

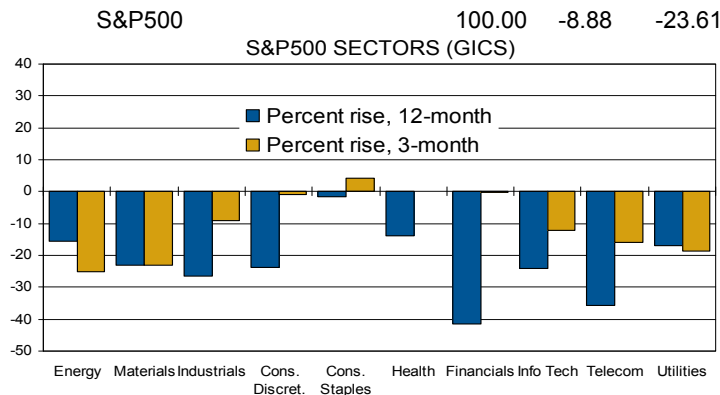
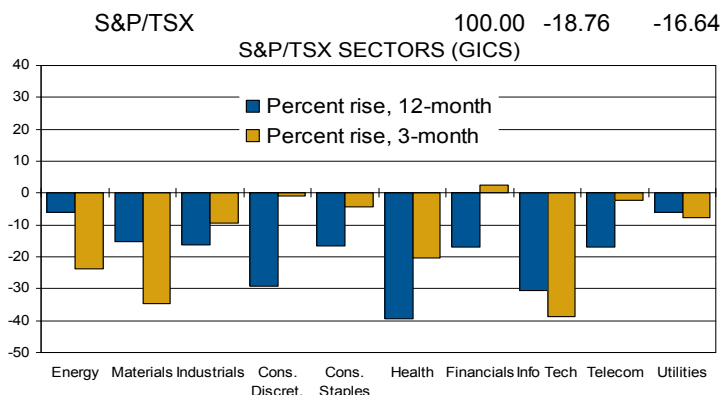
Market Monitor

October 16, 2008

by Dr. Martin Murenbeeld

		September MONTH-END 2008		
		% of	% rise	% rise
S&P/TSX SECTORS [GICS]		S&P/TSX	3-month	12-month
10	Energy	25.43	-23.88	-6.07
15	Materials	17.59	-34.51	-15.15
20	Industrials	5.56	-9.38	-16.21
25	Consumer Discretionary	3.98	-1.01	-29.09
30	Consumer Staples	2.75	-4.41	-16.58
35	Health Care	0.28	-20.49	-39.60
40	Financials	33.32	2.65	-16.77
45	Information Technology	3.91	-38.73	-30.59
50	Telecommunication Services	5.71	-2.18	-16.77
55	Utilities	1.47	-7.73	-5.90

		September MONTH-END 2008		
		% of	% rise	% rise
S&P500 SECTORS [GICS]		S&P500	3-month	12-month
10	Energy	13.36	-24.95	-15.55
15	Materials	3.37	-22.92	-23.12
20	Industrials	11.08	-9.12	-26.35
25	Consumer Discretionary	8.48	-1.04	-23.69
30	Consumer Staples	12.20	4.14	-1.65
35	Health Care	13.09	-0.01	-13.86
40	Financials	15.85	-0.10	-41.35
45	Information Technology	15.96	-12.11	-23.98
50	Telecommunication Services	3.05	-15.74	-35.63
55	Utilities	3.56	-18.74	-17.01



REVIEW

The tables and charts above show how challenging the markets have been in recent months. Note that the only TSX subsector that actually rose over the three months through September was the Financials. Indeed, its 2.7% rise is the only "positive" in the TSX table. With respect to the S&P500 table above, the only positive subsector over the last three months was Consumer Staples, which registered a 4.1% rise. Not incidentally, these are sectors our macroeconomic models had suggested might be somewhat undervalued and therefore could be overweighted.

Of course, much has happened since the end of September. The table on the right indicates how awful the Canadian market has been during the first 15 days of October.

The best performing subsector was the Telecomm subsector, and it was down 6.9%. Energy was particularly hard hit as oil prices have plunged about 30% since September 30.

September 30-October 15	
Sector	percent
TSX	-20.67
Energy	-35.14
Materials	-25.06
Industrials	-18.00
Consumer Discretion	-12.09
Consumer Staples	-7.51
Health Care	-16.64
Financials	-12.99
Info Tech	-9.87
Telecomm	-6.94
Utilities	-11.25

There is little doubt that the TSX and the S&P500 are now "undervalued"; a discounting of current earnings (and 12-month forward earnings estimates) puts each index significantly higher than where they currently sit. Indeed, the

S&P500 was about 40% undervalued by such methodologies at the end of September while the TSX was some 23% undervalued (see charts on the next page).

