In just a few short months the prospects for the world's economies have deteriorated with incredible speed. The problems that started in the U.S. sub-prime market and with a few financial institutions have metastasized into all sectors of the global economy. Virtually every developed country is experiencing troubled financial institutions, falling real estate prices and slowing consumption and investment. The seriousness of the underlying economic problems are underscored by the unprecedented response of governments around the world; massive bailouts of financial institutions, aggressive reductions in interest rates and unparalleled increases in the money supply.

As we have stated in many of our past newsletters the consequences of asset bubbles fuelled by debt can be very serious and long lasting. Given the amount of leverage that was created and employed over the past several years a catastrophic deflationary spiral could develop. As debt in all of its forms gets unwound; asset prices, investment and consumption fall into a steep decline from which it is very difficult to emerge. The gravity of the problem cannot be understated and aggressive responses to the deepening crisis are a necessity.

Global economies are undoubtably in the midst of a serious and deepening recession. Falling industrial production, deteriorating retail sales, plunging consumer confidence and declining housing values are all evidence of the serious economic malaise enveloping the world economy. European and U.S. GDP fell in the third quarter and are expected to shrink further in the fourth quarter. We would suggest that this period of contraction will continue throughout 2009 with a slow and gradual recovery starting in the latter half of 2010. These serious economic problems were a long time in the making and will take some time to work out.

Canada is not immune from this economic storm. Historically, when our neighbours to the south catch an "economic cold" we eventually suffer an "economic pneumonia" as

approximately seventy per cent of our exports are to the U.S. In addition, Canada's economic growth during the past few years has been given a large boost from the rapid rise in commodity prices. As commodity prices continue to decline in response to the "demand destruction" currently underway Canada's economy will undoubtably start to slow down at a rapid pace. Indeed, the combination of a serious American slowdown and the steep drop in commodity prices make Canada extremely vulnerable to a serious recession.

Stock markets that only a short time ago were believed to grow to the sky have fallen back to earth with a resounding thud in response to the current environment. Fear and uncertainty have replaced greed and optimism. As the table below indicates stock indices around the world have fallen sharply over the past year.[1]

Table 1

Returns of Major Equity Indices

	One Year Return
U.S.	**-40.6%**
Canada	**-38.6%**
U.K.	**-34.2%**
Japan	**-45.4%**
China	**-59.6%**

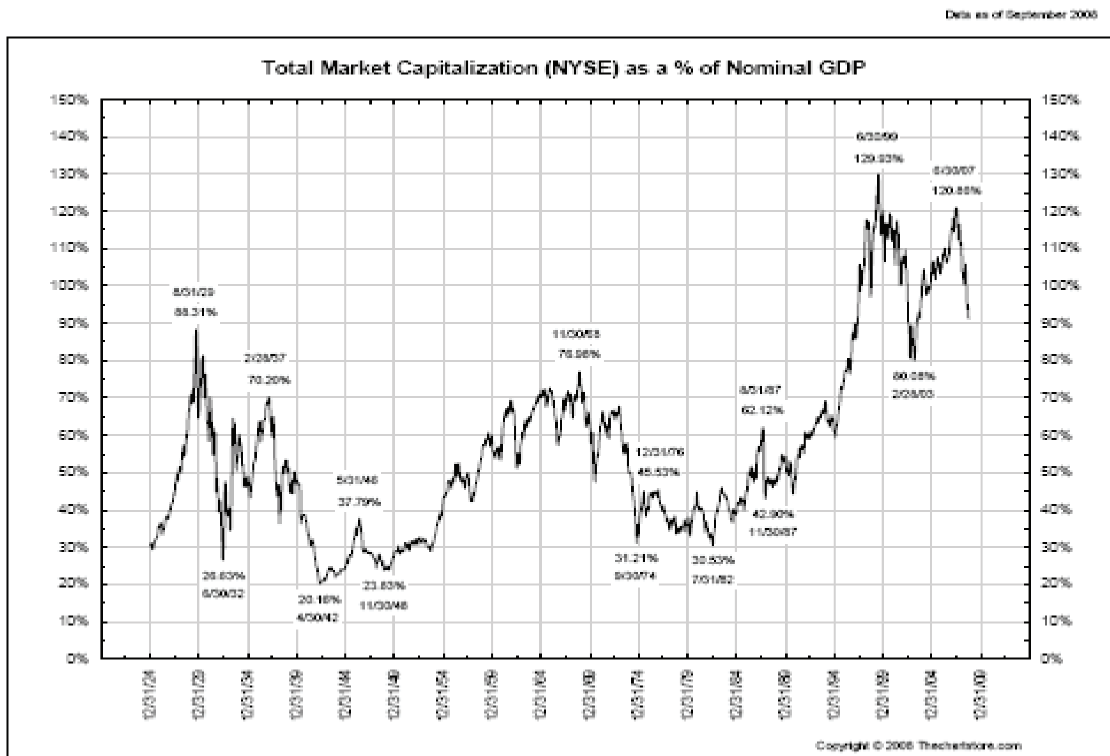
The majority of these losses have occurred in the past two and one half months. In recent weeks stocks have accelerated their declines with only brief rallies in between. Equity prices ultimately respond to the outlook for corporate earnings. Investors are starting to recognize that not only third quarter earnings have been disappointing but that the outlook

