

Quantitative and Portfolio Strategy (cont'd)

Historical precedent does serve one possible purpose. First it can illustrate the initial psychological reaction of investors to different exogenous shocks. For this reason we have included our previously published 100-year timeline that illustrates terrorist attacks, natural disasters, offshore wars, revolutions, and presidential assassinations. With extreme caution and purely from a short-term psychological point of view, we have included a table of some key terrorist attacks, the attack on Pearl Harbor, and the Gulf War to illustrate the reaction of the Dow. The San Francisco earthquake in 1906 is included only because of concerns at the time that it could undermine the financial system.

Table 1 – Dow Jones Level

Event	Before Event	After 1 Month	After 3 Months	After 6 Months	After 12 Months	After 18 Months	After 24 Months
Apr 18, 1906 - San Francisco destroyed by earthquake and fire	95.67	92.75 -3.1%	86.54 -9.5%	95.65 0.0%	83.07 -13.2%	59.13 -38.2%	68.44 -28.5%
Sep 16, 1920 - Wall Street hit by terrorist bomb	88.63	84.31 -4.9%	70.6 -20.3%	75.2 -15.2%	70.95 -19.9%	88.11 -0.6%	100.99 13.9%
Dec 7, 1941 - Pearl Harbor	115.90	113.1 -2.4%	102.1 -11.9%	104.4 -9.9%	115 -0.8%	141.82 22.4%	133.37 15.1%
Mar 1, 1955 - Puerto Rican Nationalists shoot 5 congressmen on floor of House	413.71	413.84 0.0%	424.88 2.7%	469.63 13.5%	486.69 17.6%	507.66 22.7%	468.91 13.3%
Oct 22, 1962 - Cuban Missile Crisis threatens nuclear war	568.60	637.25 12.1%	675.53 18.8%	711.01 25.0%	747.21 31.4%	823.57 44.8%	877.01 54.2%
Aug 1, 1990 - Iraq invades Kuwait	2899.26	2613.37 -9.9%	2454.95 -15.3%	2730.69 -5.8%	3017.67 4.1%	3234.12 11.5%	3395.4 17.1%
Feb 26, 1993 - first WTC bombing	3370.81	3439.98 2.1%	3540.16 5.0%	3648.18 8.2%	3838.8 13.9%	3881.05 15.1%	4011.74 19.0%
Apr 19, 1995 - Oklahoma City bombing	4207.49	4341.33 3.2%	4628.87 10.0%	4780.41 13.6%	5551.74 31.9%	6094.23 44.8%	6703.55 59.3%

Source: Scotia Capital

The pre-1950 events (1920, 1941) clearly had a three to twelve month negative impact on the Dow. Similarly the Iraqi invasion in Kuwait had a sizeable and immediate negative impact. It must be pointed out that the Iraqi invasion and related upward spike in oil prices occurred as the United States was engineering a significant economic slowdown and months before aggressive Fed rate cuts. This is somewhat different from the current period where the Fed is already in the late stages of easing. If there was ever a catalyst for ensuring a sustainable, generally lower, level of interest rates for a given level of economic growth this is it. In general, there was no evidence of other terrorist attacks restraining capital markets.

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Implications for Market Estimates

Table 2 – Market Estimates and Earnings

	Recent	Year-End 2001E	Year-End 2002E
Canada			
TSE 300	7,100	9,000	10,000
Earnings (458 June Peak)	431	380	380
Dividends	120	120	115
Yield Earnings (@low)	6.07%	4.2%	3.8%
Long Canada 30-Year Bond Yield	5.67%	5.3%	5.4%
Earnings Yield minus Bond Yield	0.4%	-1.1%	-1.60%
Dividend Yield	1.69%	1.33%	1.15%
Valuation P/E (Normalized)	16.5	23.7	26.3
3-Month T-Bills ¹	3.65%	3.30%	3.50%
10-Year Bond Yield ¹	5.29%	4.80%	4.85%
United States			
S&P 500	1,090	1,253	1,441
Earnings	47.1	45.9 ²	59.5 ²
Dividends	17	17	19
Yield Earnings	4.32%	3.66%	4.13%
Dividend Yield	1.56%	1.36%	1.32%
Valuations P/E (Normalized)	23.1	27.3	24.2
3-Month T-Bills ¹	3.43%	2.80%	3.40%
10-Year Treasury Yield ¹	4.84%	4.40%	4.70%

TSE 300 Earnings are normalized excluding extraordinary items

Source: Scotia Economics¹; S&P²

For more than a year our market estimates and earnings have been significantly affected by two facts. First, the lower TSE 300 targets resulted almost entirely from the anticipated collapse in Nortel (September 5, 2000, TSE Sensitivity to Nortel and weekly Quantitative Rankings). We estimate that the TSE 299 (Ex Nortel) closed on September 11, 2001, at approximately 7,733, only 10.29% below the highs recorded in May/June 2001 and the third quarter of 2000. Second, and more basic to the anticipated economic slowdown, we argued that there would be almost no growth in earnings this year and a decline next year. In June, TSE 300 operating earnings peaked at \$458. The current rate of ROE decline is actually consistent with past recessions. TSE 300 ROE fell 77 basis points last quarter to 13.4%, while S&P 500 ROE fell 53 basis points to 21.7%. As a result we have lowered TSE300 earnings estimates to \$380 for this year and next, although the lows are likely occur in mid-2002. Still it is the level and trend of interest rates that we would argue is central to forecasting P/E levels.

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The Portfolio and Sector Emphasis

We have throughout this year published numerous articles dealing with our portfolio. At the beginning of this year we recognized the need to change our approach to structuring the portfolio. Our portfolio system made it possible to high grade the portfolio by selecting only stocks that met a series of tests concerning value, growth, and certain minimum levels of profitability (please see "A Portfolio for All Seasons" *Weekly EDGE*, April 6, 2001).

It was our view that this would be the most difficult year in a decade to make a top-down sector call. It was necessary, therefore, to take an approach to ensuring an adequate level of diversification and extreme discipline that only our portfolio system could help us with, owing to the math involved. Frequent price momentum tilting would then allow us to benefit from a series of sector rotations.

What is apparent about the portfolio structure is its still dominant interest-rate sensitive and defensive nature. The single largest exposure is still financial services, which represents approximately 36%-38% of the total portfolio although this sector is about 30% of the TSE 300 market capitalization. Our bank exposure though is limited to the Canadian Imperial Bank of Commerce and the Toronto Dominion. Insurance companies such as Manulife, Canada Life, Clarica, and Great West Lifeco also have a significant weight. Other interest-rate sensitive names still include TransCanada Pipelines, Westcoast, and TransAlta. We have generally remained overweighted in gold stocks although this is essentially a 5% American Barrick position, which we view as a trading opportunity. We also strongly recommend focusing on integrated oils at this time rather than oil and gas producers, although we expect materially lower oil prices going forward. Specific opportunities include Bombardier, if and only if, investors have a 12-18 month investment horizon. Molsons also continues to record a very impressive combination of value, growth, and level of profitability. Economically sensitive stocks with rapidly falling ROE should in general still be avoided.