TD Bank Financial Group

TD Economics

Special Report

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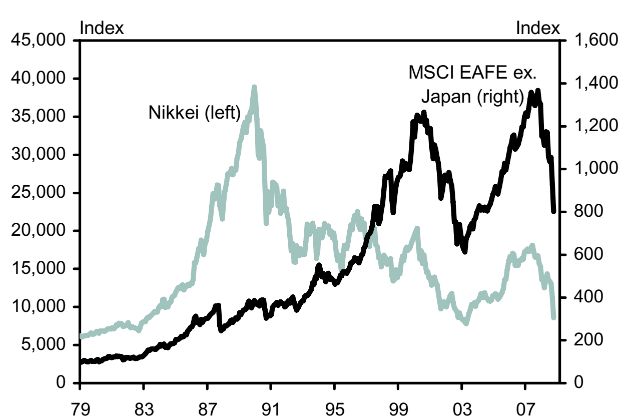
CAN EQUITIES RECOVER?

Global equity markets have suffered a severe correction, with losses over a 52-week period ending on November 12th of 34% on the Canadian S&P/TSX and 40% on the U.S. S&P500. This dramatic decline in valuations amid concerns about a global recession has led to speculation about the ability of stocks to recover. Investors worry about a repeat of Japan in the 1990s and early 2000s, when a protracted period of economic stagnation and bouts of deflation led to extended weakness in equities. Indeed, the Japanese Nikkei index in early November 2008 stood at its lowest levels since 1982. While there are some disturbing similarities between Japan's economic and financial crisis of the last decade and the problems today, there are also key differences that suggest global equities could avoid replicating the Japanese experience.

Similarities to Japan's bubble experience

Let's begin with the common themes. In Japan, a real estate boom in the late 1980s created a housing bubble.

GLOBAL STOCK INDICES



Source: MSCI Barra, Nihon Keizai Shinbun

This report is based on economic perspectives and does not provide financial, legal, tax or investment advice.

HIGHLIGHTS

- **The recent correction in equities has raised concerns about whether stocks can recover**
- **The worry is a repeat of Japan's experience in the 1990s when economic stagnation and deflation prevented equities from rebounding**
- **There are some similarities between Japan's troubles and the financial problems today, but there are also critical differences**
- **Japanese equities were far more overvalued when its real estate bubble burst**
- **Most importantly, the government and central bank policy response this time has been more aggressive and targeted at the root of the problem, which is weak balance sheets of some financial institutions**
- **The differences suggest that a repeat of the Japanese experience should be avoided if the policy response is effective**

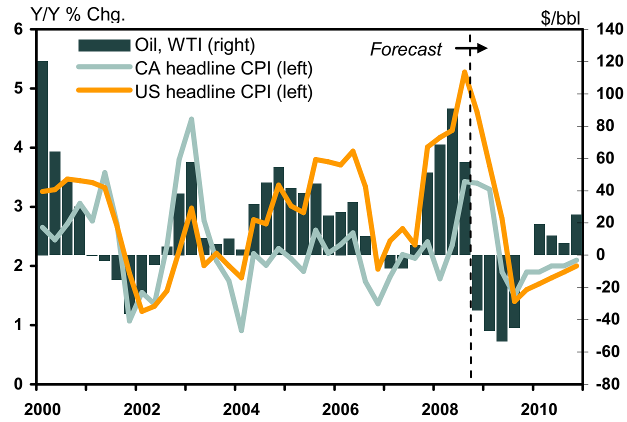
The bubble popped in 1989, which led the domestic banking system to accumulate billions of dollars of bad real estate loans. This impaired the balance sheets of Japan's major financial institutions and led to a curtailment of lending. The financial fallout ultimately drove Japan's economy into recession and the protracted economic weakness resulted in periodic bouts of deflation. It also caused a deep correction in Japanese equities, with the Nikkei falling more than 56% in the three years immediately after the bubble burst – a decline that was never recovered and was actually added to in the years that followed.

The current financial crisis is the product of a global credit bubble that developed this decade, which was characterized by real estate bubbles in several countries – including the U.S., the U.K. and a number of other nations. When the bubble burst, the international financial system was severely damaged and the availability of credit declined. The strains on the global financial system reflected the deterioration in bank balance sheets. Similar to Japan, the financial fallout is likely to result in a global recession. For details, please refer to the latest TD Economics forecast, available at http://www.td.com/economics/qef/fcstrev_1008.pdf. The global recession also foretells lower inflation. Weak demand, the accumulation of economic slack, and the correction in commodity prices brought about by the expectations of the world economic slump all augur that price pressures should weaken in the coming quarters. Indeed, the sharp decline in energy prices could lead to temporary year-over-year declines in consumer price indexes in some countries during the next twelve months. It was in recognition and in expectation of these trends that global equities have declined dramatically.

