

What Would Joseph Kitchen Say?

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I first made mention of Joseph Kitchen in a May 2004 essay called *It's Our Money*, and again a year later in *Nobody Likes To Be A Spoilsport*, both having to do with the outlook for the stock market. He identified the “Kitchen Cycle” back in 1923, and his track record has been excellent ever since. So what would he have to say were he alive today?

THE KITCHEN CYCLE IN ALL ITS GLORY

It postulates that the normal business cycle usually lasts from forty-two to fifty-four months. It can be shorter or longer, depending on the nature of the fiscal and monetary policies of the day. It has been fully fifty-four months, to June 2006, since the current economic upturn began. The question is, can the good times continue to roll on and on?

In search of the answer, let us examine the typical pattern of events as defined by the guru himself. According to him, during every business cycle, bonds, stocks and commodities follow recognizable phases.

Phase 1: Early recession. Commodity prices remain robust.

Phase 2: Deepening recession. Bull market for bonds, but slowing. Bear market for stocks, but bottoming. Commodity prices in decline.

Phase 3: Transition to expansion. Bonds in late stage of a bull market. The beginning of the rebound in stock prices. Commodity prices bottom.

Phase 4: Business expansion starting to mature. Bond prices start to fall. Stock prices move higher, as do commodity prices.

Phase 5: Business expansion peaking. Bonds still in bear market. Stock prices topping out, the early beginning of a new bear market. Commodities remain in bull market and may go into a blow-off mode.

Phase 6: Business moving into recession. Bonds nearing the end of their bear market. Stocks heading into a bear market. Commodity prices topping out.

So where are we today as regards commodity prices? As a point of reference, the Reuters/Jeffries CRB Index peaked in 1980 at 337.60, before plunging into the abyss. It was almost twenty-six years before it set a new record of 365.35 in May 2006. However, if one was to allow for the ravages of inflation, we still have a long way to go to reach, much less exceed, the adjusted highs of the past.

After a long period of extremely low prices, the onset of the gold, base metals, crude oil and natural gas bull market cycle five years ago surprised many, including, CEOs and CFOs, research analysts, and investors alike. But as the cause became clear – a combination of a prolonged period of under-investment in global exploration, coupled with a huge

increase in demand from China and elsewhere – it was not long before there was talk that this time around the mulberry bush things would be different. As I see it, the longer-term outlook for commodity prices remains positive. Canada's natural resource industries are set to do even better in the next several years, unless and until the North American central banks overreact to the increase in core inflation and bring the economic recovery to a halt. As such, investors would be wise to stand pat when the financial press chooses to talk about panic selling by hedge funds, and not the growing industrial demand for commodities. They are only looking for ways to stop the erosion in daily circulation. Whereas investors are seeking to build a fortune, these poor souls are not!

As I believe Joseph Kitchen would read the tarot cards: Phase 1 was 2001; Phase 2, 2002; Phase 3, 2003 to 2005; Phase 4 is 2006; Phase 5 will occur in 2007; and Phase 6, in 2008. Obviously no trend is absolutely predictable, but capital investment and commodity cycles, once underway, tend to endure for a considerable number of years. They are not a short-term phenomenon. Furthermore, if the greenback continues to lose ground, commodity prices will rise even higher to offset the loss in purchasing power, as each is priced in U.S. dollars. At the moment, I see nothing in the behaviour of President George W. Bush or the free-spending U.S. federal government to suggest otherwise.

GOING AGAINST THE GRAIN

Most money managers will tell you they are contrarians, seeking value where nobody else thought to look, buying stocks in sectors and markets their more conventional competitors would prefer not to consider. As you should know, this is not true. Rather, the record shows few will assume the risks that might allow them to consistently outperform the market averages. Typically, all own the same stocks and their portfolios perform in much the same way. This is unfortunate, as stepping out of line appears to really make a difference. As a recent academic study suggests, the stocks the institutional investors acquired between 1982 and 2004 underperformed those they failed to buy, and by a significant margin. All of which makes perfectly good sense. For if everyone agrees that a particular stock is a great buy, most will have already bought it and its merits will therefore be reflected in its day-to-day trading price, implying its future return is unlikely to be particularly outstanding. It also stands to reason that if few are interested in a poorly sponsored investment opportunity its attributes are likely to be overlooked, and hence undervalued. The less accepted an investment is, and the more uncomfortable the decision to buy may be, the more likely one is to make a lot of money once the research analysts come a-calling. That is why the world's most successful investors practice patience despite the pressure for immediate returns.

