

It Ain't Going To Be Any Different

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Accurate forecasts of equity markets are nearly impossible, which is why most of the world's truly great investors usually ignore the soothsayers. Instead, they find a strategy that works for them and stick to it. The winning theme for 2005 in Canada was commodities. Thirty-six of the top-forty performers of the S&P/TSX composite were resource plays, primarily energy and mining investments. The big question for 2006 is not whether the commodity driven rally will continue, but will your portfolio stand up if it does not!

The year just past was also wonderful for other stock markets, including Australia, Brazil, Egypt, India, Mexico, South Korea, and South Africa. Like Canada, each reached record levels on the first trading day of the new year, while the S&P 500 remained 20 percent below its peak of 2000, in part because the greenback is still so weak. Thanks to excess liquidity, relatively low interest rates and the "trend-is-your-friend" phenomenon, whereby people pour more money into already buoyant equity markets and currencies, most prognosticators are predicting more of the same for the S&P/TSX composite and the Canadian dollar throughout 2006. Then again, there are scaremongers predicting a 20 to 25 percent correction. They claim we are in a secular bear market. Stocks are overvalued and, therefore, carry great risk.

For those who are politically inclined, the second year of a U.S. president's term has historically seen a mild gain in the first quarter, followed by a significant slump in the second and third, and a recovery in the fourth quarter, setting the stage for the next four-year bull market. As history buffs will attest, the annual seasonal influences on North American equity markets held true when, as during the previous ten years, the S&P 500 and the S&P/TSX composite recorded slightly more than 100 percent of total gains between October 2004 and March 2005. They bottomed again this past October and have been in a uptrend ever since, lending credence to the age old saying "Buy when it snows, sell when it goes." Whatever, the most dangerous words in investing are: "This time, it's different!" because in all likelihood, it ain't! It seldom is.

COMPARING 2000 TO 2005

As scores of stock market investors have noted, the biggest parallel between 2000 and 2005 has been the dominance of one sector in propelling the composite higher. In the prior period, technology hardware and software companies accounted for 42 percent of what was then the TSE 300. Today, resource stocks represent 42.8 percent of the S&P/TSX composite, without which you could kiss most of last year's 21.4 percent gain goodbye. Five

years ago, it was difficult to find anyone who was bearish on technology. Now one is hard-pressed to talk to a soul prepared to predict crude oil could fall to U.S.\$20 a barrel, exactly where it was trading back in 2000.

Who would have thought it possible Nortel Networks Corp., which accounted for 34 percent of the master index in its heyday, might plunge from \$124 per share to just \$0.69! The good news is it was not making any money back then, and still does not earn a meaningful amount today. However, many oilpatch, mining, and gold enterprises are very profitable and will continue to be so even if commodity prices were to soften somewhat.

A more subtle difference can be found on the balance sheet. Unlike 2000, Corporate Canada is awash in money and has modest debts, the result of a streak of rising earnings and fatter margins. Overall profits, before taxes, now exceed 14 percent of the economy, the highest level in more than forty years, and substantially better than during the economic boom of the late 1990s. Even so, the breadth of the growth in earnings will have to improve to maintain this level of excellence if commodity prices decline even modestly. Such is the greatest test facing the Canadian stock market in 2006. Should stock prices fall measurably, many issuers with plenty of cash may instigate buybacks – much as a goodly number did following the stock market crash of 1987. All of which suggests the risk of collapse in share and income trust prices may be limited, so too the opportunities to buy bargains.

TRADING VOLUMES ARE INCREASING

The value of 2005 trading was \$1.075 trillion, up 29 percent from \$833.91 billion in 2004, as the number of transactions swelled by 37 percent to 55.2 million from 40.3 million, fueled by hedge funds which now account for up to 25 percent of day-to-day trading. The value of all TSE-listed securities was \$1.83 trillion, up 18.3 percent from 2004. As a consequence the TSX Group Inc.'s earnings soared, it being one of the best performing stocks in Canada. The one negative is the increase in portfolio turnover rates, which will result in greater volatility should a stock market correction take hold, causing prices to tumble further than they might have otherwise.

