Rapport

Nobody Likes To Be A Spoilsport

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Going back in time I made a case for the topping out of the stock market in my *Off-the-Record* remarks of December 1999. Though many doubted my word at the time, the major North American benchmarks soon peaked and began to fall, starting with the Dow Jones Industrial Average in January 2000, followed in order by the high-flying Nasdaq and the more conservative S&P 500 in March, and the S&P/TSX composite by September of that same year. At our annual pre-Christmas gathering of corporate clients and friends at the Ranchmen's Club in Calgary in 2002, I offered that the lows of the past October likely marked the bottom of the correction in stock prices and nothing but blue skies would prevail for the next number of years. Though I was dead right on both prognostications, forecasters know they cannot rest on their laurels. It is only the next divination that really counts, and rightly so!

However, before we can figure out where the stock market may be headed, we must first understand where it has come from, what the early signs are that change may be in the wind and what, if anything, needs to be done in the near, intermediate, or longer term in anticipation of such happening. In this regard, you may recall a May 2004 paper entitled *It's Our Money*. It warned that we should always be wary of the economic and stock market cycles. Though earnings growth in the past has tended to be better during periods of high inflation when things are booming and prices are increasing, and not so when inflation is low, business is flat on its back and pricing power is weak, we must never lose track of where we are in the various stages of the cycles. Given the declining value of the U.S. dollar, the announcement that the Reuters Commodity Research Bureau index is fast approaching its all-time high of 337.60, set way back in November 1980, and the fact that short-term interest rates are being ratcheted up by the U.S. Federal Reserve Board, attempting to stem the rise in inflation, I believe a reality check is in order!

FACTORS TO BE CONCERNED ABOUT

Although I wholeheartedly endorse the political principle of lower taxes and less government interference in our daily lives, I cannot support the U.S. president's *laissez-faire* attitude with regard to the massive, and still growing, American trade and budget deficits. Georgie Porgie has got to stop feeding us this kind of pudding and pie before he makes all investors cry!

As for the man on the street, consumer borrowing in the U.S. has been growing three

times faster than personal income. Annualized savings, which were 8.5 percent in 1990, have slumped to just 0.2 percent. Consumer spending is being driven by asset appreciation in housing and the stock market and not savings. In Canada, the personal savings rate dropped 70 percent in 2004 to 0.4 percent, the lowest level since the dirty 1930s. In keeping with the prevailing tide of consumer enthusiasm, over 60 percent of strategists foresee the stock market continuing to rise in 2005 and 2006.

While it can be argued that these very low savings rates should not be a cause for worry as they do not take into account that the value of people's assets is appreciating at an even faster pace than debt, one must never forget that the very same theory was put forward before the infamous stock market crash of 1929, after which many of our forebears were forced to sell assets at bargain prices just to stay afloat: reason enough to encourage many amongst us to assume a more conservative stance these days and in the future.

If nothing else, consumers and governments alike must eventually learn they cannot "deficit" finance their way to prosperity. At the moment both are headed down a very slippery slope; one that is not easy to escape or recover from, even under the very best of economic circumstances.

OTHER LESSONS TO REMEMBER

The top U.S. federal income tax rate has dropped from 39 to 35 percent, the capital gain tax reduced from 20 to 15 percent, and the dividend tax also pegged at 15 percent. Given that American corporate cash positions have risen by 30 percent in the last three years and the fear of God having been imposed by the likes of New York State's Attorney General Eliot Spitzer, it is not surprising there has been an impressive increase in the number of corporations initiating dividend policies, increasing the payouts and payout ratios, and announcing stock buybacks. All of these measures are designed to keep investors on side and CEOs on their thrones, and out of the courts.

It also means that corporations must be far more astute in assessing the merits of an acquisition or disposition, and not be as beholden to the whims of Wall and Bay Street mandarins. Whatever else, the deal must live up to its pro forma hype as investors are no longer willing to sit back and see the value of their holdings plummet when post-deal results fail to live up to management forecasts of cash flow and earnings, triggering massive selling by impatient, short-term traders and silly hedge fund managers. While we Canadians have tended to be more understanding, we have the likes of Nortel Networks Corp., Bombardier Inc., even the long and sad saga of BCE Inc., to remind us of how far the mighty can fall from grace when they get away from doing what they do best.

OVERALL EARNINGS GAINS WILL BE MODEST

Investors know that real earnings growth results in higher stock and trust unit prices, providing the balance sheet remains robust, margins are maintained or improved upon, and the payout is both secure and likely to be increased in time. U.S. corporate profits rose by about 20 percent in 2004. Energy company gains were a huge factor. The non-energy earnings growth rate was but 6.45 percent. Needless to say, our commodity driven economy fared even better and was reflected in the superior performance of the S&P/TSX composite which was up 12.5 percent, surpassing the S&P 500 at 9.0, the Nasdaq at 8.6 and the DJIA at just 3.2 percent.

