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(Excerpt)

The Mirage?

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Pierre's comments

It was only just this past March that US markets finally smashed old highs reached back in October 2007, a full five and a half years ago. The unprecedented accommodative monetary policy maintained by the Federal Reserve Board (Fed) has been the main driver, flooding the system with cash through various forms of quantitative easing (QE) policies. Today, a whopping 38 countries are expanding their monetary base, including Europe and Japan.

The Fed, led by Dr. Ben Bernanke – an expert whose fame and reputation was built on how the Fed could have avoided the "Great Depression" through the "printing of money" – has put these aggressive, last resort solutions to the test. The strategy has in turn accelerated the growth in funding dedicated to the restructuring and stabilization of the US banking system while contributing to the deleveraging process of corporations and, ultimately, consumers.

Taking advantage of very low overall inventory levels, thanks to just-in-time practices, once the crisis hit, corporations were able to take immediate action to reduce costs and maintain profitability. They also used the Fed's accommodative monetary policy to significantly slash their debt levels, reducing their costs even further. As corporate debt levels decreased, the Fed's balance sheet expanded and both the country's deficit and total debt soared. The irony here is that the higher the US debt level creeps, the lower interest rates or borrowing costs drop, despite a falling credit rating! How is this even possible? Would such an option be available to us? Let's assume you have a mortgage and you make your monthly payments in time, using both the husband's and the wife's income. Now suppose one of the two spouses loses their job, thus cutting the household income in half. A similar situation occurs when an economy falls into recession, government revenues decrease because there are fewer taxpayers, and because corporations earn less, they pay fewer taxes as well. The couple now find themselves strapped and start using their lines of credit to continue to make their mortgage payments. This pushes their debt level higher while reducing their credit rating. At one point the couple wants to increase their mortgage or take out a second mortgage on the house. Given the lower coverage ratio with only one income and a lower credit rating, the additional risk taken on by the lending institution would justify a higher rate. But the government, supported by the Fed, is financing at lower rates! So the Fed is being extremely accommodative and is indirectly "manipulating" the bond market, pushing bond prices up as interest rates fall, thus creating a bubble.

The government bond "bubble" is now spreading to other issuers as their pricing is based on a percentage spread over Treasuries that are kept artificially low. By definition, a bubble is characterized by "irrational exuberance" using excessive leverage… To me, this description perfectly fits current Fed's actions. Bonds are trading at all time highs, reflecting the artificially maintained lower yields. When rates start to head back up, bond prices will tumble and the longer the bond's term, the harder the fall will be. Government bonds are safe but could prove surprisingly volatile in the current environment. Assume you own a 10-year bond and yields go from 2% (where they stand now) to, say, 3%. The 1% change per year represents 10% over 10 years. Therefore, the 10-year bond price would fall by 10%, from $100 to $90. Furthermore, one may have to wait 10 years to get one's capital back! As the economy recovers and Mr. Bernanke begins to unwind his quantitative easing policy, the bond bubble may collapse and drive bond yields much higher, hurting long bond holders and consumers with excess credit. The question is <u>when</u> and <u>how</u> will the Fed withdraw its support, and what will be the impact on stock markets?

Evidently, if the Fed and the Government wish to offset the risk of such a negative impact on the markets, a meaningful positive development needs to occur. A bipartisan agreement on spending cuts and a fiscal overhaul that would eliminate tax loopholes and cut corporate tax rates would probably provide sufficient thrust to allow the Fed to slowly exit its accommodative policy. Perhaps the market is currently discounting such an outcome as it reaches new all-time highs.

After all, corporate balance sheets have never been so attractive. Dividend yields are higher than bonds yields in many cases. Price earnings ratios have gone from 10 times last fall to 14 times today, but they are still a far cry from the average 18 times recorded over the past 40 years. Last fall, one could argue that there was less credit risk in stocks, a higher dividend yield and an above average opportunity for capital gain. In other words, stocks were very well positioned in the US to outperform, resulting in the bullish view in our last newsletter. We can see more of the same today, with the exception that stocks are now more expensive. But as we close in on the debt ceiling – sometime around May 18th – we will find out if this great market rally has legs or if it was all just a *mirage*. The ongoing gridlock in the House must be broken, but the potential is just as great now as it has ever been for America. Aside from being the least taxed nation in the world, having a strong banking system and being the leading economy, the country also has all the energy it needs at home.

