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Dear friends and clients:

We have all had some time to assess the financial market events of the last year and for those that may not be aware the fall in equity prices in 2008 was the 2nd most severe experienced in the last 200 years, comparable only to the 1929 crash. The questions that follow are whether it is over and what impact will this have on the real economy.

Prior to September 2008 the US economy appeared to be deteriorating slowly however the shock of the Lehman Brothers bankruptcy triggered a sequence of cascading events that have made matters considerably worse. Given that the US is still the largest of national economies at 32% of world GDP, a severe problem there inevitably radiates to others. In this note we will concentrate on the US given its importance for others.

As we described in our letter to you in October, the Lehman Brothers failure undermined the large and very important market for commercial paper in the US. This led to a serious reduction of credit available through normally efficient channels and placed huge demands on the banks to make up the shortfall. They in fact could not deal with these demands without help and the Federal Reserve was obliged to support credit markets in a variety of ways.

Consumer and business confidence collapsed as stock markets fell. Spending, particularly on discretionary items seemed to come to a halt as consumers became decidedly more cautious. The business community faced with weaker sales and tightening credit began to defer restocking. Sharp currency movements during this period further complicated matters for cross border transactions.

It should therefore come as no surprise that activity during the 4th quarter was severely impacted. As a consequence the economic data that we have begun to see for the period is quite poor for the US and many other countries. In November, industrial production fell 5.5% in the US over the 2007 level. Significant declines have been reported in most countries. While the drop in activity in the US was widespread, automobile and truck manufacturing were particularly hard hit with declines of more than 20%.

December retail sales fell 7.9% over last year. Excluding automobile sales and adjusting for a 35% drop in sales at gasoline outlets due to the sharp drop in oil prices, sales were off 2% over the prior year. Early reports for December sales for broad line and soft-good retailers indicate comparable store sales fell 1.5%. Wal-Mart’s US sales grew 4% while Costco fell 2%. In Costco’s case lower gasoline prices pulled sales 4% lower. Macy’s experienced a 4% decline in December but indicated that the holiday shopping season ended with strong sales in the fourth and fifth weeks of December despite adverse weather and a

slow start to the month. All this is to say that given the economic tremors of recent months we believe these results are unsurprising and indicate some level of stability.

The most serious area of concern is higher unemployment. Jobs and personal incomes account for over 70% of economic activity. Employment conditions deteriorated sharply in the 4th quarter with a loss of 1.9 million. Up to December the cumulative job loss has been 2.8 million. During the last 4 recessions such losses have ranged between 1.6 and 2.7 million. During the 1979-82 recession job losses amounted to 3% of the preceding peak's employment. Given the severity of current conditions it is fair to assume further declines similar to that experienced in 1979-82, which would bring cumulative job losses to 5.2 million and an unemployment rate of 9.3% by year end.

Before going too far beyond these events we should note that they have elicited an enormous response from the Federal Reserve and US Treasury Department. Their efforts have averted the failure of various institutions, such as Fannie Mae and Freddie Mac, which are the largest sources of mortgage funding in the US. They have with the help of the Federal Deposit Insurance Corporation kept depositors' savings whole and helped to recapitalize banks.

A further government response is being crafted and should be in place within a month. This includes a large package of stabilizing and stimulative fiscal measures from the federal government. The estimated dollar value of these measures could approach $700-$800 billion or about 5.5% of annual GDP.

Our objective is to develop realistic scenarios to understand the possible economic outcomes of this crisis. To do this we have built scenarios for the US economy for 2009.

Our base case assumes a fairly severe loss of employment as described above with unemployment peaking at 9.3% by year end 2009. In that event, personal incomes should still grow 0.6% in 2009 after considering the loss of income for the unemployed and a slight improvement for the 140 million still actively working. We assume a $200 billion personal tax cut which would contribute to an improvement of disposable income by 2.7%. We calculate that a drop in oil prices from an average of $100 per barrel to $60 would help consumers with savings of $160 billion. Another benefit may come from recent declines in mortgage rates from 6.25% to 5%. We assume a $20 billion annualized benefit should $1.5 trillion of mortgages be refinanced.

The net impact of the above would provide consumers a gain of $450 billion of additional spending power which compares to average increases of $450 billion in recent years. This level of income growth could support a 0.5% increase in personal expenditures while allowing the personal savings rate to rise to 4%. We further assume a drop in investment activity of 10%, growth in government spending of 7.5% and a reduction in the trade deficit of $235 billion to $370 billion as oil imports cost considerably less. The bottom line would mean sub-par growth for nominal GDP at close to 2% but growth nonetheless. Should inflation remain weak much of this gain would represent real growth.