Differences are critical

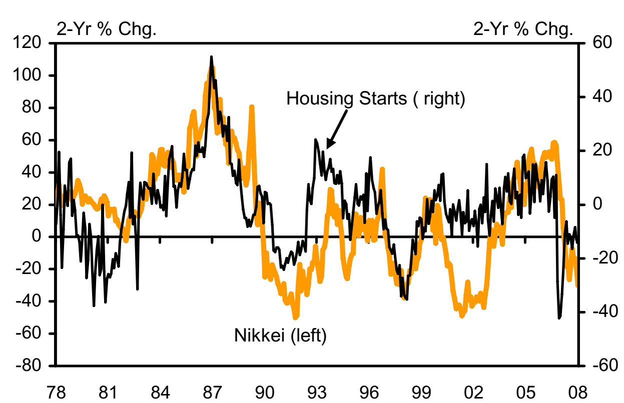
Based on the observations above, one can appreciate why investors may worry that the world economy might be headed for an extended period of economic weakness and deflation that could prevent equities from recovering. However, while there are clear similarities in the origins and nature of the financial crises, there are key differences that are be critical in shaping the future.

HEADLINE INFLATION AND OIL PRICES



Source: Statistics Canada, Bureau of Labor Statistics, Wall Street Journal

JAPAN FINANCIAL & ECONOMIC LINKAGE



Source: Japanese Ministry of Construction, Nihon Keizai Shinbun

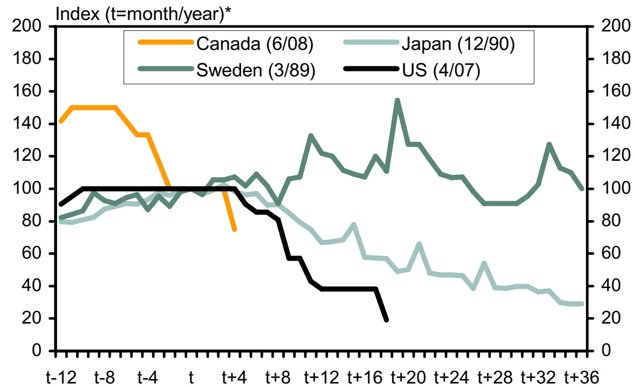
The main difference is how governments and central banks responded to the financial crisis. The Japanese government and the Bank of Japan were slow, at least initially, to respond to the deep seated problems in the banking system. For example, it took five years for the Bank of Japan to lower the overnight rate from more than 8% in 1990 to below 2% in 1995. Moreover, financial institutions also failed to acknowledge and write-off their bad loans in a timely fashion. As a result, bank balance sheets remained impaired for many years. This hampered the flow of credit and undermined the impact of monetary policy. The Bank of Japan ultimately took the overnight rate down to zero, but the lower borrowing costs were not fully passed along to households and business due to limited lending. Consequently, the economy remained weak throughout the 1990s and the accumulated vast economic slack led to bouts of deflation. This created a vicious circle, as deflation also hampered the actions of the central bank. Falling prices meant that real (after inflation) interest rates were not as supportive to the economy as the easing in monetary policy had intended. Indeed, despite the protracted economic slump, real short-term interest rates in Japan were only negative for two years (1997, 1998).

The ineffective policy response in Japan and its economic consequences were extremely damaging to Japanese equities that were extraordinarily overvalued when the real estate bubble popped. The Nikkei had soared by 492% over the 1980s, with double digit annual gains averaging close to 25% in the seven years before the peak.

While the Japanese stocks had been able to sustain double digit gains in prior decades due to rapid economic development, the maturing of the Japanese economy could not support the phenomenal appreciation in the 1980s. This explains the 56% correction that followed during the three years after the real estate bubble burst.

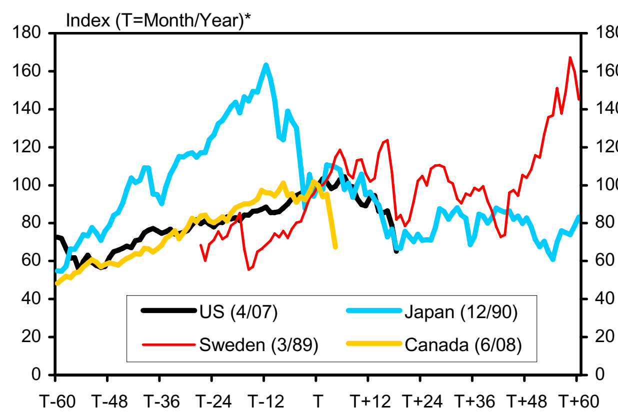
However, the continued trend decline in Japanese stocks from 1994 onwards cannot be solely explained by overvaluation. The main driving force was the corrosive impact of economic stagnation and deflation. The fundamental value of a stock is the discounted present value of future earnings. Earnings are generated from sales domestically and abroad. The problem for Japan was that the economic weakness and falling or flat prices supported weak earnings that prevented stocks from regaining their losses. Moreover, since this deflationary impact affected all asset prices, Japan has suffered from similar movements in prices of real estate and equity prices that exacerbated the economic suffering. The result has been that the Japanese Nikkei stands today at levels below those that prevailed before the real estate bubble developed.

