Rapport

Rear-ended

Edmond G. Eberts
Chairman
Rapport Capital Formation Strategists Inc.

JANUARY 2009

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

Rear-ended

Reacting to uncertainty and the threat of recession, overextended and underfunded North Americans have pulled in their horns for the first time since 1952, saving more and spending less, paying off mortgage obligations at a faster pace than granted. Companies have de-levered, banks tightened lending standards, credit integrity the new dynamic. Equity prices did tank, a vast sum of household wealth erased. The key question is whether the trend to lower debt levels is transitory or a sign of a profound shift in attitude? Will the injection of trillions of dollars of new money by the Federal Reserve Bank and the Bank of Canada alter the economic landscape or just plug the holes? Will a record-low bank rate overcome the unwillingness of individuals to use plastic, to buy houses, or whatever? Will their recklessness recur when the stock market and the economy rebound?

John Maynard Keynes (1833–1946) wrote of the tendency of "practical men" to be the unwitting slaves of "some defunct economist": "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back." Are we all Keynesian in these trying times, the government spending more than its take in taxes, promising to tighten the screws once the economy shows signs of renewed growth and before inflation takes hold? Have we joined the camp with unbridled enthusiasm, and on a scale that is truly unimaginable? The last time Canada fell into arrears it took twenty-seven years to get back to even, the dollar having collapsed to US$0.62 in the interim. Let's hope it does not happen again.

The world is awash with stimulus and bailout packages, and they are getting more ridiculous by the day. Some buy time for the walking wounded, others so narrow and politically cynical to qualify as pork. More than a few are well-intended but spread so thin as to be less than useless. How long will it take before the recipients are back on the doorstep begging for more money? All the inducements possible will not change the opinion of consumers fearful of losing their jobs, the sad state of the economy, and its dismal short-term outlook.

Henry Ford was a laudable car maker. Having founded his company in 1903, he almost single-handedly transformed the United States. He was convinced corporations that borrowed money used capital only slightly more productively than those that sold shares, in his mind the most expensive and least effective form of financing. He relied on retained earnings, kept costs in check, and thereby prevailed over his eventual competitors. Management staff was small, the key executives able to sit down together at a lunch table.

The relationship between the automotive companies, Washington, and Ottawa has long been testy. They have fought over everything from support for labour unions to the imposition of fuel-economy regulations. In exchange for an untold amount of assistance, the US government is proposing there be a “car czar” responsible for conducting a radical restructuring. The odds of finding a person who has experienced the challenges of managing a large, diversified, and successful enterprise, much less reinvented an industry in distress, are slim, if not impossible. Short of predicting a plague of locusts if the Big Three fail to get financial aid, and regardless of which pocket it eventually comes from, it will be just the most recent of a series of missteps witnessed since the global credit crisis took hold. History has many cunning corridors. We have seen this play before, and it does not have a good ending.

It is difficult to pinpoint when the CEOs, the UAW, and the industry lost their grip, and their ability to sway the existent point of view. Talk of three million jobs at risk, compared to a total of ten million unemployed across the United States, ought to scare the bejesus out of everyone. The man behind the wheel remains unconvinced by those who cry wolf. Warning of catastrophe is an old story, as old as their game of extracting funds from the public purse. At no time in the past number of decades did the announcement of a new plant or a big investment in an existing facility come without first getting a pound of flesh from taxpayers. The knife-to-the-throat tactic has poisoned street opinion. This is why, in their hour of need, they have been put through the political wringer, their credibility damaged with the people they hope will resume buying the cars they produce. Do the indebted, exhausted companies have what it takes to get back up to speed? Would the smarter solution be to restructure under bankruptcy protection? The majority of voters believe this to be the better choice. In a Canadian context, the forest sector is getting down to its last log. Business is so quiet you can hear an axe drop. The pine beetle, a lack of investment in innovation, new machinery, and human capital are likely to do it in unless the low, value-added mentality is shaken, and resistance to rationalization overcome. Government prompting will not make an iota of difference longer term. It is always wiser to attend to the quick, and not try to resuscitate the dead.

These are also challenging times to be a banker, criticized by investors for taking on risk, by government for hoarding money and not doing so. Not a one is prepared to lend General Motors, Ford, or Chrysler any more money. The business-as-usual mentality has been squelched. Whatever eventually comes to pass, the domestic car makers will look a lot different: leaner and, with fingers crossed, more capable of going toe-to-toe with foreign nameplates. Employees, retirees, suppliers, creditors, and neighbourhoods will have to adjust. The appointment of new directors, the departure of senior executives, layoffs, a reduction in the compensation gap with non-union workforces, the weeding out of unprofitable brands, models, and dealerships is inevitable. Ownership will change, the creditors take over, the bondholders certain to take a serious haircut, shareholders left with a tax loss more valuable than the current stock price.

There is much to be said about stepping out of an industry’s mould. Apple is the epitome of cool. Managing to breathe new life into every category it touches, it has earned a cult-like following. Its products are imaginative and pleasing to the eye, fun to use, and wreak havoc on competitors. Instead of charging into esoteric products as its erstwhile competitors did, JP Morgan Chase shied away and beefed up reserves. It survived while others failed. Few have proven as influential beyond their respective industry. Toyota’s

fabled production methods mean a bare-boned cost structure, less waste and increased efficiency. With US$40 billion of cash and securities in the till, it is well placed to continue investing in research, new vehicles, and facilities, holding an ever-greater advantage over its rivals. It will remain the odds on favourite hot rod for decades to come.

Savvy investors understand risk. They know surprises and scandals are inevitable and bubbles eventually burst. No one has repealed economic cycles, not even commodities in short supply can rewrite the rules. The latest economic signals are enough to make even blinkered optimists nervous, few convinced the price of securities has bottomed or the groundwork laid for a long-lasting rally. The good news is that the risk-reward ratio is recovering, price volatility less intense. Bargains abound for those still standing tall amid the carnage of the worst bear market in memory. There is money to be made betting the stock market will do as always, recover and go on to set a new all-time high. There is a big difference between a person confined to visible effect and another able to combine the seen with the unforeseen. Investors are concerned about viability and growth. Research analyst projections are notoriously unreliable. Many corporations and trusts shirk their responsibility to keep existing and potential investors informed. All have much to learn from each other. Standing apart wastes the chance to earn industry-leading multiples of cash flow and earnings, thereby reducing the cost of capital, the greatest of business expenses. Perception is in the mind of the beholder. Sentiment accounts for half the price of a stock. CEOs need to pound the pavement or hazard being rear-ended by government, competitors, and out-of-the-loop shareholders.