In 2007, new rock fracturing technology (fracking) became available which would significantly increase the potential recovery rate of one of the largest oil formations discovered in the 1950's, namely the Bakken formation laying mostly in North Dakota and southern Saskatchewan. While the estimated total reserves stand at 167 billion barrels, horizontal drilling and new fracturing technology would allow the recovery rate to increase from roughly 3 billion barrels to 24 billion barrels. In addition, the technology also allows the recovery of natural gas locked in shale formations. Natural gas is recoverable today over almost the entire North American continent, where supply estimates range as high as 100 years, a most optimistic figure according to Chris Nelder (*What the Frack?*, Dec. 29, 2011). (See North American gas map.)

Source: U.S. Energy Information Administration based on data from various published studies. Canada and Mexico plays from ARI.
Updated: May 9, 2011

Yet infrastructure spending within a new energy policy could create a significant number of much-needed jobs and reduce if not eliminate US dependency on foreign oil. This would translate into lower cost for energy domestically, which would act in the same way as a tax cut to consumers and even corporations. It would also mean that governments could have room to introduce other types of tax revenues without affecting consumer spending or economic growth while reducing the deficit and paying down debt. Jack Welch, former GE CEO, was recently quoted on CNBC saying: “The US energy boom could mean another American century of economic dominance.” Other highly influential individuals such as JP Morgan CEO Jamie Diamond and Warren Buffett, to name but two, are also pressuring government officials to act accordingly and promptly in order to eliminate uncertainty and allow cash-rich corporations to put their money at work *domestically* and reestablish America’s leadership worldwide.

While the potential for strong economic growth is achievable and realistic, many hurdles will have to be overcome. Free markets must prevail, and the *addiction* to the Fed’s “free” financing must be cured. Short-term pain for long term gains might dissipate the mirage, only to find a real oasis hiding behind it.

The Pillars

The two pillars of a consumer-based economy, as mentioned in past newsletters, are the banking system and the health of the real estate industry. Although the latter is still weak, it has shown significant improvement and is on the right track. Many economic indicators are showing positive signs, including lower unemployment (chart 1) and strengthening property sales and prices in many areas throughout the US (chart 2).

Chart 1

Source: BMO Capital Markets

Chart 2

Source: BMO Capital Markets

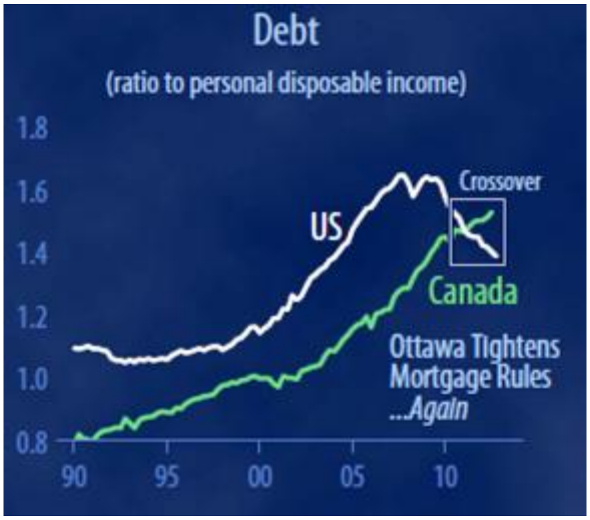
The three most important signs of real estate growth are:

A) Strong buyer demand as expressed by a sharp decrease in inventory levels (lowest level in years in certain areas)
B) An increase in sales despite a tight inventory
C) A shift in sales from foreclosures and short sales to more conventional home sales.

