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(Excerpt)

Wrestling on a knife's edge

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Portfolio managers find themselves wrestling with the various possible economic outcomes following the global financial crisis and unprecedented government and central bank interventions. They are paranoid about the dangerous “Ds”: “**d**eflation” or “**d**ouble **d**ip” recession, that is the question! Perhaps we are just going through a lengthened **d**estabilization caused by **d**eleveraging.

In this newsletter, we will try to demonstrate what makes investment decisions so difficult and the facts that justify a bearish sentiment. Alternatively, we will also highlight our case for a bullish scenario based on historical data, comparable ratios and the psychology of investment.

At the time we wrote our last newsletter (March 2010), we were in the midst of the European sovereign debt crisis. Markets – which had enjoyed a significant rebound from the previous year lows (with the TXS shooting up from 7500 to 12400, for instance) – caught the shivers and clipped 1200 points, or about 10%, as “countries” became the new victims of the financial meltdown of 2008. The so-called “PIGS” countries, namely Portugal, Ireland, Greece and Spain (one could make a point for Italy as well) were quickly becoming incapable of meeting their debt obligations, unable to generate enough tax revenues to pay the interest on their growing debt. They were no longer able to maintain the minimum requirements to remain part of the European Union (EU). With the help of the International Monetary Fund (IMF), the European Central Bank worked out a deal with the first potential victim (Greece), a deal which required the implementation of very strict fiscal measures, effectively putting Greece on artificial respiration. The only other alternative for its raging population would have been to be kicked out of the EU and suffer the worse consequences of a heavily devalued currency and uncontrollable inflation. That agreement generated a new platform and measures that are now being implemented in other vulnerable countries. Across Europe, governments have been tabling austerity budgets and measures (higher taxes and lower government spending) to get their houses back in order.

Meanwhile, last August 10th, the Federal Reserve Board announced “QE2” or the second round of “quantitative easing” better defined as “Money Printing – Part II”. This parting of ways between the US and the EU could accelerate the devaluation of the US dollar as it pushes US deficits higher, which would at least partly explain the current gold rush. While US consumers are slowly improving their own balance sheets, reducing their debt loads and increasing their savings (see chart #1), their government is doing the opposite.

