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## Market Activity Last Month

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The stock market in Canada has had a nice bounce off the bottom with the index up 16% from the January low and up 11% from the March 19th low and is only 3.7% below the all-time high of 14621 reached last October 31<sup>st</sup>. We turned fairly bullish for at least the short-term when the market hit a lot point in January on the notion that investor sentiment had gotten too bearish, valuation levels were looking attractive again and central banks (particularly the US Federal Reserve) were cutting interest rates much more aggressively than we would have expected, especially since inflation was still a concern and interest rate cuts do tend to be inflationary. The higher that the market has headed (in both the US and Canada as well as globally) over the past few months, the more bullish investors have become, suddenly believing that the end of the recession was in sight and that economic and earnings growth would pick up in the second half of this year.

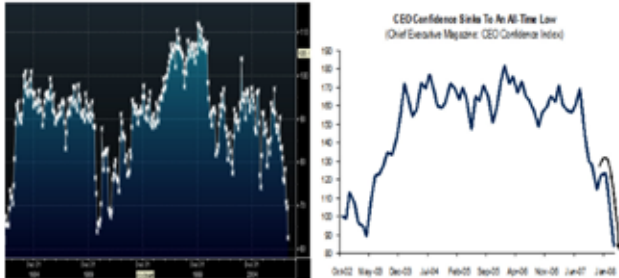
We may indeed have seen the lows in stock prices for this cycle (although we wouldn't be betting our last dollar on that call), but we don't think that we can confidently say that we can see the end of this economic downturn yet. The indicators that we pay the most attention to are still heading down and seem to be in the process of gathering more momentum to the downside as economies outside of North America also start to slow down (Korea announced that first quarter 2008 growth was only 0.7%, less than the 1.0% expectation and the worst quarter since the fourth quarter on 2004). **Although it is true that the stock market always bottoms well before we see the low point in the economy, we find it difficult to call an end to the economic downturn this early in the process, particularly since the economy and markets got so stretched to the upside over the prior few years** as exceptionally low interest rates lead to substantial speculative activity in the housing and financial markets that will have to be unwound before any new upturn can begin.

The last economic downturn in the 2001-2002 period was lead there by a downturn in business spending after companies had spent far too much on capital equipment into the run-up to the year 2000 as well as by the excess spending by all the newly-capitalized telecom companies, some of which never saw the operational light of day even after raising so much capital. **The downturn that we are now seeing is totally different in that it is being lead by a slowdown in consumer spending, something which we didn't see any hint of in the last downturn.** But the housing boom in the US and other global housing markets created 'phantom wealth' in terms of higher real estate prices. Consumers then turned this 'phantom wealth' into real spending by leveraging up the value of their homes using all the newly-minted, attractive financial products being marketed aggressively by a plethora of new and old financial services companies. As we unwind those excesses, the consumer is suffering a serious retrenchment at the same time that job growth has turned negative (in the US) and savings rates are basically at zero. A look at the chart below shows how bad it is for both the consumer as well as the confidence of business CEO's (the guys who control the 'purse strings' of business spending). With consumer confidence at a 26-year low and business confidence at an all-time low, it's hard to see where the impetus is going to come from to quickly lift the economy out of its current malaise.





### Consumer and Business Confidence Have Come Down to Multi-year Lows

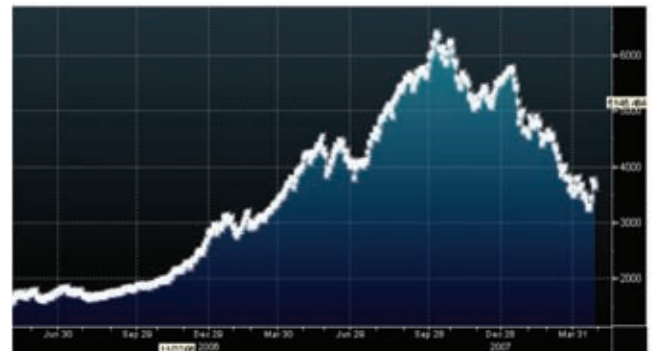


Consumer confidence (left chart) has dropped to a 26-year low while CEO confidence (right chart) is at an all-time low. Declining job growth, low savings rates and the credit crisis could keep spending low for some time while business spending could be hurt by slower profit growth.

On top of the bad economic outlook for the US consumer (who makes up 70% of the spending in the largest economy in the world), we are really also starting to see some slowdown outside of North America where those economies are suddenly dealing with a higher valued currency which squeezes profit margins as well as a fall in demand for exports from the US. **The IMF just released a dire report on the global housing market, which estimates that house prices are more than 30% above their fair value in Ireland, almost 30% overvalued in the Netherlands and the United Kingdom, and more than 20% overvalued in France.** The consensus thinking has tended to be that the housing problem was an issue specific only to the US market. While conditions in the US clearly got extended more than most markets, the 'lax lending policies' of banks and the speculative activity created by excessively low interest rates was not limited to the US market. The same study also suggests that US home prices are still 10% too high. Moreover, the IMF's chief economist warns that the US market is vulnerable to tough credit conditions and could overshoot on the way down.

