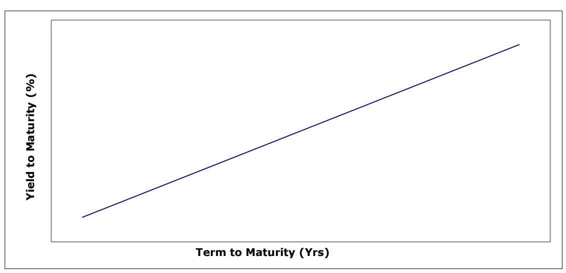
January 2006

Yield Curve Flattens
Charles Ponzi--Alive and Well in Canada

Most of you are aware by now that I pay more attention to the shape of the yield curve than to any Ph.D. of economics, because of the remarkable accuracy of its predictions. For example, in the year 2000, of 34 leading economists, not one predicted the recession of 2001, whereas the yield curve predicted it bang on.

What is the Yield Curve?
The Yield Curve is arrived at by plotting the interest rates on the vertical axis of a graph with the term to maturity on its horizontal axis. A typical curve slopes upwards to the right, indicating the manner in which investors are rewarded by investing longer term rather than short term.



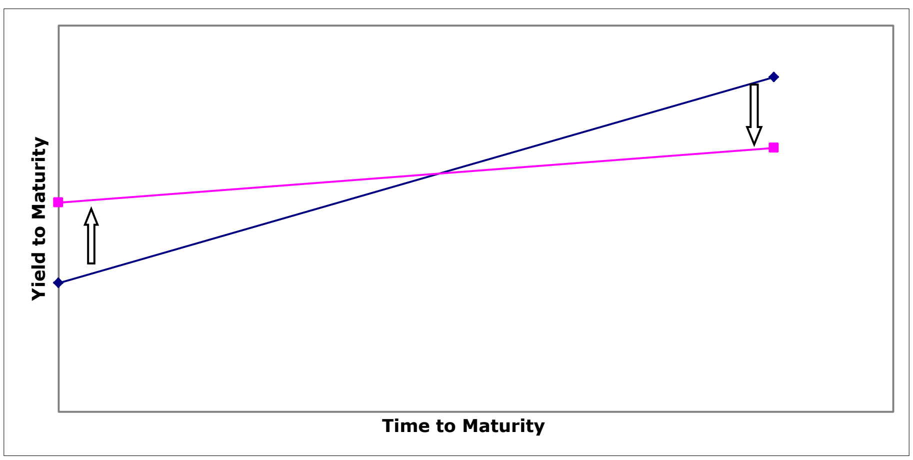
In Canada, the Bank of Canada controls only the very short-term interest rates, while the market's purchasers of bonds control longer-term rates.

How Does the Yield Curve Indicator Work?
When bond market transactions are done at yields above rates that the Bank of Canada (or any central bank), has set short term rates at, the bond market is signaling that the economy is healthy and that rates will either stay neutral or rise. On rare occasions, however, bonds are transacted at yields below the Bank of Canada's rate, indicating the bond market's prediction that an economic contraction is coming. This is known as an inverted yield curve.

Not only does the yield curve give us a clue as to the direction of the economy, but the shape of the curve may itself foster growth or contraction. A steep upwards curve, as occurred in the summer of 2004, promotes increased bank lending. Banks can borrow at the short term rates and lend out money at longer term rates. (This is known as the carry trade.) The steeper the slope, the more money banks can make by lending. Conversely, an inverted yield curve (higher short rates than long) not only predicts an economic contraction but contributes to one. If short-term rates rise above the rates which banks can charge on loans, then banks will sharply curtail their lending. In fact, many demand loans would get called. Inverted yield curves preceded the recessions of 1981, 1991, and 2001.

Where Are We Now?

In the summer of 2004, I predicted that bonds would still be a good place to invest money despite the inevitable rising of short-term interest rates by the Bank of Canada. The yield curve was so steep that the bond market had fully anticipated the economic growth and interest rates of the coming year.



In 2005 the yield curve has once again done an excellent job of predicting economic performance. However, the current flattening of the yield curve is warning that economic growth will soon slow. The yield curve has not yet signaled a recession; but with both the Bank of Canada, and the US Federal Reserve Board signaling further rate hikes, there is a good chance of inversion early in 2006. Stay tuned!