Fortunately, and as was predicted several years ago, the Reuters/Jeffries CRB Index recently reached a new high, surpassing the previous record set back in 1980. While it took twenty-five years to achieve, I have little doubt we have yet seen the top, and may not for several years to come. On the technology side of the quotation, giddy Google Inc. recently traded in the U.S.\$450 range, up from its IPO price of U.S.\$85 of less than two years ago. Some research analysts are targeting the stock to go to U.S.\$600 by the end of 2006. Could it be another flame-out like Nortel? I do not think so! This headliner has really impressive earnings which are growing very rapidly.

To top things off, and despite meddling by the federal government designed to cool off the runaway and some might say overvalued income trust sector, these widely popular investment vehicles show no sign of taking a back seat. By year-end 2005, the total value was about \$185 billion, a good 10 percent of the country's entire equity market. According to sources, the present backlog of IPOs and secondary issues could be as much as \$5.5 billion, once again far outdistancing all other forms of equity financing. There were, by the way, a record number of 223 new listings on the TSE in 2005, which will have a positive impact on the value of trading, and the earnings of the TSX Group Inc. going forward.

THE THREAT OF AN INVERTED YIELD CURVE

In case you spent the holiday season in a shortbread-induced coma and missed the financial media's hysteria concerning the threat of an inversion of the U.S. Treasury curve, as the yield on two-year government bonds momentarily and marginally traded above that of ten-year notes for the first time since 2000, this is what the fuss was all about. Though this technical indicator has predicated every recession in the U.S. since the 1950s with but one false alarm, the yield curve must remain negative by twenty-five basis points or more over ninety days or more before an economic turndown can be expected four to six months hence. Though Canada would no doubt feel the pain should such come to pass, continued strength in other economies about the globe, which feed off our supply of commodities, would lessen the impact. Not so in the U.S., despite its impressive gains in productivity.

All this chatter has raised my contrarian hackles. Sure, if the lemmings jump on the media bandwagon and head for the cliff, it could be a self-fulfilling prophecy, and we may indeed be headed for a recession. Why even otherwise sane investors may start running for the exits, moving portfolios into cash and canned goods. If the stock market subsequently lost 40 to 45 percent of its value it would, once again, be time to buy anew assuming you had put money aside to do so. Though the North American central banks typically raise (or cut) interest rates at least one time too many, I see no reason why they would stand by and allow an inverted yield to come to be in this day and age. As such, I believe the economists are offside in suggesting this time, it's different. Sorry, but a near-term recession is not in the cards. A stock market correction, maybe!

WHEN YOU ADD IT ALL UP

For the past number of years consumers have been the driving force behind the economic expansion in Canada, accounting for 84 percent of the total, spending their way through the tribulations of an appreciating loonie, higher energy prices and a manufacturing downturn. However, by the third quarter of 2005, business investment and exports became the mainstay, responsible for 57 percent of the equation. While housing-start numbers still look healthy, even a slight slowdown due to rising interest rates will exasperate the trend of weaker personal spending, despite a high-flying job market and a rise in disposable income.

The good news is that corporate profits have been growing steadily in recent times. Companies are sitting on huge stockpiles of cash. Commercial development is strong. Though the pulp and paper industry may still be struggling, all aspects of the petroleum and mining industries have never had it so good. Canada's stronger dollar, currently trading at a fourteen-year high of U.S.87.21 cents, makes machinery and equipment imports less expensive to buy, which will inevitably help to boost the country's lagging improvement in productivity. Overall, GDP growth should average about 2.75 percent in both 2006 and 2007. However, the regional pattern of activity will differ. The resource-rich areas in the west, east and north should experience double the much weaker gains in the manufacturing-focused central provinces, reflecting the reshaping of our economy by the new dynamics of the global market place.

