

# TIME TO THROW IN THE TOWEL?

## MARKET LOSSES CONTINUE

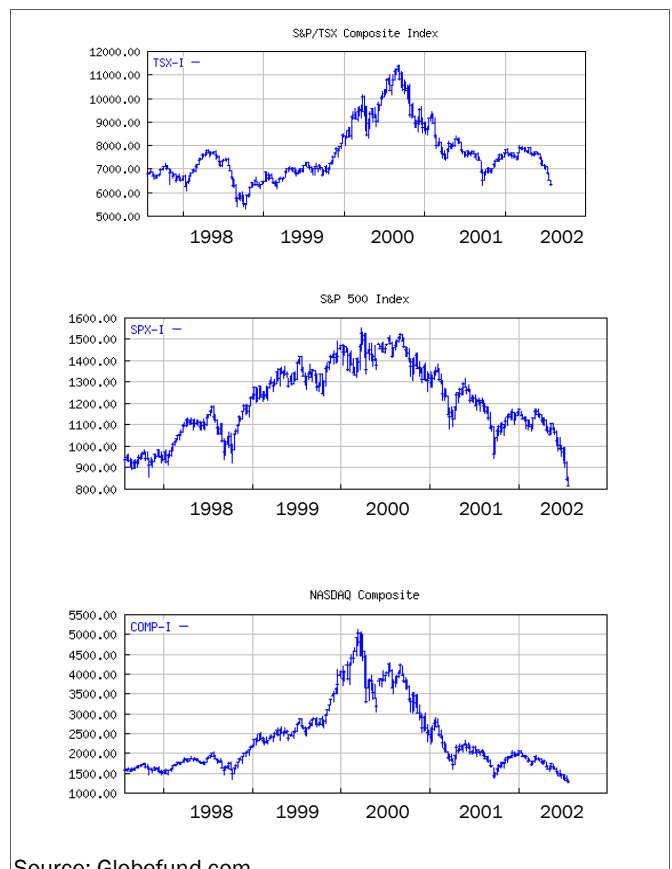
### Special points of interest:

- Last 24 months have been extremely challenging in equity markets.
- Over long term, stock prices are driven by Earnings.
- Macro Economic drivers of Demographics, Globalization and Technology remain firmly in place.
- Monetary Conditions remain stimulative.
- Canada GDP Growth leads G-8 countries.
- Inflation remains well within Bank of Canada target range.
- Corporate Profitability beginning to show signs of a turnaround.
- Markets will rebound; question is not if, but when.
- Based on P/E ratio, markets are approaching fair valuation, but short term volatility will remain.
- The key to successful long term investing is to find an efficient mix of investments that will provide the investor with the highest level of return for the least amount of risk the investor is willing to accept

There can be little argument that the market conditions witnessed over the past 24 months can be described as nothing short of challenging. Many are calling this the worst bear market of our lifetime. The S&P 500 is off its high set in August 2000 by 31%, the TSX Composite is off its high by nearly 35%. The Nasdaq fared worse than either of these indices and has plummeted a staggering 73% from its high. The vast majority of technology and telecom stocks have followed suit.

Given this very dismal scenario, many are asking: What's next? Should I sell now? Where should I be investing? When will the markets turn around? The simple answer to each of these questions is: nobody really knows with any certainty. However, just as two years ago many thought that the market would continue to go upwards forever, today, many feel that the market will go down forever. History has shown us time and time again, that this is not the case. Today's situation is no different.

In the simplest of terms, there is really only one thing which drives stock prices higher over the longer term – earnings. When you buy a stock, you are essentially buying the future earnings stream of the underlying business. The stronger that potential earnings stream, the more investors are will-



Source: Globefund.com

ing to pay for that stock.

There are two types of factors that allow a company to generate earnings: Micro and Macro.

Micro issues are the company specific issues such as management, financial situation, product and so on.

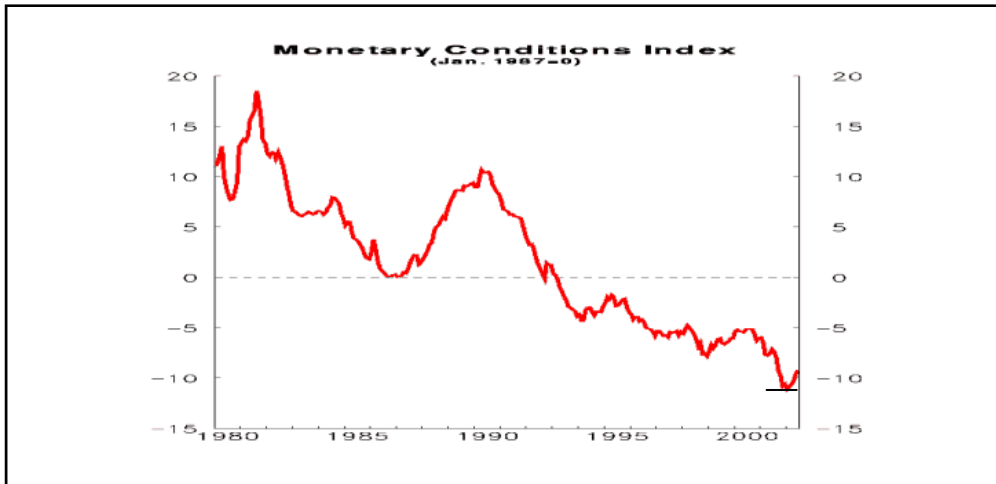
Macro issues are the overall economic and industry specific situations. Since our practice involves managed money products, we will ignore the micro issues. If the

