NATCAN WEEKLY MARKER

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A ROCKY START

Markets are off to a volatile start in 2008. This edition of the Marker considers the background to current market action in an effort to provide context to a situation where emotions run the risk of dominating investment decision making. Economic growth over the five years ended in 2007 has been one of the strongest (averaging approximately 5% per year) and most diversified (with over 50% from emerging countries' economies) in history. What's more, inflation remained below the 2.5% mark throughout this period. Developed and emerging countries alike truly benefited from globalization during this period.

It is logical for equity markets to have recorded brilliant performances against such a backdrop. Corroborating market statistics are equally eloquent and frequently referenced. Let us however mention that not only did the main Canadian and American stock markets yield great returns, volatility reached its historical low. Canada most certainly was one of the greatest beneficiaries of these trends, as further evidenced by the strong currency.

TREND REVERSALS ARE ALWAYS UNSETTLING

A trend reversal is lurking over the markets. Investors are expressing their fears in an environment marked by a financial crisis and an economic slowdown in the U.S. The media is sounding the alarm on the risks of economic contagion. Markets may move down only to experience a sharp rebound; in other words, volatility is back. In our opinion, the adjustments taking place at this point within the global economic and financial systems are not only normal, they are necessary. Let us remember that central banks acted to calm inflationary pressures emerging out of a stronger-than-anticipated economy throughout 2005 and 2006. These rate increases are in part what prompted the current financial and residential crises in the U.S. Almost every cycle of interest rate hikes has led to a financial or economic crisis. Historians have logged a dozen of these in the U.S. since 1970 (see table).

Federal Reserve Tightening Cycle	Financial Crisis		Economy
1970	Penn Central	(Jan)	Recession
1974	Franklin National	(May)	Recession
1980	First Penn	(Feb)	Recession
1982	Latin America	(Jul)	Recession
1984	Continental Illinois	(Jul)	Mid-cycle slowdown
1987	Black Monday	(Oct)	Mid-cycle slowdown
1990	S&L Crisis	(Apr)	Recession
1995	Mexico	(Feb)	Mid-cycle slowdown
1997	Pacific Lit	(Aug)	Mid-cycle slowdown
1998	Russia/LTCM	(Oct)	Mid-cycle slowdown
2000	Nasdaq collapse	(Oct)	Recession
2007	Sub-prime	(Aug)	Mid-cycle slowdown

Markets react swiftly to crises. Investors in turn often react to downward market trends with a great deal of emotion. One is best in such times to take a step back and remember that markets discount the future, and thus act as precursors. An economic slowdown and a market correction have already begun; it is therefore best to stay the course - in accordance with a long-term plan - to ensure we can benefit from the imminent recovery.

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Investment opportunities are emerging from the current market turmoil. Markets will anticipate the economic rebound. Implementing now a strong defensive stance would amount to market timing, and could be costly. The year 2008 will most likely favour disciplined investors, to the detriment of speculators.

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FINANCIAL MARKETS

RETURNS AS AT JANUARY 18, 2008 (%)	MTD	QTD	YTD
S&P/TSX	-7.88	-7.88	-7.88
S&P 500	-6.62	-6.62	-6.62
S&P/TSX Small Cap	-7.80	-7.80	-7.80
Russell 2000	-9.13	-9.13	-9.13
MSCI EAFE	-5.33	-5.33	-5.33
MSCI World	-5.86	-5.86	-5.86
DEX Universe Bond	1.08	1.08	1.08

	RATES AS AT JANUARY 18, 2008
CAD/USD	1.03
CAD/Euro	1.50
US Treasuries yield 10-yr/30-yr	3.64/4.30
GOC bond yield 10-yr/30-yr	3.80/4.08
Fed Fund Rate (target)	4.25

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.