[1] As of November 14, 2008

for the fourth quarter and 2009 have now gotten worse. The prospect of declining earnings will continue to weigh heavily on share prices.

The question many are asking today is "how low will stocks go?" The true answer is that no one knows. A better question may be "how low can equity prices go?" The graphs below, courtesy of The Chart Store, indicate that share prices can still fall by quite a substantial amount.

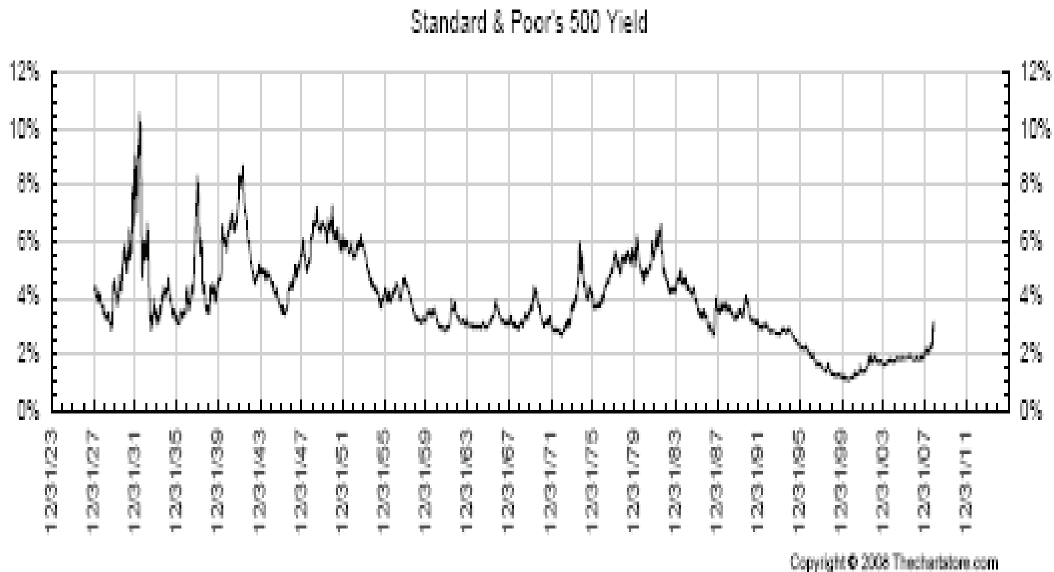
Chart 1



As of mid-November we estimate that Total Market Capitalization as a percentage of Nominal GDP is approximately seventy to seventy five per cent. This figure is substantially above previous market bottoms. As we can see in the chart above the market capitalization of equities fell to approximately thirty per cent of Nominal GDP at the market bottoms of both 1974 and 1981. Thus a further decline of sixty per cent is not without precedent!