**We're very surprised that more attention has not been paid to the fact that the Chinese stock market has dropped so sharply in 2008.** Given that practically the whole commodity story has been premised on the superior longer-term growth from the emerging markets, particularly China, and that investors are very willing to accept the view that the stock market is an accurate leading indicator of economic growth, it seems surprising that there is not more investor concern that this is a harbinger of a slowdown in Chinese growth as well as a growing black hole in the bullish commodity story.

### Chinese Stock Market Dropped Almost 50% from its October High and is Down 34% in 2008



The stock market is not the only 'apprehensive' indicator for the Chinese economy. Export growth from China to the US has slowed significantly in the past year from a growth rate of over 25% to almost zero! The OECD leading indicator for China has also weakened while banks have increased interest rates and reserve requirements in order to slow down capital speculation as well as try to control the emerging inflation problem, where inflation rates have soared from the stated limit of 3% to over 8%. Finally, the slightly less scientific fact that on all but one occasion since 1960, the country hosting the summer Olympics has faced slower economic growth in the year following the Olympics, and we all know what will be happening in Beijing this summer.

So if the US is leading North America and Japan into a consumer downturn, and the powerful economic engine of China is shifting down to a lower gear, you can see why we're a bit skeptical of the idea that economic growth is about to snap back to the upside, and why we've been selling into the current stock market rally, which has been driven primarily by an anticipation of such a rebound. History and experience suggests that economic moves tend to carry more momentum and last longer, in either direction, than investors generally expect. Given how strong and speculative the upside move of the prior four years had been, we would be very surprised to see this ending up as a 'short and shallow' economic downturn like so many are anticipating. But the most important indicators to watch will be those outside of the US. The American economy is clearly going to struggle for at least the near term since consumers are 'tapped out', banks still aren't lending aggressively, savings are non-existent and profit growth has turned negative. But how the rest of the world reacts to this slowdown will be a bigger determinant of the movement in stock prices. Investors, particularly in the commodities markets, are clinging tightly to the 'decoupling theory,' the idea that the biggest



economy in the world can slow down but that internal growth in the emerging economies will more than offset that until the US begins to recover. The flipside to that argument is that the lion's share of the growth in these emerging economies has been exports to North America and Europe, which are clearly in the process of slowing down. The jury is still out on the magnitude of the 'decoupling theory' in this cycle, but growth trends in China, Korea, Eastern Europe, Brazil and Russia will tell an interesting story for global stock markets over the balance of 2008.

Back in North America, the US Federal Reserve (which was recently joined in its efforts by the Bank of Canada) has certainly been doing what it can to keep the credit crisis under control and stop it from spreading to the general economy. The chart below shows how aggressively the Fed has cut rates since last August (white line in chart) from 5.25% to 2.25% currently (and probably down to 2.0% by Wednesday). We have been surprised how aggressively the Fed has cut rates since last summer, particularly since inflation had not pulled back into the 'comfort zone' that the Fed had been looking to achieve when it was raising interest rates in 2005 and 2006.



- US Federal Reserve has been cutting short-term interest rates which has lead to weakness in the US Dollar and an explosion in commodity prices.

**The collateral damage of these aggressive cuts has been the US dollar** (red line in chart) which has continued to deteriorate as investors funds flowed to currencies with higher yields, particularly the Euro and Asian currencies. **The winner in this environment has continued to be the commodity complex** (the CRB commodity index shown by the yellow line in the chart below). This group has benefited not only from economic growth over the past five years which has driven an increasing demand for commodities (particularly from the emerging economies which tend to use more basic materials and also have been growing at a faster rate) but

there has also been very strong financial demand for commodities from funds which have exited US dollar investments to focus on real goods.

This situation could start to reverse quite soon if the slowdown in China starts to take hold along with slowing growth in the rest of the world. Also, it seems that the US Federal Reserve is almost done cutting interest rates and some even expect that they may take a pass this week and not cut rates  $\pi$  point like investors expect. **If the US is close to done cutting rates at the same time as the Canadian, British and European central banks are moving more aggressively into a 'rate cutting mode,' then money could start flowing back to the US dollar, at least temporarily. This, in turn, would probably lead to a sharp reversal down in commodity prices.** In fact, when we saw a slight stabilization of the US dollar last month, we also saw gold prices fall more than \$60 per ounce in one day, a clear indication of financial players exiting that market. The size of financial assets in the commodities market is quite staggering right now. For example, in a mature commodities market, the value of 'paper trading' is usually around 3-5 times the size of real world demand. In the energy market right now, the trading value of energy futures was over 13 times larger than actual global oil demand! Although there is probably a very legitimate longer-term story on the growth in demand for commodities from the emerging markets of the world, the current level of financial speculation has lead to commodity prices which are most likely unsustainable even assuming decent longer-term growth rates.

