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Economy Worsens Yet Stocks Getting Downright Cheap

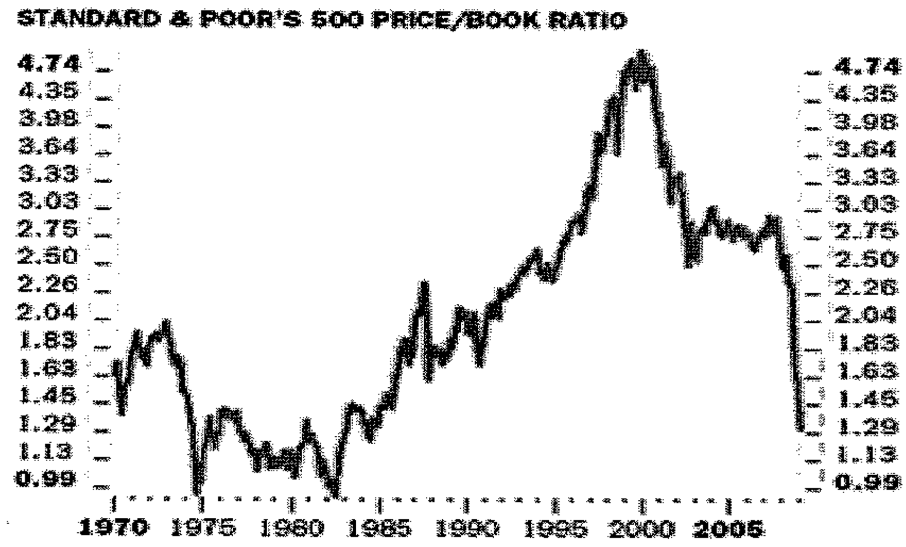
Stocks worldwide have staged a stunning decline of more than 50% from their recent highs. The precarious economy has created fear amongst investors, who have been hitting the sell button with each piece of negative economic news. The percentage decline marks the third worst bear market in U.S. history. Only the 1929 to 1932 and the 1937 to 1942 markets fared worse.

Canada recently recorded its highest monthly job losses; while the unemployment rate in the U.S. hit a 26-year high. Profits at the 500 largest publicly traded companies in the S&P 500 index have plunged 60% from March 2008 to March 2009. Moreover, with consumer spending making up 71% of U.S. economic output, there does not appear to be a rebound likely anytime soon. With their balance sheets at record levels of debt, households are more likely to pay down debt than to increase spending. If one were to graph the economy going forward, it might look like a giant letter L rather than a V, as was the case in 1981 and 1991.

Nonetheless, history shows that the best time to exit stocks is when the outlook is most favourable; and the best time to buy is when the outlook is most miserable. Moreover, the current values of stocks indicate that they are in line with the lowest valuations of other bear market bottoms.

Profits and earnings can be misleading measures of value at market tops or bottoms. When the economy is booming, profits may surge but be unsustainable. In a recession, profits may all but evaporate. Value investors try to stabilize between such fluctuations in value over an entire business cycle.

One way to assess valuations is to look at book values. According to Doug Kass, of Seabreeze Partners hedge fund, profits have historically averaged 12% of book value. Using this measuring-stick, we can see that the current market is near a historic low of 11 times earnings. The only markets that have been cheaper than today's occurred in the mid 1970's and 1980's, when interest rates were far higher than they are today, and thereby provided investors with an attractive alternative to stocks.



Source: Barron's (March 9, 2009)

One way for Canadians to invest in the U.S. stock market without exposure to the U.S. dollar is through the ishares Canadian S&P 500 Index symbol XSP. Consumer staples like Heinz, Kraft, Proctor and Gamble, Coca-cola, General Mills or McDonalds are currently trading at 10 to 12 times earnings, with dividend yields of 3% to 5%.

In Canada shares like those of TransCanada Pipelines have recently increased their dividend and currently trade near a historical low of 11 times earnings, with a yield over 5%. Electric utility operator Fortis is sheltered from economic swings, yet its shares have tumbled 25%, and now yield 5%. Rogers Communications is producing record cash flows, yet at 50% off its 52-week high share price, the yield is now over 4%- a record high for the stock. Shares of the leveraged buyout firm, Onex, have tumbled 56%, yet have traded near their cash flow levels.

In my September 2008 letter, I have commented on the current market as 'History in the Making' and this month's letter continues that theme. The Bank of England has recently announced a policy of "quantitative easing". Easing, in economic terms, usually refers to the lowering of interest rates to ease borrowing costs. Although central banks around the world have already lowered rates to near zero, the economy continues to contract. Quantitative easing is the policy of buying bonds in the open market with money that did not exist before. In short, this is what economists call "printing money."

The Bank of Canada has already announced that if the Canadian economy does not recover by the end of the year, they too might apply quantitative easing. This is perhaps one reason the Canadian Dollar and British Pound have been two of the world's weakest currencies of late.

In any event, creating money will likely be successful in bringing an end to the current deflationary environment; however, the danger is that printing money will dilute the value of the existing money that we as investors hold. As the world attempts to help out the debtors of the world through monetary inflation, they will likely hurt those with savings.

By buying solid companies, you can store your wealth in businesses that can raise prices for their products or services. In this period of deflation, it may be time to bet on inflation coming back sometime soon.

A final point- I have suggested that it is a good time to go back into the market; however, I have had several clients inquire whether it is a good time to get back into Canadian bank stocks. My advice is NO. In my opinion, the dividends at the Canadian banks will be cut some time in the next year. Firstly, the banks have not earned enough profit to continue to pay high dividends. Secondly, the cost of borrowing by the banks has soared recently. As an example, CIBC recently borrowed $1.6 billion, in two trenches 10 and 30 years respectively, at 9.98% and 10.25%. These interest-bearing notes were actually issued as share certificates; and hence the interest does not in fact have to be paid. However, the notes take precedence over common shares. CIBC pays $1.4 billion in dividends on its common stock and yet, borrows $1.6 billion at 10%. Would it not make more sense to reduce or eliminate the dividend? Also remember that banks make money on interest rate spreads yet they are borrowing capital at 10% to lend money at mortgage rates of 4.5%. All of the big six Canadian banks have recently issued debt at high interest rates.

Sincerely,

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