The Bank of Canada's role is to protect the Canadian dollar from excess inflation. The primary tool the bank has is to raise short term interest rates to cool excess demand and thereby stave off or minimize inflation. Listed below are some of the main reasons I think short-term interest rates will rise further in 2006.

1. The rise in energy prices has increased prices at the gas-pumps and on home heating bills, and there is increasing evidence that other companies, besides oil companies, are passing on their higher costs–as, for example, BC Ferries or airline tickets.

2. Capacity utilization is at a record high. In other words, businesses are operating at close to full capacity--which means they are likely to increase prices.

3. Wages are beginning to rise. With employment at a 30-year high, businesses are having a tough time hiring workers and are therefore having to raise wages. Moreover, strike activity is picking up.

4. Gold is rising to 24-year highs, signaling in part a growing loss of confidence in global currencies.

5. Global money supply is surging, which must be curtailed by higher interest rates.

6. Personal levels of debt are at all time highs.

My guess is that interest rates in Canada will peak somewhere around 4.75% with bond yields rising to around 4.5%. Under this scenario, 10-year bonds would drop by 4% in price, leaving the total return for the year at zero. I'll take the cash returns over bonds.

Charles Ponzi - Alive and Well in Canada
In 1920, Charles Ponzi attracted 30,000 investors and issued notes totaling $15 million. [1]Ponzi claimed to be able to make large profits by exploiting arbitrage opportunities between European and American postage coupons. Apparently there were some genuine profit opportunities, as the currency exchange rates did not correspond exactly to the rates implicit in the coupons.

Of course, few investments were actually made by Mr. Ponzi. Instead, a second round of investors financed the return of the first round; and a third round finances the second round; and so on. News of the fantastic returns of course spread, which then brought in several new rounds of investors. All Ponzi schemes, or pyramid schemes, eventually fail since there are simply not enough new investors to finance the scheme indefinitely.

Investors in BC may remember Aaron Mortgage, which turned out to be a Ponzi scheme.

Which leads me to the income trust sector in Canada. An income trust is an investment that holds assets which are income producing. The income is passed on to the unit holders. Sounds like a decent idea. With interest rates last year at 2% to 3%, the investing public have fallen in love with this asset class. And why not, yields in the sector have been in the range of 6% to 14%.

That's where Charles Ponzi comes in. A recent research report by Al Rosen, published in the National Post, points out the fact that 75% of the largest 50 business trusts are paying out an average of 158% of their net income. From their net income of $2.2 billion, they have paid out $3.6 billion of distributable cash! [2]Is it any wonder that insiders have been heavy sellers of their own units? Not to worry, as the cash dries up the trusts can always tender a new stock offering. In other words, a new group of investors will pay the existing investors-- and so on, and so on.

Let's also look at the type of businesses that have become income trusts. The largest business trust in Canada is Yellow Pages Income Fund. This was a business owned by BCE Inc. BCE no longer regarded the business as a good long-term holding, and so sold it to KKR. One year after purchasing the business, KKR was able to double their money by turning it into an income trust. Now let's think about the yellow pages business for a moment. Why do you suppose that BCE and then KKR wanted to sell it? If you talk to anyone who buys space in the yellow pages, they will probably tell you that they're taking out smaller and smaller ads. Why? Well, I know I haven't picked up a yellow pages in 2 years, I simply do an internet search.

The amazing thing is that since Yellow Pages has come to the market, investors have bid up the stock 60% above what KKR sold it for! I personally think this is a "buggy whip" company. Will it even be around in 10 Years? Of course there has been subsequent financing that investors have snapped up. The market is now valuing this company at an amazing $7.6 billion! Investors seem to have lost focus on the nature of the underlying business itself. In the case of Yellow Pages all they can focus on is the yield of 5.9%

If I ask what could derail an income trust scheme, I am brought back to my first point. Interest rates at 50-year lows have caused investors to rush into anything with a yield. Higher rates, however, are likely to curtail the flow of funds into the area touched by the income trust, which would in turn put downward pressure on unit prices themselves. