

THE MARKET IS THE MESSAGE

Marshall McLuhan coined the phrase, “The medium is the message.” Well, we think, similarly, the market is the message.

We have never believed that stock markets are completely efficient; that is to say, that inasmuch as they reflect the sum total of all market participants’ knowledge, they must be correctly valued. Otherwise where would be the opportunity to find mispriced bargains. Nonetheless, we are concerned that the ugliness of this market may be sending investors a message.

And that message may be that the market is ugly because the economy is ugly and its recent reluctance to rally even from oversold conditions is because the economy is worsening, because it may be worse than is generally perceived, because the downturn is global in nature and may last longer than is generally anticipated.

Our last quarterly letter titled “Stick To What You Know” postulated that the worst in the market was likely over at the March 22 lows. And indeed, since then, there was a spectacular rally, the NASDAQ at its peak up about 50%.

Now, however, we believe the markets are in a declining mode again with our downside objective on the Dow at 9200 (an anticipated drop of 12%) and the NASDAQ100 sure to follow, maybe to retest its April low of 1349.

And it isn’t merely North American markets which are giving a message of gloom. It’s stock markets all over the world. Indeed, the Nikkei Dow recently made a 16-year low, this from the second largest economy in the world. And markets around the world have been similarly weak. The Europe, Australasia, Far East Index known as EAFE is down 16% this year to date.

And so should they be. The news has been bleak. Maybe we’re not in a technical “recession” according to the economists’ definition of two successive quarters of negative growth, but this sure looks and feels like a recession.

Although we have a near term bearish outlook, even in our own shop there is controversy about how bearish we ought to be. So let’s look at the facts both negative and positive.

- **NEGATIVES**

Fact: Clearly, we’re in a profits recession. S&P500 companies reporting the second quarter were short of expectations by 6.7% and down 22.5% from a year ago. Telecommunication earnings were down 70%. And over 200 companies have already warned about the next quarter.

Moreover so-called “visibility” by companies about their future expectations is clouded, recoveries now being pushed out into 2002. The rise in the dollar took its toll on the earnings of US exporters and multinationals and rising unit labour costs and energy prices have squeezed earnings too.

Fact: Although the Federal Reserve cut short-term interest rates six times this year, GDP grew at only 0.7% annual rate in the second quarter (compared to 5.7% for the same quarter last year), the slowest rate in more than 8 years.

Fact: In June, factory orders slumped 2.4% and industrial production fell for the 9th straight month making this the worst non-recession ever.

Fact: Clearly we’re in a capital spending depression so we shouldn’t count on business spending to bail out the economy. We just came off the biggest bubble in history when the cost of capital from Wall Street was zero so you didn’t need much return on the capital you invested in redundant capacity. But post-bubble, old-fashioned notions like “return on investment” are back in vogue, and when there ain’t no return, there ain’t no investment. Capacity utilization at about 77% confirms there’s lots of slack to be taken up before spending recommences. In 2000, capacity rose 50% in technology manufacturing while technology production declined at an 18% annual rate in the past six months, the largest decline in 26 years. Nortel and JDS Uniphase are not coming back soon. And since Nortel is Air Canada’s biggest customer and its revenues from Nortel are down 60%, Air Canada’s got some extra technology capacity too.

Fact: Corporate debt is high and rising as companies can’t raise equity, but need to fund losses or sustain their businesses. But even though rates are coming down, banks are nervously tightening and the rate of defaults on corporate debt is at 10-year highs.

Nortel, Amazon.com and Air Canada are just a few of a multitude that could be facing serious cash crunches.

Fact: Personal and corporate bankruptcies are expanding and some big names might even bite the dust or need serious restructuring.

Fact: Just when credit may be being rationed, government surpluses at every level are dwindling from declining capital gains taxes and other tax revenues and higher outlays. What’s a struggling company to do when it has to compete with governments for borrowing? Remember crowding out? Long-term rates should be coming down more than they are. Is the all-knowing bond market worried about an improving economy, higher inflation, a lower dollar, a greater supply of bonds or all of the above?

Diminishing government surpluses mean diminishing liquidity which is the lifeblood of bond and equity markets.

Fact: Final demand has been poor and getting worse. With business spending down for the count, and public spending in secular decline as governments strive to reduce deficits and debt (US government debt which was 25% of total debt in the ‘50s and ‘60s is now only 17%), only the consumer is carrying the economy now. He’s pretty important because consumer demand represents 2/3 of the economy. But we believe he’s the next domino to fall. This baby boomer’s

best spending years are behind him and he's got enough "stuff" already. Sales of personal computers declined for the first time in a decade (down 1.9% from 2000). "Everyone who wants a PC pretty much has one," says one computer analyst. The consumer is overindebted; his net worth has taken a big hit (down 8% from the year before); he's spending more than his disposable income, and as unemployment rises, his confidence will wane. Indeed, US consumer confidence took a surprising turn for the worse in June. We think the Fed is deathly afraid that worried consumers may start to save more, usually a characteristic conducive to better markets, but not in this case.

