

PUNCHBOWLS AND UNCONVENTIONAL TIMES

Maybe we spend too much time commenting on the general economy. Didn't Peter Lynch say that even 5 minutes dwelling on the economy is 5 minutes too much? After all, economists are often wrong anyway, the economy is very resilient so it's unwise, as in this anemic recovery, to bet against it, and bottom line, if you put away cheap stocks, they'll pay off in the end regardless of periodic economic cycles.

Generally, we would agree with that, and we tend to be "bottoms-up" stock pickers believing "value will out." Nonetheless, we still like to contemplate the big picture, not only because Herb is a macro junkie, but to be aware of forces that could derail us—particularly when those forces seem unfamiliar. Even to armchair economists like us, these seem to be unusual times which warrant an unusual amount of attention to the big picture.

Extraordinary Cycles

Most cyclical economic downturns are normal corrections, either engineered by monetary tightening to curb excessive growth and inflation—the Fed, as it is said, removes the punchbowl from the party—or organic downturns from the weight of excessive inventory accumulation which needs to get worked off in a quarter or two. However, the current slow period seems anomalous to us. It was caused by neither Fed tightening nor by excessive inventories. Rather, it was caused by fallout from the stock bubble of the late '90s and early '00s and by the excessive capital, indeed much of it misdirected capital, and excess credit creation that accompanied the bubble. And maybe also by the confluence of all these excesses concurrent with weakened demand after years of overconsumption, with excessive competition in many industries and many economies too, with trade imbalances and with inadequate savings. Armchair economics 101. Whatever the cause, this downturn seems not to be of the garden variety kind, but more of the "supercyclical" type, of the kind, without seeming alarmist, that is more like the '30s than the mid '70s or early '80s, of the kind Japan has gone through for more than a decade.

The grander cycles are clearly harder to kick start. This Fed's punchbowl overfloweth. Despite thirteen rate cuts in the US, taking Fed funds to a mere 1%, huge increases in money supply, significant tax cuts and increased government spending, plus a war to boot, the US economy sputters—unemployment is still rising, consumer confidence is waning, the savings rate is low, corporate earnings are anemic, pricing power is nonexistent, business investment is lacklustre (unless it's in China), the yield curve is frighteningly steep, both the US current account and budget deficits are approaching unsustainable levels, and the US dollar is in serious decline.

Credit Bubble

Debt levels for government, corporations and consumers are excessive and encouraged even higher by plentiful liquidity at low rates accompanied by tax incentives. The consumer has borrowed almost \$500 billion against his home equity over the last 2 years to finance his spending. Yet, despite record house prices and 45-year lows in mortgage rates, home equity as a percentage of value is the lowest in decades and homeowner debt service has not declined. Common sense, if not simple arithmetic, suggests this credit bubble and housing boom could come to an untimely end if interest rates take an unexpected rise.

And interest rates recently had an unexpected rise. In fact, the longer dated bonds rose more in a 40-day period than at any time since pre crash 1987. Over a 40% rise in 10 year treasury yields. We're told the rise is from mortgage lender esoterica called "convexity" or "duration gaps", or ominously, perhaps from derivatives blowups, hedge fund problems, or Freddie Mac or Fannie Mae mortgage-backed securities problems. Or, on the other hand, we're told, it suggests better times lie ahead. Or that inflation is returning. Who really knows? Scary. Unusual.

In our last quarterly letter, we repeated, presciently, several times, "Sell bonds, buy gold." In the quarter ended June, the Vanguard Treasury Bond Fund was down 11% and its Inflation Protected Treasury Fund down 7.6%. A Japanese investor in US 10 year treasuries lost almost 8% from May, taking both a capital and currency hit. These are outsized losses for investors who only expected 3.2% per year for the next 10 years. Meanwhile, the HUI Gold Bugs Index and Newmont Mining, the world's largest producer, reached their highest points since 1997. Scary stuff. Unusual times.

Frustrated Fed

We know this to be an anomalous period because the obviously tepid response to all the monetary and fiscal stimulus and the continuing threat of deflation have prompted Fed Chairman Greenspan and Fed Governor Bernanke to speak about "using unconventional methods", "pulling out all the stops", employing "a highly accommodative stance...for as long as it takes" to get things going, including, if need be, the Fed, itself, buying treasury securities of all maturities across the yield curve (though, after getting snookered by the rise in long-term rates, some refer to the Chairman's promise as "Greenscam"). When the Fed uses spooky Fedpeak, it must be seeing stuff out there that spooks it. So we're spooked too.

