

Beyond Belief

Edmond G. Eberts

Chairman

RAPPORT Capital Formation Strategists Inc.



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

Beyond Belief

It takes considerable study and front-line experience to anticipate the twists and turns of the economy and capital markets. To be successful requires the strength of mind to differentiate good from bad advice. If you want to sleep well at night and avoid drowning in someone else's dirty bath water, you have to think beyond belief. A year ago everyone was a raging bull. Now most are ferocious bears. Few saw the correction coming and will, in all likelihood, botch the turn when it happens. This sequence of events is no different from the past. The news these days is almost uniformly awful. Consumers are despondent, investors tired of the seemingly endless parade of lousy earnings and lame duck excuses. Lovers of the horror film genre should be in their element as one after another of the major institutions owns up to the carnage inflicted by their greed-fuelled forays into the dark world of complex financial instruments. If and when the mounting pyre of debt gets lit, will anybody be able to put out the fire?

With the nadir of the credit crunch nowhere in sight, the naysayers are convinced the pain will only get worse and last longer than first computed. In spite of aggressive interest-rate cutting and mighty increases in the money supply, efforts to improve inter-bank liquidity have fallen on deaf ears. Until the velocity at which it changes hands gets back up to speed, both fixed income and equity securities will remain skittish. Having fought the good fight, surging prices for food and fuel, combined with falling home and investment portfolio values, people are saving more and spending less for fear of a recession. Even so, with initial public offerings a trickle and payout increases minimal, it is a good time to start loading up on downtrodden stocks at bargain prices. Many are ripe pickings for the patient contrarian exercising good judgment.

DOLLARS AND COMMON SENSE

The US dollar is no longer as good as gold. Its rapid devaluation has whipsawed financial and trade markets everywhere. The authorities seem to have abandoned all sense of duty associated with providing the world's key reserve benchmark. Their cavalier attitude is an affront to those who believe in a level playing field, a truly globalized economy with free movement of goods, services, and capital. Manipulation is like moving goal posts. Many are convinced it is cheating. The resulting furor will inevitably affect the personal fortunes of millions of citizens; once unleashed, it can spawn social resentment and political

upheaval capable of changing the destiny of a nation. To restore its integrity as a meaningful unit of account, a reliable store of value, will require renewed dedication to fiscal discipline. Had there been, it might not be the basket case it is today, causing countries so pegged to question the advantages. While it is never too late, there are no signs of wanting to put such a strategy into practice. Quite the opposite. If Canada was to adopt the US dollar, eliminating the biggest source of currency fluctuation, we too would become subject to US monetary policy. Few Canadians want that to happen.

ROBBIN' HOODS

We all remember the legend of Robin Hood, who robbed the rich to provide for the poor, and fought against injustice and tyranny. Today's highfalutin' robbin' hoods of the financial world are a self-centred gang who steal from both, to their advantage and nobody else's. In the 1990s they drove technology stocks beyond reason, then blamed the research analysts when prices subsequently plummeted. Their most recent gig has been the creation of exotic debt and other questionable securities, only to see the after-market collapse, claiming the rating agencies shirked their responsibility. Soon afterwards the deal-hungry underwriters could be found scurrying around attempting to raise even more money to sop up the spillage, only to get caught with a hand in the cookie jar, forced to eat some of their own makings, and suffer significant writedowns. All the while, equity investors have taken an almighty pasting. These braggarts are not to be trusted to safeguard an investor's weal. They can't even protect their own.

Corporations also have a bag of tricks to play with when it comes to reporting financial results. In addition to overly aggressive and deliberately opaque accounting practices, buybacks reduce the size of the denominator; leveraging the balance sheet is another strategy. The current rage of American multinational corporations is to translate foreign earnings into US dollars. As Canadians can attest, this is a big mistake that will come home to roost. Instead of continuously investing in the most-up-to-date equipment available as their overseas rivals are doing, this tomfoolery has a habit of lulling management into believing the enterprise can continue to prosper despite inefficient domestic plants. As a consequence they will inevitably find themselves behind the eight ball when the economic tide turns. At which point the stock market takes its toll, reflected in lower multiples of cash flow and earnings, and a comparatively greater cost of capital, the foremost determinant in achieving long-term success. Stock splitting is also a questionable practice. Investment bankers suggest doing so makes the shares "less expensive," encouraging investors to buy more driving the price higher. If this is, why not do so every quarter?