More difficult conditions would ensue should households decide to spend less and increase their savings rate further. Given that households have experienced a decline in net worth of an estimated $11 trillion or 18% due to lower home and share prices, it would not be surprising to see a more aggressive effort to save. Were the personal savings rate to move quickly from recent levels of 2.8% to 8%, this would result in about $400 billion less of consumer expenditures compared to the above scenario and cause a decline in nominal GDP of between 1-2%.

Under current circumstances, the first series of assumptions for growth in the economy may appear optimistic but we believe this scenario is within the realm of the possible. Two key factors will affect the outcome. The first is the degree of stability in the employment markets and second is our assumption that

credit markets continue to stabilize. With regards to the latter, we point to a number of factors that indicate this is underway.

- Commercial paper issuance in the US has resumed. Outstanding balances have returned to the level of $1,760 billion after shrinking $365 billion in the wake of the Lehman Brothers bankruptcy. Interest rates for A1 commercial paper have fallen from their October peak of 4.7% to 1.2%.
- The key reference rate in the London inter bank loan market, LIBOR, has fallen from over 4% to 1% indicating a return to more normal conditions.
- European corporate bond markets are experiencing close to record levels of issuance.
- Corporate bond issuance in the US has increased and reopened to large issues such as the recent $4 billion, 30 year bond issued by GE.

Turning to bond markets, we see considerable risk in government debt. US short rates are close to 0% while the 10 year issues offer 2.3%. As economic activity improves we expect the full government yield curve to rise causing losses in virtually all government instruments. Investment grade corporate bonds of 5 year term continue to trade at elevated spreads. However given treasuries yield 1.5%, these corporate instruments offer very modest yields of 3.8%. High quality telecommunication shares are far more attractive with dividend yields that range from 4%-8%.

Corporate profits will of course be negatively affected given current conditions. Third quarter profits were 9.2% below 2007 levels and should experience a further drop in the 4th. To date, bank profits have suffered most but the wider corporate sector will see weakness in the 4th quarter. S&P 500 EPS for 2008 are estimated to have fallen 20% to $69. Excluding the financial sector, consensus earnings were flat. Considering our 2009 range of GDP forecasts of either negative or at best subpar GDP growth we find consensus estimates of 7% profit growth for 2009 to be optimistic. We do believe that the financial sector will show improvement but oil and gas producers will suffer due to lower prices as will others in the materials sectors. Using a range of earnings of $60-75, (the latter figure being consensus), the S&P 500 trades at 11.2-14.0x 2009 profits. We find this valuation quite reasonable for clearly depressed profits. A longer term perspective would suggest that profits could double over the next 5-7 years which would make current share prices very attractive.

We continue to emphasize several important sectors in our portfolios including telecommunications, energy and health care. Telecommunications companies are appealing because of their stable revenues and profits as well as the growth we envisage particularly in mobile data services. Companies such as Vodafone, France Telecom and AT&T trade at very reasonable valuations, offer very high current dividend yields and hold positions in their respective markets that are difficult to challenge.

In the energy area we believe that recent declines in oil prices will prove excessive. While softer demand has created some oversupply conditions, we believe this will be temporary as excess capacity remains limited and OPEC controls a very large portion of production. The industry still faces enormous pressures from production declines and must drill to maintain and grow capacity. Oil and gas producers such as Petro-Canada, Talisman, Nexen and others offer a rich base of developed reserves and trade at valuations that significantly discount their assets.

The pharmaceutical industry is a sector that offers stable revenues and considerable growth potential. We believe that important advances in the science of drug development continue to be made and have not yet been fully reflected in new commercial products. An aging population and enormous unmet needs remain around the world and this industry has targeted to serve them. Valuations are at historically low levels and companies such as Pfizer, Astrazeneca, and Sanofi offer attractive current dividends.

The financial sector remains a problem as international banks are about to report year end results that will likely include additional losses from 4th quarter trading positions. The impact of these on their capital base will be an issue that markets and regulators will have to assess. Beyond this however, we note that the provisioning for loan losses has been such that banks have created reserves that exceed the current level of non-performing loans. This will make for more normal provisioning next year and beyond thus gradually allowing income statements to return to normalcy. Should this be correct, many large international banks are trading at less than 5 times more normalized earnings and significant discounts to their book value. It is clear that regulators see the core value of these institutions in our economic lives and will continue to offer them whatever support is required.

We believe that while conditions remain troubled it may be difficult to comfortably commit to equities however it is the asset class that offers the greatest potential. Today share prices reflect forced liquidations, tax loss selling and fear. Prices fail to reflect the value of great businesses that will continue serving the needs of our global economy.

Letko, Brosseau & Associates Inc.