individual investment managers are doing their job properly they will have dealt with these issues in the creation of their investment portfolios.

When looking at macro issues, these can be broken down into short term and long term factors.

There are three major factors driving the economy over the long term. These factors are Demographics, Globalization, and Technology. Any of these occurring on their own would have the

# BANK OF CANADA LOOKING FOR ECONOMIC GROWTH



Source: Bank of Canada

ability to significantly impact investment markets. However, we are in a time when all three are occurring simultaneously. Despite the recent events and market sell off, these long term macro trends remain firmly entrenched. This will allow for a continuation of the long term trend of economic growth for the next decade or so. This should ultimately translate into a return to a rising stock market.

The short term trends in the Macro Economic environment include such things as economic growth rates, monetary and fiscal policy, and inflation. Governments both here and in the US are committed to economic environments of low inflation, balanced budgets and a strong private sector.

Despite recent increases in the Bank of Canada rate, monetary conditions remain stimulative. The Monetary Conditions Index which provides a measure of ease or tightness of monetary conditions in the Canadian Economy remains very close to record lows, indicating that the monetary policy in Canada is very stimulative (see chart above). This indicates that the Bank of Canada is looking to increase the rate

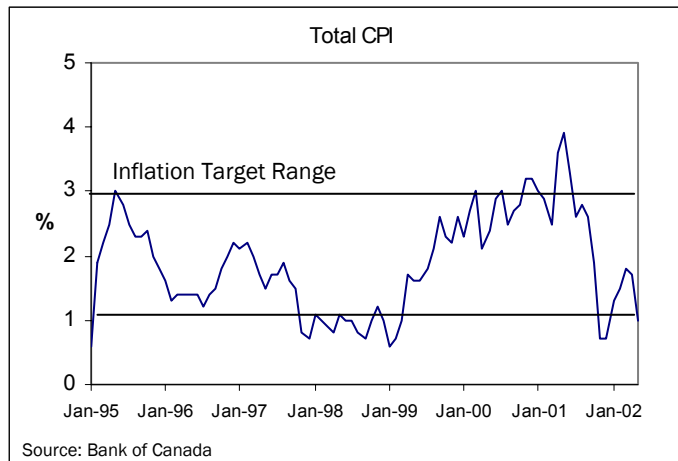
of economic growth within the country which should lead to strong corporate profitability and higher stock prices.

Despite this easiness of monetary policy, the overall level of inflation remains very much in check here in Canada. In May, the Total yr/yr CPI came in at 1%, (see chart below) which is at the lower bound of the Bank of Canada's target range. This price stability, coupled with cost containment measures employed by a lot of companies will enable increasing profit growth once things turn around.

Economic Growth remains strong. In looking at the past 12 months, Canada has

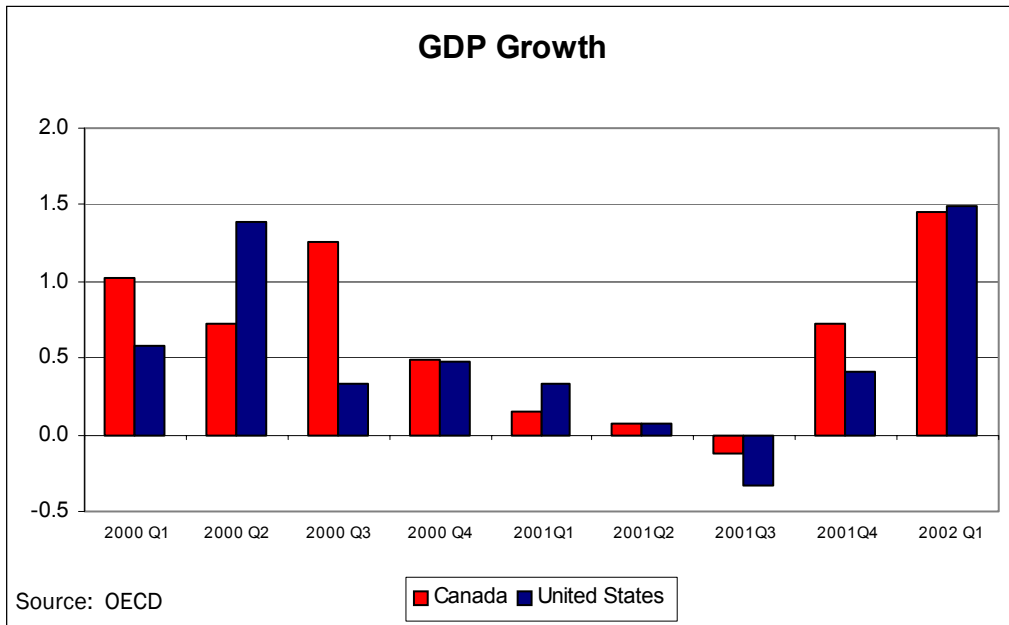
posted a solid 2.1% growth in GDP, which ranks 4th behind Korea, Australia, and New Zealand. The housing market continues to be strong and all signs indicate that the Canadian economy should continue to show surprising signs of strength for the remainder of 2002. This will prove to be very positive for Canadian companies for the balance of the year.

