REVIEW & COMMENTARY
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The New Normal

This term is the new buzz word on Wall Street. This is the equivalent of telling investors that things are going to get back to normal with one exception, normal is going to be different. Past prices for equities, homes, private equity LBO's are all going to be different. So where do we stand today- what is the new normal? Are we headed towards a depression? Is this the Great Recession (combination of The Great Depression and Recession)? When will it all be over and what are things going to look like?

When the market first started to unravel, many investors looked at it as an isolated stock market event. But the equity markets are a leading indicator. Not only have equity prices dropped but so have housing prices, car prices and business revenue. The only things that appear to have gone up are taxes, insurance premiums and education costs. So the new reality is that asset pricing around the globe has been re-calibrated to a lower level. But if equity prices are a leading indicator, what has the most recent rally, none more powerful since the1930's, telling us?

In early March, the US equity markets hit a 12 year low. There had been only two other times when this occurred- once was 1974 the other 1932. In the former case, it marked the end of a bear market; in 1932, it was another three months, and more downside, before the market actually bottomed. The past doesn't always predict the future but it is usually a pretty good indicator. Have we hit bottom? Well, we thought we had last November and after that we had a significant rally only to retest this year. In fact, there have been several rallies since the markets high in late 2007. Last November the market rallied roughly 16% and many thought, including us, that we may have found bottom. So what about this time?

One of the reasons the preponderance of investors remain bearish is that the characteristics of this market decline in many ways, has been unprecedented. This recession is most similar to the one that preceded the Great Depression. Both were caused in some part by excessive leverage and exacerbated by short selling. From 1929 to 1932, the market dropped 89% with several bear rallies along the way. According to Bill Ganzel, in the first ten months after the 1929 crash, 744 banks failed. While somewhat fewer than that number had failed during the decade from 1920 to 1929, a total of 9,000 banks failed during the 1930's. Since 2007 the US has had almost 50 banks fail. (It is important to remember that many of the banks in the 1920' and 1930's were very small local banks). Between 1929 and 1932 there were 6 bear market rallies that ranged from 12 to over 100% in measurement- the first rally was 75%. Since late 2007, we have had 3 significant (more than 10%) rallies, the latest just ending a few days prior to the writing of this quarterly. Another similarity is that big business executives, back then dubbed Robber Barons, were as they are today, vilified.

But as similar as these two events are, there are significant differences. The US government, and many global Central Bank counterparts, have spent trillions and trillions on stimulating the credit markets. Deposits now are insured and safe, something that didn't happen in the 1920's and 30's. Not only did investors suffer significant losses, some depositors were completely wiped out. Bank's in major economies around the world are being supported by their governments (except Canada which was recently declared by the IMF to have the best banking system in the world) until they can prosper on their own. This didn't happen in the 1920's and 30's. In the 1930's, the US financial regulatory body imposed restrictions on short sellers (one important imposition was the up –tick rule- something the US reversed in 2007) due to abuses by large investors. The Securities Exchange Committee is now considering reinstating it.

Certainly the greatest difference is that investors these days have access to information 24/7- it hasn't quite been decided whether this is an advantage or a disadvantage. Too much information can be detrimental, if not paralytic. Remember, that bears are boldest when the market is the weakest and vice versa. Remember how many TV interviews per day dealt with technology just prior to the tech bust? Just six months ago, those who thought oil was going to $200 per barrel got a lot more airtime than those who thought it was going down.

Also, cash levels are very high – according to Business Week, as of early March 2009, there was roughly 9.3 trillion dollars in cash and cash equivalents (earning close to zero return) which represented at the time 84% of the market value of US securities. While we were unable to find comparative statistics from the 1930's, however, it would be hard to imagine the market will trace the 1930's down turn further with so much cash on the sidelines. If this market were to trace that decline, that would suggest that there would be enough cash on the sidelines to buy all the US companies at least twice!

Another important difference to the 1930's was the US government was too quick to reverse the decisions that helped stimulate the economy. Decades ago, Japan stopped the stimulus prematurely and has not been able to reach its old highs after 20 plus years of trying. Mr. Geithner, the US Treasury Secretary, has been emphatic that the US government will not take their financial foot off the peddle early; to do so would endanger a *sustained* recovery he has clearly stated. Another difference is we now have a superpower, the US government, under new leadership that is willing to listen. It would appear the new administration is extending every effort to forge new relations and repair old ones.. This economic downturn is not an isolated event and it can't be solved by any government in isolation. However, if the US, China and Europe can lead others, will follow.

So what is going to happen and what is the new normal? An important indicator is that large companies are starting to use the downturn to make strategic acquisitions. At home, we have had Suncor and Petro-Canada do the merger dance. Other companies like Pfizer, Merck, Agrium, Dow Chemical, and IBM have either tried or acquired companies. Most of these deals are done with stock which tells you that those doing the acquiring consider their stock cheap. Bank executives who have received TARP payments started buying shares of their own company with their *own* money prior to the recent uptrend in prices. Time will tell whether they will be right, however, these are good indicators that the market is beginning to turn. There is a lot of fear and potential peril-that isn't new, but it is normal before markets turn. What also isn't new is that we are staying the course.

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