If there's no pent-up demand to stimulate then lowering interest rates and printing money may not increase demand much.

Fact: And unemployment is rising. Layoffs are occurring at a frightening pace: 30,000 from Nortel (a third of its total), 20,000 from JDS Uniphase, 8,500 from Cisco, 7,500 from Air Canada. Initial jobless claims in the US rose to 445,000 to July 7, the highest since 1992 and job layoffs so far in 2001 are almost 1,000,000—the highest in recorded history.

The Fed's policy committee forecasts US unemployment could reach 5.25% (now 4.5%) next year.

Hiring intentions are low and help wanted ads have fallen dramatically. It's a Catch 22. If profits can't get restarted, then job losses will continue which will further weaken demand leading to more cost cutting and jobs slashed and so on.

Fact: The slowdown is spreading globally. Europe and Asia are suffering too. Singapore is in recession and Japan is close to another one, its fourth in 10 years. Germany is struggling and Turkey isn't recovering from its IMF bailout. Argentina is in crisis and infecting Brazil and Latin America generally. Export markets for the US and Canada will be impacted. Bank of Canada governor David Dodge recently said the greatest threat to Canada's economy is a deterioration in conditions outside of North America. The excessively high US dollar is affecting US competitiveness, and understandably, exporters and multinationals are pressuring for a lower dollar. A lower dollar may benefit profits for many companies, but it will deter capital investment flows from foreign investors and risk higher inflation from rising import prices, both negatives for the US market.

Fact: It's not just about technology. The two usual engines for the US economy, autos and housing, should weaken too. The big three automakers just reported sales down 9%, and GM reported second quarter earnings plunged 74%. US construction spending declined in May; June housing starts have peaked, and housing sales activity is declining. Retailers, airlines, hotel operators are all under pressure. Autos and housing won't be immune from corporate cutbacks and consumer willies. Nor even the services industries which contracted in July.

Fact: The US economy is overleveraged. And a lot of debt is owed to foreigners who may want to reclaim it. And trillions, yes trillions, of dollars in derivative instruments are held by financial institutions, with equity capital only a mere fraction thereof. A potential accident waiting to happen.

Indeed, symptomatically, American Express recently took an \$826 million bath on its collateralized debt derivative positions. American Express “did not fully comprehend the risk” it was taking, admitted its CEO. Yikes!

Fact: A tug of war exists between inflationary and deflationary forces. Certain areas of the economy are deflating while others are inflating. Excess money printing by the Fed is ultimately inflationary as would be US dollar weakness, while lack of demand and surplus capacity and inventories are pressuring the prices of many commodities and manufactured goods. In the US, average hourly earnings year over year to July were up 4.4%, the highest since April '98. In Canada, we're waiting to see how Vince Carter's deal with the Raptors affects our average hourly earnings.

Fact: Most important, even after a significant pullback, stocks are still not historically cheap with the S&P500 still trading at an expensive 26x earnings and the NASDAQ100, in our work, is still 40% overvalued. Some real bargains are starting to appear in mid and small cap land (and mid and small caps have been outperforming), but overall the market's no screaming buy and real bargains among quality companies are hard to find.

Those seem to be some of the negatives. Whew!

However, though the negatives do abound, we must not lose sight of the positives.

- **POSITIVES**

Fact: Recovery is inevitable. It's only a matter of time. The economy will in time work off excess inventory and excess capacity.

Fact: Bear markets inevitably end—from selling exhaustion—and invariably before all the bad news is out. Markets are a leading indicator, a forecasting mechanism, and typically discount the worst and anticipate the recovery before the recovery is evident in the statistics. So we try to listen to the message of the market more than the message of the headlines or the economists.

Fact: Japan's bear market may already be ending after 10 years of decline. A new progressive leadership may finally be taking the steps to liberalize and reflate the economy and stimulate consumer demand.

Fact: There is huge cash on the sidelines—over 2 trillion dollars of cash in US money market funds, sufficient to fuel a market recovery when investor confidence improves.

Fact: The Fed is doing its job and it usually succeeds. Lower interest rates and increased money supply will make stocks more attractive, after the lag time it takes to get the economy revived. A glimmer of hope, initial jobless claims in the US fell to their lowest level in 5½ months. Maybe the worst in job reductions is over.