Renewed inflation will keep the Bank of Canada on a gradually tightening path. Ever mindful of the perils of a yield curve inversion, the bellwether overnight rate is expected

to climb to 4 from today's 3.25 percent, still low by past history. The Canadian dollar will likely reach the U.S.90 cent threshold and maybe the U.S.93 cent level. It is going to be another good year and potentially a great one for the economy.

Europe is on the move, but gains in productivity remain problematic. Not so in Japan where, as their stock market suggests, the economy has finally shaken off its fifteen-year funk. With the GDP growing at 9.5 percent per annum, China will continue to have the greatest influence on worldwide commodity prices. There are signs it may be headed towards a period of industrial overcapacity and consolidation. If so, it would put a temporary lid on the demand for raw materials, including: crude oil, coal, lead, copper, and zinc. The recent rise in short contracts for crude oil on the New York Mercantile Exchange, outnumbering the longs speculating the price will continue to rise, is food for thought. It is quite possible the August 30, 2005, record high of U.S.\$70.85 per barrel may be safe, at least in the relatively near term. If the mild winter weather persists on the populous east coast of North America, ditto for the U.S.\$15.41 per mcf record price for natural gas. Whatever the case, there is no chance either commodity will again double or triple in price. Even so, the oilfield services outfits will continue to operate full out, and margins show every sign of improving for this year as a minimum. Of note, Statistics Canada has revealed energy exports, almost all to the United States, totaled \$9.2 billion in October 2005, surpassing cars and machinery, the traditional leaders, for the first time.

The remaining question is whether or not the growth in Canada's economy will be reflected positively in the stock market. The answer is yes, but not in a straight, upwardly inclined line. Bargain hunters are advised to pay heed to the Dogs of the Dow strategy by buying the ten highest yielding stocks – often the past year's worst performers. The idea has worked brilliantly over the long run, trouncing the S&P 500, the S&P/TSX composite, and most mutual funds by a wide margin. The reason being investors usually underestimate the ability of large, established companies to adapt to change. The negative sentiment about them makes the stocks cheap, and a healthy dividend offers a modicum of downside protection. More times than not, the nearly deads bounce back. The hard part is sticking to the strategy, and allowing the dogs to do their thing better than most would have ever expected. General Motors is a perfect prospect in the U.S. So are some of the forest products stocks in Canada.

Another measure is the cash flow to debt ratio, which simply divides the trailing twelve-month cash flow by long-term debt. Companies with a robust ratio not only show lower risk, they also have a greater ability to repay debt. Annual returns in 2005 were 11 percent higher than overall stock market gains, with less dramatic swings in share price. Better still, companies with sound cash flow to debt ratios, ample interest payment coverage, and high rankings by research analysts really stood out from the crowd of also-rans.

Despite all these schemes, it seems to me the seasonal trading pattern of the past is bound to hold true this year. The stock market will rise in to March, slough off in the summer months, and start its next upward move toward new record levels come October. Despite what the naysayers might suggest, this time around, it ain't going to be any different! So if you are a CEO in charge of a company or income trust that could do with a boost in equity capital, call your underwriter today and get on with what needs to be done to secure the balance sheet. While you are at it, set a little extra aside for a rainy day in the hope of buying a competitor, or some of its assets, at a discount when the stock market trails off, and others have to scramble to make ends meet. It is also imperative you do all

you can to keep costs in check, and the investment research analysts on side, particularly if your primary competitors have a reputation for doing so.

From an investor's perspective, portfolio rebalancing is an ongoing discipline. Book your losses now, before they become any greater. Pare back on portfolio holdings which account for more than a reasonable share of your wealth, and set aside a store of cash to buy bargains if and when they become available. Never be shy about being ahead of the crowd. Those who are always get to fight another day. Pigs get slaughtered. This time through the turnstiles it will not be any different than it has been for the past decade! Never believe those misguided souls who have the temerity to suggest otherwise. Or as the poet Robert Frost once said, "Take care to sell your horse before he dies. The art of life is passing losses on!"