Searching for Value in a Weak Macro-Economic Environment

There is a long-running debate in money management between investors who use macroeconomic research in their decision-making process and those who prefer to ignore macroeconomics and focus solely on company-specific developments. Peter Lynch is an example of the latter group who was quite successful in generating high returns. He once said: “if you spend 13 minutes a year on economics, you've wasted 10 minutes.”

We cannot fully agree with Lynch. While we do quite of bit of company-specific research, we think that macroeconomic influences on the market have actually become stronger in the last decade. The secular bull market in stocks from 1982 to 2000 was supported by declining interest rates and inflation, and governments occasionally ran surpluses (like the US during the tail end of the Clinton administration). In other words, the macroeconomic environment was often benign and did not require a lot of research to understand. Stocks thrived during many of those years as the economy grew strongly.

Contrast that with today’s environment – the macroeconomic environment has been a persistent headwind against stock performance. Macroeconomic research is essential during these times, mainly to monitor risk, as negative macroeconomic developments have frequently overshadowed positive progress made by individual companies in the past few years.

Currently, the world’s major economies may be sliding towards another downturn. Europe and the US could experience economic contraction in the next 12 months, and China’s growth appears to be slowing. Most of the recent market-moving headlines revolve around Europe, but we also want to review the important developments in China and the US in this issue of the Armstrong Schmidt Perspective.

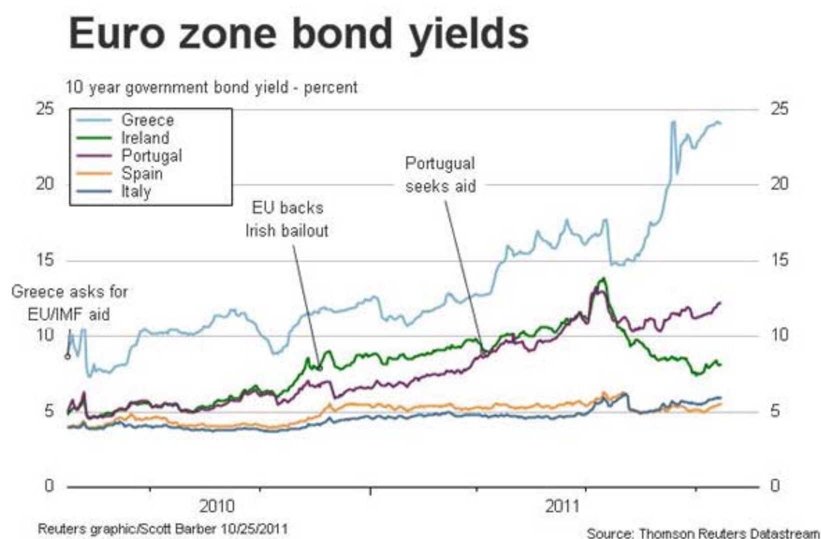
European Debt Crisis

We have faced a barrage of headlines coming out of Europe in the past quarter. In late October a plan appears to have come together involving a 50% reduction on Greek debt, a bank recapitalization of around 100 billion Euros, and a larger European Financial Stability Facility (EFSF) than previously contemplated. The goal of these measures is obviously to prevent the European sovereign debt crisis from spreading to larger countries like Italy and Spain and becoming a triggering event for another global financial crisis.

Time will tell if these measures are successful. Judging by the strong gains in stocks after the announcements, market participants expect at least short-term relief.

We do not think these measures give us the green light to take on significantly more risk. Even if they prevent sovereign defaults in the near-term, what we really care about is economic performance. Europe will not be an engine of global economic growth in the foreseeable future. In fact, Europe will likely be an economic laggard, as austerity measures (reductions in spending and increases in taxes) are going to be necessary to contain the sovereign debt crisis.

One indicator that we will be monitoring in the coming months is Italian and Spanish bond yields. Over the past year, rising yields on Greek and Portuguese debt warned of the problems ahead for those countries. The chart below compares the recent financing costs for various countries implicated in the European sovereign debt crisis.



The reasoning behind the European bailout measures is reminiscent of the US policy environment surrounding the bailouts of 2008. The immediate crisis has been postponed, with root causes ignored. At some indefinite point in the future, fundamental changes to economic systems will be necessary. Governments cannot permanently run large deficits – at some point, they will have to shrink to the size that citizens can afford. Future generations will not work endlessly to discharge today's debt obligations without complaint. Something will give. The rise of the Tea Party and the Occupy Wall Street protests are symptoms of the average person's growing discontent. Europe is experiencing protests and will have its own incarnations of these movements.

China Slowdown Coming?

