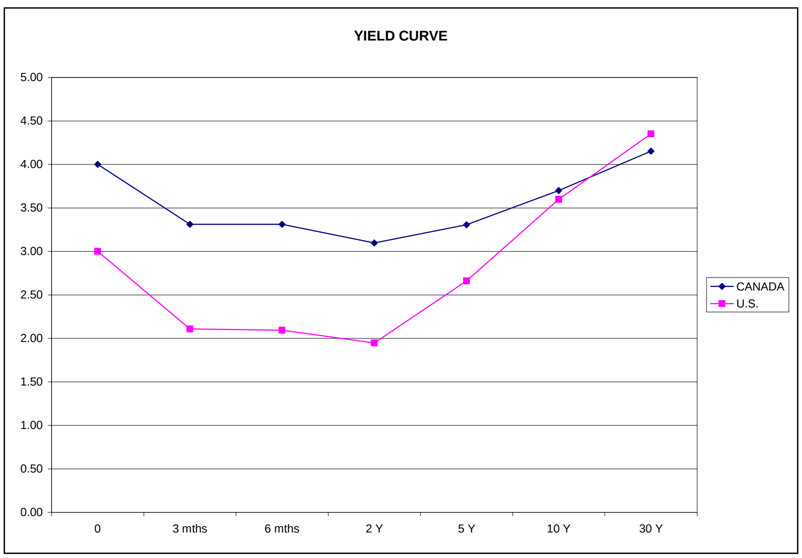
February 2008

Recession



Although the U.S. will not officially be in a recession until two consecutive quarters of negative economic growth (GDP) are confirmed, recent data suggests that the U.S. entered a recession some time in November or December of 2007.

70% of GDP comes from consumer spending and the industrialized world recently experienced an unprecedented four-year spending explosion fostered by banks' excessively easy lending. As readers of the LePoidevin Letter know, in August 2006, I wrote a letter titled "Yield-Curve Inversion – Recession on the Horizon." In the letter, I explained that short-term interest rates had exceeded long-term interest rates and that this would squeeze profits in the banking sector and cause banks to curtail lending.

A year later, by August of 2007, banks were reporting problems with loans which caused tightening lending standards. As lines of credit became harder to find, consumers responded by reducing spending in the fourth quarter of '07.

Ironically, the stock markets chose to ignore such warnings of the yield-curve inversion for more than a year. By early October 2007, markets had achieved an all-time high level. Triple-digit daily fluctuations became the norm as investors continued to chase returns. However, the markets could no longer ignore the continuing deterioration in the financial sector.

As 2008 rolled in, the stock market was in full retreat. By the third week in January, the stock market had wiped out the returns of the market since before the yield-curve inversion - retreated to levels not seen since November 2005. Cash is now king. The two-year return of cash is now significantly higher than the stock markets.

The U.S. Federal Reserve Board (which sets U.S. interest rate policy) has a dual role. On the one hand, it aims to keep inflation low; on the other hand, it must set U.S. interest rates consistent with economic growth. Despite rising inflationary pressures, however, especially in energy and food, the U.S. acted to stimulate the economy by dropping U.S. interest rates by 1.25% in just eight days at the end of January, thereby erasing the yield-curve inversion that had been in effect for 18 months. U.S. short-term interest rates are now 3% compared with 10-year government bonds at 3.6%.

Unfortunately, there is a lag between interest rate policy and its effect on the economy. Just as the inversion took 15 months to slow the economy, the current normal yield-curve will likely take 9 to 15 months before the economy stops deteriorating. By that time, the situation could look much worse than today. A decrease in the cost of money does not necessarily translate to an increase in the number of loans. In fact, the number of loans is still dropping. One year ago, 1 in 100 mortgage payments were delinquent in their payments. Today, that number in the U.S. is closer to six. Banks need to charge customers more to offset the losses they incurred in delinquent mortgages.

Mortgages aren't the only area that is in trouble. Recent data shows that credit cards and lines of credit also have growing number of delinquencies. Banks have responded by cutting back on credit card issuances as well as by tightening up available lines of credit.

Canada will not be immune from the U.S. credit crunch. The yield-curve is still inverted in Canada. Moreover, there is evidence that the U.S. credit problem is a global crisis. Problems have emerged with banks in the U.K., France, Germany, Australia, China, Japan and Canada. CIBC will likely suffer a huge first quarter loss due to U.S. exposure, which could worsen if the U.S. insurers default on their obligation to CIBC.

As I mentioned, one year ago, 1 in 100 U.S. mortgages was delinquent – that has surged to 6 in 100. Today, in Canada, there is only 1 delinquency per 100; yet Canadians carry more principal mortgage debt than Americans. Watch for Canada to follow the U.S. in bursting the real estate and debt bubbles.

Where to put your money in 2008?

If one were to look ahead 6 months, when the recession is fully entrenched while high-interest savings accounts are sitting at 2%, where will the money flow to?

1. Real Return Bonds – Real return bonds pay a fixed interest rate plus the rate of inflation as measured by the all-items Consumer Price Index. With Canadian interest rates mirroring lower U.S. rates, I recommend the Quebec 5-year bonds yielding 2% plus inflation. The 5-year U.S. Real Return bond called TIPS yield just 0.75%. Canadian interest rates tend to follow U.S. rates.

2. Preferred shares – With interest rates being driven down, investors can park money in high-quality preferred shares with yield in excess of 5%. In addition, investors receive a tax credit whereby the total taxes are significantly less than interest income if purchased outside of registered accounts.

The following is a list of recommended preferred shares

Preferred Shares (As of Feb 6th, 2008)	Yield (%)	Equivalent Yield on Pre-tax Interest Income (%)
E-L Financial Corp	6.10	7.625
George Weston Ltd	6.50	8.125
Sun Life Financial	5.20	6.500
Great-West Lifeco Inc	5.30	6.625
Manulife Financial	5.05	6.313
Canadian Utilities	5.35	6.690
Bombardier Inc	8.51	10.640

3. Common shares – While a recession may cause declining profits in many sectors of business, not all companies are considered economically sensitive. For example, a recession is not likely to curtail one's use of prescription medications. Cable television or telecom use tends to be quite stable. Likewise, food or beverage sales have historically held up well in previous recessions. Moreover, in late 1999, U.S. multinational corporations traded at roughly 35 times their earnings, which was extremely high by historical standards. Today, these blue chip companies are trading at about 17 times earnings, which is about average valuation but makes a compelling buy in comparison to low interest rates.

   With interest rates on the way down, investors will tend to gravitate to the safer sectors of the stock market. That being said, many sectors of the market will continue to deteriorate. Canadian bank stocks should be avoided.

4. Gold – The bull market in gold is likely to continue. With U.S. 5-year bonds yielding 2.7% and U.S. inflation close to 4%, there is little propensity to sell one's gold for a U.S. real return of -1.3%. I favour gold shares such as Barrick, Agnico-Eagle or Newmont; and have recently suggested the South African producers of gold fields – Goldfields and Harmony Gold. Physical gold can be purchased through the ETF, StreetTrack Gold Trust, whose NYSE stock symbol is GLD.

5. The Japanese Yen – As U.S. and Canadian interest rates are driven down, the interest rate differential between North American currencies and the Yen has narrowed; so the recent rise in the Yen should continue through 2008.

Sincerely,

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