Just a few years ago the commodity stocks were out of favour, individual investors the only buyers. Now quite a number of institutional investors are at long last coming to the conclusion that a twenty-year super cycle may be underway and are busily upgrading their forecasts for crude oil and natural gas, gold, precious metals and industrial mining, and even some of the beleaguered forest product stocks. Despite the very recent 7 percent decline in the Reuters/Jeffries CRB Index, the biggest since 1988, and the fact that hordes of hedge funds and speculators have caused volatility to increase, I am prepared to bet that Joseph Kitchen would tell everyone to stay aboard for the ride to even higher values. To his way of thinking, the buying panic in commodity and stock prices, so typical of a Phase 5 blow-off, is nowhere near in sight.

Even so, we Canadians have much to do to secure the future of our natural resource industries. Rather than subsidize the also-rans, like the ethanol producers, we must do all we can to encourage the true wealth creators. Improved productivity must be the goal of everyone in government and business. We can no longer afford to dither when those about us are making substantial capital investments in infrastructure, advanced technology, state-of-the-art plant and equipment, research and development, employee education and on-the-job training. If we fail to keep in step with foreign competition, our standard of living will never be what many of us would have hoped for and, as a consequence, more and more of our up-and-comers will move elsewhere in search of their just rewards. Canada has an abundance of capable people eager to make their mark. We must do all in our power to allow them to get on with whatever their aspirations may be. Using our store of natural resources as a base, and being ever mindful of what Joseph Kitchen would say about commodity cycles, there is no valid excuse why Canadians cannot achieve their potential as a people and as a nation. None, whatsoever!

AS TO THE STOCK MARKET IN GENERAL

The S&P/TSX composite, Canada's benchmark index, recently set a new all-time record. On the other hand, the S&P 500 has not had such a good go of it in relative performance terms. Whereas some were betting that our resource-heavy stock market was due for a substantial correction, many wonder when the U.S. blue chip stocks will start to gain ground. A signal that such may soon come to pass was the announcement by several major U.S. mutual fund companies that they were in the process of seeking approval to invest in smaller companies, and switch to the racier Russell 1000 Growth Index as the performance barometer. Anytime these sorts capitulate, the very opposite tends to occur. So, it would not be surprising if the bigger U.S. company stocks began to do much better than they have over the past number of years.

For the record, during the 1982-2000 bull market, they returned an average of 16 percent a year, far outpacing the underlying growth in profits. The average price-to-earnings ratio rose from 8, to as high as 35 by the time the tech bubble burst. Even a conglomerate like General Electric Company sported a ratio nearly double its current 18 times multiple of earnings. When the growth in profits stopped, so too did blue chip supremacy. Reported earnings for the S&P 500 companies fell from U.S.\$50 in 2000, to U.S.\$17.50 by 2002. The price of the largest stocks dropped by 53 percent from peak to trough. Assuming an 8 percent average annual return, it would take Cisco Systems, Inc., seventeen years to surpass its previous record high; Microsoft Corporation, 10; GE, 8, and The Walt Disney Company, 6. In recent times, the smaller stocks have fared better for two reasons. Their valuations never got as overblown. They are more nimble and have adapted faster to changing economic circumstances. However, with the North American and other economies about the globe on the move, it is hard to bet against the multinationals now that they are back up to full strength and earnings are increasing at an impressive pace. As such, I believe many of the S&P 500 companies are about to get a needed boost in comparable stock price performance; the smaller success stories no longer the only game in town.

