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October 2012

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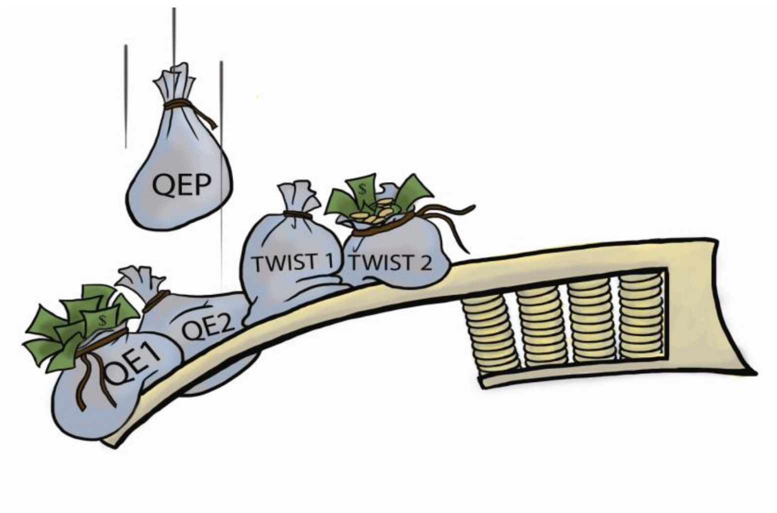
(Excerpt)



Spring loading

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Pierre's comments

Thanks to relatively decent returns posted by the S&P500 in the US in 2011, followed by an impressive rally this year to date, Canadians are being left behind for the first time in over a decade. On the back of a lackluster year for the TSX (TSX -11% vs. S&P + 0%) in 2011, its performance year-to-date is still well off compared to its US counterpart (TSX -3.03% vs. S&P +14.56%). In our last Newsletter (#47, April/12) we re-iterated our thoughts on why the US economy was poised to outperform the Canadian economy given their much higher productivity ratio, an uncompetitively high Canadian dollar, a slowdown in emerging market expansion led by China, and a contraction in commodity prices. Accordingly, we continued to build upon the US stocks we began reintroducing in our portfolio in February 2011 by adding four new US positions between February and April 2012. Fortunately, that decision has helped us outperform the TSX so far this year, but the question of sustainability still remains: can the US keep up the pace in view of the many major hurdles it faces in the coming months?

The recent intervention by the Federal Reserve Board (the Fed), namely the introduction of yet another round – the third – of quantitative easing (QE3), to be renamed QEP for Perpetual was met with mixed reactions by markets. After an initial positive impact, markets began questioning the necessity of making this round perpetual. Such an open-ended plan allows the Fed to buy back up to $40 billion/month in mortgage-backed securities for as long as it takes… Which begs the questions: Is the US economy doing that badly? Does the Fed foresee a worse outcome than markets expect? Or is the Fed implementing a monetary policy platform on which both parties can build their own budget proposals in view of the coming US elections? Although we are all aware of the fundamental differences between the two parties, it remains that both parties are now faced with the weakest economic recovery since the depression, with stubbornly high unemployment, despite the Fed's unprecedented monetary policy interventions. Both parties know that to jump start the growth engine, you need to create jobs. But where both parties disagree is on how to light the spark that will fire up the engine. Democrats want to raise taxes, mostly for high income earners ($250,000+/year), and fund programs that would create jobs and, thus, increase tax revenues. This would also help consumers regain confidence and, eventually, increase their spending. On the other hand, Republicans want to cut taxes even further while eliminating existing "loopholes" used by rich people to avoid paying their fair share, and eliminate some social programs that have proven to be both mismanaged and too costly. The idea of simplifying the tax system was first introduced by President Ronald Reagan in the 1980s. Dubbed "Reaganomics", the idea was to lower the tax rate but broaden the taxpayer base. This would lead to an increase in the government's overall tax revenue without dampening an already fragile economic recovery. Its original impact was a huge success, which triggered a long and sustainable recovery.