We have to footnote the discussion above with some of the rationale from the bullish camp on emerging markets and commodity prices in the longer-term. It's a very tough argument to refute over the very long term that the demand for basic materials won't be positively impacted by the growth in the developing world. Attempting to quantify that growth is obviously key to that process. To that end, a recent PWC (Price Waterhouse Cooper) study forecasts that China will be the largest economy, having surpassed the U.S. in 2025. By 2050, Chinese gross domestic product will be 29% larger than that of the U.S. In 2007, the Chinese economy was less than one-fourth the size of the U.S. measured in dollars. But based on purchasing power, which eliminates the effect of the undervalued Chinese renminbi, the Chinese economy actually was half the size of U.S. GDP. India would be the third-largest economy in 2050, with its GDP rising to 88% of U.S. GDP. That would be up from 7% of the U.S. in 2007 based on dollars, and 22% based on purchasing-power parity. Brazil's economy would follow, with the GDP rising to 26% of U.S. values by 2050, from 8% measured in dollars in 2007 and from 15% based on actual purchasing power. Russia rounded out these BRICs, with its economy projected to grow from 8% of U.S. output in 1980 to 17% by 2050, as measured



in dollars. Based on purchasing power parity, the Russian economy already is equal to 17% of the U.S. economy. This certainly can explain why the longer-term positive story exists for the demand for basic materials. **The risk is that financial markets often attempt to take the next 10-20 years worth of good secular news and 'jam' it into six months of superior financial market performance.** This is what happened in the technology bubble, another case where the advent of the internet and high speed data transmission changed the productivity trend and cost structures of the bulk of the economy in a positive way for a long period of time (much of which is still to come). But, even though this impact was going to be over a period of decades, that didn't stop investors from driving stocks to such an excessive valuation that an 80% correction was needed in order to bring prices back in line with these longer-term growth trends. **Our point is that the commodity story is clearly a good, legitimate longer-term growth theory on secular trends that are clearly taking place and are unlikely irreversible.** But the momentum (or is it greed?) of financial markets has probably pushed these valuations well beyond shorter-term fair values at a time when cyclical growth could be slowing down. That situation leads to substantial volatility in financial markets.

Within our *Equity Funds*, we have lightened up on many of our cyclical stock positions in the past few weeks after a solid run up from the January lows. We have reduced Energy and Basic Materials sector weights to about 60% of index levels. We are also still not comfortable with the outlook for the bank stocks as they continue to raise capital to shore up balance sheets and fund 'off-balance sheets' assets. This will dilute future earnings growth and we think that many analysts are far too bullish in their estimates of bank earnings. We have added to positions in life insurance companies, some REITS and investment companies to get to our 15% weight in the Financial sector (slightly over half the index level). We maintain an overweight position in consumer discretionary stocks, especially those in specialty broadcasting and leisure activities. We still expect the BCE deal to be completed sometime in the next few months and view recent stock weakness as being impacted more by problems with some similar US deals as opposed to increased risks with the BCE funding, the regulatory environment or the desire of the buyers to close this transaction. Other telecom names should also benefit once this deal closed,

especially larger players such as Rogers and Telus. We also remain overweight in the technology group as earnings from Research in Motion, Exfo, Miranda, Sierra Wireless and many of the bigger US tech companies have all exceeded expectations despite the slowdown in spending. Clearly spending has slowed within the technology industry but companies are still committing new funds to the 'niche areas' where they see higher growth; this includes wireless spending, digital broadcasting and optical access markets. We have focused our buys on companies in those niches.

Within our *Canadian Balanced Funds* we have recently sold positions in the Energy and Basic Materials sectors and reduced our equity weights overall from about 110% of the benchmark weight to around 90%. We came into the year with an equity weight of as little as 50% of the benchmark and then used the weakness in mid-January to move that up into the 115% range. Within *Foreign Balanced Funds* we have also reduced our overall equity weight to below benchmark but have left the foreign equity component at the benchmark level with a larger focus on the US market (mostly export oriented companies in the manufacturing, technology and pharmaceutical industries) as well as emerging markets indices. Within our *Hedge Fund* we have moved to a 'net neutral' position in the stock market with short positions in the Canadian market (particularly the gold and energy sectors) against long positions in the US market (including financials and export-oriented companies) and Emerging Markets.

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