CENTRAL BANK POLICY RATES AND CREDIT CRUNCHES



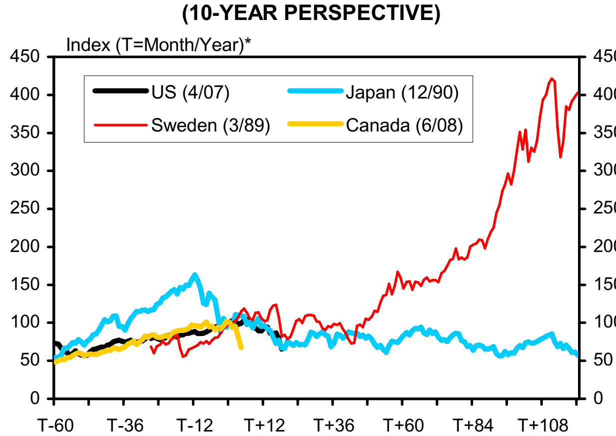
*t=100 at month of peak in home prices; Source: Bank of Canada, Federal Reserve, Bank of Japan, Sviergeș Riksbank

EQUITIES AND CREDIT CRUNCHES (5-YEAR PERSPECTIVE)



*T=100 at month of peak in home prices; Source: Bloomberg

EQUITIES AND CREDIT CRUNCHES (10-YEAR PERSPECTIVE)



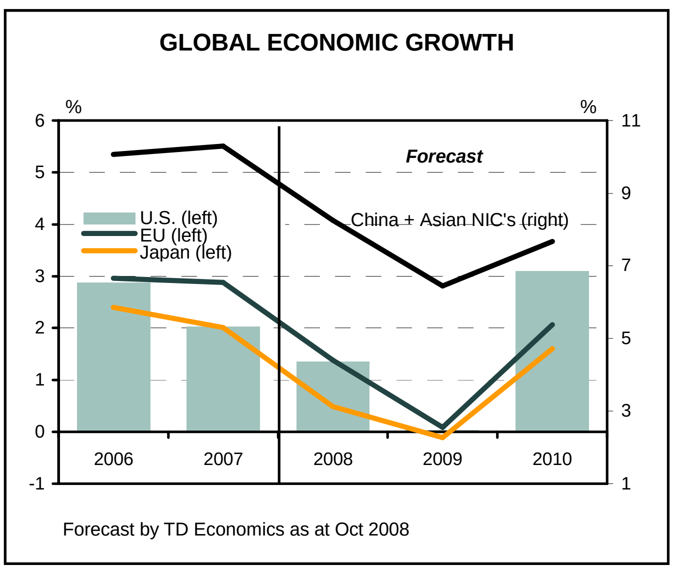
*T=100 at month of peak in home prices; Source: Bloomberg

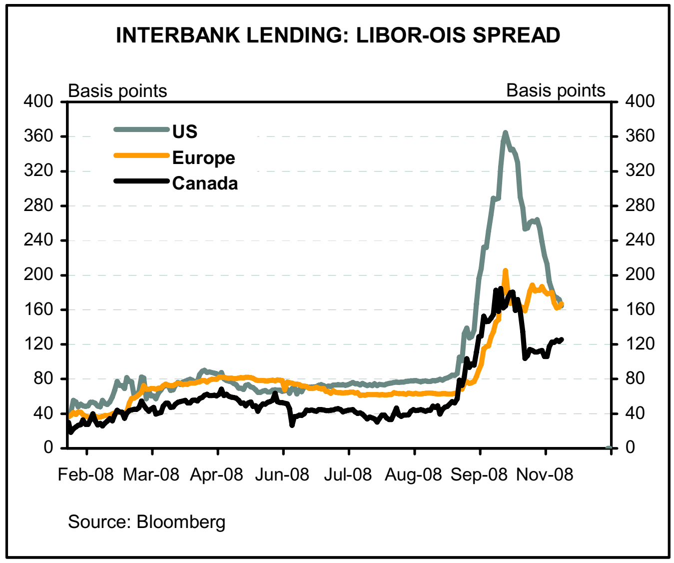
Policy makers have learnt from the Japanese experience

In contrast to Japan, the equity markets of the industrialized world were not as overvalued heading into the recent crisis. For example, while the Nikkei had climbed almost 500% in the 10-years preceding the Japanese crisis, the Canadian S&P/TSX was up 149% when the credit crunch hit in August 2008, while the U.S. Dow Jones Industrial Average had increased 36% and the U.S. S&P500 had gained only 19% over the prior decade.

