NATCAN WEEKLY MARKER

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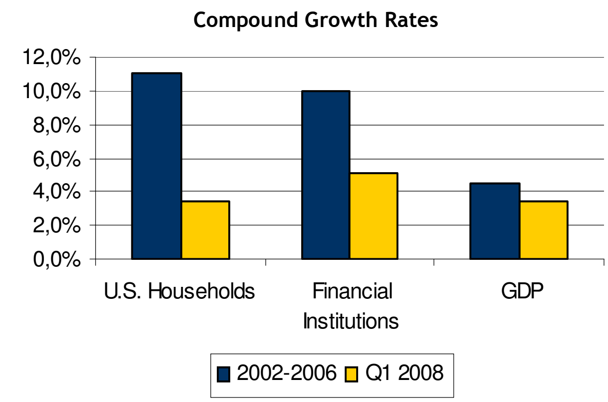
GLOBAL ECONOMIC DELEVERAGING: THE END OF AN ERA

The past weeks will go down as one of the worst financial crises in modern history. What began as a short-term paper crisis 13 months ago has now become a global deleveraging exercise. This week's edition of the Marker reviews the situation in an attempt to provide a contextual backdrop to recent events.

BINGE LEVERAGING LEADS TO INDIGESTION

Global financial markets have been under serious stress for several months now. Across asset classes and geographies, investors have been compelled to face new market realities and downward price revisions. When markets correct across asset classes and geographies simultaneously, they have to be reacting to a set of common factors. Under current circumstances, the dominating factor is deleveraging. Simply put, this is the need to replace borrowed money with equity capital. As trends in recent months have shown, the process can be unsettling and quite painful.



Source: Natcan Investment Management

Any economic system functions like the human body. It must maintain balance between its various sub-systems or risk illness. This analogy is pertinent insofar as recent years have seen strong imbalances develop between growth in leverage employed by households, financial institutions and across the economy relative to GDP growth, as illustrated by the accompanying table.

After more than 5 years of excessive growth in debt, the world has been experiencing forced deleveraging over the past 13 months. The process starts with forced asset sales, placing further downward pressure on prices. The writedowns force investors to raise capital, too often by selling more assets and spreading the pain to a larger group of market participants. As with a patient trying to overcome infection, periods of improvement are interrupted by strong fevers; this was the case last week when truly extraordinary events took place in the markets.

IS THERE AN END IN SIGHT?

Investors, regulators, and policy makers all voice the same question: is there an end in sight? At least three things need to happen for the deleveraging process to have run its course. First, investors need to come clean by selling or writing down dubious assets. This painful process, which forces more losses through their balance sheets, is required to re-establish transparency in the markets and investor confidence. Then, debt must be paid off, and capital reserves rebuilt. This is neither easy nor without pain. Three classes of market participants can absorb capital losses: shareholders, debt holders, or "everybody else", i.e., the government. That is why markets now expect massive government intervention will be required to nurse the sick patient back to health.

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The global deleveraging process that began over a year ago has now created a new pain threshold across financial markets. The positive sign is the fact that the real economy appears to continue to grow, albeit at slower rates. In this challenging environment, investors are more likely to win by avoiding panicked reactions and focusing instead on maintaining investment discipline while looking for signs of further government intervention.

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Senior vice president, Distribution

FINANCIAL MARKETS

RETURNS AS AT SEPTEMBER 19, 2008 (%)	MTD	QTD	YTD
S&P/TSX	-6.14	-10.27	-4.90
S&P 500	-3.12	1.49	-8.28
S&P/TSX Small Cap	-11.40	-17.50	-17.82
Russell 2000	0.85	12.86	4.94
MSCI EAFE	-7.11	-9.88	-17.51
MSCI World	-5.00	-4.55	-12.25
DEX Universe Bond	-1.19	0.39	2.61

	RATES AS AT SEPTEMBER 19, 2008
CAD/USD	1.05
CAD/Euro	1.51
US Treasuries yield 10-yr/30-yr	3.76/4.37
GOC bond yield 10-yr/30-yr	3.70/4.14
Fed Fund Rate (target)	2.00

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.

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