Chart 2 is a graph of the S & P 500's Dividend Yield since 1923. As the graph illustrates today's yield of 3.4% is substantially lower than other market bottoms. The dividend yield approximated 6% in the 1974 and 1981 bottoms. The S & P 500 would have to fall another forty three per cent to equal the six per cent yield of the 1974 and 1981 market lows.

Chart 2



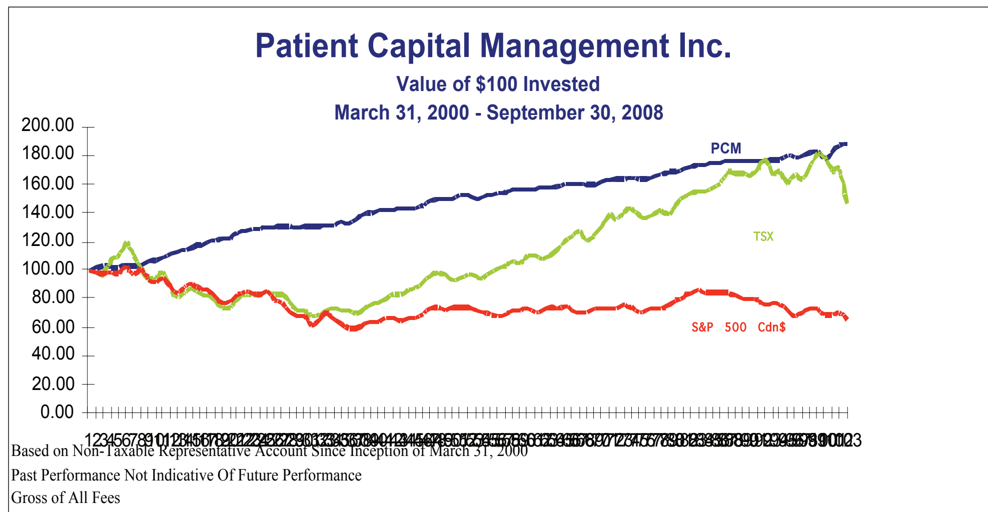
While we can't predict how low stocks will fall there is historical evidence that they can fall another forty to sixty per cent from current levels. We believe that the current problems are as deep and serious as the economic crisis of the mid seventies and early eighties. Thus equity declines of the magnitude reached then are not entirely out of the realm of possibility.

For PCM and our clients the current environment spells tremendous opportunity. The decline in equity prices has resulted in some very attractive valuations. We have been able to purchase high quality global businesses at compelling valuations in the past month. We anticipate that we will continue to add to our current holdings and uncover new investments that meet our criteria. We hope to deploy the remaining sixty per cent of our

cash balances as opportunities that meet our standards of high quality businesses trading at a substantial discount to their intrinsic value present themselves.

The events of the past few months have validated our approach. We have always simply stated and followed what we believe with unshakeable confidence; that valuation is the key driver of future returns, that risk should be a primary consideration when assessing potential returns and that excessive leverage in any situation is extremely dangerous. These beliefs have stood the test of time and have augured all of our clients very well. As Chart 3 below illustrates, one hundred dollars invested with PCM since our inception would have grown at a higher annual compound rate with far less volatility than the major North American indices.

Chart 3



Based on Non-Taxable Representative Account Since Inception of March 31, 2000
Past Performance Not Indicative Of Future Performance
Gross of All Fees

For the past several years we have effectively advocated doing nothing. Our message has been that it is indeed alright to do nothing and wait for opportunities to present themselves. However, now is the time to "get busy!" The next several quarters are likely to be quite difficult but out of these difficulties will emerge the opportunity to create portfolios of great

businesses that will offer the potential for a substantial return over the next five years. For the first time in a long time we are starting to feel excited about the returns available to the prudent and patient investor!

Vito Maida
November 17, 2008