A Positive Quarter: Adding Long-Term Investments Despite a Cautious Economic Outlook

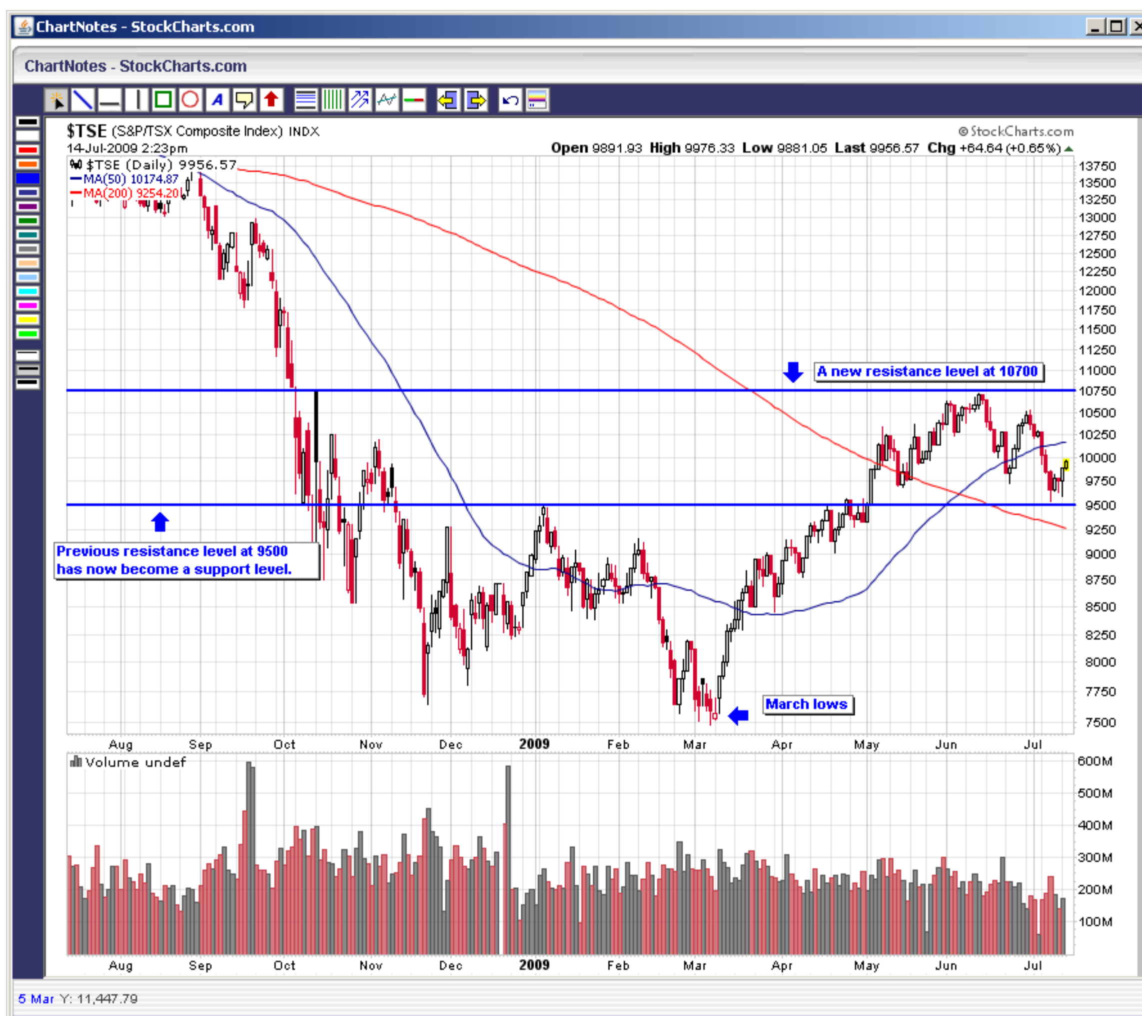
In the second quarter of 2009, global equity markets rebounded from their March lows. Although the rally has stalled somewhat recently, investors have shown a greater willingness to bid up equities and embrace risk.