Fact: The developing world will be a huge market for the goods and services the industrialized world provides and may make up for the slack demand we see at home.

Fact: The capital misallocated to technology and away from the old economy may ultimately, when the economy starts to recover, result in shortages of commodities and certain manufactured goods resulting in better pricing power and profitability for cyclical companies. We want to own the beneficiaries of these shortages.

Fact: The technology revolution is hardly over even though capital spending in this area became irrational as were the share prices. New technologies may be around the corner and could kickstart investor excitement again.

Many tech companies will not survive, but those that do will have huge opportunities. We want to look for the survivors. We need to be alert as to which companies might be beneficiaries of the carnage. Shrewd bottom-feeders like Celestica buying deals from troubled bigger fish like Lucent are likely getting some extraordinary opportunities.

Fact: With enough pain, public sentiment may eventually permit more government spending on long overdue infrastructure needs increasing the demand the economy needs to get going.

Fact: Value stocks have over the past year outperformed growth stocks and we're value investors so we've benefited. The new high list is populated with formerly neglected value stocks so there are opportunities if you look for them.

There you have it. Some of the facts as we see them. And as we see them, the negatives outweigh the positives.

- **BEAR MARKET STRATEGIES**

Well how do we protect ourselves and make some money without undue risk in this troubled period? We only want to own those things where we have a great deal of conviction. Like the song says, "We want to accentuate the positive, eliminate the negative." Even though we're bearish, it is unwise from an investment standpoint to adopt such a bleak outlook that one would hold no stocks. After all, most stocks are down already and many stocks are down a great deal. As such, their prices may have already discounted the worst. Maybe Lucent, JDS Uniphase and Nortel, already down 90%, have not much further on the downside.

Some stocks, like foods and drugs—the safe dependables, should be relatively impervious to the economic downturn, yet their share prices get unduly affected by the selling of stocks generally and they tend to offer relatively good value. So we own Schering-Plough and Kimberly-Clark and are looking for others in this category—others like Safeway, McDonald's, Anheuser Busch and Pepsico.

Some stocks operate businesses that don't correlate to the economy or are growing so fast organically that their growth rates offset the drag of the economic slowdown. So we own Cryptologic (on-line gaming, making recent highs) and AES (electric power utility in 32 countries and meeting earnings' expectations even though temporarily burdened by Brazilian issues).

Or we own companies that are not just cheap, but absurdly cheap, like oil companies, Hurricane Hydrocarbons trading at only 2x earnings and PanAfrican Energy trading at less than its net cash per share with its growing oil assets and production as a freebie. Or like Goldfarb which is in liquidation mode and has a net asset value more than triple its share price.

Or companies that are cheap and where we believe there may be some catalyst that could make them go up regardless of the direction of the overall market, like Canadian Natural Resources which could get acquired by a larger US oil company, or InterTAN which is in play, or gold stocks like Franco Nevada and Dundee Precious Metals and Gold Fields which will benefit from the rising bullion price we think will occur shortly as the US dollar declines.

We want to be alert to some developing themes. For example, as we believe the US dollar is in decline, we want to own companies that will benefit, like Schering-Plough and Kimberly-Clark and other multinationals and, of course, the golds.

With defense spending increasing, there may be opportunities in that area, even though most of the group is not cheap, but Honeywell which we traded profitably may again be attractive.

Normally, as value investors à la Warren Buffett, we would want to find good companies that are bargains and hold them for the long run. But we've had to adapt to the current precarious and volatile market environment by trading more. So, for example, we bought and sold Symantec, Gemstar TV Guide, Microsoft and others, usually generating a satisfactory rate of return. When we initiate a buy, it's always in a company where we'd be comfortable to hold it for the long run. However, in the current environment, we're nervous holders and utilizing some powerful tools that assist us in recognizing good points to buy and to sell, we're able to make short-term profits or cut losses if we have to.

Capital preservation is paramount to us. So we're not letting ourselves be too exposed to any one position even if we love it. Therefore, we have trimmed positions in favourites Hurricane Hydrocarbons and Cryptologic. We're always looking to raise some cash if we can. And where our clients allow it, we hedge the risk by short selling overvalued stocks currently to about 20% of the total portfolio. We continually urge our clients to consider allowing us to hedge risk in this manner. It has worked well for us.

In our view of the world, we believe the negatives are still overwhelming and not fully in the market. So we're being cautious and waiting for the market to give us the message that the worst is over.

Randall Abramson, CFA

August 7, 2001