More importantly, the government and central bank response over the past 16 months to the credit crunch has been quicker and more aggressively targeted at the source of the problem – the weak state of financial institution balance sheets. Monetary policy was eased, with negative real short-term rates occurring in both the U.S. and Canada. Even more critical was the introduction of huge new lending and liquidity facilities to provide additional funds to financial institutions to help them weather the balance sheet problems. Recently, governments around the world have taken dramatic actions to address the balance sheet problems, channeling trillions of dollars of funds into the financial system. To illustrate, the U.S. government and Federal Reserve have announced more than US$3 trillion in measures to help rebuild the balance sheets of U.S. financial institutions. A number of European countries have taken strong actions to recapitalize their banks, including major government ownership positions. The government actions should help bolster the weak balance sheets of many financial institutions. They should also eventually encourage credit to start flowing to a greater extent, which should be accompanied by lower interbank lending rates. If the actions to date prove insufficient, further capital injections and fiscal stimulus will be provided. However, the policy response could take many months to be fully implemented and they cannot prevent the weakening in the global economy.

Nevertheless, if the policy actions have their desired impact, and TD Economics believes they ultimately should, the near-term economic recessions and weak inflation environment should pass in late 2009 or 2010. Although the recovery could prove drawn out, as credit conditions might improve only gradually, the outcome would be positive for equities. On a relative basis, equity valuations could look attractive due to the past sharp sell-off. Real interest rates are expected to be low or in negative territory in many industrialized nations. The low interest rates may also be supportive to equities in terms of relative asset valuations, such as the Fed funds model. And, the turning of the economic cycle should lead corporate profits to begin rising again. In Canada, the corporate profit picture is expected to receive an added boost from a renewed rally in commodity prices that could come in late 2009 or 2010, but a rally falling well short of the prior peaks. The main message is that the rise in earnings should support a modest rally in equities if price-to-earnings ratios do not change, or might fuel a major rally if price-to-earnings ratios rise significantly from current levels.





Skepticism is natural after the recent correction

Given the steep equity correction that has just occurred, some may be skeptical about the ability of stocks to rebound and some will fret about a repeat of the Japanese experience where stocks cannot fully recover. At this point, it is useful to introduce another historical reference that counters the Japanese experience. The Nordic countries experienced a real estate bubble in the late 1980s that led to a more than 30% correction in the Swedish stock market over the two years that followed. The Swedish government policy response was to nationalize the banking system to restore its balance sheets. The successful policy actions eventually proved extremely positive for equities, which recovered all of their prior losses by 1993.

This is not to say that financial markets will respond the same way again. Each financial crisis is unique. The most distinctive quality of the current problems is the global nature. And, while there is some preliminary evidence that the current credit freeze is starting the thaw, it is early days. The key indicators to watch are the interbank lending rates and other credit measures, which are posted on the TD Economics website under 'daily financial indicators' (http://www.td.com/economics/comment/daily_fin.pdf), for evidence that the policy actions are working. Nevertheless, history does suggest that the policy response should eventually be stimulative to the economy and equities.

Conclusions

So, what are the main messages? The recent deep correction in equities is reminiscent of financial crises in the past. The unique character of the current bear market is the global nature of the rout in stocks, which reflects the international integration of the world economy and financial system. No one can predict when equities will reach a bottom, but the key question for long-term investors is whether equities can recover over the years ahead.

The Japanese experience shows what could happen if the government and central bank policy actions fail to diminish the problems in the financial system – the outcome would be economic stagnation and deflation that would likely prevent a recovery in stocks. However, the Swedish experience highlights that an eventual economic recovery and a rebound in equities should occur if the balance sheets of financial institutions are repaired in a relatively timely fashion.

With respect to these two potential scenarios, we believe there is likely to be a global recession and the possibility of a short period of deflation, but the government policy actions should eventually help to restore the global financial system. This will be accomplished in three key ways. First, some governments are injecting capital directly into bank balance sheets. Second, increased liquidity facilities are providing the financial system with additional funds, which helps firms to weather the storm and gives markets time to sort out the repricing of financial assets. Third, governments are likely to introduce additional fiscal stimulus packages and easier monetary policy to bolster their economies during times of weakness. All of this is ultimately good news for equities, although the Swedish experience highlights that the recovery could take an extended period of time. It should also be stressed that markets could continue to experience considerable volatility in the near term, as investors assess the extent of the global recession and the effectiveness of the government policy response.

Craig Alexander
VP & Deputy Chief Economist
416-982-8064