Regardless of the outcome of the upcoming election, the US is yet again staring down the barrel of the debt ceiling limit imposed by Congress in the summer 2011. Both parties, Republicans and Democrats, must tackle this problem before the end of January 2013. Obviously they are both hoping for a strong mandate to apply their policies, but the polls show they are split. In such a case, one or the other – and most probably both – will need to compromise… But is that realistic? Although more than 30 different approaches have been suggested since last year, none of them has made the cut. The most famous was the Simpson-Bowles by-partisan proposal, put together by a group of three Democrats and three Republicans, which was tossed out by President Obama last year.

However, the last postponement and extension of the debt ceiling came with a set of predetermined austerity measures that will become law if both parties and Congress fail to come up with a compromise solution “in time”. And that time comes when the ceiling is reached once again, and that is expected to occur on or about the 21st of January, 2013.

You’ve probably heard or read in the news about the “fiscal cliff” the US is facing. This refers to the mandatory implementation of these austerity measures if no compromise solution is adopted. It will drag the economy into another recession which may lead to deflation this time around. Jobs would be lost, not created, and cash would stay on the sidelines… lots and lots of cash…The compound excess liquidities (generated by QE1, QE2, Twist 1, Twist 2 and QEP) currently held by banks and corporations will remain there, as they will not invest, or borrow, or grow their businesses if there is no buyer for the end product. Can we blame them? Unlike governments, banks and corporations aren’t carrying a deficit…nor have they reached yet another debt ceiling! Should we blame consumers for racking up too much debt because of the real estate bubble? No doubt banks carry some of the blame, since they are the ones that lent money to unqualified homebuyers. But homebuyers as well carry some blame, as both they and the banks have been guilty of greed. When things got dicey, banks began foreclosing on these poor people while banks themselves were being bailed out by the Fed and the government (whose money came from poor people!). No wonder Occupy Wall Street was born! Perhaps we now have a new definition of “putting one’s house in order.” Perhaps that is the solution: not only the government’s house but poor people’s houses should as well be put in order. Let me explain.

In our last newsletter, we wrote about the two pillars of the economy, one being the banking system and the second being the real estate market.

At this point, the US banking system has strengthened significantly since its restructuration in 2008-09. US banks are now among the most capitalized in the world, although they still have a way to go to meet the new Basel III minimum capital requirements, which must be reached by the end of this decade 2018-19. The one important red spot left on US banks’ balance sheets is the sizable inventory of foreclosures, which carries huge recurring costs including municipal taxes as well as maintenance and administrative fees. The Fed’s recent intervention, with its QEP, should push mortgage rates still lower, and this could eventually spur private equity investors into buying defaulting residential real estate portfolios from banks at a discount. The impact could be significant for banks for the following reasons. The banks would:

1- take one last write-off and stop the bleeding once and for all
2- cut all recurring costs related to holding these non-productive assets
3- generate a positive spread by lending to or financing the buyer of these assets
4- strengthen their balance sheets and improve their return on equity

Buyers, on the other hand, could negotiate a discount that would allow them to cover those recurring costs for three to four years, providing them time to sell in a strengthening market. A long shot? Only if you don’t believe the real estate market will bounce back. But for those who believe that buying low and selling high is a better way to make money, why not take advantage of mortgage rates that are at **all-time lows**? As inventories begin to decrease, home prices should firm up and this action corresponds to the beginning of all new cycles…

Meanwhile, the US real estate market has shown signs of improvements since late last year, in terms of both sales and prices (chart #1). Although new construction is still well below the historical range of 1 to 2 million units (only once in fifty years prior to the 2008 meltdown did the number dip below 1 million units) (chart #2), we are seeing improvement there as well.