Wages aren't rising, but interest rates are. Mortgage refinancings were down 50% in July and mortgage applications were down 30%. The punchbowl is clearly leaking or needs more potency. It's "dysfunctional", says Stephen Roach of Morgan Stanley, a favourite economist. It is unusual when the policymakers can't make it happen. Unusual and scary.

Positive Signs

To be sure, there are some positive signs too. Durable goods orders rose 1.7% in June. GDP growth in Q2 was an annualized 2.4%, up from Q1 and higher than expected. Jobless claims

have been declining. Service sector numbers improved. 60% of companies reporting beat analyst expectations. And, of course, there's the stock market, which is up double digits from last July's lows and lots of new wealth thereby created. Lots of cash on the sidelines too in money market funds waiting for a better investment home. Inventories are not excessive and productivity growth continues strong as unit labour costs decline. Business is getting lean and mean. And economists tell us we could be picking up momentum, that capital spending will inevitably kick in as earnings improve and that, eventually, hiring will ensue. The spinmeisters suggest rising interest rates and higher stock and commodity prices are signs of better times ahead.

Our own SVA work too has now reversed and given us buy signals on the major North American markets. And after getting very oversold in the last few days without dropping materially, the markets look set to move higher. Accordingly, our discipline caused us to reduce the number of our shorts. However, though our current Fair Market Values look attractive, they will look less so as interest rates rise.

We're Worried

We want all those positive signs to be the outcome. But we get paid to worry. And these days, we should get danger pay. Maybe the market rally we've had is merely a typical bear market rally of the kind the Nikkei Dow had many times on its way to new lows. Maybe the economy too is only having a dead cat bounce. Maybe we're in some sort of "echo bubble". In other words, maybe this is not the real thing.

It seems to us there's still too much greed and not enough fear in the equity markets. For twelve consecutive weeks, bullish sentiment has exceeded 50% and bears are only slightly more than 20%. Momentum investing is back. Expensive sexy stocks with poor earnings, or even no earnings, perform better than cheaper stocks with reliable earnings. Which explains why our long/short accounts underperformed this year, mostly from the shorts going against us, though July was pretty good.

Though earnings expectations are being met (Q2 S&P earnings are up 8.8% over the same period last year), the quality of earnings is suspect. Better earnings are often being realized on lower revenues, aided by cost cuts and the lower dollar. Cisco, for example, from cutting 7% off R&D expense, the lifeblood of a technology company. Ericsson, by reducing its workforce by a third. Kodak, lousy sales and a poor outlook, but earnings boosted by a lower dollar and cost cuts. Kodak intends to lay off yet another 6,000 workers. Toronto may have SARS. Rochester has Kodak. The big three US automakers have been losing money on each car sold at interest-free financing and even with incentives and help from a lower dollar are still losing market share to imports. 90% of GM's earnings came from its finance operations, a big slug of it from mortgages. Many struggling businesses are selling what they can to survive. Sears had to sell its substantial credit card business to improve its balance sheet. Bombardier is selling its finance operation. BCE sold its profitable Yellow Pages directory. Air Canada may have to sell Aeroplan. They all may be selling the wrong parts of their businesses.

Productivity and Unemployment

Productivity is improving and that, for sure, contributes to better earnings. But further productivity growth from technology and cost cutting may have reached the limits of their impact on earnings improvement. It's a double-edged sword, as employee count is reduced and average hourly earnings are restrained. Over 500,000 jobs have been lost in the US in the last 6 months. Over 9 million people are currently unemployed. Despite the apparent recovery, US companies in July announced plans to lay off 85,000 workers, up 43% from June. In the end, the economy needs final demand for goods and services from consumers and business. But job insecurity does not inspire confidence in consumers. Neither do rising interest rates. Nor will weak sales demand, and capacity utilization under 75%, incent businesses to invest, no matter the tax breaks.

Down the Road

We're not blind to some obvious signs of recovery today, but as professional worrywarts, we're concerned that, in a year or two, with a larger budget deficit in 2004 and higher interest rates, with the potential of an even larger trade deficit caused by an improving economy (talk about a catch-22), another slowdown may be unavoidable. Higher interest rates hurt the economy, hurt stock valuations and higher yielding bonds compete with stocks. To be sure, a lower dollar will help—the US. As for its trading partners, it's the flip side of the US coin. Italy, the Eurozone's third largest economy, just fell into recession in Q2 for the first time since 1992 from poor consumer demand and shrinking exports. Germany is in one too and France can't be far behind. Japan seems to be in a modest overdue recovery, but, on the other hand, even fast growing China won't be immune from a slowdown if their exports get hit in a slowing global economy. And China is currently subject to a full court press from its western trading partners to raise the value of its currency to curb the flood of cheap imports.