As for 2005, twelve of the best-known Wall Street strategists estimate that the S&P 500 and the DJIA will record further modest gains, ranging from 5 to 10 percent. Only three foresee gains of over 6 percent; four estimates are basically flat. As I see it, wage gains will remain in check and this year there will be no additional kick from lower personal tax rates. Debt pressure will slow consumer spending, and lower consumer confidence will lead to greater savings. The Japanese, Chinese and many other central banks will continue to buy U.S. government bonds because it is so essential for these countries to sell their manufactured products to the Americans. Although this arrangement may be somewhat tenuous, it does help to keep a lid on long-term interest rates, which is positive for the U.S. economy and the stock market.

Even so, we should not lose sight of the fact that manufacturing now accounts for less than 10 percent of the U.S. economy. Consumer spending is up to 70 percent. Governments account for the balance. Chinese labour costs average US$0.64 per hour. The U.S. manufacturing equivalent rate is US$21. In additional to which the Chinese are graduating 350,000 engineers per year, the U.S. just 75,000, of which about half are foreign students. The 30 percent rise in the value of the loonie over the past three years, as compared to the greenback and the renmimbi, is reason enough to explain why the Canadian manufacturing sector is having, and will continue to have, a tough time trying to compete with U.S. and Chinese companies. It also should be noted that much of our problem is self-inflicted in that, while the Americans took steps to increase productivity as far back as the 1990s, our manufacturers are only just beginning to do so. As a consequence, real GDP in the U.S. in 2004 jumped 5.1 percent while the hours worked climbed by 1.1 percent, resulting in a healthy productivity gain of 4.0 percent. Canada, on the other hand, saw GDP grow by 2.9 percent, the number of hours worked by 2.8 percent, and productivity by just 0.1 percent. All of which will lead to a further deterioration in our relative standard of living unless we can mount a dramatic turnaround. Let me assure you that government subsidies are not the answer. They will only exacerbate the situation.

THE QUALITY OF EARNINGS IS IMPORTANT

Although the translation of foreign earnings by multinationals back into U.S. dollars may boost the final tally and pro formas may deflect attention from disappointing yet indicative GAAP numbers, Thomson Financial has discovered that the shares of companies with high Earnings Purity not only do better than their peers, they also consistently outperform the stock market as a whole. All of which suggests that if a company is monkeying about with its numbers in order to meet the research analysts' consensus earning per share forecasts, investors will punish the stock price. If the CEO tells it as it really is the shareholders are far more likely to stay put or buy more, bidding up the stock price. They are not the fools some accounting firms and investment bankers make them out to be! Unfortunately, there appears to be a return to the mumbo jumbo of the past, some companies ignoring normal business costs as a way of padding their bottom lines, skirting the U.S. Securities and Exchange Commission's January 2002 rules that require more clarity in corporate earnings results. When will the CEOs, directors and auditing firms ever learn?

We should also be cognizant that after a twenty-year bull market in bonds, we may have hit the ceiling for secular multiples. As such, we are left with only the ebb and flow of the economy as the main driver for the North American stock markets.

OUR TAX SYSTEM NEEDS REVISING

To put it bluntly, the Canadian system for taxing shareholder income is a mess, in part due to poor public policy. However, I very much doubt the free-spending minority federal Liberal government has the will to set things right. If they did they should knock corporate dividend, income trust distribution and capital gain tax rates down to match the 15 percent level in the U.S. At a minimum, they should increase the dividend tax credit to make conventional dividend-paying equity securities as attractive as income trusts and limited partnerships. Reducing the dividend tax rate to the capital gains rate would at least help to establish neutrality among different forms of organization.

Although I do concur with the federal government's long overdue move to reclassify Canadian limited partnerships as being domestic-type investments as far as pension funds and RRSPs are concerned, doing away with the 30 percent limit on foreign investments "as a way to improve the performance" of retirement savings smacks of nothing more than political opportunism. As you and I both know, very few wise people would willingly leave a relatively safe harbour to sail off into unchartered waters, or risk being zapped by currency exchange fluctuations and withholding taxes, the sort of things that have bothered others when it comes to investing in Canada and elsewhere. Had those in Ottawa any real understanding of the vital role the capital markets play in financing our collective future, I have no doubt they would have instead taken steps to address the imbalances in our tax system. Until they do, the value of our retirement savings will never be as great as they would otherwise be.

THE OUTLOOK FOR THE CANADIAN STOCK MARKET

Canadian corporate profits increased by 17.7 percent in 2004. Those businesses selling to Canadians prospered. Exporters, challenged by the run up in the value of the loonie, did not fare nearly as well. Some economists have warned that more fallout could be on the way given that inventories of manufactured goods have been piling up over the past six months. The projected growth in GDP for 2005 is likely to be lower than the 2.8 percent increase in 2004, maybe just 2.5 percent. This would be less than the 3 percent rate that is considered to be average growth in a normal year and the level at which the Bank of Canada estimates there to be adequate spare capacity in the system. If GDP growth rates in the U.S. and elsewhere are going to be more modest in coming years, and the Canadian economy is bound to have a difficult time bucking the trend, then the North American stock markets may go nowhere for a while. As such, successful stock picking, rather than indexing, will be the only way for investors to make a substantial amount of money.

