GOLDILOCKS AND THE BEAR

Our past several quarterly letters have talked about the bear market which we believed was upon us even though it wasn't obvious because a few large cap, mostly technology names, were sustaining the averages and obscuring the carnage in the breadth of the market. A "stealth bear market" it was sometimes called. Well, it now appears obvious to more though not yet to all, that a full-fledged bear market decline, not merely a short-lived "correction" is upon us. The bear is exposed, bear naked! And while much damage has been done with the Dow Jones down 11%, the NASDAQ down 33% and the TSE down 17% from their highs leaving many investors worried and most perplexed, this is merely the "Concern" stage, not yet the "Panic" stage, not yet time when investors throw in the towel.

Still a Bear Market

Many strategists are suggesting that the worst is over and that investors should be accumulating those high tech bargains for a rally that will propel the averages higher over the next year. We, however, believe that while many stocks are cheap, indeed many very cheap, there are still too many that continue to be ridiculously overvalued with the NASDAQ itself still trading over 100x earnings and the S&P 24x. The stock market will continue to decline, with intermittent "fake out" rallies, until the excesses are wrung out. In fact, we believe that just as stocks overshot on the upside in a bubble driven by greed and "irrational exuberance", they will tend to overshoot on the down side, as they always do in a bear market, from fear and eventually from disdain for stocks. That will continue until the bear exhausts itself.

Overvalued Stocks Getting Shot

In the new environment, overvalued stocks that disappoint are being taken out behind the barn and shot, one by one. Lucent, Microsoft, Intel, Home Depot, Motorola, and now, even mighty Nortel, to name a few. Even cheap companies like Kodak are mauled pretty good when they warn of problems. And, in a classic sign of a bear market many companies whose results are even meeting market expectations are tending to decline. Why is this happening if all appears rosy? After all, isn't this a "Goldilocks" economy with high growth, high productivity, low inflation and low unemployment? I think it was Bill Clinton who once said, "It's the economy stupid!" The fact is, "It's the market stupid!" In this prolonged bull market, a bubble developed in the technology and Internet part, with overvaluation in much of it and in the averages and with investor expectations so high they couldn't realistically be met. The market was driven more by speculative expansion of price to earnings multiples than by actual earnings growth, a characteristic of a mania. In that environment, modest corporate disappointments can turn into a market disaster. And modest corporate disappointments are bound to inevitably occur, as a result of enhanced competition, management miscues or adverse changes in the economy. As Nortel shows, when stocks are overvalued the news doesn't have to be bad, just not as good as everyone expected.

Slowdown in the Cards

Our colleague Martin Braun observed that whereas the market used to reflect the economy it has now become the economy. Probably 1/2 of US households are now invested in stocks, a historically very high percentage. And many are investing with borrowed money with purchases on margin near record levels. Any dip in the market was seen as an opportunity to buy more. In the "feel good" economy too, things were barreling along with US consumers spending as though there were no tomorrow and excessive consumer credit was out-stripping income gains even as interest rates were rising. Personal savings recently hit a record low. We think it wouldn't take much to cause this extended consumer to retrench, and that when it does, a slowdown, maybe a recession, is likely.

Goldilocks to Change

Several years of the Goldilocks economy have masked many weaknesses that are about to surface. The Goldilocks economy was characterized by high growth, low inflation, government surpluses, fiscal conservatism, US supremacy and a strong US dollar. Look for some changes.

Inflation to Rise

First, we think that inflation is likely to rise—in fact, it is already rising as evidenced by the recent Producer Price Index and Consumer Price Index increases. It even costs $12 now to go to a movie at Famous Players. General price increases should not be surprising in light of the dramatic rise in oil prices and other commodity (popcorn?) price increases, the tight labour market, productivity peaking, interest rates rising and some strong money supply growth which always leads to inflation.

US Dollar Peaking

The phenomenal strength of the US dollar has been masking domestic inflation as it keeps imported goods cheap and continues to enhance US competitiveness. But we believe the US dollar is likely peaking and in fact will prove to be the Achilles heel to the US stock market. The huge US trade and current account deficits are at record levels and as a percentage of GDP at levels that cannot be sustained. Trillions of US dollars earned from trading with the US are now held by foreigners who recycle it back into US equities (8% of the market) and debt (38% treasuries and 20% corporate) and it is these capital flows that have been propping up the dollar. As the stock market corrects, so will the dollar as the foreigners repatriate capital and then as the dollar declines, it will, in turn, add further pressure to already declining capital markets. It will be more difficult to think of the dollar as a "safe haven" when the prices of real assets priced in dollars keep going up. Fed Chairman Greenspan may be in a box because even as the economy slows and he may wish to lower rates, a declining dollar and higher inflation may not permit lower rates. Remember stagflation? That's when movie ticket prices go up even as movie exhibitors are going broke.

