



## Economic outlook: Recession, recovery or stagflation?

In this interview, Benjamin Tal, Senior Economist, CIBC World Markets Inc., discusses the investment implications of sluggish growth and rising inflation.

### What is the outlook for economic growth in the U.S. and Canada for the second half of the year? And, are we seeing a recession?

Economic growth in the U.S. will remain weak through the second half. We project flat growth for the U.S. and below-potential growth for Canada. In general, we expect another six to eight months of weak economic activity, with recovery becoming the story sometime in 2009.

While the "official" definition of recession is two consecutive quarters of negative growth, that becomes clear only in hindsight, and is really only a tool for economic historians. We must admit that if it feels like one, and looks like one, it probably is one.

### Inflation has appeared on investors' radar screens as a serious factor in making investment decisions. What is feeding inflationary expectations?

Inflation has indeed become a major issue for both investors and policy-makers. June's 5% headline inflation rate in the U.S., for example, was the highest that it has been in 17 years, and we expect it to ratchet up to 6% in the fourth quarter.



Its Canadian equivalent is poised to move above 4% by the first quarter of 2009. And this is a global trend. A number of complex, interrelated influences are driving the current bout of inflation. Soaring energy costs are a major culprit, of course, including their subsequent effect on transportation and manufacturing inputs, all leading inevitably to rising consumer prices.

### With the combination of slow growth and rising inflation, has "stagflation" returned?

Over the past 60 years, the worst episodes of global stagflation (rising

inflation coupled with flat growth) have followed major oil supply shocks. Today, strong global demand is behind soaring prices. Because we still expect global economic growth to remain near 4%, even in 2009, commodity prices should remain high for the foreseeable future.

Many years of very low inflation are allowing central bankers to respond much less aggressively to inflationary challenges than in past episodes, tempering the resulting impact on GDP growth. The major central banks of the developed world, for example,

*Continued on Page 2*

### In this issue

**2** How to screen for blue-chip value

**3** How to stay focused in volatile markets

**4** View your accounts the paperless way

## Economic outlook

Continued from Page 1

left interest rates unchanged in August, while voicing continuing concern about the upside risk to inflation. So it looks like at least a mini-stagflation will be with us for a while.

### How can investors position their portfolios to mitigate the risk of the slowing domestic growth, while hedging against the risks of rising inflation?

Investors are right to worry about inflation. Historically, nominal returns in the U.S. and Canadian equity markets generally have failed to fully compensate for inflation. However, this has not been true for all sectors. Precious metals and related equities are thought of as good hedges against inflation. Real equity returns for gold and silver companies historically have improved during periods of higher inflation. In contrast, financial and merchandising stocks show weakening real returns as inflation rises.

In the current environment, the resource-laden Canadian market should continue to post solid returns. Global growth is being driven by the developing nations, and their demand for commodities is pushing up prices.

As a result, global growth is much more closely correlated to the Toronto market than New York.

The correlation is most noticeable in individual TSX sectors such as materials and industrials. Sectors like consumer staples, on the other hand, are more attuned to the North American economy and, more broadly,

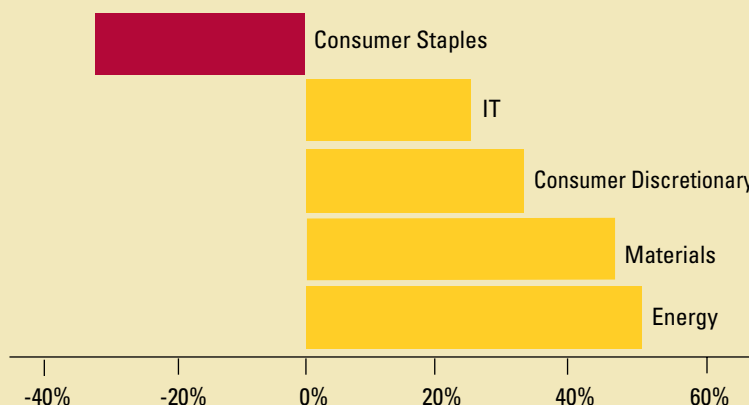
G-7 growth, which we expect to remain soft well into 2009.