Despite the very positive quarter in the stock market (and it should be noted that the TSX remains down 26% in the last 12 months), my economic outlook remains cautious. Most economists believe that the US and Canadian economies will return to growth in the second half of 2009, in no small part due to government stimulus spending. North American stock markets have therefore anticipated a recovery by rising in the face of bad economic news. I believe a recovery is likely, but it is unlikely to be very strong. Therefore I plan to remain appropriately flexible in my macro outlook to respond to changing conditions. Many of the small hints of economic recovery that have recently been labeled “green shoots” in the media need to materialize more substantially to keep the stock market heading higher.

For now, I am pleased to own companies that continue to pay my clients while we wait for signs of a sustainable recovery. I have also reduced the large cash position in portfolios to 20% by opportunistically adding several new positions to client accounts during the quarter. These positions are in companies that I believe are undervalued, and my reallocations have had a very positive effect on performance so far.

While the earnings outlook for many companies remains negative or flat for the near term, I continue to monitor North American markets closely with the aim of finding more high quality companies that are undervalued.

The one year chart of the S&P/TSX Composite Index displayed below will give clients a visual sense of where Canadian stocks in general have come during the quarter and the current trading range for the major Canadian index.



Inflation Outlook

Inflation risk, especially over the longer term, is a central theme of my previous newsletters and many of my investment selections in client portfolios.

Hasty monetary expansion and increased government deficits and debt contribute to this risk. Countries around the world have followed the lead of the United States by using monetary and fiscal policy aggressively to increase liquidity during the credit crisis and in an attempt to stabilize the erosion in GDP.

While most economies are too weak at the moment to sustain higher prices as reflected in their consumer price indices (CPIs), the adverse implications relating to the value of paper currencies lead me to worry about long-term inflation risk. In the short run, these aggressive monetary and fiscal policies do have some beneficial effect on economic performance as measured by Gross Domestic Product (GDP), although it is unlikely that funds are being directed towards optimal uses.

Interest Rate Outlook

Could we be reaching the end of the multi-decade downtrend in interest rates in North America? Interest rates are notoriously difficult to predict. More seasoned readers will recall the high rates on government securities, mortgages and GICs in the early 1980s. But how many of you bought and held long term bonds, understanding that inflation and rates would decline? Since then interest rates have slowly and steadily headed lower, with a few brief exceptions.

Borrowers on all levels of society (individual, corporate and government) have responded by borrowing more. Many borrowers are now heavily reliant on low rates and their business models would fail if rates do not remain relatively low.

Monetary policy makers know this, and they have attempted to improve conditions for borrowers through quantitative easing (which is effectively printing money to buy assets, including government debt). However, a policy of quantitative easing is not free of consequences. Holders of longer-term government debt worry (justifiably) about inflation and want higher rates. If quantitative easing results in increased economic activity, some bond investors will sell government securities in search of higher returning assets and, by doing so, will put upwards pressure on yields.

With these factors in mind, it seems strange to me that any profit seeking entity in the world today would find value in long-term US Treasuries. The yields are miniscule and do not compensate the holder for inflation risk or currency depreciation risk. It appears that the largest buyers of long-term US Treasuries are foreign entities that have an interest in maintaining the value of the US dollar. With the current levels of US government deficits, the US will need to issue massive amounts of Treasuries over the next 12-18 months. There are serious questions about whether foreign buyers will continue buying the amounts necessary to keep long-term rates low.

I expect that interest rates will begin to rise as the US government will need to provide a higher return to attract foreign investors and in order to protect against future inflation.

Precious Metals Outlook

Precious metals continue to make up 20% of the Total Return Portfolio as they provide a significant hedge against the prospect of future inflation (or, for that matter, any return to financial crisis). It was recently announced that John Paulson, the manager of New York based hedge fund Paulson & Co., put some of his fund’s cash to work by buying Anglo American’s stake in South African based gold miner AngloGold Ashanti

for US$1.28 billion. Paulson moves are worth watching – he made over a billion dollars betting against subprime mortgage securities.

Paulson has also placed a very large bet on gold by increasing his fund's overall position in a Gold ETF (SPDR Gold Trust) to over 30% of the portfolio which equates to an investment of approximately US$2.8 billion. With our 20% Precious Metals weighting in mind, I wish him all the best in his endeavors.

