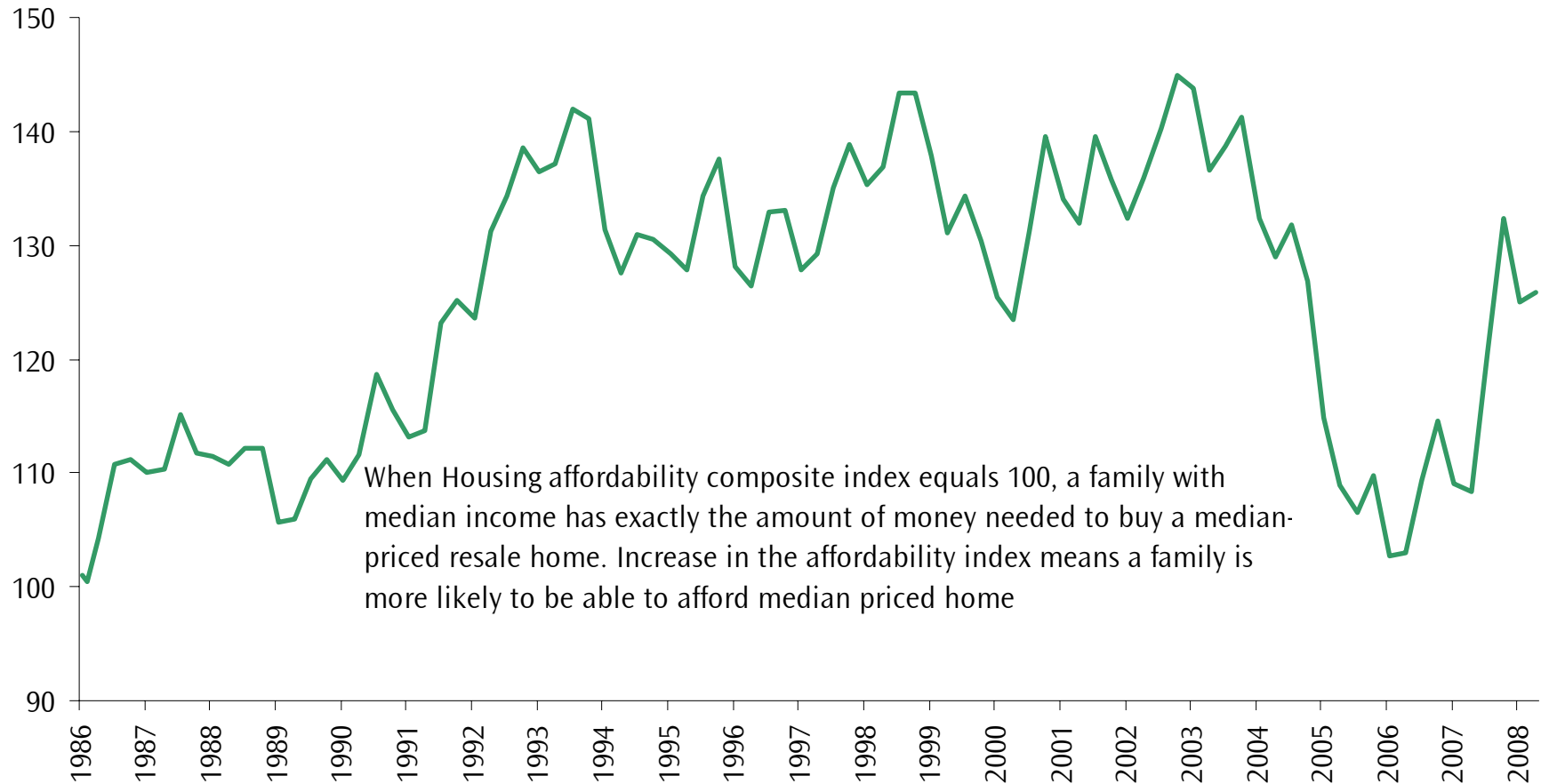
MORTGAGE RATES LAGGING

US existing home ave price (in 1000s)



Source: Desjardins Securities, Bloomberg

Housing affordability composite index



Source: Desjardins Securities, Bloomberg

Wealth effect US

- home about 2x stimulus as stocks?
- \$1 rise in housing → \$0.04-0.10 increase in spending
 - Minimal aggregate change due to stock price change
- economic data implies further 5-10% housing price decline
- 20% = MASSIVE Consumer Retrenchment & 40% Distressed Mortgages
- 20% Decline = 1.0-1.5% GDP Decline
- BUT Issue of Linearity

TRADITIONAL!!!