Furthermore, bank financing and credit are still difficult. Banks are showing discipline and do not like to lock themselves in for a 30-year fixed mortgage loan at such low rates. In fact, we have been witnessing a turnaround in the 30-year fixed mortgage rate, now standing at about 3.63%, up from a low of 3.34% last fall. Another healthy sign that the US real estate industry is recovering is that we are seeing less re-financing and more new financing. Building permits and new constructions have been increasing as well, although they remain well below normal long-term levels. In fact, this may explain why inventory levels are falling. Home construction has been under-served for almost 7 years (see chart 2, “Housing Starts”). To meet immigration and demographic demand, housing starts must average approximately 1 million units per year. Today, demand outstrips supply and it is expected that an average of 1.7 million to 2 million new homes will be needed to close the gap. This is why a study released in mid-March by JP Morgan shows expected growth in house prices at 7% in 2013 and 14% in 2014. According to Stuart Miller, CEO of Lennar Home Builders, Florida is one of the hottest markets around, and as the state’s micro-markets heal, so too will the outskirts. But as prices rise we might see inventories increase again as underwater home owners seek to strengthen their balance sheets and downsize. Job growth remains the key to real estate price growth.

In Canada, real estate is a different story. Although we have avoided a collapse like that experience by the US in 2008, it seems that we haven’t learned much from it. Today, Canadian debt levels per dollar of revenue (Chart 3) are nearing the levels reached by US consumers in 2008. Even our Minister of Finance Mr. Flaherty is using moral suasion techniques to persuade banks to hold mortgage rates at current levels and avoid a mortgage rate war.

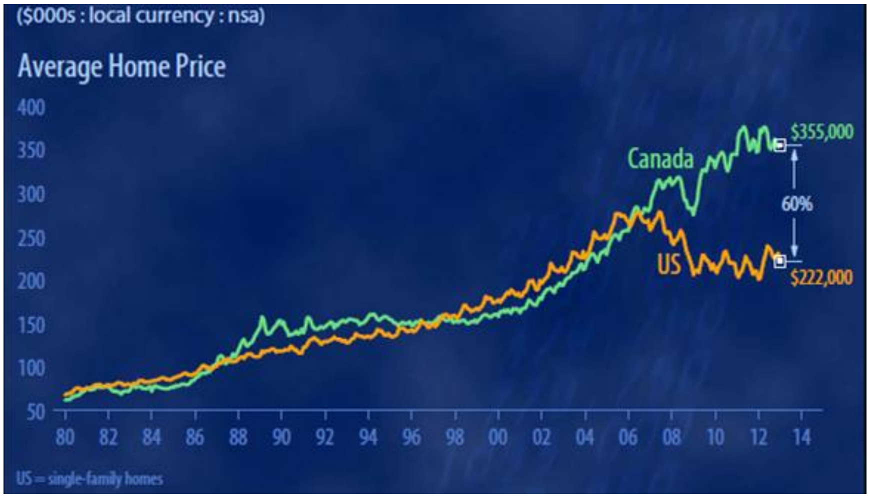
Chart 3



Source: BMO Capital Markets

The average home price in Canada has reached an all-time high and the 60% spread between the US and Canadian average home price is unsustainable. Here too, something will have to give! (Chart 4)

Chart 4



Source: BMO Capital Markets

Home prices in Canada are getting out of reach for new home buyers, forcing them to extend their credit. They may be unprepared and/or unable to meet the challenges of higher mortgage rates, or an economic slowdown. Prudence and discipline are key, here.