Yet during recessions equity markets go down; even “undervalued” equities often get sold because: (1) emotions get in the way of rational investment decisions; (2) investors need cash/liquidity as the recession bites into their credit lines and cash flows; and (3) forecasts for further declines abound (meaning the investor is afraid to buy today “because tomorrow everything will be cheaper again”). Ergo, recessions are often great times for those with free cash to invest (note Warren Buffett who has been sitting on a mountain of cash) because values are attractive within the context of a longer investment horizon.

In the current situation, which has developed into the worst financial crisis since the Great Depression, it has become imperative that deep-pocket investors – essentially the government and its agents – step up to the plate and buy assets. And they are doing just that, even if not necessarily at the speed some might have wanted or in a manner agreeable to all observers. Nevertheless, the knowledge that the authorities will continue to do whatever is necessary to stabilize the financial system leads me to conclude that there is an upturn out there on the horizon. We will get through this!

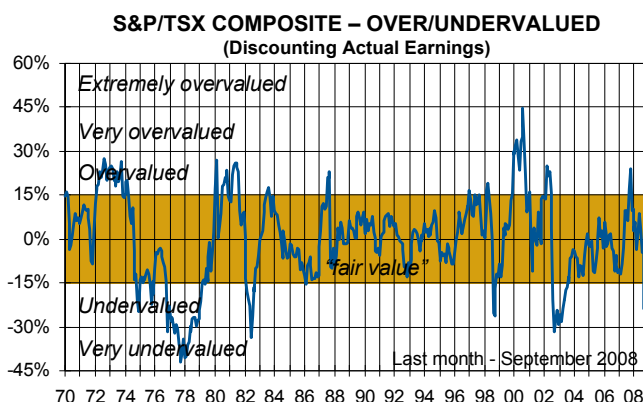
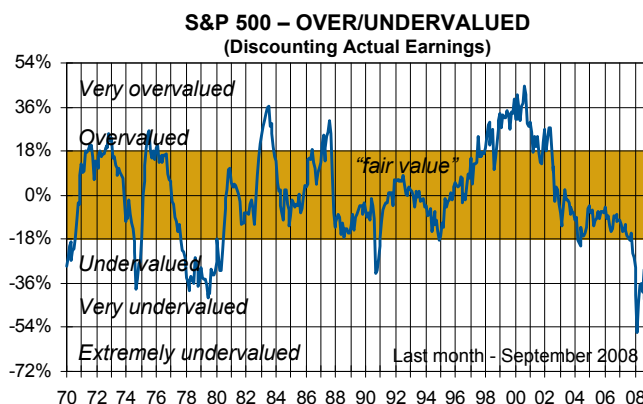
I have suggested elsewhere that the current US recession might have started in January 2008 – those who “date” recessions haven’t made this clear yet, but some have suggested January is the most likely date. That is not as important of course as when the recession might end as markets invariably turn up about five months before a recession ends. If we assume that this recession will be the longest since WWII, it will last longer than 16 months. Ergo, we assume it will end around the summer of 2009. If so, we could potentially see markets begin to recover more fundamentally in early 2009.

It is not clear to me that the markets will necessarily set a new low between now and then, although the wild volatility of recent days suggests this can clearly happen. As it stands, the TSX had declined 40% on October 10 from its high of June 18, 2008. That decline is within 4% of the worst peak-trough decline since 1969. (The TSX declined after the 2001 US recession, despite bottoming during the recession. That post-recession trough was 47.9 % below its peak prior to the 2001 recession. I don’t think such a

decline will be repeated for a number of reasons, including that the TSX was grossly overvalued prior to the 2001 recession on account of Nortel, etc.)

STRATEGY

The best strategy is to stay the course as we are very likely to be within sight of the bottom. Yes, the markets are now focusing on the “recession” and this means more volatility is in the cards. But when P/E data is contrasted with the 10-year government bond yield, it suggests there is a fair degree of “recession discounting” going on already. The S&P500 P/E ratio was 17.5 for the week of October 13 (899 and 51.3) for example, and the US 10-year yield was 3.9%. That “spread” (3.9 - 100/17.5) is -1.6, or about as low as we have seen since the late 1970s.



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