- HOUSING INVENTORY WAS ESTIMATED 11.2 MONTHS IN NOVEMBER 2008*
- RECENTLY, FELL TO 9.3 MONTHS* – BEST SINCE MID 2007
- NORMALLY, 5 MONTH SUPPLY
- TYPICALLY, INVENTORY COLLAPSES THEN PRICES STABILIZE
- PREREQUISITE, IF FINANCIAL SECTOR & CONSUMER CONFIDENCE TO STABILIZE
- IF SUPPLY FALLS BY 2 MONTHS FOR EVERY MONTH GOING FORWARD

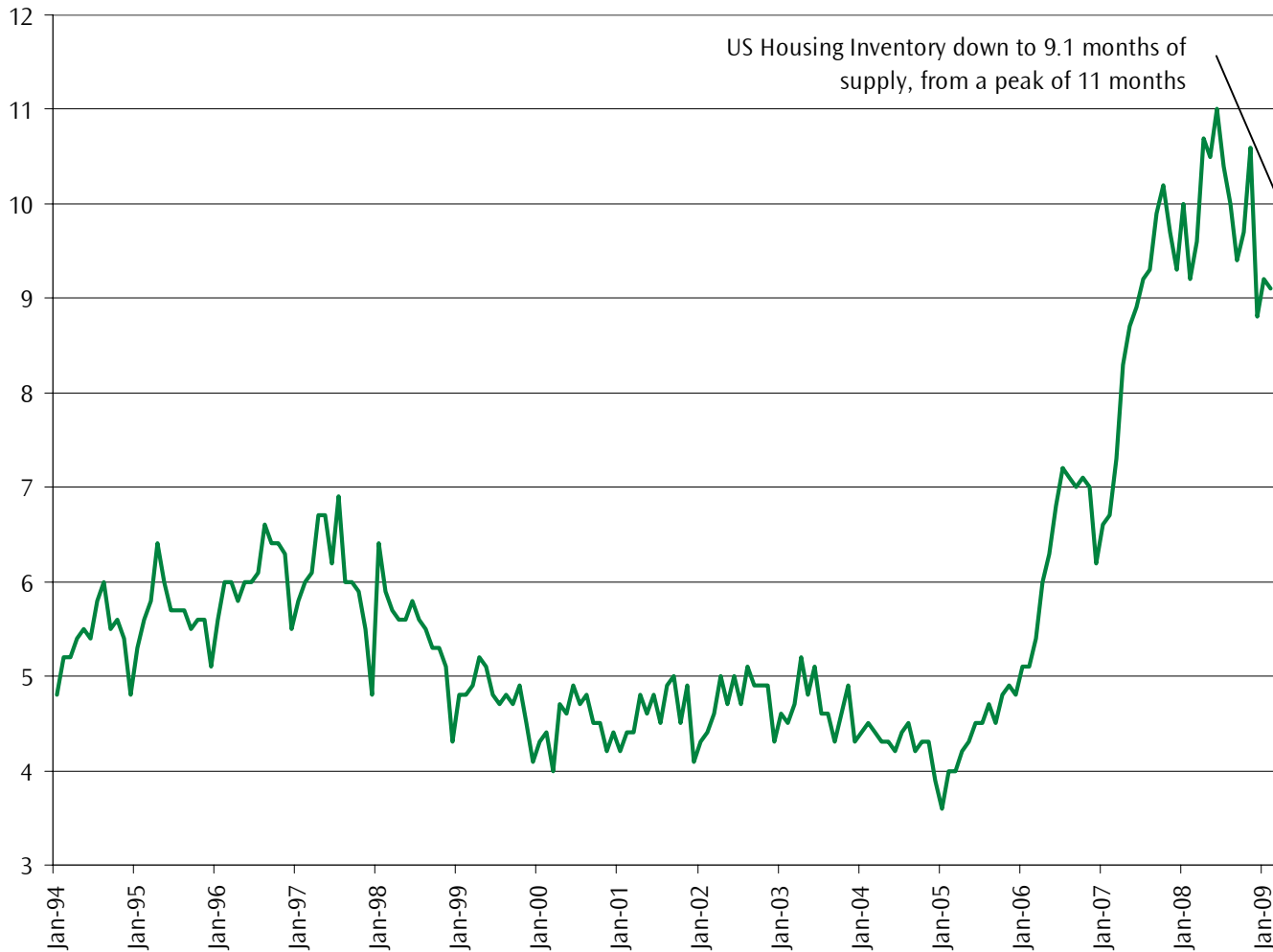
THEN HOUSING STABILITY BY JUNE?