Chart #1

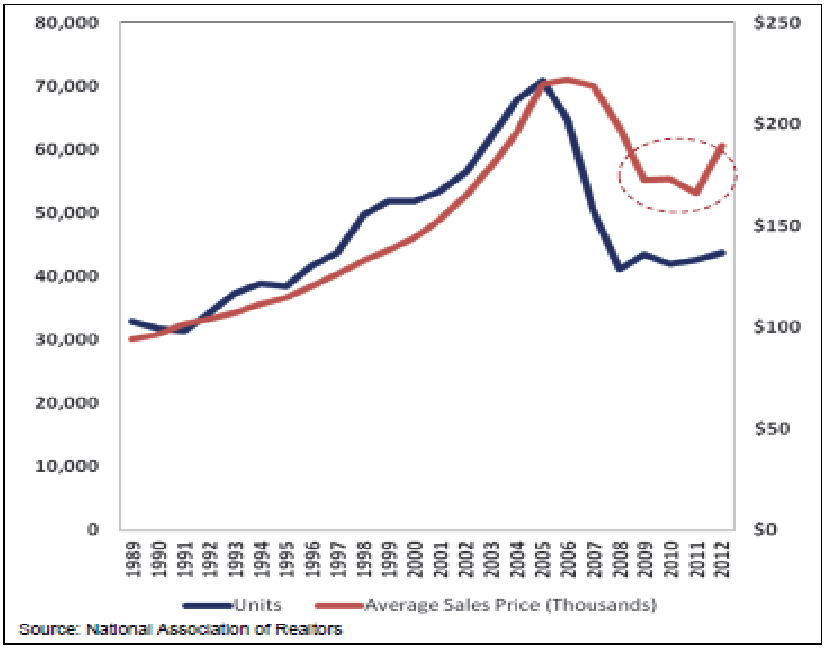
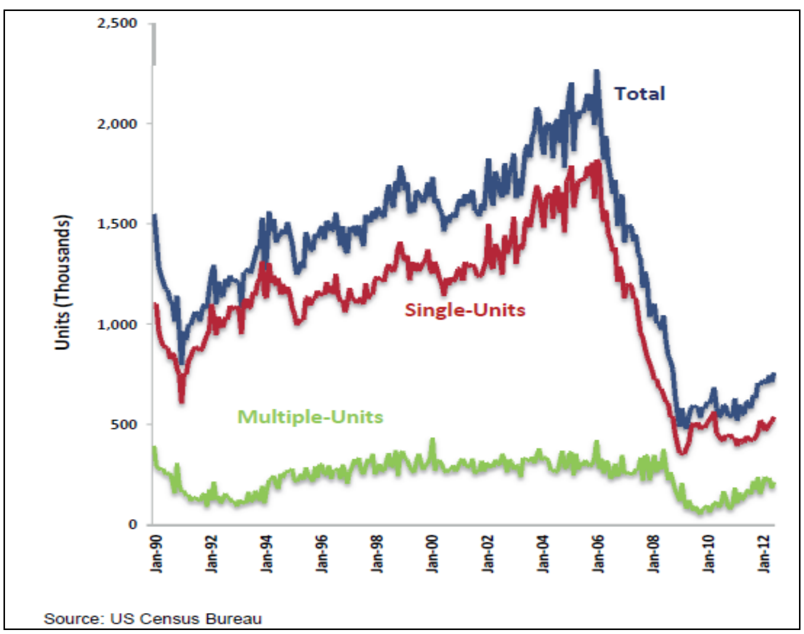
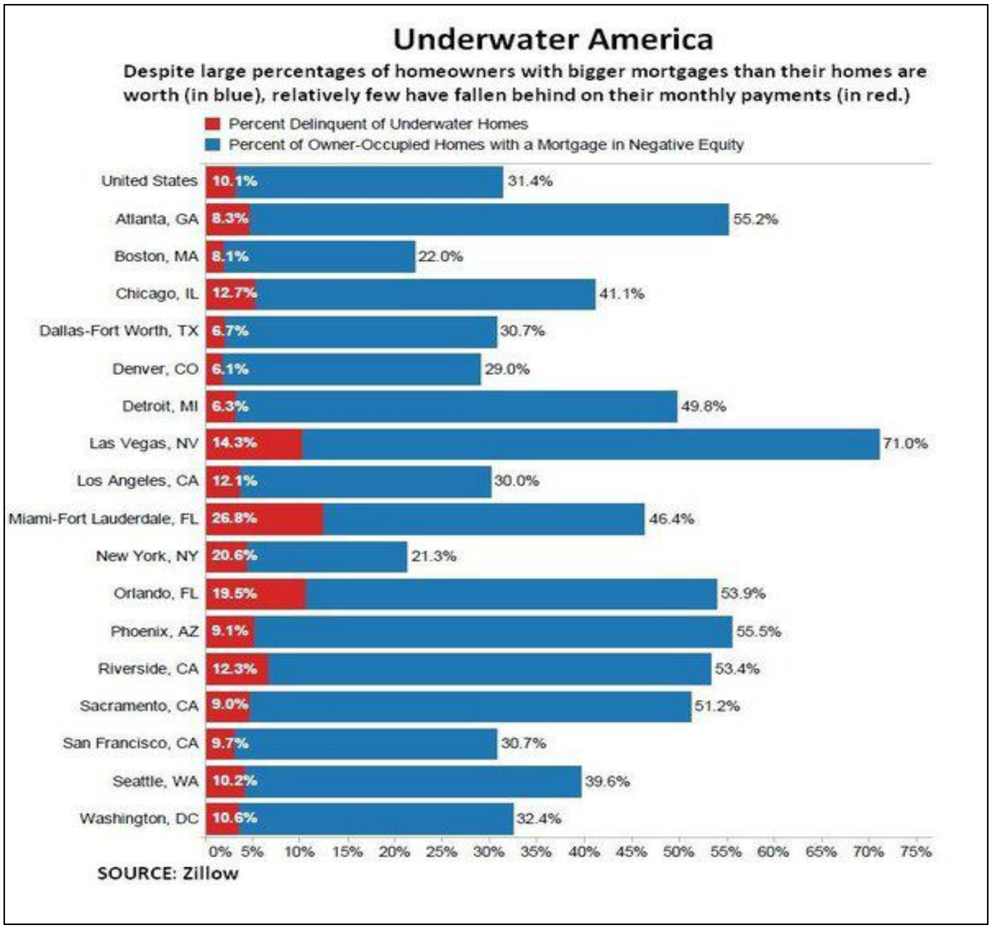