SETTING THE STAGE FOR THE NEXT BULL MARKET

Whatever factors impact the economy and financial assets, investors count on old-fashioned trust to be their ultimate guide. The extent to which they react depends on their unique time horizon. Tied to changes in generational attitudes, stock market indexes have a history of moving through a different era every fourteen to sixteen years. If volatility is high, performance is low, and vice versa. When the longest and most lucrative bull market in modern history got going in 1982, few individuals owned equities. Many deemed them to be too risky. By the time the averages peaked in 2000, the masses were completely sold on the mantra prices might go down in any given year but, over time, stocks would produce double-digit returns. Barring a miracle, it is unlikely we will soon experience

another enchanted run of gains compounding at 20 percent per annum, doubling the net worth of portfolios every four years, twice the rate of the previous fifty-six, when dividend yields were almost three times greater. Notwithstanding, they should continue to out-do high-quality bonds, with or without efforts to prop up the ratings. The one caveat is stagflation, which would reduce the ultimate return and discourage further investment in equities.

Charged with protecting the soundness of their respective banking system, the chairman of the Federal Reserve Board and the governor of the Bank of Canada have a moral responsibility to guard against political panic and public euphoria. The current brouhaha is the result of their predecessors' reckless monetary policies. Worried about deflation, they kept interest rates unnecessarily low for too long, creating a subsidy for borrowers, the root cause of mortgage mania, delinquencies, default, and disillusionment. In an effort to ease the pain and improve the wherewithal of financial markets, an alphabet soup of new credit facilities has been introduced, a clever gamble to provide large institutions time to get their affairs back in order. With compelling evidence that initiatives to redirect an economy almost always fail, it will be interesting to see how central bankers walk this delicate tightrope, and when they will have to ratchet up interest rates again. Meanwhile, the banking industry needs more capital from the private sector. If not available, government intervention may be required, the way similar crises around the globe are resolved. Since the rise in the stock market came to a shuddering halt in the summer of 2007, a process economists refer to as deleveraging has gripped investors and those who are overextended. The arduous task of determining what portion of the world's prosperity is intrinsic and how much due to the no-money-down driven frenzy has only just begun. At the tag end of the bloodletting, lending standards will be more stringent, the financial system healthier, and many first-time house owners will have learned a costly lesson.

The US has one of the most uneven inflation records, our's mitigated by the appreciating value of the Canadian dollar and cross-border shopping. The primary drivers have proven to be global shortage-of-supply issues, under-investment in infrastructure, duty and excise taxes, the explosion in public-sector employment and compensation costs, red tape and exorbitant security measures. It is not you and me racing out to buy a new plasma television set. We are not the cause of the fireball burning through the talking heads' psyche. Many in position to take action believe dealing with the downturn is more pressing than worrying about a consequential increase in prices that could trigger a vicious circle, whereby employees seek wage gains to protect their purchasing power, and business takes steps to preserve profit margins. There is reason to question productivity improvement claims. If illusionary, standard-of-living prospects ought to be tempered. Fortuitously, the capital-to-labour ratio is headed in an upward direction, a key to realizing productive potential. Take-home pay increases reflect differing levels of responsibility, in keeping with a well-functioning workforce.

There is nothing wrong with scrutinizing the motives of people engaged in the dicey debate of which way the stock market is headed, as it acts as much on sentiment as it does on information. The subjectivity arises from only taking into account one side of the discussion and with a preconceived notion of what will be found. When inflation accelerates, equities can struggle. Should the economic scourge prove stubborn, it will have a negative effect as it reduces the value of future cash flow and earnings. If times are tough

and the outlook grim, investors have a tendency to seek shelter from the storm of doubt in owning trusty blue chip stocks able to stand the test of a bear market, and pay a dividend. Fearing the return will be volatile, they often overlook well-positioned small-capitalization companies. This is a mistake as, in many instances, the only ingredient conspicuous by its absence is constructive research analyst sponsorship, and that can be had. Despite corporate earnings forecasts having further to fall, there are signs the S&P/TSX Composite Index is starting to put aside the stream of bad news.

