

Beware the ideo of the stock market

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As many of you may recall, we foretold of the early 2000 topping out of the raging bull market of the late 1990s in our *Off-the-Record* remarks of December 1999. Last December we suggested that the three-year bear market had likely run its course as of October 2002. In March of this year, when the world was gripped by the outbreak of war, BSE and SARS, our *What's going on in the stock market?* paper reaffirmed our bullish stance and, low and behold, the stock market subsequently took off like a rocket!

That said, forecasters are only as good as their very next prognostication. Even though we have proven time and time again to be closer to the mark than most other sages, this is not a métier where one can survive by just resting on one's laurels. So here are my predictions for the next while, up to and beyond the "ides of the stock market", being the fifteenth of October, 2003, and the fifteenth of March in the year 2004.

FOR THE RECORD

Since the March 7 low and the June 6, 2003, high, the S&P/TSX composite has gained 10.8 percent; the S&P500 is ahead 23.2 percent and Nasdaq has soared better than 30 percent. Whereas the forward price/earnings ratio of the S&P/TSX at 16.6 seems to be quite reasonable, and that of the S&P500 at 18.51 is generous enough, the Nasdaq at 40-plus times earnings is substantially overvalued. Even though the popular financial press and the electronic media remain quite bullish, most stocks have been trading sideways or lower for the past few weeks, the intraday highs recorded nearly two month ago still holding as the highs since the market turned up in early March.

REASONS FOR BEING CAUTIOUS

Notwithstanding investor optimism and an increase in day-to-day trading statistics, the unemployment rate for June in the U.S. jumped 0.3 percent to a nine-year high of 6.4 percent, as the so-called "jobless recovery" forced nearly one million more workers to the sidelines, questioning whether other signs of an economic rebound were reliable. The increase was the largest on a month-to-month basis since the September 11, 2001, terrorist attacks on New York and Washington and the highest since 1994.

Apart from that fact that second-quarter corporate earnings may come in above

tempered expectations, there is little evidence that short-term U.S. interest rates at or near 45-year lows, the massive infusion of liquidity into the system and the first of the U.S.\$350 billion in federal tax cuts will persuade American corporations to invest a whole lot more in capital goods. Given as surveys suggest that fully 45 percent of American consumers plan to use their tax-cut windfall to pay off debt and only 22 percent say they will spend it, forecasts calling for the anaemic 1.6 percent growth rate recorded year-to-date in the U.S. in 2003 to increase to the 3-plus percent level in the second half of the year seem to be improbable. Despite the fact that the made-in-Canada content of our exports has dropped to about 64 percent, down from 73 percent in 1990, fully 40 percent of our gross domestic product is exported and better than 80 percent of shipments go to the U.S. So growth in the United States economy is very important to Canadians.

While what consumers say they will do, and what they actually do, can be “polls” apart, the fact is that Americans have already unlocked a great deal of the equity in their homes to spend on SUVs, home renovations and the like. So, even though bargain-basement interest rates prevail, and may continue to do so for the foreseeable future, the three-and-a-half-year-old bull market for bonds has likely run its course, and Americans may not be as willing to borrow and take on even more personal debt to the extent that they were prepared to do in recent years.

As such, I remain skeptical about a robust rebound in the North American economy and that brings into doubt any suggestion that investors are willing and able to take charge and bid bond and stock prices to new 52-week highs. At the moment, only a few trust units, some preferred shares and a smattering of mostly dividend paying stocks are doing so with any regularity. All the while the new low list continues to record additional names.

RISKY STOCKS HAVE LED THE WAY

Even though the second quarter of 2003 was the best in years for many of North America’s stock market benchmarks, it left value-conscious investors scratching their heads in disbelief as a number of securities of dubious value led the way. Some mutual fund managers, who got caught off guard by the stock market’s strength, ultimately piled into “high-beta” stocks hoping to make up for their index-lagging performance. Some investment dealers went so far as to provide portfolio managers with lists of very volatile stocks for those looking for a quick score!

In fact, most of the best performing stocks were small and micro-caps, components of the Russell 2000 index, which posted a gain of 23 percent, the best quarterly performance since 1991. Stocks with market caps below U.S.\$181 million soared 47.2 percent in the past three months. Having no earnings was no problem. Money-losing companies posted better stock prices than many money-makers, gaining 38.5 percent on average!

LOOKING TO THE FUTURE

Judging by the Federal Reserve Board’s recent decision to cut its interest rate by just 25, as compared to 50, basis points, one would have to conclude that the mandarins in Washington, D.C. are of the opinion that the U.S. economy will bounce back in the second

half of 2003 and deflation remains a remote risk. If they should go another quarter-point at the next meeting on August 12, and if the news release is more forthcoming than the last, the clouds overhanging the stock market in the U.S. might soon dissipate, or so the financial press and the investment community gurus would have us all believe!