Chart #2



But given that real estate is the largest single investment made by most households, it is imperative that the real estate market strengthens again. Nearly 16 million homeowners – almost a third of all mortgage holders – owe more on their mortgages than their homes are worth. This represents a $1.2 trillion hole in the collective home equity of American households (according to real estate website Zillow) (chart #3).

Chart #3



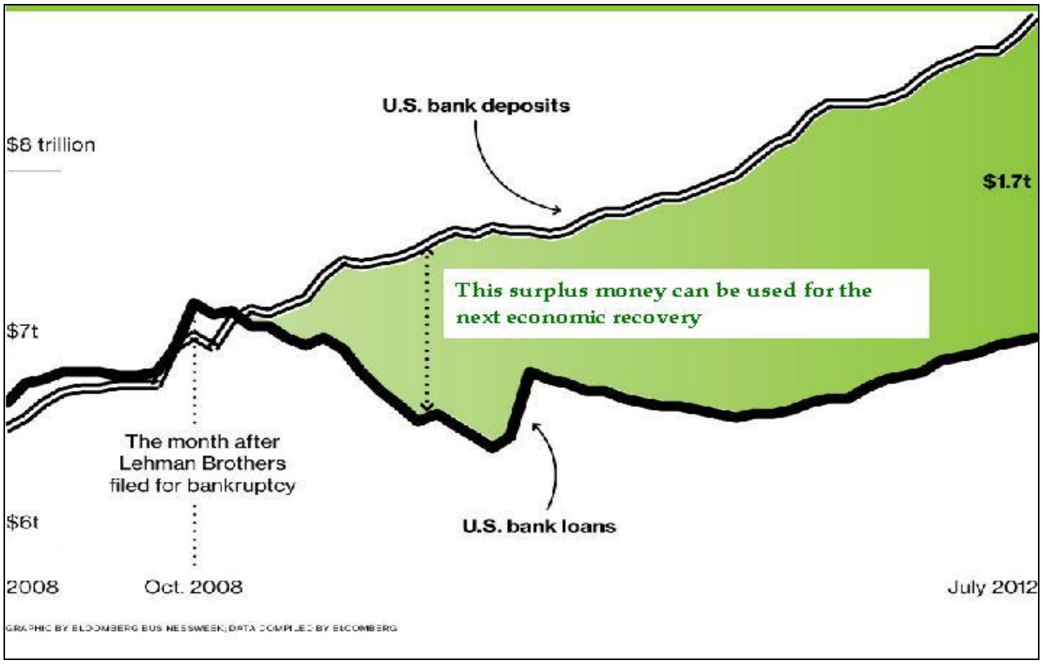
These statistics truly express our view that a consumer-based economy cannot expand significantly until the real estate deleveraging process is completed. The Fed is doing its part to accelerate the deleveraging process; the government must do the same as well. The root cause of the financial crisis of 2008-09 was the collapse of the real estate market… This was the source of the problem and it must become the cure to the problem today. Regardless of the approach taken by the US government to raise tax revenues, some of these funds must flow back to help those 16 million poor people refinance their homes so that they can keep them. Home inventories will then start winding down, pushing prices up to reach the needed comfort zone to restore consumer confidence. As more consumer heads come out of the water, corporations will start to hire again. They too will increase spending and borrowing, further supporting the banking system.

