# Gathering Storm Clouds

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Optimism is back in style. Fully 54 percent of households, as compared to 41 percent a year ago, believe stocks will continue to go up in 2004. This is a statistical tie with the frothy 1999 bull-market high of 52 percent. Amongst those who actually own stocks, 67 percent expect equities to do better this year, as compared to 47 percent a year ago.

Investors have also regained confidence in their own stock-picking ability. An overwhelming 75 percent believe that the stocks or mutual funds they pick will beat the stock market averages, up from 64 percent in 2003.

Notwithstanding bullish long-term return expectations, stock valuations are expected to remain well below the level of the giddy 1990s. In the wake of the investment industry scandals that have recently come to light, many are dubious that retail investors will ever really get a fair shake. Though immensely cheered by the stock market rally of the past while, investors do not seem to be dangerously euphoric. One might say that the bulls are still running up and down Wall and Bay streets these days, but not as fast as they once did just a few short years ago.

## SOBERING SECOND THOUGHTS

While the short-term aspects may look just fine, the longer-term picture is not so sure. Viewed over the course of the past twenty-five years, or longer, the bears regard the stock market's longer-term prospects with alarm. Some would say that prospects are grim.

Since the 1974 and 1982 lows, stock prices have gone up far more than earnings, dividends, or shareholders' equity would equate. Corporate debt has also soared, all of which could lead to a severe revaluation of stocks, as invariably the succeeding move after every mighty bull market is a huge bust, resulting in a swing from very high to very low valuations. By any measure, the stock market still carries an extremely high price tag. Only fools would dare to suggest that "This time it is different!" It never is, as it is the result of human emotion, not hard, cold facts.

The one thing that has changed is the duration of the business and stock market cycles. Every part has lasted longer than its predecessors. While no one really knows at the outset how long a cycle will remain intact, bear markets typically last one-third to one-half the length of the preceding bull market. Valuations go from above twenty to less than ten times earnings. For the S&P 500, that implies a drop from the 2003 year-end close of 1,112 to about 400 sometime this decade. As to the S&P/TSX, the implied drop is from 8,221 to something like 4,000.

For seventy years the venerable Dow Jones Industrial Average of the bluest of blue chip stocks traded below three times book value and mostly thirty times dividends. For the past ten years it has traded above these benchmarks. Presuming the market will once again trade back down to these measures, the Dow Jones Industrial Index (DJII) will likely drop to 5,000 or less, from the 2003 year end close of 10,454.

As the bears are also quick to point out, insider trading has reached record volumes. As noted in our paper *Dark Clouds Can Have a Silver Lining*, the ratio of insider sales to purchases recently hit a ten-year high at fifty-nine to one, a bearish sign said to be anything greater than twenty to one. Is there something the various managements and directors see in the tarot cards to suggest that the stock market will be much lower a year or two from now? If the insider selling persists, they likely do.

What about the average trading volumes on the NYSE, Nasdaq and the TSX? If insider selling is heavy and trading volumes are light, there could well be trouble ahead, particularly if volatility is expected to remain relatively calm as it has been for the past while. Given the record level of earnings recently reported by Wall and Bay street firms, one would be led to believe that the stock market rally is intact and headed higher for the moment.

Even so, we should not lose track of the fact that bear markets revalue – or devalue – just about every stock. Not even super stocks are immune to the ebbing tide. Income trusts are simply variations within the equity asset class. Asset allocation is the most important decision an investor must make. It determines success or failure longer term.

Though many mandarins are bothered by the prospect of inflation and higher interest rates, the weight of evidence is deflationary. The surge in commodity prices may be a short-run happening, caused by near-term shortages and the declining value of the greenback. Today's futures prices seem to be anticipating significant drops in the foreseeable future.

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If such proves to be so, investors would be wise to consider switching into Treasury bills and their equivalent, bonds, gold and gold-mining stocks. Between 1978 and 1980, the DJII average traded at only 1.6 times the price of gold. Lately the index has been as high as forty times. It could well return to the low single digits again. If gold rises to U.S.$1,500 an ounce, the Dow could drop to the 4,500 to 5,000 level, in line with the aforementioned seventy-year record of trading below three times book value. An economic slowdown or contraction would eliminate the threat of inflation, the only factor holding back a bull market in bonds.

do you mean DJ Industrial Index average or DJ Industrial Average?

Other concerns have to do with the ballooning U.S.-trade and budget deficits, the very low savings rate and, of course, the declining value of the greenback. America's geopolitical dominance causes its leaders to subordinate the trade problem to the high politics of war and peace.