In summary, strong growth and low inflation made equities an easy winner through the 1990s and into the first part of this decade. But stagflation means that sector selection will be increasingly critical to portfolio performance from here on. **IE**

## Canadian equities well positioned for growth

With its heavy weighting of energy and materials stocks, Canada's S&P/TSX Composite Index stands to perform well, as global economic growth continues.

### TSX Sector Correlation with World GDP (annual correlation since 1984)



Source: CIBC World Markets, "Stagflation, Stocks, and Sector Selection," StratEcon, July 30, 2008

## How to screen for blue-chip value

During periods of stock market volatility, many investors look to blue-chip stocks for investment opportunities. The prices of these large, fundamentally sound stocks may be affected by market events, even though their underlying value has not changed. In fact, a down market may represent an opportunity to add to your blue-chip holdings at extremely attractive prices.

Although the definition of a "blue-chip" stock may vary, such stocks share a number of key characteristics. These are shares of companies with a

large market capitalization, a strong and recognizable business franchise, a variety of revenue streams, a history of steady and growing earnings, strong cash flow, and a consistent and increasing dividend yield. They are among the most widely followed, researched, reported, and analyzed publicly listed companies.

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# How to stay focused in volatile markets

**W**hen major stock indices undergo periods of fluctuation, some investors may be tempted to move out of the markets entirely and into cash or cash-equivalent assets such as Treasury bills. However, that may be precisely the wrong move to make. Selling based on emotion has the potential to skew long-term portfolio objectives, and might also have tax implications.

Historically, stock markets have rallied from deep slumps in a relatively short time. Bear markets typically last an average of 14 months and take about 12 months to recover losses. During that time, the market may, in fact, present some valuable buying opportunities.

You can use the following guidelines to help you keep a healthy perspective during episodes of market volatility.

**Keep your emotions in check.** Take the daily business news headlines with a grain of salt. Ask yourself whether there is a strong portfolio, tax, or financial-objective reason to sell your holdings. Has your tolerance for risk really changed that much?

**Stay focused on goals.** Before you take any action, calculate the effect on longer-term goals and portfolio structure. Selling at the bottom and buying at the top significantly dampens long-term returns.

**Avoid rebalancing "on the fly."** Adjust your portfolio only if established asset weightings have exceeded your previously defined limits, pushing your portfolio to an undesirable risk level.

**Exercise discipline and patience.** Market slumps tend to be relatively short-lived and losses are typically recaptured in a few months. Bull markets continue for a relatively long time. No one can

## INVESTING STRATEGIES

know in advance when one will end and the other will begin.

**Search for new opportunities.** Broad market sell-offs typically reveal opportunities to buy fundamentally sound companies at an undervalued price in a variety of sectors and geographic regions.

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## Understanding short-term trading strategies


When they think a stock's price may go down, sophisticated traders sometimes use short-term trading strategies. Here are two of the most common. Note that these strategies may not be appropriate for all investors. Before implementing any strategy, be sure you are aware of the potential risks.

**Stop-loss orders.** Stop-loss orders are used to hedge against a decline in a stock that's appreciated from its purchase price. You enter a sell order at a price below the stock's current level. If the stock's price drops to that level or lower, it triggers the order to sell. Note, however, that your order will be filled at the market price, which may or may not be the same as the stop-loss price you specified.

To use this type of order, log on to your Investor's Edge account at

[www.investorsedge.cibc.com](http://www.investorsedge.cibc.com), click on **Trading**, and select the **Stop Loss** button at Step 1 of **Stock Order Entry**.

**Short-selling.** This strategy involves borrowing shares to sell with the intention of buying them back at a lower price, and making a profit on the difference. Advanced traders use this technique when they believe that a significant price decline is a strong possibility. Aggressive traders use it to enhance capital gains in individual stocks, or during a broader market decline.

Short-selling is generally considered a high-risk strategy. Continual monitoring is essential to mitigate the risk of short positions. To enter a short position, call **1 800 567-3343** and speak with a CIBC Investor's Edge Investment Representative. 

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