Many claim to have foretold of the tech bubble collapse, few predicted the housing boom, or bust that followed. In time a new force will emerge to rekindle consumer spending and keep corporations on their toes. Canada may be battling a bad case of the sniffles, but is unlikely to catch pneumonia. Foreigners continue to scramble to buy the sort of staples it has to offer in abundance. It is not a question of whether the petroleum industry will have to suffer through another down cycle. It is about rapidly increasing overheads. This helps to explain the US\$100-plus price and its resilience to weakening demand signals. Unlike farmers and ranchers tied to their land, oilpatchers are free to roam in search of the best return on capital. They will continue to move away from Alberta until the government recants its new royalty policy.

NATURAL RESOURCE STOCKS TO CONTINUE LEADING THE PARADE

Every investor has a theory as to how to beat the stock market. One thing for sure is it goes up to go down, and down to go up. On any given day possible sellers outnumber potential buyers. Keep the existing investors onside, and the new players will have to pay up. If not, the price will go nowhere, or down. This proves there are steps to be gained on the competition by keeping the dialogue alive when either the sun is shining or the moon is out. Whether it be the crash of 1987, the real estate collapse of the early 1990s, the Mexican peso problem of 1994, the Asian contagion of 1998, the technology bubble of 2000, or the sub-prime stupidity of today, the reaction has been one of panic. Yet the world has never come to an end. If one steps back from the fray and concentrates on the changes in the fundamentals one will come to the realization setbacks are as inevitable as gravity, recoveries worth looking forward to.

Preserving capital is all important. Ignoring the significance of asset allocation is a form of reckless abandon. Failure to comprehend and manage risk exposure is the reason many investors fare poorly. Those who use leverage run the chance of having their savings wiped out. The gains needed to recoup losses are larger than may seem obvious. The good news is that a few highly respected mavens have concluded the bull market never died. Though it may waiver from time to time, enough to cast doubt, it is just working its way through a normal correction. Recent performance and technical charts suggest it would only take a slight rotation out of money-market instruments to have a positive impact on the overall S&P/TSX Composite Index. Adding to the upside potential is the covering of short positions, triggering a melt up, rather than a melt down. It is time to figure out how to take advantage of the bounce back. To stew in one's own juice will do you no good.

The masters of the universe who enriched themselves though the miracle of borrowed money have seen the apex of their glory. We are in the midst of an extraordinary transition – away from private equity and hedge fund investing that was the source of unimaginable wealth until it was not anymore, and into a more reasonable allocation of both intellectual and economic capability. The research analysts are back in the driver's seat. With a choice

of disclosing the outlook details or not, many CEOs chose to keep their mouths shut. Of the few who provide guidance, three out of four revise their prognosis, downgrades outnumbering upgrades by two to one. Those who do better than they foretold are also of little help to investors in their quest to determine whether or not to buy or sell. Confusion is the greatest challenge to realizing the benefits of peer-group competitive multiples.

There are concerns some banks and financial services companies may not be reporting the true cost they are paying for short-term loans for fear of appearing desperate for cash. A sharp and unexpected rise in the interest rate spread would spell more trouble if undercapitalized. In contrast, the energy, materials, pharmaceutical, and technology sectors, and junior industrials with a better-than-average growth vantage-point can be expected to record strong gains, accelerating as the year progresses.