Because so much of today's trade deficit is structural, exchange-rate shifts do not produce the predicted gains. The greenback has steadily fallen against the loonie, the euro, and the yen, yet the trade imbalance keeps rising, as the others keep pricing to the market. However, if the decline in the purchasing power of the greenback persists, it is quite likely that import prices will rise over time and have a negative impact on the cost of living. Until U.S. politicians come to appreciate the true risks, and adjust government policies accordingly, the trade deficit will just get worse.

Unfortunately the George W. Bush administration shows little interest in addressing the deficits. Though economists may disagree on how much of the trade deficit is structural, they do concur on what a hard landing looks like: world financial markets lose confidence in the U.S. dollar and stop financing the folly; the greenback goes into a free fall; the economy crashes; and the price of gold goes through the roof. It is not a pretty picture.

In order to avoid this, America's political leaders need to grasp the real causes of the imbalances and to remedy them. At the moment, there appears to be little chance of this happening any time soon, at least not until after the 2004 presidential elections. Unfortunately, neither the incumbent nor the other front runner would appear to be the sharpest knives in the drawer. That in and of itself is enough of a concern to have the gold bugs dancing up and down main street.

Though we Canadians may have good reason to celebrate the U.S.$0.78 loonie, back up from its recent all time low of U.S.$0.62, we too have structural challenges that need to be addressed. Prime Minister Paul Martin is going to have to introduce tough measures at a time when the citizenry is clamouring for more services, and anti-American rhetoric is running high.

Simply put, at 41 percent versus 30 percent of GDP in the U.S., our federal and provincial governments are taking far too much out of our economy to allow us to compete toe to toe with the Americans. Our effective tax rates on capital are almost 12 percent higher than theirs, and as a result, our productivity and living standards trail by a wide margin. In fact, Canada's GDP per capita, adjusted for purchasing power parity, is tracking fully 17.2 percent below that of the U.S.

If Canada is ever again to be considered an economic powerhouse, we must sacrifice some sacred cows and resist the complacency that can come with strong budget surpluses and shrinking federal debt. We must reduce the total tax burden on individuals and businesses, while reforming everything from protections in industries like banking, to unemployment insurance policies that encourage inertia. Where there is extra money, it should be used to upgrade our education system, and the strained infrastructure.

If we fail to do so, Canada's unemployment and productivity rates will always lag well behind those of our neighbours to the south. Many of our brightest people will continue to move away, attracted by better paying jobs and much lower effective tax rates. We must do what is right in the longer-term best interests of all Canadians.

## THE NEAR-TERM OUTLOOK

Despite the longer-term concerns about the U.S. and its economy, after two years of a tepid, hit-or-miss recovery that offered little assurance of better times ahead, all signs now point to a year of strong economic growth, that many say will generate a lasting upturn. Better balance is the key: between spending gains by business and consumers, between rising profits and household incomes, between productivity increases and job growth.

Whereas rising productivity has improved margins and the real wages of workers who kept their jobs, stronger and more widely based demand will cause revenues to grow and profits to jump. With payrolls rising, the North American economy should keep rolling along. Given much in the way of unused labour, equipment and buildings, inflation is not expected to rear its ugly head, allowing central bankers considerable leeway to keep interest rates low and in check.

In any event, you may be amused to discover that the *Wall Street Journal* publishes a semi-annual survey of approximately fifty top-flight economists, and has done so since 1982. These learned souls have been asked, twice a year, to predict the future yields six months out on a common benchmark of interest rates. In only twelve of the past forty-two surveys have they correctly called the direction of the change in rates, much less the magnitude. Hardly what an investor might have expected or hoped for.

Although very low interest rates may not be consistent with the long-run goal of price stability, I very much doubt that U.S. short-term rates will rise by any meaningful measure. Nonetheless, even the bulls are concerned about the immense current account and trade deficits and the risk of a dramatic decline in the purchasing power of the U.S. dollar. A sharp plunge in its value would, inevitably, take most bullish bets off the table.

Since the stock market peaked in 2000, many long-term investors have paid more attention to dividend paying companies, including their kissing cousins, the income trusts. That is so because dividends have a habit of being increased over time, and such can never be said of bond coupons or stock buybacks. In addition to which, those companies with high payout ratios have tended to be the very best long-term buys. Whereas 240-plus S&P 500 companies increased their payouts in 2003, a record number of twenty-one paid a dividend for the very first time. Dividends are expected to increase by 8 percent in 2004. They are the best downside protection an investor could hope for when times take a turn for the worse.

## THE PICKS AND PANS OF INVESTMENT RESEARCH

Many stock broking firms go to great lengths to assign investment grade rankings to a variety of industry groups and a whole host of specific stocks. Their picks and pans range from A to E, from 1 to 5, from top to bottom, from buy to sell.

Despite all this effort, most firms failed to earn a passing grade in 2003, when, in many cases, the pans dramatically outperformed the picks! For example, mighty Merrill Lynch & Co.'s sell recommendations jumped 46 percent, the buys gained but 30 percent. Several factors account for this anomaly.