We generally agree with the idea that China has a bright long-term economic future. In 2010 China surpassed Japan as the world's second largest economy and it could surpass the US as the world's largest in the next few decades. China's rapid growth has conditioned investors to expect 8-10% GDP growth from China perpetually. But some risks to Chinese growth are now emerging. If Chinese growth underperforms expectations, there could be some serious negative consequences for the financial markets.

As Canada's economy is now strongly linked to China's growth due to its demand for our natural resources, we think it is prudent to monitor Chinese economic risks. Neither of us have ever set foot in China, so we are not arrogant enough to believe we can make pronouncements on exactly what will happen in that country. But when we come across warning signs during our macroeconomic research, we have to take notice.

Unlike the consumer-led US economy, China's economy appears to be driven largely by investment in infrastructure, real estate development and industrial capacity. Hedge fund manager Jim Chanos recently pointed out that construction accounts for 50-60% of China's GDP, and a large part of that construction consists of residential and commercial high rises.[1]

On the commercial side, we have seen some evidence that there is high vacancy and overcapacity in the office market in many Chinese cities. On the residential side, many people have been buying condos with unfinished interiors purely for financial speculation. They do not rent them, preferring to keep them as pristine as possible for resale. No rental income is generated – these transactions are for capital gains only. As a result, some areas of China have numerous new high rises with no occupants and have been labeled "ghost cities". Economist Andy Xie recently commented on this phenomenon:

> How many flats in China are sitting empty? The media recently floated a story – denied by power companies – that 64.5 million urban electricity meters registered zero consumption over a recent, six-month period. That led to a theory that China has enough empty apartments to house 200 million

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[1] Vince Veneziani, Q&A With Jim Chanos Part II: China's High-Rise Property House Of Cards, http://articles.businessinsider.com/2010-04-14/wall_street/30035428_1_bad-bet-china-property-bubble (October 28, 2011).

> people. Statistical transparency is lacking in this area, so the truth about empty apartments remains under wraps.[2]

Clearly there are enough people in China to fill these empty condos at some point in the future, but that is not the problem. The problem is that the condos sell for multiples of what the average worker can afford. For example, in Beijing, housing is selling at over 20 times the average family income. In Shanghai, homes sell at 13 times the average family income and Shenzhen is now at 14 times.[3] This appears pricy even in comparison to our expensive home city Vancouver, which sells at just under 10 times family income. Price declines in Chinese residential real estate may be necessary for the actual end-users (as opposed to speculators) to absorb this vacant inventory.

That said, the price declines may be starting. China's largest real estate developer recently stated that the country's property market has turned and expects conditions to worsen in the coming months as sales prices and volumes decline further. The developer said government efforts over the past year to rein in soaring prices were having a severe impact on the market and developers were being squeezed after sales volumes in 14 of the country's largest cities halved in September from a year earlier.[4]

Also, there have been anecdotes about property speculators violently protesting developer price cuts:

> Hundreds of angry home buyers launched a series of protests in China's commercial hub of Shanghai this week, as owners decried falling prices for their properties, state media said Thursday. Hit by weak demand and lack of funding, developers have slashed prices for some new projects in the city by more than 20 percent, the China Business News said, causing an outcry among those who bought at higher levels….In the latest incident, some 200 home owners on Wednesday besieged the sales office for a

[2] Andy Xie, China Has Enough Empty Apartments To House 200 Million People, http://articles.businessinsider.com/2010-08-13/markets/29972262_1_price-bubble-empty-apartments-china#ixzz1c7HEFuwB (October 28, 2011).

[3] Brett Arends, Watch out for China's 'freak' economy, http://www.marketwatch.com/story/watch-out-for-chinas-freak-economy-2011-10-25 (October 28, 2011).

[4] Jamil Anderlini, China developer warns on price falls, http://www.ft.com/intl/cms/s/0/328123ce-ff0a-11e0-9b2f-00144feabdc0.html#axzz1brQ4vn5Z (October 26, 2011).

> project of leading developer Greenland Group, demanding refunds. "We require a refund because the loss we are suffering now is too great for us to afford," the Shanghai Daily quoted a protestor as saying.[5]

Some articles cite the fact that Chinese property speculators put 40% down on property purchases as a factor that adds stability to the market. But clearly some of the property speculators in China are middle class, inexperienced investors who rode the boom without understanding the risks involved and are not capable of comfortably bearing losses. If positive sentiment towards real estate changes and property speculators stop buying, it could negatively impact the portion of China's GDP that is driven by construction. That means less demand for commodities like copper and other base metals, not to mention structural steel. Even energy demand could lag expectations if Chinese growth weakens. Lower Chinese commodity demand would hurt countries like Canada that export to China.