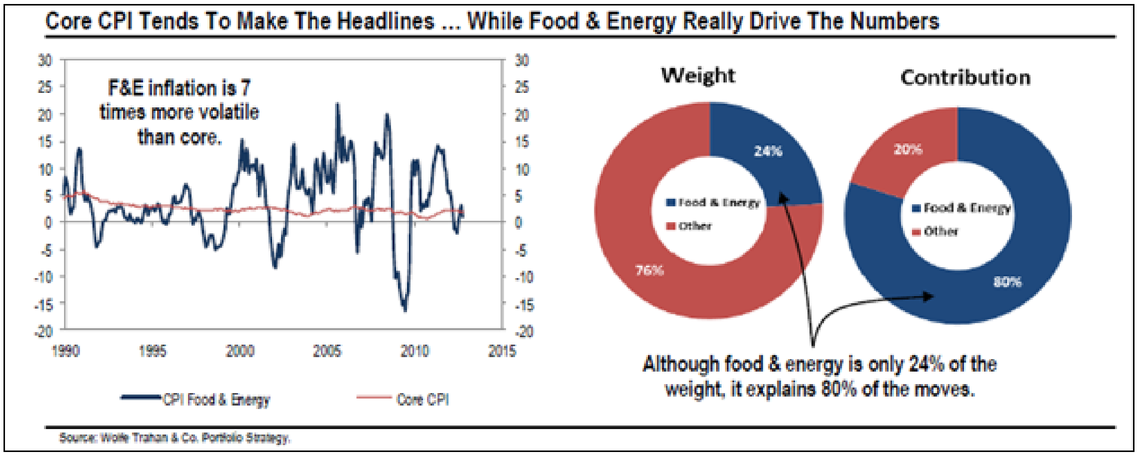
<u>The inflation risk</u>

At this point no one is focusing on inflation. We are very slowly recovering from a severe recession caused by a financial crisis resulting from the collapse of a real estate bubble. But the strategy being used to pull us out of this crisis has been nothing other than "printing money." True, things are looking better. In fact, the current monetary policy is exactly aimed at stimulating inflation, the lesser of two evils. But inflation has this very sneaky way of insinuating itself back in. First, it will give you a warm feeling as it initially inflates the value of your assets, namely your portfolio and your real estate. Then, it will sneak its way inside your house (think heat or air conditioning, in other words the cost of energy) and even onto your plate (food). Just like you, inflation loves to travel (gas) using all kinds of means to transportation (cars, boats, buses, planes, etc.) Eventually, it really gets on your nerves and hits you where it hurts – your wallet!

In fact, printing money equals devaluation, meaning your purchasing power dissipates thus making you poorer… One might argue that the Fed is legally "stealing" from consumers! Is this true?

We are being told that the consumer price index or CPI is only up a fraction and therefore not worrisome for now. The Fed uses the "core" CPI, which excludes certain items that can experience temporary price shocks, and give a false measure of inflation. These certain items happen to be food and energy, which are truly more volatile than housing, medical care or apparel, but they are still a huge part of our everyday lives and therefore affect our purchasing power and discretionary consumer spending. (Chart 5)

Chart 5

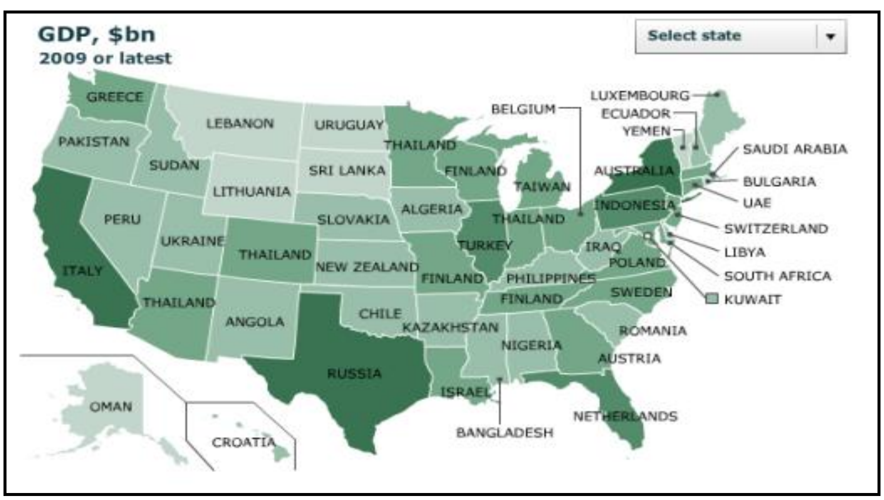


If food and energy inflation turns out to be more permanent than expected, spending power evaporates and, with it, economic growth. Workers will ask for wage increases and unions will become more popular. This is when inflation can become a major issue. Although we are far from that, it is important to note the benefits of keeping food and energy prices under control, and becoming more self-sufficient and independent. Again, to ensure long-term and sustainable economic growth, we need a proper energy policy and a fiscal policy overhaul which would stimulate domestic infrastructure expansion and more conscientious and efficient government spending programs.