Chart #1

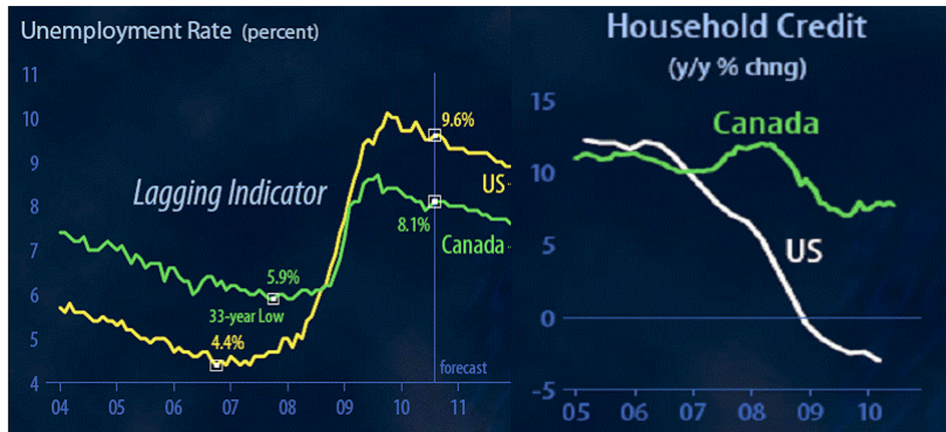
Source: BMO Capital Markets

Growing government deficits need to be financed. The US Treasury Department issues bonds on a regular basis, sometimes to obtain new financing; at other times, to refinance old maturing debt. Roughly $5.2 trillion out of the $13.4 trillion estimated total debt, or nearly 40%, is set to mature in the next 3 years. The decision of the Federal Reserve to act as a buyer of treasuries is called quantitative easing. The Fed, which has the right to print money, is acting somewhat like the lender of last resort. The Chinese – the largest buyers of treasuries over the past decade – have actually become net sellers as of late….not good news. Chinese holdings of US treasuries peaked out at $940 billion in July 2009. By the end of June 2010, these reserves had shrunk to $844 billion, a decrease of 10.24%. At the time the US needs them the most, the Chinese become net sellers (refer to Newsletter #38, Oct. 07, pg.5.) The US deficit is expected to reach $1.47 billion this year, slightly higher than last year according to late July White House estimates. Could this mean that if the Fed doesn't buy US Treasury bonds, very few other buyers would? What interest rate would it take to attract buyers? Could it be that this second round of quantitative easing is the last attempt to hold down long-term US interest rates so that the US Treasury can continue to secure the financing it must have to remain afloat?

The use of this easy and cheap money becomes critical. Consumer confidence must be restored given that the US economic model is consumer-based. Consumer wealth is therefore essential. However, consumers have consumed in excess of their capacity for years (if not decades), using tax deductible mortgage money. They are now winding up at retirement sooner than expected, or out of a job, with a sizable mortgage on a devaluating house price, and a cut in pension benefits. This is not the type of situation that will stimulate the US consumer anytime soon. Perhaps this is why a 30-year 4% fixed mortgage rate has been made available in the US today. Such low rates allows real estate values to be somewhat maintained. They also potentially help to clear the oversupply of houses for sale as well as the growing, bank-owned real estate inventory from unsolved foreclosures. If abused of, such an intervention could produce a boomerang effect, in the likely event that interest rates on banks deposits increase, which could set the stage for yet another financial crisis.

Fortunately Canada has never allowed either tax deductible mortgage interests or 30-year fixed term mortgages. Most of our mortgage rates must be reset every 5 years at most, although the loans can be amortized over a maximum of 35 years. Accordingly, Canadian banks' long-term mortgage revenues are less exposed to changing monetary policies. Canadians have a strong incentive to pay back their mortgages as quickly as possible, given the non-deductibility of such loans. As a result of a more stringent and restrictive Canadian Bank Act, Canadians' indebtedness is not as bad as that our neighbors and leaves lots of room for additional credit. As well, our stronger financial position improves our relative capacity to consume, which helps maintain a lower unemployment ratio (see chart #2).

Chart #2



Source : BMO Capital Markets

Perhaps what the US needs is job creation and a way to somehow allow the cheap credit made available by the Fed to find its way to corporate America. Why isn't this happening? It seems that US banks are using that money for their own benefit…They use cheap credit to buy government bonds and cash in on the spread between the rates (government bond rates are higher than the cost of borrowing from the Fed). This hoarding of cash by the banks is not helping job creation which, in my view, is the single most important thing that will set the consumers back on their feet and kick start consumption, albeit at a much slower pace. Only then will investor confidence be restored. Today's 10-year bond yields are hovering below 3% both in Canada and the US – not exactly a vote of confidence for future economic growth. Gold prices reaching new all time highs are also a testament to investor sentiment about the US economy and its currency.

The paradox:

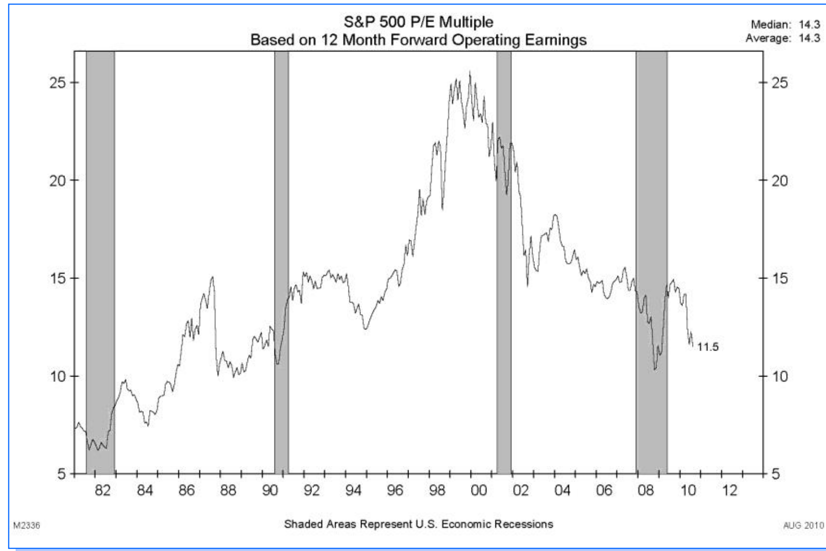
In extremely rare occasions in the past, say, 100 years, yields on stocks were higher than on government debt. Such inversions are extremely rare and perhaps represent the best opportunity to buy good assets cheaply. Although historical lows on 10-year Treasury bond yields express a run for safety, 10 years is a relatively long period of time in investment and economic terms.

Many corporations were very efficient in cutting costs during the financial crisis. Unlike the 1929 crash, these quick actions avoided inventory run-ups causing price wars and deflation, which in turn can lead to protectionism.

The swift corporate action along with the quick government and central bank interventions (i.e. expenditure programs and a zero interest rate policy) resulted in a major rebound in corporate earnings. Cost of energy plummeted and debt was refinanced at a discount. Consequently, corporate America's balance sheet has never been so lean. However, stock prices in relation to earnings are relatively cheap on an historical basis (see chart #3). Arguably, all the bad news might already be discounted in stock prices.

Chart #3

Bull Case — Bad News Priced In



Source: Global Insight, Thomson Financial, CPMS, Bloomberg, TD Newcrest

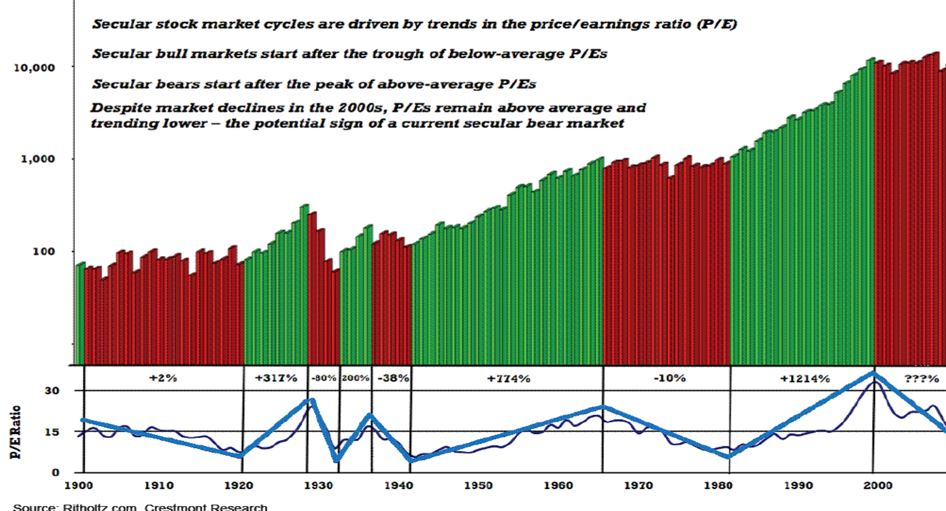
Source: BMO Capital Markets

Stocks, which were trading in excess of 20 times earnings in the late 90's, are now being exchanged at nearly half that price. We have to go back to the period after the 1987 crash to find such discounts. However, in the early 80's, the deepest recession since World War II, interest rates peaked at nearly 20% and price earnings multiples had reached lows of 7 to 8 times. Assuming corporate earnings would remain stable, a return to early 80's P/E multiples would represent an approximate 30% correction in the market. What drove those low multiples back then was the cost of money or interest rates. In an effort to curb inflation, Mr. Paul Volker, the chairman of the Fed at the time, tightened monetary policy, and raised interest rates high enough to smother inflation, and, consequently, earnings growth. Ultimately, the lower the expected growth in earnings, the lower the multiple stock prices trade for. Today, the US central bank, headed by Mr. Ben Bernanke, is keeping interest rates at 0% for "as long as it takes" to get the economy back on track. That is a far cry from the 20% of the early 80's and therefore reduces the risk of a further contraction of P/E ratios.