US GDP Outlook

With most investors obsessing about recession and recovery, I thought it would be topical to delve into the concept of Gross Domestic Product (GDP) and where US GDP might be headed. GDP is a basic measure of an economy's economic performance and is simply defined as the market value of all final goods and services made within the borders of a nation in a year. A more helpful definition is as follows:

GDP = consumption + gross investment + government spending + (exports − imports), or,

$$GDP = C + I + G + (X - M).$$

Considering the above equation, what variables will drive the US economy in the near future?

Consumption is going to be a negative number, as America has just fallen off the most consumer driven economic expansion in history. People are not spending money. The US consumer will not be able to drive the economy out of this recession.

Gross investment is negative as individuals are not borrowing money to make investments as generally the value of their largest asset (their home) has dropped in value. Personal saving rates are at 40 year highs and global companies and most countries don't see US treasury yields as a good place for investment.

Government Spending is way up. Trillions upon trillions of loans made by the US government (to be paid by future generations of tax payers) to essentially bankrupt companies and to pay for massive deficits and a growing list of social entitlements is what passes for economic stimulus these days. This is what is putting a floor under US GDP? That is quite a scary thought.

Net Exports is harder to gauge. For many years the US has been a net importer of goods produced in China, India and all over the world. While this may slow as demand slows and the US dollar drops (making goods produced in the US more attractive), I don't see the US becoming a net exporter anytime soon.

So 3 out of 4 US GDP variables are currently negative and the only variable that is resisting the trend is Government Spending, which often leads to higher taxes in the future to pay for increased deficits and debt. Looking forward, economists surveyed by Bloomberg News earlier this month estimated the US GDP contracted at a 1.8 percent pace from April through June and projected a return to growth in the second half of 2009.

As mentioned up front, my economic outlook remains cautious - I believe a recovery will occur, but it is unlikely to be very strong. I plan to monitor economic data closely in the coming months for signs of sustainable recovery and evidence that the private sector is beginning to pull its weight again.

Global Economic Performance

If the statistics are to be believed, China's economic performance appears to be considerably more robust than America's. An ambitious economic stimulus program and aggressive bank lending have contributed to the country's 7.9% GDP growth in the second quarter.

Towards the end of 2008, China set a target growth rate of about 8 percent in 2009. Many analysts doubted it was possible, given the country's reliance on exports to recessionary economies, but China's growth is roughly on target. Chinese stock markets have outperformed many other markets, and auto and retail sales are reportedly strong. China's fiscal stimulus is offsetting weakening export activity.

The Canadian economy and stock market are well positioned to benefit from the economic success of China and other developing countries. Chinese economic activity is reflected in the recent rise in commodity prices and the rise in the Canadian dollar versus the US dollar. Increased long-term demand from China and other emerging economies could result in the Canadian economy becoming less correlated with the US economy. This would be a welcome occurrence, given that rapid growth in the US economy is unlikely any time soon.

Portfolio Review

I continue to maintain a large cash position of 20% in accounts at the end of the quarter, down from 30% at the end of March. I recently reallocated some of the cash to securities that I believe are conservative long-term investments or interesting recovery stories.

Westshore Terminals Income Fund is a good example. Westshore has been in business since 1970 and operates the largest coal loading facility on the west coast of North and South America, located at Roberts

Bank, British Columbia. If you have ever boarded a passenger ferry in Tsawassen, British Columbia, you have probably seen Westshore's facility off to the side (and wondered what it was).

Westshore generates revenues on a throughput basis and receives a handling charge from customers based on volumes of coal exported through the Terminal. Westshore does not assume ownership of the coal and is therefore not directly exposed to the price of the commodity.

Infrastructure projects in China and around the world will need steel, creating demand for metallurgical coal. Much of this coal that is produced in western Canada will pass through Westshore Terminals before heading east. Westshore is a stable, conservative, industrial infrastructure business. The units currently yield in excess of 10%, and I believe this is the right type of investment for the current economic environment. As I continually emphasize, dividends and income distributions can provide a reasonable return even when capital gains are harder to come by.

Overall, I am pleased with the additions made to the portfolio since the start of 2009. Return numbers in client accounts during Q2 have been very satisfying, and I believe there is still significant value in many of our positions that has not been recognized by the market.

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Michael Armstrong is a Portfolio Manager with CIBC Wood Gundy in Vancouver. He or his clients may own securities mentioned in this column. The views of Michael Armstrong do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2015.