RECENT MORTGAGE RATES -100BPS HAVE LAGGED MORTGAGE APPLICATIONS SOARED[†]
100%yoy THEN 20% FORMERLY BROKEN PRICES AT 2000 LEVELS

[†] MORTGAGE APPLICATIONS REFINANCING VS NEW HOME PURCHASES?

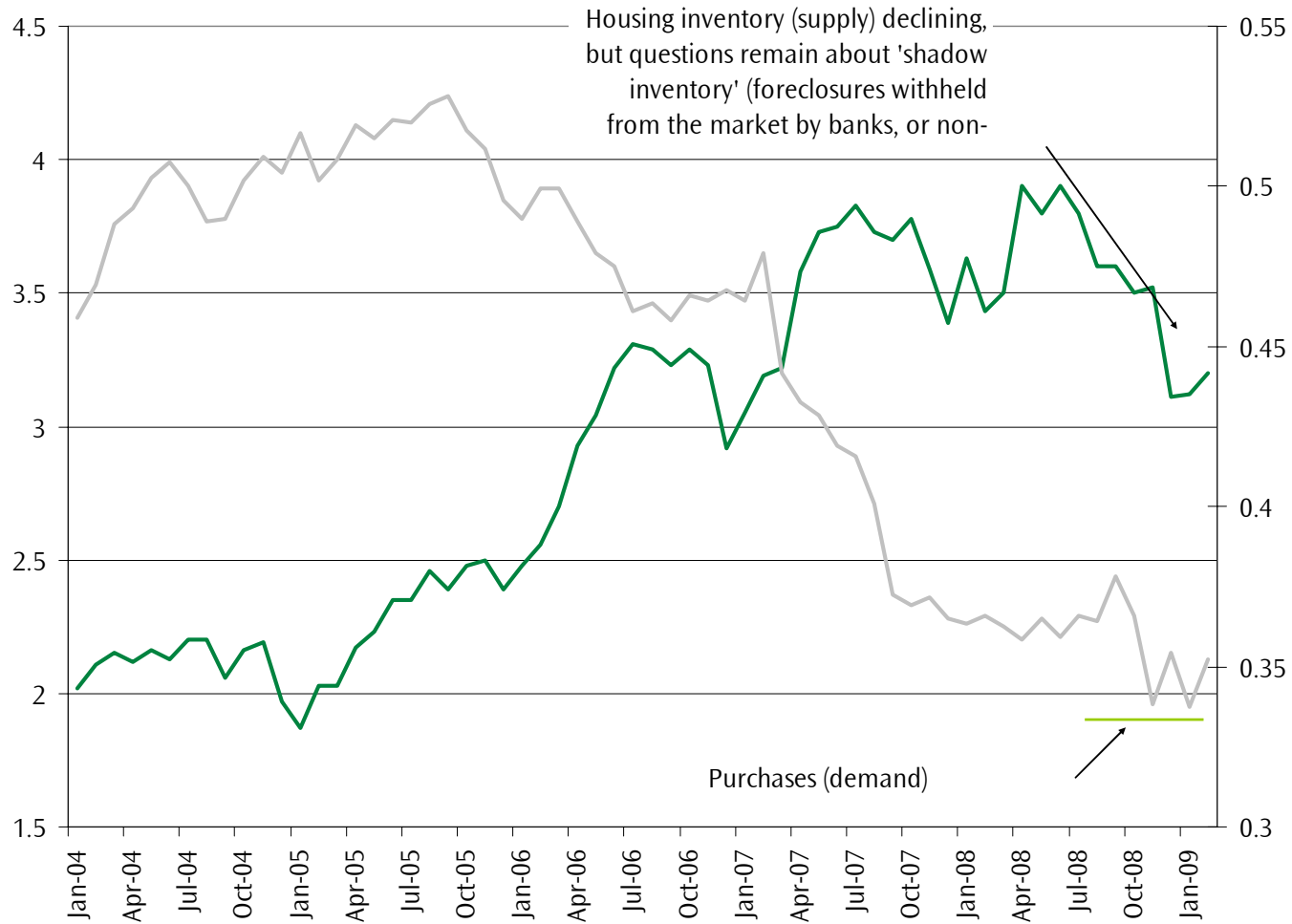
* National Association of Realtors

US housing inventory (supply) (as of April 8, 2009)