Putting the government's house in order by developing an action plan in which both sides of the floor will compromise will reduce the deficit at an acceptably gradual pace, without compromising the slow economic recovery. Such a plan would put the houses of 16 million mortgage owners currently underwater in order as well. This won't be an easy task, but if there is one country on this planet that can do it, that has the wherewithal, the capability and the power to do it, it is the United States of America. But does the country have the will to do what it takes to get there? As the old saying goes, where there's a will, there's a way. And in fact, in this case, there are various ways!

As an investor, we must uncover and seize opportunities as they present themselves. And this is why we believe that within a period of three to five years, the markets, and especially the US market, will have the power of releasing their huge potential… I would go so far as to say "unprecedented" potential, as we have "unprecedented" capital being pumped into in the system in the form of all the quantitative easing measures put together in order to avoid a 1930s-like depression.

Consider the following: Banks are currently flush with cash, more specifically about $1.7 trillion in excess cash, that they wish they could lend… (chart #4).

Chart #4



Source: Bloomberg

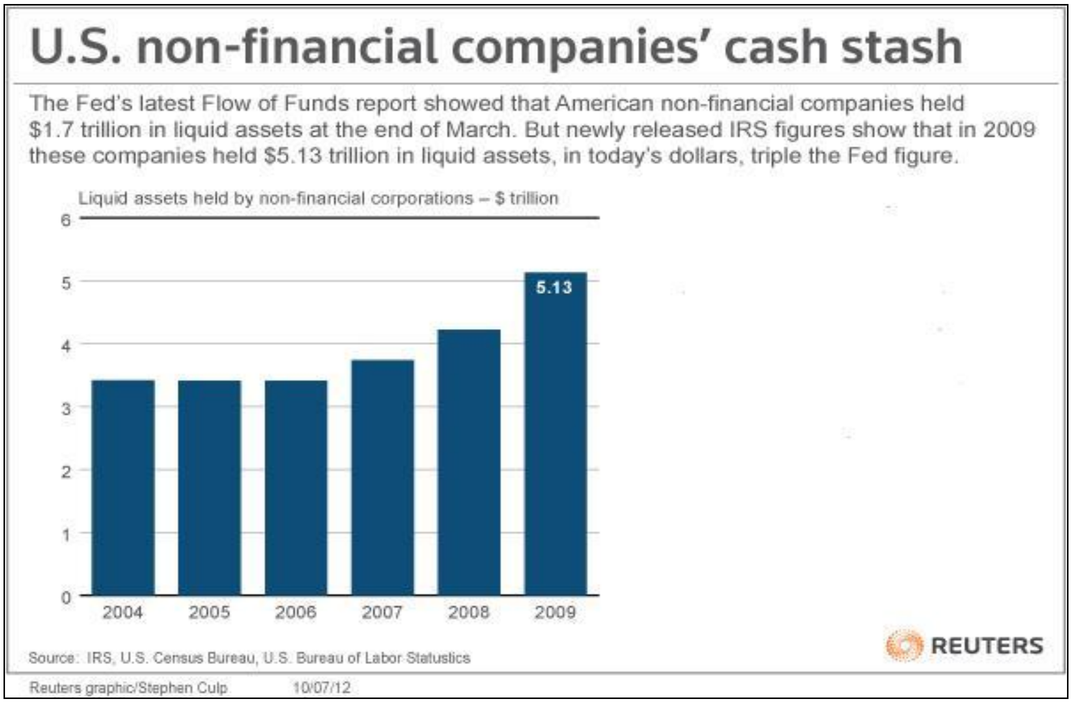
But corporations are not borrowing! They aren't borrowing not because rates are too high, but because of the uncertainty surrounding their own future prospects. Therefore, the Fed's actions have limitations given they are restricted to monetary policies. It is as if the Fed is pushing on a string. But this excess capital is building and growing, as if loading a spring…