Economic growth is sure to slow as extended consumers restrain their spending. A declining stock market will make them feel poorer and rising costs, especially oil prices, will shrink their spending power. Rising corporate and personal bankruptcies will make them wary. The affordability of housing is decreasing with higher prices and higher mortgage costs.

Corporate Earnings to Slow

As the economy slows, so obviously will the growth in corporate earnings. We are already seeing declining earnings growth rates among retailers, transportation companies (especially impacted by rising fuel costs), growth cyclicals and others. In Canada, companies like Canadian Tire and Hudson's Bay are trading at their lows. Many internet companies with questionable business models and no cash flow like Amazon.Com, Bid.Com and Chapters are making lows and their survival is in question. Technology companies will not be impervious to a slowdown. So Goldilocks needs to get ready at least for a profits recession. Banks will be exposed to bad loans and many technology companies, as Lucent has already disclosed, will be exposed to credit problems from startup customers they have been financing. Brokerage firms will be adversely affected by lower trading volumes, fewer corporate issues and more margin calls.

What also will be revealed as the economy and profits falter is the accounting gimmickry used by even the largest companies, including Cisco and Nortel, to make it appear their reported results are better than they actually are. Huge stock options skew earnings and also represent an avalanche of potential selling.

Surpluses to Disappear

Goldilocks should also prepare for the peaking of government budgetary surpluses. These surpluses were driven by high tax revenues from a strong economy and unusual capital gains. Tax revenues on both accounts are set to decline even as politicians are campaigning on promises of tax cuts and more spending for health care, education and defence. And lower surpluses will mean that the national debt will still stay excessively high and need to be financed keeping upward pressure on interest rates. We speculate that the US government has been at work trying to help get Gore elected by, somehow or other, using bond buybacks, sale of oil from the strategic reserve, intervening to prop up the stock market on bad days and restrain the gold market every day and by fudging the inflation numbers. Watch for Goldilocks to reveal her problems after the November 7 election, whoever is elected. Problems in the Middle East won't help her either.

Credit Problems in the System

Risks in the financial system are to be noted. Yields on junk bonds are the highest in ten years. Investors were recently cautioned by the manager of Pimco, the largest bond fund in the world, to shun corporates and buy only government bonds. The amount of troubled loans syndicated by commercial banks is increasing. Credit quality is deteriorating and the huge holdings ($400 trillion) in derivatives and swaps held by commercial banks may be an accident waiting to happen, especially if the dollar weakens much and liquidity declines.

A slowdown in the US will be bad for the world economy, including Canada, which is so dependent on the US economic engine. After many years of boom times, excessive leverage and speculation has developed which we believe has made the US financial system more fragile than commonly believed.

Defensive Portfolio

Continued caution is clearly warranted. We are targetting about 10% cash and/or fixed income investments; about 15% gold stocks (which tend to move contrary to the market); about 20% oils (Pan African, ridiculously cheap, mostly in cash and Hurricane Hydrocarbons, soon to be debt free as well and trading at only 2-1/2x next year's earnings based on only $20 oil); 30% in very, very cheap stocks that are growing and have strong balance sheets like Abercrombie & Fitch, TJX Companies and Jones Apparel.

Antec, which we recently bought thinking it was cheap, declined because it "missed" its earnings number and got cheaper. But it is acquiring a fast growth business from Nortel which will then own 46% of Antec and at only 13x next year's growing earnings is very cheap for a technology company. We own stocks that are "in play" or don't depend on the direction of the market like Hollinger C (below its retraction price of $16.75). Goldfarb is in the process of winding up for at least twice its share price. United Dominion, a classic old economy stock, trades at only 6x earnings and is in takeover talks. Our Honeywell also got taken out last weekend for a good gain in a short time. In cases where we can, we're about 25% short overvalued stocks as a hedge. That kind of portfolio composition should allow us to be defensive yet generate some positive returns even if things get ugly.

Despite our pessimism, we have been outperforming the market and hope to be able to continue to do so by being careful and occasionally opportunistic.

This phase will pass, but we think things will get worse before they're better. Goldilocks and the bear are both about to be exposed.

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