Globalization? Free trade? Watch for political pressure everywhere to devalue local currencies and devise protectionist measures, if necessary, to stem rising unemployment.

There could easily be a US dollar crisis ahead; then interest rates could rise more, especially as an overindebted economy is overly reliant on foreign lenders. That could cause a worldwide slowdown. Maybe of serious proportions. That would mean higher unemployment, more bankruptcies, debt repudiation, higher savings and lower asset prices, maybe lower house prices. Then, of course, we'll get the biggest punchbowl you'll ever see. We're talking 100 proof. A Keynesian cocktail. Relentless money printing and a newer New Deal. For a number of years.

Portfolio Strategies

Remember, we get paid to worry. Our primary mandate is to preserve capital. So, in this unconventional period, we see the possibility of several outcomes: deflation, moderate inflation, stagflation, hyperinflation—take your pick. Believe it or not, we know very smart people who have each embraced a different one of those outcomes. We have our own biases, but we need to suppress them because if real economists often get it wrong, we armchair economists could really be out to lunch.

This is no time to over-intellectualize. No time to be a hero. No time to chase yield or outperformance. This is a time to play safe. This is a time for humility. Anticipate the probable, but don't exclude the impossible. Who would have thunk it? Same sex marriages. Schwarzenegger for Governor. 100°F in London. Gold may hit 1000 before Greenspan hits 100. Or, Bush, like his father, after also winning a Gulf war, maybe also engulfed by a poor economy. Or, Osama and Saddam get caught. The stimulus kicks in, the economy takes off, Bush is reelected and the US dollar strengthens. Good for stocks. Hard on the imagination.

This is a time to go with our greatest conviction and invest where the outcomes are the most predictable. Where the risk-to-reward ratio seems obviously the best, even to armchair economists. Thus, we avoid long-term bonds because, not only is the direction of long-term rates unpredictable, at such low historic rates the returns don't justify the risk. Instead we buy 3-5 year high yielding corporate bonds, including convertibles when we can find them. And relatively low risk, high yielding income trusts whose returns mirror the economy and the direction of rates—i.e., if business picks up so will their returns and vice versa. Inflation protected, so to speak.

We overweight gold stocks because where there's clearly a predilection to devalue currencies we want the ultimate safe haven currency. And because the bullion price is likely to rise much more as a result of a diminishing supply of the commodity after a 20-year bear market and a low level of exploration, notwithstanding the 40% price rise in the metal price from its low. And because investors generally are underinvested in this sector, allowing for lots of upside. We can hardly envisage a scenario where, volatile as they may be, the gold stocks don't offer a good risk-to-reward ratio.

We are overweight oils, particularly the very cheap ones we own, *Pan-Ocean* and *Petrokazakhstan*, because the oil price, which was supposed to be coming down in a slow economy post the Iraqi war, remains stubbornly high, not only from increased demand, but also from diminishing supply. We also own *Canadian Superior*, which produces oil and gas in Drumheller, Alberta, but is soon to drill a potentially high impact gas well offshore Nova Scotia, mostly with El Paso money.

It's a similar story with other commodities. Their prices are rising not only from some increased demand, especially from China, as the recovery ensues, but as much from years of diminishing capital investment and now, therefore, diminishing supply. So we're buying *Sherritt* for nickel, oil and coal.

And we buy other cheap stocks in companies that aren't overly sensitive to the economy with good prospects for earnings growth no matter the economic forecast: *La Senza*, *Goldfarb*, *CAE*, *A.J. Gallagher*, *Laboratory Corp.*, *Brown & Brown*. And short overvalued stocks as a hedge: *Ericsson*, *Four Seasons*, *Novellus*, *Yahoo*, *Cephalon*.

And we try to diversify, though admittedly still carry some outsize weightings in groups and stocks that have gone up a fair bit, but we still have trouble parting with. And we use our SVA work to get us in at the right time and out early if we're wrong. And, if need be, we'll carry cash too.

This is a time for investors to be more careful than ever. These are, it is plain to see, unconventional times. Extreme volatility. In long-term interest rates. In currencies. In stocks. Excessive leverage. An outsized carry trade. \$140 trillion in unregulated derivatives. A potential for a financial calamity. A clearly nervous Fed. A punchbowl that isn't working its usual magic even though the market often appears to be punchdrunk.

We need to wait for a real party with potent punch. Something to celebrate. This one feels like a wake. But, if, during this strange period, we can protect capital and get a reasonable return, we can live with the hangover.

Herbert Abramson and
Randall Abramson, CFA
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