Be Realistic

Edmond G. Eberts
Chairman
Rapport Capital Formation Strategists Inc.

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Toronto, Ontario M5H 2Y4

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1175 Sherbrooke Street West
Princess Patricia Room
Montreal, Quebec H3A 1H9

RAPPORT CAPITAL FORMATION STRATEGISTS INC.
703, 141 Adelaide Street West
Toronto, Ontario M5H 3L5

Telephone: 416-366-9264
Toll free: 800-363-8134
Fax: 416-366-1855

rapport@rapport.ca
www.rapport.ca

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Fighting for the common man, and challenging the right of elites to monopolize power and wealth, dates back to the legend of Robin Hood. The majority of mankind wants a radical redistribution of both. There is contempt for the overseers of credit markets, and anger about the ruined investments of millions of ordinary people and from the growing army of the unemployed. The recession could last not just for months but for years, and the longer it goes on and the deeper it gets, the more questions it raises. Government has a responsibility to be counter cyclical, to lean against the wind. To be effective it must achieve efficiency-minded savings and restrain overall spending. The economic crisis presents an opportunity to embrace a phase of radical reform aiming to do away with redundancy, and creating a more agile and resilient public sector. Each agency should have a clear set of objectives, be encouraged to challenge the status quo, and be accountable for its successes and failures. Achieving clarity is where to start, implementing truly transformational change arguably a greater challenge.

Recurrent bouts of euphoria and despondency are aftermaths of the societal credit mania, a finger-pointing maelstrom about who is to blame. Canadians expect more from their political leaders than parochial war dances, qualities superior to those of the average hack. The trouble with economic gloom is how it becomes mentally contagious. If Parliament continues as a national broadcast pit of depression it could spur on a plague of self-fulfilling consumer pessimism. Rather than add to the cacophony of angst it should tackle prevailing problems with the same urgency devoted to passing member pay raises. Its ignorance of what causes economic ailments, and how to treat them, is profound. Hastily conceived policies jeopardize crucial beliefs in the value of private initiative. Large increases in government expenditures usurp precious resources from supporting the innovation necessary for long-term prosperity.

The trend towards internationalism is occasioned by a leveling of the global power structure, the United States less dominant and hierarchies less prominent. Canadians with the courage to examine themselves in a mirror will discover the image of a copycat nation, one willing to follow in the footsteps of the Americans and drown in a sea of red ink. Why relinquish the competitive advantages afforded those with a surplus? Instead of fostering a market-based economy in which choices have consequence, we are in peril of creating one that is savior-based, careening from one ad-hoc decision to another. Though we cannot stop the global recedence, we can make Canada stronger and more competitive. The centre right of the political gambit is a formula for prosperity that has proven successful. Lowering and flattening the income tax curve will help retain and attract talented and knowledgeable workers; reduced corporate rates will discourage shifting production elsewhere and will appeal to foreign investors. Dollars cannot be conjured out of thin air. Regardless of how the pork is paid for, it will be exorbitant. The resulting inflation will be expensive, and will undermine the value of our dollar and the stock market. If the beneficiary of government largesse expends the cash or credit in a less productive way than the taxed or lender, the net impact on growth will be negative. Instead of wasting time attempting to prop up the dying and the doomed, we would be further ahead by investing in the retraining of the workforce, preparing it to play a more significant role in the future.

Plum-positioned government watchdogs failed to bark warning of the oncoming tsunami; syndicated columnists, research analysts, and business news infotainers were in awe when it struck, and adversarial voices few. Conventional wisdom had investors believing equities produce the highest returns, that balanced portfolios protect against loss, and that risks could be contained if held for a long time. They now realize this is not always the case. Advisors with the proclivity to be inappropriately certain did not make allowance for the possibility of a bear market and, after it struck, were slow to respond. Notwithstanding a lousy return, cash is not trash. It provides rainy-day cover for individuals, the wherewithal for investors to make the most of opportunities on short notice. Many corporations thirst for more, others squirrel it away. The capital-restrained often outperform their wealthier competitors by doing more of what they do best, resisting the temptation to take a stab at diversification. Market sentiment will enable them to take advantage of premium multiples of cash flow and earnings and related book-value ratios.

Psychics are often dismissed as charlatans because they predict the future without the date. The trick is to know when the change in direction will take hold. The best way to succeed is to be in position to benefit as it happens. Long-term indicators of value, not corporate profits, are the single-most important signal to heed. Canadian equities have not been so inexpensive in decades. Strategists suggest it is a good time for patient investors to start buying high quality stocks in anticipation of above-average returns down the road, few with much to say about near-term potential. Another valid tool is an understanding of factors affecting supply and demand. Having suffered negative retained earnings, many of the biggest financial institutions are in dire need of additional funding. Though stock prices are down significantly, and a generous discount may be offered, demand for new issues is greatly reduced, dilution inevitable. Having splurged on big ticket expansions and costly acquisitions, many now-humbled businesses are being forced to pay back loans when they can least afford to. Some will not survive. Governments will be in the doghouse when the time comes to raise interest and tax rates to curb inflation and payback the billions dispensed without a clearly defined game plan.