The following chart gives you a perspective of stock market performance during expansion and contraction of P/E multiples. Given that the contraction period can be quite lengthy and that it took nearly 20 years for the TSX to reach its 1929 peak, confirms the importance and necessity of dividend income. See chart #4

Chart #4

Bull Case — Multiples Compressed



Source: Ritholtz.com, Crestmont Research

Source: BMO Capital Markets

There are some less cyclical industries which are less prone to volatility in earnings, which currently pay a higher dividend than government bonds, and which trade at relatively low P/E multiples. Although stocks do not offer the guarantees that government bonds do, if you take the emotions caused by stock market volatility out of the equation, you can easily earn a sustainable 5% to 7% dividend, equivalent to an interest income in the 7% to 9% range for years to come. Furthermore, in a slow growth environment combined with the strong corporate balance sheets we find in America, compounding corporate cash flows will have to be put to work. Perhaps this explains the recent acceleration in M&A (mergers and acquisitions) activity worldwide. According to a recent internal study, some 12% of companies listed on the Russell 3000 and TSX composite index trade at levels that are financially attractive for takeovers for pension plans and private equity firms.

Corporations also have the flexibility to buy back their own stock with their excess cash flows. By doing so, earnings per share can grow faster than organic growth itself. On a relative basis, a financially sound company could outperform its peers just by buying back its own shares, which should in turn help expand its P/E multiple.

The case for both a bear or a bull scenario is strong, and that is why it is so difficult for money managers to commit lifetime savings aggressively. However, an investor must remember that he is not investing in the stock market but rather in a market of stocks, and that makes selection a key component of success over the medium- to long-term. Volatility will remain nerve-racking, but we must remember that it is the “leverage hedgers”, “short sellers”, “naked

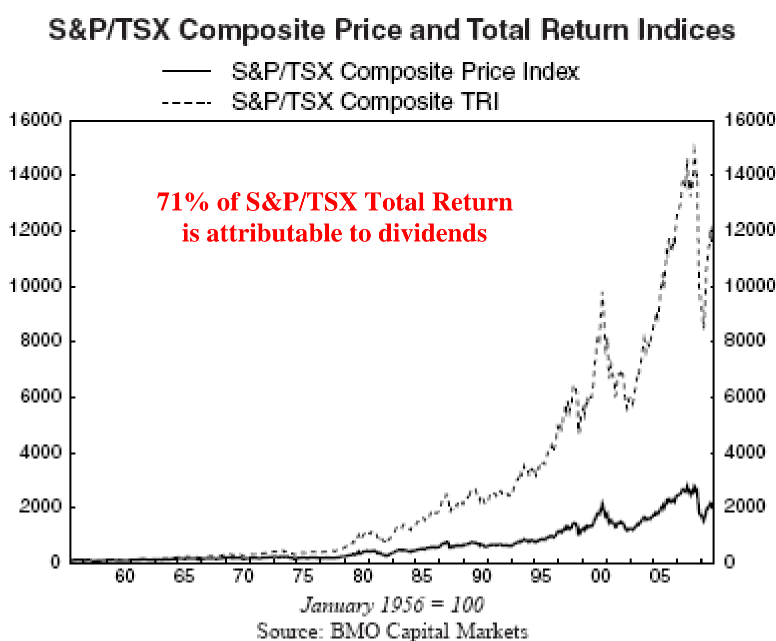
short sellers" and others who create such unwanted volatility. At the end of the day, however, value always prevails. We don't need to wrestle on a knife's edge!