Forecasting the demand for crude oil and natural gas is fundamental to market psychology and performance. The relationship of supply to demand determines the equilibrium. Forward strip contracts are a key guide, and more accurate than other methods of making commodity price predictions. Many producers do not invest in futures; rather, they speculate. Jumping in when they believe they have the capacity to beat the odds, only a handful ever succeed, last year's disappointing experience a perfect example. They should stick to shoring up balance sheet ratios, containing costs, and driving production, just as the shareholders would have them do. Another pet peeve is excessive CEO compensation. Though investors may worry about making ends meet when times are tough, senior executives who fail continue to rake it in. Over the past twenty-five years their take has risen faster than the rate of increase in the GDP, corporate profits, and worker wages. A sensible alternative to the current system would be to require them to own a significant number of shares, just as entrepreneurs do, their salaries to reflect the appreciation in value. Bonuses ought to be based on improving cash earnings relative to the cost of capital, not an easily manipulated measure like earnings per share, and not paid out for some period of time to discourage a short-term ploy. Unfortunately, most directors seem immune to reform, going along with the get-along culture of big-company boardrooms, damaging the prospects for the enterprise and punishing the investors whose best interests they were elected to protect.

The S&P/TSX Composite Index started outperforming the S&P 500 in 1998, marking the beginning of the commodity bull market optimists expect will endure for another five to ten years. How the TSX Capped Energy sub-index does is important. Bears think the tightening of credit standards will handcuff speculators, and that a recession will reduce refinery requirements, causing the WTI price to drop to US\$65 per barrel. Or it could reverse course and shoot up to US\$165. To some extent, the basic market mechanics have broken down. A paucity of significant new discoveries to keep abreast of natural declines in mature fields and an ever-increasing world demand, means the age of cheap and easily pumped crude oil is over. Be prepared to pay more for gasoline from now on.

The Federal Reserve Board appears to have completed its easing cycle and now has to contend with surging inflation. As raw material costs remain stubbornly robust, the task will prove difficult without a drastic reduction in demand or increase in supply. Accounting for nearly half the total weighting of the S&P/TSX Composite Index, only the energy and materials sub-indexes outperformed the averages in the first quarter of 2008. The question is, how high would the price of crude oil and interest rates have to rise to be a serious drag on the economy and the stock market? At US\$120 per barrel it is, in real terms, about the

same as it was back in 1979, when interest rates were a horrendous 16 percent compared to less than 5 these days. If they remain so, the new choke point would be US\$150. Though volatility can be expected to continue, it seems unlikely the roof will cave in. Further, fewer than 20 percent of large-capitalization money managers beat the market in the first quarter of 2008, the lowest reading since 1999, when the records were first kept. The tally is based on total return, including dividends, but excluding fees and expenses. While it may be argued institutional investors are forced to maintain a cushion of cash, individuals do so of their own choosing, positioned to pounce when a sound buying opportunity is brought to their attention or participation in a new issue is offered. They are, simply put, better at playing the performance game. With the NYMEX suggesting a price of US\$124 or higher come a year from now, chances are the big boys will soon bite the bullet if for no other reason than to show they are on target.

Fortune tellers insist a stock market in the depth of despair is a turnaround just waiting for a catalyst. Though no one fancies trying to catch a falling sword, astute investors are growing weary of bonds, and beginning to drool at the relative attractiveness of equities. The missing link is commitment. When the heady cocktail of cash and confidence combine, those who raise their glass will do exceptionally well. A year from now they will wax nostalgic about the great buying opportunity missed by the many who had the chance to outdo their peers. Unlike the Internet bubble, when price-to-earnings ratios were high and profits low, the reverse is true for the energy industry. Fearing a slowdown in the United States could spread to the rest of the world, investors worry the results are vulnerable. Notwithstanding, the propensity to shrug off negative news continues. There is a clear pattern of higher highs and higher lows, and buying power is building. All factors bode well. Whereas EnCana Corporation, Canadian Natural Resources Limited, Nexen Inc., and Talisman Energy Inc. are getting the headlines, it is the reopening of the bought-deal floodgate that should grab the attention of junior and mid-size producers, oilfield services companies, royalty and income trusts. A conference call is no substitute for a face-to-face encounter. In order to realize the highest-possible new issue price, take to the road and tell the greater audience about who you are and what to expect in the future. Never forget it is the individual investor who buys to own and sets the day-to-day closing price, not the late-to-the-ball game institutional types who buy to sell. It is important to think beyond belief.