Lost in the game of bailouts is an appreciation of the significant role played by family-controlled and wholly-owned enterprises. Success is built on clever ideas and state-of-the-art manufacturing facilities; talented employees, hard work, and good luck are all aspects of meeting performance goals. Management is not under the gun to exceed research analysts' consensus estimates of quarterly results, and there is nothing to gain by going off half-cocked. It can afford to spend whatever time is necessary to make the right decision, the reason why they tend to outperform their short-fused TSX-traded counterparts, dividend payers throughout. Because of their vitality and steadfast commitment to improving productivity, Canada is doing better than otherwise. The owners have a longstanding record of giving back to their communities, and are generous supporters of worthy causes. Though it may be good politics, fleecing the successful makes no sense at all. They are the country's primary employer and the true drivers of the economy.

Much of what happens in the investment world is done under pressure to produce results in short time periods and rapidly changing environments. Systemic risk aside, the star players want to be judged on their ability to seize or create opportunities, compensation for outstanding long-term performance partly paid in treasury stock. Regardless of the prevailing brouhaha over bonuses there will always be another firm willing to hire away the best. Despite outsiders being mad as hell, and politicians wanting to add their two cents worth, few of the firms will go down for a full count. Their next home run could be carbon-credit trading, with problems of its own. The American government can toss around the idea of salary caps for bankers because it has effectively nationalized the cartel. In Canada pay-for-performance is real. Several CEOs saw their take-home drop dramatically on weak results, the value of their options wrecked. Many higher-ups, with precious little of their own savings on the line, now say they want a greater portion paid in cash. Seeing as they failed to make the right moves when the stock price was flying high, odds are their timing will prove to be wrong again.

The stock market reflects the collective wisdom of investors. It is the ultimate gauge of economic expectations and consumer confidence, an indicator of which way wages are headed. Its message of distress is plain but incomplete, the depth and duration of the slowdown still to be determined. Unrealistic, boardering-on-delusionary earnings targets lent unsustainable support to expectations creating the illusion of stocks and trust units being oversold, today's valuations closer to the mark. Ditto for third-party credit ratings. Only fools attempt to call the bottom of a bear market. Being early or wrong is worse than late, added patience worth the while given the severity of the macroeconomic landscape. Notwithstanding mounting job losses and profits plunging, there are signs the rate of economic decline is slowing, glimmers of stabilization emerging. Interest rates at which banks lend to one another are easing and liquidity is expanding, laying the groundwork for an upswing in business confidence. The issuance of high-rated corporate bonds is soaring, signaling debt markets are getting back to serving their core purpose – providing funds to companies to grow and prosper. Could the equity market soon respond in a positive manner?

In the past several years profit growth was greater than average, investors willing to pay more for each dollar thereof, triggering outsize gains in stock prices. Price-to-earnings ratios back in line with historical norms, the degree of euphoria is unlikely to be repeated anytime soon. Single-digit appreciation may not be thrilling, but for many a stretch of modest returns might be a great relief after suffering sizable losses in the past year or two. It was a quarter century before the market got back to even following the Great Crash of 1929, more than seven years to recover after the 1973 and 2000 downturns, only eighteen months for short-term corrections of which there have been many. The US bear market took hold in October 2007, the Canadian in July 2008. Are we talking 2014 or 2015 respectively, or April 2010 and March 2011, before portfolios are back to square one? With just-in-time manufacturing, better cost and inventory control, and money being pumped out in unprecedented amounts, the supply side of the equation is ready to rumble, consumers another matter. They are still licking their wounds. Savings rates are gaining, obligations declining, self-assurance returning step by step. Running to stores they are not. But, they will. It is only a matter of when. This year or next? Indications suggest they are itching to get into the swing of things, and things should start getting back into swing by year end. With almost everyone saying the situation can only get worse, what matters is likely to go in the opposite direction. It always does.

History holds, with almost no exception, that categories of stocks which fared relatively well at the outset of a downturn but poorly so in its later stages, tend to lead at the start of the next bull market, and for a considerable time thereafter. Included are: energy, materials, industrials, consumer discretionary and, now, the banks. Next year could be the dawning of a new economic upturn, led as always by the stock market. In keeping, Canada will emerge from hard times sooner than its peers, the Canadian dollar will regain lost respect, equities their lustre. Be realistic. The world is not coming to its end. It will survive and prosper anew.