"The Fed's power pales in comparison to the potential impact Congress would have addressing the fiscal cliff fears" said Dean Croushore, an economics professor at the University of Richmond and a former Fed economist. But as the Fed keeps easing its monetary policy, it keeps loading the spring…

Meanwhile, as banks keep piling up cash, so are corporations, while repaying their debts at a record pace, given the lower rates and their growing cash reserves. Board of directors and shareholders are pressing corporations to make use of this cash and, if they can't justify investing, they use other avenues such as stock buybacks and/or higher dividend payouts. This may be good over the short-term for stocks, but it's bad for future economic growth.

According to the Fed's latest flow of funds report, US non-financial companies held $1.7 trillion in domestic liquid assets at the end of March 2012 (see link on our website). However, according to Internal Revenue Service (IRS) estimates, which include worldwide cash holdings of US corporations, US corporate cash reserves stand at nearly $5 trillion! (chart #5)

Chart #5

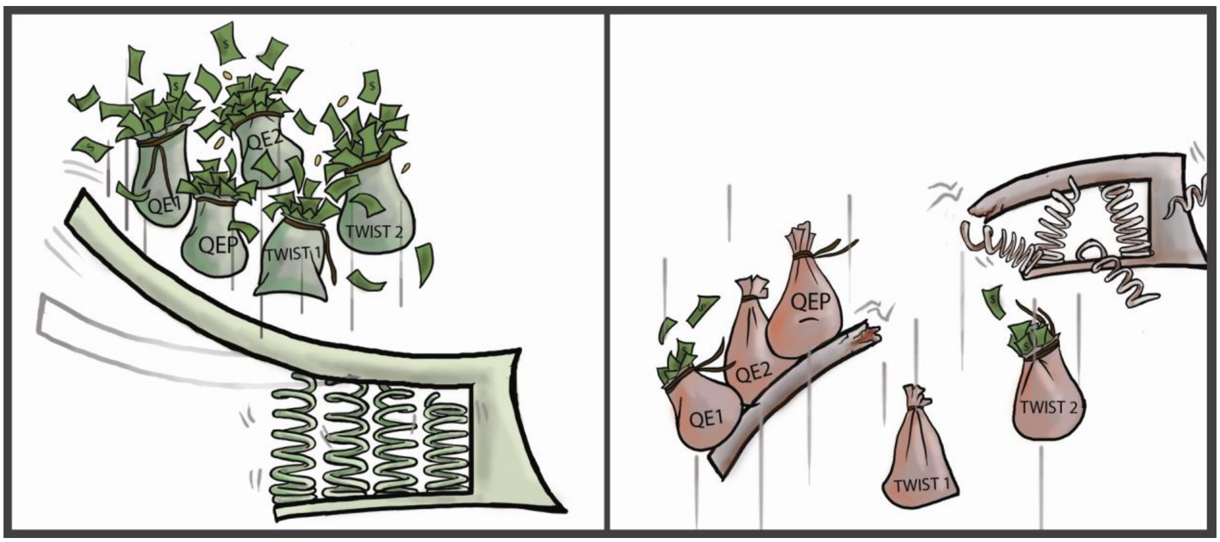


This huge gap is explained by the fact that cash originating from offshore profits, held in offshore subsidiaries, is not taxed in the US. Companies have been hoarding cash, which is counterproductive for the US economy. Congress recognized that risk when it implemented corporate income taxes way back in 1909. Under section 531 of the Internal Revenue Code, a corporation can be hit with a 15% levy on top of the 35% corporate income tax if it holds "excessive" cash (over and above what is reasonably required to operate the company). But under section 532(c), President Ronald Reagan excluded cash held offshore, generated from offshore profits. Meanwhile, at 35%, the US corporate tax rate ranks among the highest in the world. Here too, a lower tax rate and broader tax base policy (including offshore cash) could be a significant source of revenue for the government. Regardless, US$5 trillion could have an unprecedented impact on the economy if it were put to work. Add to that the $1.7 trillion in cash that banks are desperately waiting to lend. Talk about spring loading…

But there is more to be optimistic about… What about all the extra prudent money managers, fund managers and pension fund managers who not only hold an overweight position in cash as a safety net but an important bond exposure yielding close to 0%?