Conclusion:

Investing is a continual balancing act. However, the importance of evaluating your own tolerance for risk has never been so important. Market volatility is here to stay. Make sure you can withstand the volatility in your portfolio by adjusting your asset mix accordingly. Once you have established an appropriate asset mix, stick to it – adjusting your mix in the middle of a downturn can be very costly. In fact, given that investing is not for the next day, week or month, a wise investor should consider investing in stocks when times are tough (i.e. when risk "seems" to be high, stock prices are cheap) and divest when things couldn't be better (i.e. when risk "seems" to be low, stock prices are expensive).

Sustainable cash flows are perhaps the most important criteria to look for when selecting a company. These cash flows provide companies with the ability to make attractive acquisitions, buy back stock and/or grow their dividends. Did you know that no less than 71% of the TSX total return over the last 50 years is attributed to dividends? See chart # 5

Chart #5



Four years ago (in October 2006), Mr. Flaherty, our Minister of Finance, attacked Canada's income trusts fiscal policy, and decided to force their conversion into traditional companies or face tax implications starting January 1, 2011. Although their popularity fell in the aftermath of this decision, many of them remained extremely attractive investments, especially in the public utilities sector, which we retained all along. Today, rather than paying a 10% distribution, taxed as interest, they pay more or less 7% in dividend income. For a shareholder, the after tax income is exactly the same, given the dividend tax credit. As a result of a slow growth economic environment and extremely low interest rates, their popularity has returned in a vengeance. We recommend holding roughly 10% of your portfolio in such utilities (i.e. electrical power plants and pipelines).

Canadian banks are enjoying the strongest financial position in the world and should be able to take advantage of opportunities now that the new Basel Accord has been issued. The accord sets new standards as well as minimum capital requirements for the banking systems of

most of the G20 countries. Although earnings growth is bound to be a challenge given the eventual contraction in monetary policy (rising interest rates), Canadian banks provide shareholders with a sustainable cash flow stream, allowing them to at least maintain their current dividend payout levels. We would recommend maintaining a 15% to 17% exposure to the financial sector, including real estate companies.

The energy sector will not only provide you with a relatively stable cash flow, but some old income trusts converted to traditional companies offer hefty dividends as well. Energy stocks also offer a good hedge against inflation or the likelihood of a weaker US dollar. A weighting of 8% to 10% in that sector appears to us to be appropriate.

Consumer staples also provide a defensive way to invest in the market. However, given the stiff competition and extensive capital expenditure programs, margins are very slim and so are the dividends. Still, we like the growth potential of Couche-Tard, Metro and/or George Weston. A weighting of 3% to 5% is recommended.

In the materials sector which includes all base metals, gold and agriculture, it is about impossible to find attractive dividends. They, too, are extremely capital intensive. However, we believe that growth in emerging markets is here to stay. Not to say they won't stumble over their own hurdles along the way, but 10 to 15 years down the road, their infrastructures will have evolved considerably. Canada is among the countries best positioned to capitalize on their expansion. Although dividends are hard to come by in this sector, we believe in holding at least a 5% exposure in gold with an additional 3% to 5% in base metals and agriculture combined.

Currently, there is a disproportionate amount of capital in cash and short-term bonds which eventually will make its way back in the market. This is not a matter of if but rather when. Patience can be worth a lot of money.

There is no secret, except to develop a plan and stick to it all the way through. Again, no one needs to wrestle on a knife's edge.

RECOMMENDED ASSET MIX

INCOME PORTFOLIO			BALANCED PORTFOLIO	
Apr 2010	Oct 2010		Apr 2010	Oct 2010
15%	15%	CASH (CSB, QSB, T-BILLS)	10%	10%
50%	50%	FIXED INCOME (BONDS)	30%	30%
15%	15%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	15%	15%
15%	15%	EQUITIES	35%	35%
5%	5%	FOREIGN	10%	10%

Sources:
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*Excerpts from the Canadian Equities Guided Portfolio, September 2010

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