As noted earlier, the venerable Reuters CRB index of seventeen commodity futures, having advanced 23 percent in 2002, 8.9 percent in 2003, and more than 11 percent last year, is closing in on its all-time high. Thanks to insufficient investment in supply infrastructure, surging demand from emerging Asian economies, coupled with the decline in the value of the U.S. dollar, an additional multi-year cycle of rising prices in anticipated. Although this will dampen worldwide GDP growth somewhat, and may cause a recession in time, it should do wonders in the next while for the Canadian dollar and investors who are properly positioned to reap the rewards. The questions they need to ask themselves are these: Where do I stand vis-à-vis the various stages of the bull market? How much risk can I afford? What should my portfolio strategy be on a going forward basis?

If one refers to the aforementioned May 2004 essay titled *It's Our Money*, wherein I

made mention of the "Kitchen Cycle," identified by Joseph Kitchen back in 1923, you would know that Phase 4 refers to the period when business expansion is starting to mature. Bond prices begin to fall, stock and commodity prices move still higher. Phase 5 relates to when business expansion is peaking, bonds are still in a bear market, stock prices show signs of topping out and there are early signs of an impending bear market. Commodity prices remain strong and may go into a blow-off mode. In Phase 6, business goes into the tank, bonds are near their low, stock prices head lower and commodity prices peak.

Using these guidelines, I would suggest we have entered Phase 4. We could step into Phase 5 sometime in 2006, and Phase 6 a year or two after that. Optimists will say that the commodity side of the equation has several years to run, Canada being in the right place at the right time. The pessimists, concerned about the ripple effect of higher crude oil prices, could decide the time is nigh to start battening down the hatches in anticipation of rough going in the years ahead. I would offer that, as the bull market runs its course it will become far more susceptible to catching a cold. By which I mean, little things will likely cause it to be far more volatile than it has been over the past few years since the last correction in stock prices bottomed out in the fall of 2002. The 175 point one-day drop in the DJIA on the rumour that South Korea's central bank may be dumping U.S. dollars is just such an example. The greater than 3 percent decline the week of April 11, on concerns about the impact of higher short-term interests, is another. There will be more of these sort of jolts as time goes on.

THE LAST WORDS ARE THESE

From an economic perspective, the main threat to current expansion is not necessarily the ballooning U.S. trade or budget deficits, nor the measly savings rates in North America, or any of the other media fads. It is a renewal of inflation that forces interest rates higher than they would otherwise be. In order to keep it in check, the U.S. Federal Reserve Board is going to have to tighten the money supply. The sooner and faster it does so, the less economic damage there is likely to be two or three years from now.

With the possible exception of the Nasdaq, the principal North American indexes are well on their way to a full recovery from the 2000–2002 downdraft in stock prices and will soon record new all-time highs. Yes, there are a few ifs but, in the main, the bull market is still very much intact. Though it will be difficult for many of the high-beta stocks to reach the levels they once did fully five years ago, the chances are that most commodity based stock prices will move still higher than they are today in the next twelve to twenty-four and possibly thirty-six months.

The risk, as I see it, relates to increasing market volatility and not the fundamentals per se. Even so, we must all strive to keep in step with reality. If you are holding on to the darlings of yesteryear, you are in the wrong space. Book your losses and get to where you should be if you ever hope to make up for mistakes of the past.

Be well aware of where you stand with respect to the trusts. Though they easily outperformed the S&P/TSX composite in terms of total return in each of the past nine years, the field is becoming somewhat overcrowded as the ever accommodating investment bankers go about their way flogging whatever new issue opportunity that happens to come knocking on their door. This practice not only distracts attention away from the better quality ones, many of which are already having a difficult time maintaining a solid base of well-informed research analyst sponsorship, the underwriters' lack of discretion will

eventually have a negative impact on the entire sector. But why should they care when the fees and commissions just keep on rolling their way!

The last words are these. Do not stay wedded to a fallen angel. Get and stay committed to commodity driven stocks and trust units. Keep your head up, your eyes wide open and your ears well tuned, and do not flinch when an absurd rumour happens to sweep through the investment community. Just because the short-fused day traders and hedge fund managers panic is no reason for you to do so. Rather, they may well provide an opportunity for you to buy more of your favourite investments at a bargain basement price! While nobody likes a spoilsport, if the U.S. government and North American consumers fail to get their financial accounts in order in a reasonably short period of time, the worrywarts will eventually get to wring their hands with glee. Let's all do our best not to give them such a chance to make a mess of things important to every investor, large or small!

As to Canada being in the right place at the right time, may I leave you to ponder a story I was once told. It goes like this.

In the very beginning of time, when God was setting up the world, his disciples came to him to express their concern he may be giving Canada more than its fair share of wealth: land that stretched from the Atlantic to the Pacific and north to the Arctic; oceans, lakes and mighty rivers teeming with fish; high mountains, evergreen forests, and great plains; and a bedrock rich in minerals, crude oil, natural gas, coal and uranium. To which God replied: "Oh, but just wait until you see the kind of politicians I put down there!"