Consider the impact on equity markets if consumer and investment confidence were to be restored! Never in history will anyone have witnessed such a “tsunami” of cash driving growth and equity markets. And this is besides the fact that most portfolio managers and investors would switch asset mixes from a fixed income bias to an equity one in the expectation that interest rates would firm up, signaling the end of the longest bond bull market of all times. Inflation would become the new evil, but inflation is what the Fed has been feeding throughout this Great Recession.

Spring loading carries a major risk…the risk of breaking the board and falling…And this is precisely what American policy makers are facing while aiming to propel the future of the greatest country in the world to yet new levels and lead all nations out of recession. All the ammunition is there, ready and waiting to be used. Unfortunately, they could also miss the boat, failing to capitalize on this unique opportunity… and break the unity that is the foundation of this great nation.



Conclusion

Fear and uncertainty have never been great friends of stock markets. Although we are facing an increasing level of uncertainty over the next few months, I still believe in a very positive outcome over the mid- to long-term (3 to 5 years out). We must stay invested, perhaps with a little extra cash on the sidelines, say 5% to 10%, ready to be reinvested in equity markets in due course. Dividend paying stocks remain the focus of our investment strategy, as well as a proper mix of inflation-sensitive stocks and utilities. Short-term, we remain cautious as we believe markets are overbought. However, gold and especially gold stocks are attractive in this environment and even longer-term as inflation will return sooner or later. With the European Central Bank (ECB), the US Federal Reserve Board and, more recently, the Bank of Japan (BoJ) now printing money, could gold become a new reserve currency, or at least part of one? According to Treasury International Capital’s data flows, China increased its US Treasury holdings by $12.4 billion in the first six months this year. Meanwhile, according to Zero Hedge, China’s year-to-date imports of gold as at June 30 reached a record of 488.6 tons, representing approximately $25 billion in gold, or twice the amount of US Treasuries. This is unprecedented, according to Zero Hedge (online economic forum), notwithstanding the fact that China is the largest gold producing nation and doesn’t export any of its production… A 3% to 5% holding in gold would be, for us, a minimum exposure.

Other sector weightings based on a balanced approach are consumer staples (5%), health care (3%), utilities (10%) and financial services (16%) which continue to be core investments with steady growth and solid dividends. Inflation-sensitive sectors such as energy (8-10%), materials, including base metals (2%), gold (3-5%) and agriculture (3-5%) typically have lower dividend distributions but offer a better inflation hedge. Telecom stocks (6-8%) offer a good balance of growth and income for all types of investors. Future growth for wireless lies in the "space real estate", also known as bandwidth and broadband. While industrials (5-7%) are more cyclical in nature, it is important to own world-class companies and/or industry leaders. Technology (3%) can be quite volatile as well, but here too you can find more mature businesses with very strong balance sheets, solid dividends and strong cash flows.

Although the near future is quite uncertain, we must build on what the longer-term future has in store for us. In the last few pages, I have elaborated on my vision of what that future could be and how we could accomplish one of the greatest economic and market rebounds, if there is a will… Your patience might be as compressed as the spring but if you hang on long enough, chances are, you and your portfolio will be propelled to new highs!

RECOMMENDED ASSET MIX

INCOME PORTFOLIO			BALANCED PORTFOLIO	
Apr 2012	Oct 2012		Apr 2012	Oct 2012
15%	15%	CASH (CSB, QSB, T-BILLS)	10%	15%
50%	50%	FIXED INCOME (BONDS)	35%	35%
15%	15%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	15%	15%
10%	10%	EQUITIES	25%	20%
10%	10%	FOREIGN	15%	15%

Disclaimer: Subject to an evaluation of the risk profile of individual clients

Sources

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*Excerpts from the Canadian Equities Guided Portfolio, September 2012

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