Given this positive economic tone, when will the markets turn around? In the near term, this downward momentum will be extremely difficult to change. There appears to be nothing on the horizon to signify a turnaround. There is the stench of corporate fraud, mistrust and scandal hanging over the markets.



Source: Bank of Canada

*“...all signs indicate that the Canadian economy should continue to show surprising signs of strength for the remainder of 2002”*



On the political front, there is the ever present threat of an escalated conflict in the Middle East. Given all of this, investors have simply had enough, and appear to have thrown in the towel.

Markets will turn around, and will move higher. The question is when. Typically, the market bottom is generally not known until we are 6 to 9 months past it. This time will be no different. Economically, we are in decent, and improving shape, there are signs that a return to improved corporate profitability is not too far off, and may have already occurred. The consensus is that the catalyst for a meaningful market turnaround will be a return of Capital Spending. When that will occur is the big question, with many market analysts indicating that the soonest we will see the return of spending will be Q4 2002 or Q1 2003.

Does that mean that today is a good time to buy? Not necessarily. Valuations remain historically pricey, trading around 15 times earnings on the TSX, and around 17 times on the S&P. Given the current forward earnings estimates on both the TSX and the S&P, it appears that a fair level of valuation would be around 6300 on the TSX,

and 720 on the S&P. We are fast approaching those levels. However, anyone who invests in the short term may be in for a rough ride.

Timing the market is often a fool's game, particularly when one invests for the long term. The key to successful long term investing is to find an efficient mix of investments that will provide the investor with the highest level of return for the least amount of risk the investor is willing to accept. Once that mix is set, it should be constantly monitored to ensure that the investments are within specified target ranges within the portfolio and that the investments are

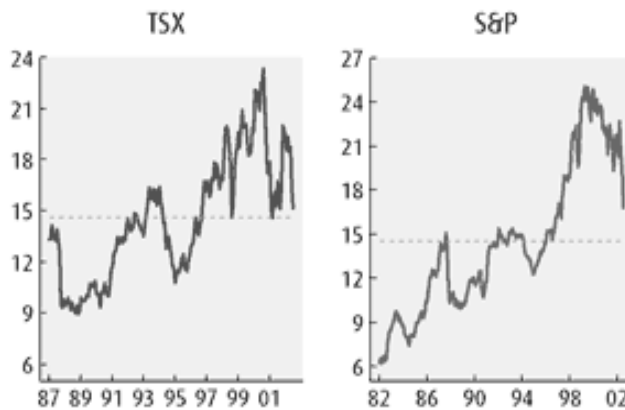
maintaining their original risk return characteristics.

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**For more information on Paterson & Associates and our Portfolio Optimization Service, please contact Dave Paterson at 416-706-5087.**

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#### Current Versus Historic P/E Ratios



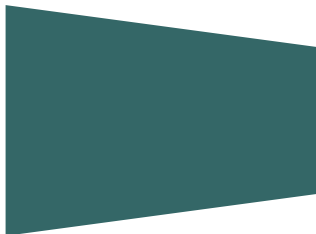
Source: BMO Nesbitt Burns

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## TOP RANKED FUNDS

Rank	Fund Name	Fund Type
1	Sprott Canadian Equity***	Cdn Equity
2	Fidelity Canadian Disciplined Equity***	Cdn Equity
3	Clarica SF Trimark Global Equity	Global Equity
4	CI Signature Select Canadian***	Cdn Equity
5	AGF European Equity Class***	Global Equity
6	CI International***	Global Equity
7	Trimark Canadian Resources	Cdn Equity
8	Clarington Global Equity***	Global Equity
9	Trimark Fund***	Global Equity
10	Orbit World***	Global Equity

\*\*\* - One page Fund Profiles available July 25, 2002.

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