Conclusion

Sometimes, a picture is worth a thousand words. Although you have heard that the US is the world's largest economy, it may be difficult to imagine. Last month's The Economist produced a map of the US and inserted 52 countries of the world whose total economic power equates to that of the mighty United States of America. (Chart 6)

Chart 6



Source: The Economist

Backed by Canada, one of the largest resource basins on the planet, the US is extremely powerful. Sir Winston Churchill once said: “You can always count on Americans to do the right thing – after they have tried everything else.” I would add to that that they can also afford mistakes and retries…

Although they find themselves in terrible financial shape, they are printing money like there is no tomorrow. They go from tech bubble to real estate bubble to bond bubble… always leaving you wondering what will bubble up next. The fiscal cliff, the sequester, the debt ceiling, all these have come and gone, yet the market is at all-time highs and the US dollar is climbing, relative to other currencies. This may provide us a good hint on the relative strength of the rest of the world! Capital from all over the world is flowing into the US because they, at least, have the means to turn their economy around. But do they have the will? And will they find compromise and common ground to lead the world for the next century? Just a small step for US politicians, but what a giant leap for America… beyond the mirage, the oasis!

<u>Summary and strategy</u>

We are back to all-time highs but the markets are much better off than in 2007.

1- Earnings today are higher than in October 2007
2- Dividends today are higher than in October 2007
3- The quality of earnings is much higher than in October 2007, when 20% of earnings came from financials (mostly mortgages)
4- Interest rates are much lower than in October 2007
5- Current P/E ratios at 14x are lower than in October 2007
   Historical average P/E is 15x to 16x, however when interest rates are low, P/Es are closer to 18x to 19x, suggesting continued strength in markets.
6- 2013 earnings could increase from 8% to 10% if GDP growth continues to expand north of 3%
7- Combined with P/E multiple expansions, the rise in earnings constitutes jet fuel to this market

Although either inflation or a hawkish change in the Fed’s monetary policy are possibilities, we do not believe they will have much impact in the near future. However a persisting gridlock in the House could damage the US credit rating and negatively impact consumer confidence.

Our strategy remains a cautious one as we continue to build our US exposure up to at least 15%, with an income focus. Dividend growth truly provides a shareholder with great long-term rates of return. When going above a 15% exposure to the US, we like to use currency hedged exchange trade funds (ETFs) as well as where the Canadian dollar falls below parity.

Consumer staples (6%), health care (4%), financial (16%) as well as utility stocks (10%) have performed particularly well and remain a safe bet in the current environment. Although our weightings remain unchanged in these sectors, we may reduce exposure in utilities as they are the most interest-sensitive of all. Industrials (6% - 8%) should continue their recent push, as long as economic growth continues to expand.

Energy (8% - 10%) should have a better year in 2013 on the back of improving world economies. We expect materials (5%-8%) to lag the recovery and we favor agricultural stocks along with a necessary minimum gold exposure as a long-term hedge against inflation resulting from excessive easing by the world central banks. Telecom (6%-8%) stocks continue to be an integral part of the portfolio given attractive growth prospects and a generous dividend policy. Technology stocks (3%) appear pricy and we are cautious to add to our positions at this time.

The debt ceiling and the political gridlock are the most import threats to this market over the short-term. Longer-term, the jury is still out as to when and how central banks will phase out their QE programs and what the impact on equity markets will be, although Mr. Bernanke assures investors that the Fed has all the tools it needs to retreat from its monetary support in a timely fashion. Head for the oasis!

RECOMMENDED ASSET MIX

INCOME PORTFOLIO			BALANCED PORTFOLIO	
Oct 2012	Apr 2013		Oct 2012	Apr 2013
15%	10%	CASH (CSB, QSB, T-BILLS)	15%	10%
50%	50%	FIXED INCOME (BONDS)	35%	30%
15%	15%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	15%	15%
10%	10%	EQUITIES	20%	25%
10%	15%	FOREIGN	15%	20%

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

Sources:
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