



## **An Update on the Financial-Market Situation From the PWL Investment Committee**

**October 3, 2008**

### **Recent Developments**

The sharp stock-market declines witnessed around the world on September 29 were triggered by the following news:

1. The U.S. Financial Sector Bail Out package failed to be approved by Congress on September 29 (approved today);
2. Two major European financial institutions were taken over by their respective governments (Fortis in Belgium, the Netherlands and Luxembourg; and, Bradford and Bingley in the U.K.).

Investor confidence in the financial system is rattled. The press coverage and the interpretations of these events have been extremely negative, citing the possibility of a “Great Depression” or a protracted economic recession.

### **Equity Markets Work**

In recent months, the landscape of the financial sector was transformed abruptly: some major institutions were merged, some were nationalized, and others went bankrupt. Despite the volatility and the fast-paced transformation of the financial sector, equity markets around the world continued to function properly. Unlike the credit markets, (the Canadian Asset Backed Commercial Paper market, the U.S. Auction Rate Securities market, and the interbank lending market), which have been disrupted for over a year, on the equity market, stocks continue to be bought and sold in large volumes every day, and trades are settled without problems.

The largest volatility factor in this crisis was the failure of the U.S. Congress to approve the rescue package for the financial sector on September 29. This event triggered an 8.79% decline of the S&P500 Index. For the sake of comparison, we have prepared a list of similar—or worse—one-day declines in the market since 1980:

October 16, 1987	-5.16%
October, 19, 1987	-20.47%
October 26, 1987	-8.28%
January 8, 1988	-6.77%
October 13, 1989	-6.12%
October 27, 1997	-6.87%
August 31, 1998	-6.80%



In short, this volatility is very serious, but not without precedent.

### **Short-Term Pain for Long-Term Gain**

We cannot predict the future. However, contrary to conventional wisdom, we do not view these events as being totally negative.

The fact that U.S. banks are writing off impaired assets quickly contrasts positively with the Japanese experience in the 1990s, where it took more than 10 years to clean up the bad loans. This may turn out to be a positive development for the economy because the U.S. financial sector is rapidly purging its toxic assets. We believe these actions will clear the way for a quicker, broad-based recovery in the financial sector and the stock markets.

The problems being encountered by U.S. authorities in trying to stabilize the financial system are to be expected, due to the rapidity with which they are addressing the situation. In our view, both the Federal Reserve and the U.S. Treasury Department are doing the right thing by confronting the problems of the financial sector.

Industry consolidation in the U.S. financial sector can also be viewed positively from another point of view. As financial institutions merge, there is a reduction of counterparty risk with problematic derivative positions, because these merging financial institutions were almost certainly counterparty to some of these transactions.

### **The Missing Link**

Although we are not as negatively inclined as many market commentators, we recognize that there is much work left to do before this crisis is resolved.

The financial landscape has been transformed to better address the sector's problems. The next step must be for the U.S. Government to put in place a mechanism for the orderly disposal of the toxic assets held by financial institutions.

This market volatility could continue for many weeks and months. We cannot forecast when it will end. While we understand that you may be concerned during this difficult period, our advice is to maintain your investment discipline, stay invested, and ride out the market turmoil.