China bulls believe that the central government will manage the risks of a real estate downturn and achieve a soft landing. While this may be a desirable result, we think it will be challenging to achieve. Chinese policy makers have limited options due to inflation running at around 6% per year. Indeed, an article in the Chinese central bank's official newspaper recently stated that the Chinese economy would cool next year and efforts to spur growth would be constrained by inflation.[6] When average citizens receive bank interest below the rate of inflation and face price increases in daily necessities, they start to feel aggrieved. Combating high inflation requires constraints on the type of easy bank lending and speculation that supports increasing real estate prices.

In other words, if Chinese policy makers act to support real estate markets by easing credit conditions and changing regulations, they risk angering citizens who are concerned about high inflation. On the other hand, if they continue to fight inflation and tighten credit, they risk a major downturn in real estate. We do not purport to know exactly what will happen, but this is a risk that we think is worth monitoring, especially considering that the ongoing US housing downturn that started around 2006 was integral to the 2008 financial crisis.

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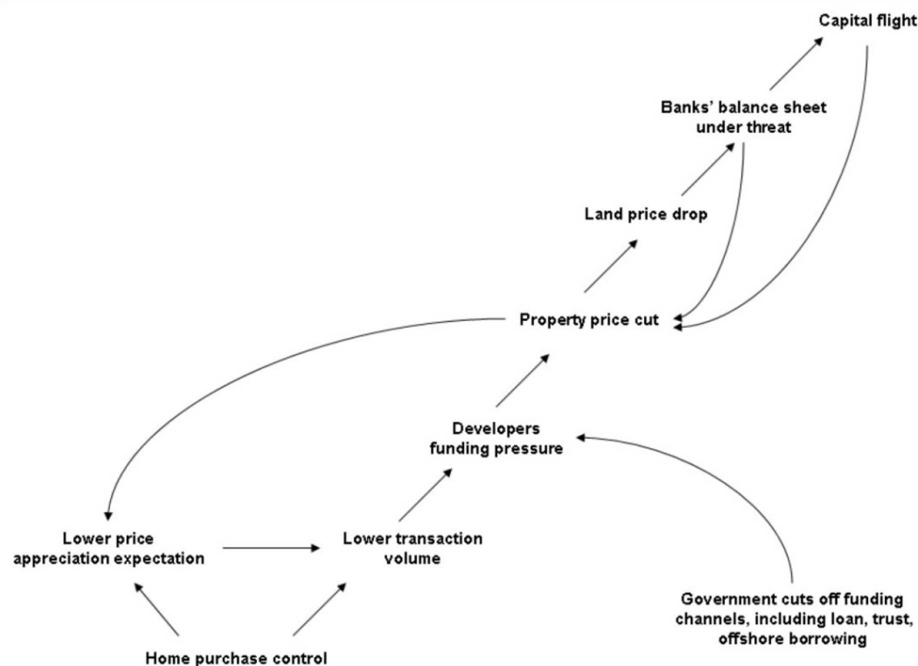
[5] Bill Savadove, Protests hit China as property prices fall, http://news.yahoo.com/protests-hit-china-property-prices-fall-062027680.html (October 28, 2011).

[6] Sam Jones, China growth fears boost Hendry's fund, http://www.ft.com/intl/cms/s/0/14b63e54-e210-11e0-9915-00144feabdc0.html#axzz1brQ4vn5Z (October 25, 2011).

Bank of America Merrill Lynch provided a visual of the negative loops that could activate in the Chinese real estate market in an adverse scenario. This visual is a reminder of why downturns in leveraged markets are hard to contain. Everything is connected – for example, land price declines impact buyer psychology and even bank balance sheets and credit availability.



United States

Just prior to Q3, the US Federal Reserve expressed concern about the economic outlook and announced that it would hold interest rates at ultra-low levels at least through mid-2013. Reading between the lines, this means that the Federal Reserve doesn't expect the economy to get much better during that time. Judging by US consumer behavior, they are probably correct.

Recent data showed that total US household debt has fallen 8.6% since mid-2008 through debt repayment or default.[7] There are several implications. First, some US consumers are behaving more responsibly by deleveraging and refusing to purchase goods they cannot afford. Second, other consumers are struggling

[7] John Hilsenrath and Ruth Simon, Spenders Become Savers, Hurting Recovery, http://online.wsj.com/article/SB10001424052970204294504576614942937855646.html (October 26, 2011).

financially and defaulting on debt or being denied credit by cautious banks. Overall, signs of household deleveraging are positive for the long-term financial health of US households but negative for GDP growth in the short-term, as the US is heavily reliant on consumer spending.