To begin with, when short-term investors jump back into the fray, they tend to go looking for big gains from stocks that suffered the greatest clobbering during the bear market. These risk takers know from experience that low-quality stocks with volatile earnings often see dramatic rebounds in share price as the economy improves and the stock market rallies. In addition, the switch in sentiment suddenly forces short-sellers to cover their positions in junky companies, or get caught holding onto the wrong end of the stick. Nortel Networks Corp. is a prime example of this phenomenon.

That said, the well-established big-cap stocks favoured by computer models and competent research analysts should begin to lead the charge now that the dead cat bounce phase of the stock market has come to pass. In other words, I would expect that the picks will outperform the pans by a wide margin in the foreseeable future.

Putting aside the longer-term possibility of a U.S. dollar devaluation, what might the North American stock markets do in 2004? Good question! The following is my best guess and a plan of action for the coming year.

## A PLAN OF ACTION FOR 2004

According to Thomson Financial/First Call, the consensus view is for gains of 13.3 and 13.6 percent in U.S. corporate profits for the first and second quarters. The third and fourth quarters are pegged at 9.7 and 14.2 percent, respectively. The full year estimates range from 9 to 13 percent, which is higher than the long-run average profit growth of 7 percent. The agency's estimate, based on research analyst forecasts, is 12.2 percent for all of 2004.

Of note, the actual numbers never do better than the forecast at the beginning of the year. They often end up being three to four percentage points lower. So the real number is likely to be in the neighbourhood of 8 to 9 percent, give or take a percentage point either way. If they are better, it will be because of further gains in productivity. If they are lower, blame it on the economy.

As to the S&P/TSX composite index, the long-term average profit growth is somewhere between 5 and 7 percent. It is estimated to have been 32.7 percent in 2003, and to be 14.6 percent in 2004. As noted earlier, these first-of-the-new-year projections usually err on the side of optimism. Nonetheless, there is nothing like having a superb year for equities to get people thinking positively about the stock market. The recent uptick in mutual fund sales is one of the consequences.

The most optimistic prediction I have come across for the U.S. calls for an 18 percent gain for the S&P 500, to above 1,300. It assumes that the real growth in GDP will average 4 percent, though the U.S. dollar will continue to struggle to hold its own. The targets for the DJll and Nasdaq are 12,000 and 2,400 respectively.

In Canada, the raging bulls are hoping for the S&P/TSX to rise 16.5 percent, to 9,570, by year end 2004, reflecting an eighteen-times multiple of an estimated $532 in earnings. If it were to trade at the past ten-year average of 21.05 times earnings, the target becomes 11,200, fully 36 percent higher than the 2003 close of 8,221. Quite frankly, I do not think such is possible.

Both the U.S. and Canadian stock markets would get an additional boost if the U.S. Federal Reserve board was to hold off increasing interest rates until the end of the year. However, there is little or no chance that last year's sterling performance by the major North American benchmarks will be repeated in 2004. Those days are behind us until such time as the U.S. steps up to the plate and starts to address the longer term problem of its twin deficits. Consumer debt is also at record levels, which does not bode well for the immediate future. In fact, all the tools that are available to the U.S. government, like tax cuts, have been used to prop up the economy, and there is very little dry powder left in the keg. Proof can be found in the rise of the price of gold.

So, from a CEO's perspective, if your outfit is in need of equity capital, I would get on with raising it now. Waiting for the stock market to go up another 25 percent, as it did in 2003, is not in the cards for this year. That, my friends, will not come to pass until more of the necessary adjustments are made by corporations and governments in the U.S., Canada and elsewhere about the globe. If they fail to respond in a meaningful way, history may repeat itself. The U.S. could fall from grace, and China might take its place as the world's greatest superpower.

As such, let us all hope that the President of the United States and the Prime Minister of Canada hear our call. Times could be much better if they do. In the meantime, it behooves all CEOs to keep their nose to the grindstone. Remember that productivity gains drive earnings growth. Guidance needs to be raised to justify current stock prices.

Wise old investors know that "the trend is your friend." At the moment they are buying dividend-paying laggards. It is only the younger, bright-eyed and bushy-tailed mutual fund managers who are still clamouring for the more-volatile, high-beta stocks. They risk getting their hats handed to them once again if our political and businesss leaders fail to get on with what truly needs to be done.

With total debt now greater than three times nominal GDP, the U.S. is cruising in totally uncharted waters. Let us all hope that it does not run aground before it reaches a safe harbour. If it does not make it, the price of gold will skyrocket, and we will all be scrambling to make ends meet. In the meantime we Canadians have a whole lot of lost time to make up in order to secure our long-term future.