It is interesting to note that 5 percent or more drops in the Dow Jones Industrial Average have happened 355 times since 1900, or an average of 3.3 times per year. In only thirty-one instances did the decline amount to 20 percent or more, suggesting a bear

market only occurs about once every three years. Though forewarned in our February 2006 paper, *It Ain't Going To Be Any Different*, if the May-June correction has more or less run its course, which I believe is the case, it was nothing more than a hiccup. After all, corporate balance sheets are strong, profits are robust, GDP is growing at a healthy year-over-year pace of better than 3 percent, and interest rates, though rising, remain modest by historical standards. In terms of multiples, small caps, traditionally a bit cheaper than the blue chips, look relatively expensive. The component companies of the Russell 2000 are currently selling for 38 times earnings, compared with 21 for the DJII, and 17 for the Standard & Poor's 500. Which is why many believe the big boys and girls are likely to do relatively better in the next while, whether or not we are in a secular bear market as some suggest, or not. Overseas, the Morgan Stanley World Index, which tracks 820 stocks in twenty-six developed countries, surpassed its 2000 record high in May 2006, only to plunge by 25 percent, as compared to 12 percent for the S&P/TSX composite and 10 percent for the S&P 500. While emerging markets have been the object of speculator lust over the past three years, many of these countries now sport current account surpluses and substantial foreign exchange reserves, and have slashed their external debt since the last time investor sentiment turned against them in 1998. As such, the pullback is unlikely to lead to a long-term bear market, particularly as 20 to 30 percent corrections are quite normal even in bull markets, and the very latest was but par for the course. So I would suggest that the MSWI, like the principal North American indexes, has nowhere to go but up in the next number of years.

PEOPLE IN THE KNOW

Strange as it may seem, when it comes to picking winners and losers, the Bay and Wall street boutiques usually have it all over the behemoths. The accuracy of their earnings forecasts is also closer to the mark. They punch well above their weight. While it can be argued that increased regulation has left the global investment bankers' research analysts at a disadvantage, the smaller firms are continuing to attract those willing to stir up a storm, confident about their own non-consensual point of view. They create wealth for investors by spotting emerging trends long before they come into focus, which allows them to be better stock pickers than their competitors. In Britain, the U.S., and eventually Canada, there is a move afoot to make the payment of brokers' commissions more transparent – a process known as unbundling. Given the pressure to clarify the amounts paid for execution and research, it is expected that the portfolio managers will, in time, only pay for access to the top-ranked analysts, which will cause even more of the all-stars to relocate and work for the research-oriented firms. So if you are striving to gain sponsorship, chase after the independent thinkers for longer-term institutional investor commitment, and the well-established national firms for astute individual investor buying support. Never forget that it is the likes of you and me who buy early, the more conventional professionals the primary purchasers during later phases of a bull market. We are also the first to cash in our chips in a bear market.

In keeping with the theme that most institutional investors are far more skilled at preaching long-term investing than practicing it, those chasing after the hot stocks tend to have portfolio turnover rates far exceeding 100 percent per annum. They also jump from one new issue to the next, yet seldom do as well as the S&P/TSX composite index for more than a year at a time. On the other hand, those who buy overlooked securities when they

are relatively inexpensive, and wait patiently for everyone else to recognize the underlying value, make inactivity a virtue. Which all goes to show that if your outfit is doing well but the shares or trust units are not, there are intelligent investors standing in the wings willing to buy, if only they knew what you were up to, and about the prospects for continuing success. The very same applies to those in the throes of effecting a turnaround. Proof enough that boarding yourself up in your office is the worse possible thing to do, yet that is precisely what most timid or hard-hit CEOs tend to do. It is also inconsiderate given as the existing shareholders have every right to know what is going on, quarter-by-quarter, year-by-year, and most depend on the research analysts and their stockbrokers to keep them up to date. Otherwise they will take their lumps, sell and move on, never to return. Furthermore, they are likely to bad mouth you until your dying day. Such is hardly the way to maximize the value of one's investment and/or options in the company or income trust you happen to work for, nor what smart people ever do. Do whatever you can so that never happens. Otherwise, Joseph Kitchen would have every right to say you are a fool!