Also worth noting, the Economic Cycle Research Institute (ECRI), a high-profile New York- based independent economic forecasting group, notified clients in September that the US economy is tipping into a new recession and there is nothing policy makers can do to head it off. The following passage from one of their publications is quite interesting:

> At least since the 1970s, the pace of U.S. growth – especially in GDP and jobs – has been stair-stepping down in successive economic expansions…. So it comes as no surprise to us that, with the latest expansion only a couple of years old, we're already facing a new recession. Actually, such short expansions are hardly unheard of. From 1799 to 1929, nearly 90% of U.S. expansions lasted three years or less, as did two of the three expansions between 1970 and 1981. In other words, such short expansions are unusual only with respect to recent decades.
>
> It's important to understand that recession doesn't mean a bad economy – we've had that for years now. It means an economy that keeps worsening, because it's locked into a vicious cycle. It means that the jobless rate, already above 9%, will go much higher, and the federal budget deficit, already above a trillion dollars, will soar. Here's what ECRI's recession call really says: if you think this is a bad economy, you haven't seen anything yet. And that has profound implications for both Main Street and Wall Street.[8]

With three of the world's most important economic regions, Europe, China and the United States, facing a weak economic outlook, we must continue to respect the potential downside risk in stocks, which precludes an overly-aggressive stance. We think our style of value investing in high quality businesses is very suitable for this environment. Looking at the performance of some of the areas of the market we avoid entirely, the TSX Venture Exchange was down -35% year to date as of September 30, 2011.

Portfolio Commentary[9]

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[8] Economic Cycle Research Institute, U.S. Economy Tipping into Recession, http://www.businesscycle.com/reports_indexes/reportsummarydetails/1091 (October 26, 2011).

[9] All return numbers discussed are taken from the returns of the model account for each respective discretionary PIMG portfolio. These numbers are generated using Dataphile software and individual client's account performance may vary. These numbers are not a promise of future performance.

So how did we fare in this challenging macroeconomic environment? As of October 31 for the year, the Total Return Portfolio was down -9.46% and the High Yield Portfolio was down -0.75% as compared to the S&P/TSX Composite Index which was down-8.86%. This is an improvement over early October, when stocks were down quite a bit more. It has been a volatile six month span, and as mentioned above, macroeconomic factors have frequently moved the market.

The High Yield Portfolio is a newer offering of ours, as it was launched in March 2011**.** From now on, we will be discussing the developments in that portfolio in this newsletter as well. Readers should understand that the High Yield Portfolio will likely outperform the Total Return Portfolio in down markets and underperform the Total Return Portfolio in up markets, as it holds positions in certain bonds and preferred shares, which are typically less volatile than the stock market and have limited capital gains potential. Call us if you have any questions about the different portfolios that we offer.

Total Return Portfolio

In early July we took a 3.5% position in Seaspan Corp., which leases out container ships, mainly to large Asian conglomerates. What makes Seaspan different from other shippers is that it has an average duration of 11 years on its fleet of leases. That creates dependable cash flow in comparison to other shippers operating in the volatile spot market. Seaspan is projected to grow strongly over the next 12 to 24 months as it takes ownership of new ships that it has ordered and puts them out on charter. Seaspan is also attractive due to its dividend of almost 6%. BC readers should note that the company "Seaspan" operating tugboats in local waters is a different company.

After the end of Q3 we switched out of one US financial for another. Bank of New York Mellon exited the portfolio and was replaced by Berkshire Hathaway Inc. We also added PepsiCo Inc., Richie Brothers Auctioneers Inc., Fortress Paper Ltd., iShares Canadian Financials Index Fund and Central Fund of Canada Ltd. and trimmed our energy positions. We will discuss these investments in detail in our year-end newsletter.

The recent stock market volatility has created opportunities, causing us to be more active than in the past. The best example is our management of the position in Silver Wheaton Corp. Silver Wheaton Corp. has been a long-term position which was originally added to client accounts back in early 2009 under $10. Since that time we have taken profits off the table multiple times. Most recently, we sold half of our remaining position at $40.27 and we were able to repurchase the shares at $29.89 two months later. In extended sideways or down markets this type of active management can add value.

High Yield Portfolio

The one recent transaction of note in the High Yield Portfolio was our purchase and sale of Wal-Mart Stores Inc. Wal-Mart is a company we have followed for some time, as its valuation seems to decline year after year while the company grows its earnings and continues to reduce its own share count through share repurchases. The downside of a company like Wal-Mart is limited growth potential while the upside is high quality and relative safety. We were finally tempted to purchase in August when the stock fell to $50.08. When the stock rallied to $57.22 in October, we sold the position for a 14% gain, as further near-term upside potential appeared limited.

Conclusion

This has been a challenging environment for the markets, for clients and Portfolio Managers alike. While short-term results tend to be fickle, our investment process and value-based approach are conservative and time-tested. As discussed above, the macroeconomic environment has weighed against our results this year. Investors who do not heed the warnings being dispensed by the global economy run the risk of negative returns. We are paying very close attention to macroeconomic developments and remain confident in our ability to generate above average returns for clients in this market environment.

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