In Canada, whereas the Bank of Canada had raised interest rates five times for fear of an overheated economy and a rise in inflation, and proved to be dead wrong on both accounts, the minister of finance and the governor of our central bank may have at long last come to the realization that lower interest rates are essential in order to spur on capital goods spending and increase productivity, as there is very little chance of a substantial budget surplus or significant tax cuts to help boost the economy.

In the meantime, the TSX is likely to continue to underperform the other bourses in the coming months as most Canadian companies, taxed by the robust loonie and relatively higher interest rates, struggle to show an increase in earnings per share. Our best hope is that the U.S. economy begins to grow in a meaningful way to help our exports and, thereby, ease the economic malaise in Canada.

BEWARE THE IDES OF THE STOCK MARKET

Turning to the stock market, there are many weird and wonderful theories floating about these days.

For example, according to Scotia Capital, over almost the past fifty years, the S&P/TSX has outperformed the S&P500 57 percent of the time in the years when a Canadian team won the Stanley Cup or an Olympic gold medal in hockey. It only happened 28 percent of the time when a Canadian team failed to walk away with either honour. The comparison takes into account changes in the Canadian versus U.S. dollar exchange rate. If the indicator is to be proven right this year, when the Ottawa Senators lost to the New Jersey Devils, either the Canadian dollar has to fall or U.S. stocks must outperform the S&P/TSX for the remainder of the year.

With substantially higher interest rates in Canada and higher productivity rates in the United States, I would bet that the U.S. stock market will continue to outperform ours. Although the Canadian dollar has very likely passed its peak in terms of value, it could remain relatively strong given worldwide concerns about the ballooning U.S. government deficit that must be financed.

Then there is the phenomenon called the political investment cycle. It fits perfectly into a decades-old pattern of strong market showings in years leading up to a U.S. presidential election. Furthermore, presidents who plan to run for a second term have a keen sense of this paradox. According to the Hirsch Organization's Stock Trader's Almanac, the last time the stock market declined in the third year of the political cycle was 1939 – ancient history in economic and financial terms. Even so, a good pre-election year does not in and of itself guarantee political success, as George H. Bush was to discover. The current president was a front-row witness of his father's defeat and is pulling out all the stops, blindly determined not to come up short at the ballot box in November 2004!

As such, and if I may be allowed a mulligan to offset my early-March forecast to the effect that the large caps might well lead the way, I would like to now suggest that as the unwarranted attention paid to the more speculative and volatile stocks wanes, the ides of

the stock market may well prove to be critical turning points in the capital markets. If the 2003 uptrend in stock prices holds true through October 2003 and the major North American indexes move still higher, the nearly four-year-old bear market may have finally been wrestled to the ground and a new bull market might be all set to go in the new year.

However, before longer-term investors commit their entire portfolios to equities, they should realize that the stock market can be quite beguiling. Just when most of the stars in the investor universe appear to be aligned, as they seem to be today, it may take off in the opposite direction. Were that to happen, and there is still a 40 percent chance that it could, it might go back down again and retest the bear market lows of October 2002. That is why we believe the recent uptick could be nothing much more than a rally in the bear market. In keeping, we must all be concerned about the need for the U.S. to effectively get its economic house back in order. Until steps are taken to deal effectively with the untoward government deficit, one would be wise to be wary of the ides of October 2003 and March 2004. The stock market has a long history of going against the grain of conventional thought on or about these very dates.

AN INTELLIGENT PLAN OF ACTION

Investors are advised to take advantage of recent gains in stock prices to sell the underperforming portions of their portfolio and book profits to offset any realized losses. Rather than reach for the moon, I would advise that purchases be limited to stocks and trust units with an established record of increasing the payout to investors over time. In this regard, it is important to know that investments with relatively high payout ratios tend to do better during both robust and troubled times, and over the very long term. Buying gold is for bugs only!

CEOs wishing to gain the upper hand on the competition should do whatever is necessary to maximize returns and strengthen the corporate balance sheet. Low-margin operations should be disposed of, capital investments made to improve productivity and equity raised to position the enterprise to take advantage of new opportunities. One must also never lose sight of the fact that the best deals are first offered to those who have the wherewithal to make things happen, not to those who have to scramble just to make ends meet.

These are facts of business life that all successful investors know full well – and that is important to know as it is they who ultimately afford successful companies premium multiples of cash flow and earnings. So please sit up and pay attention. If you do, “the ides of the stock market” will have little or no effect when the time comes for the others to pay their dues.

Finally, please realize that there will invariably be differences of opinion between the CEO and investors at large. The CEO will always strive to stress the positives, whereas the investor is always looking to buy at a fair price. The key to success is to get the investment research analysts on board and have them assist in getting your company’s story across to longer-term investors who are prepared to support you, come what may. Short-term traders, many performance-pushed institutional investors and redemption-pressed mutual fund managers simply do not have the muscle to carry the full load, despite what most fee-hungry investment bankers would have us believe. Good luck!