Source: Desjardins Securities, RadarLogic

US housing inventory (supply) (as of April 8, 2009)

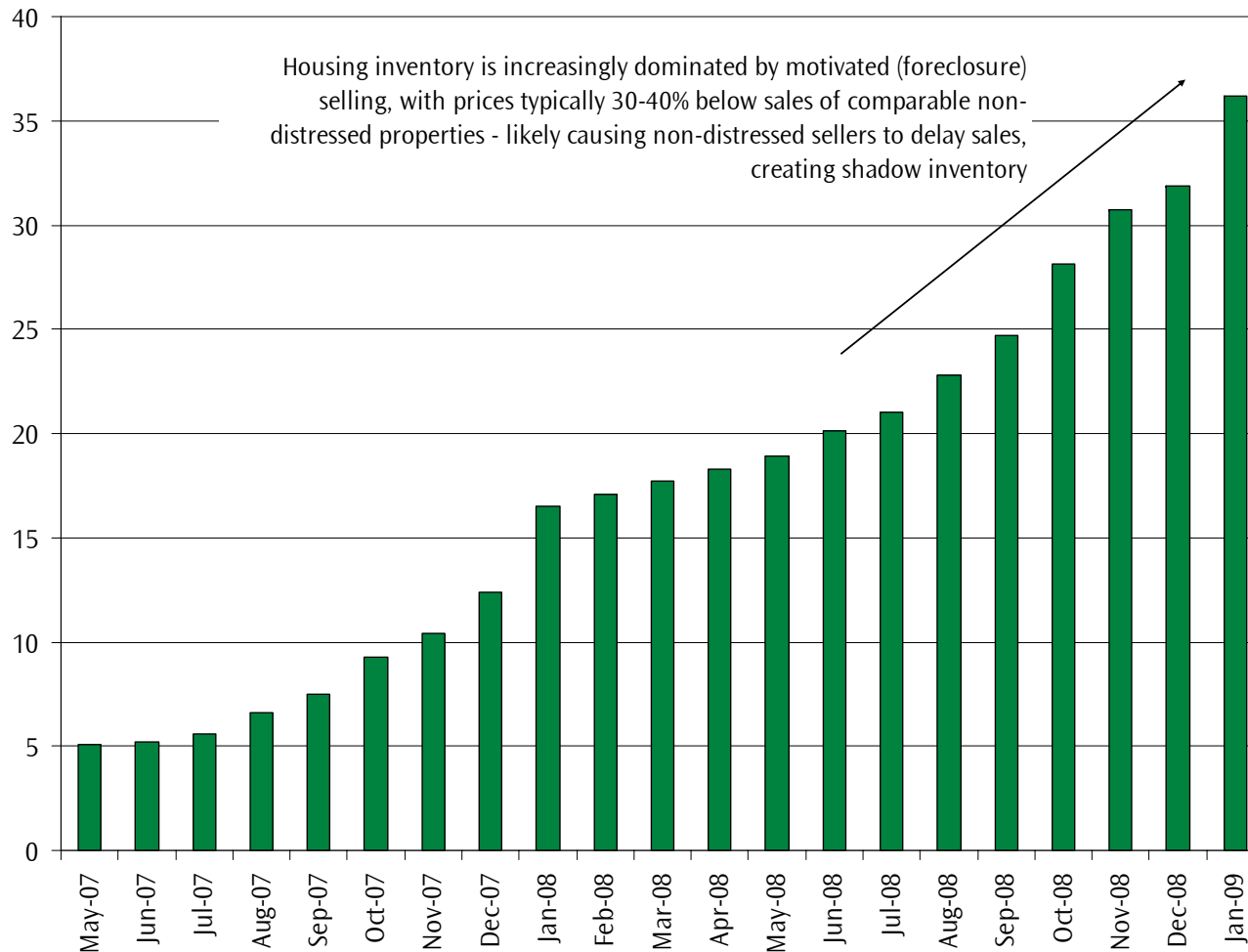


Source: Desjardins Securities, RadarLogic

— Inventory

— Sales/Month

% of transactions 'Motivated' (as of April 8, 2009)



Source: Desjardins Securities, RadarLogic

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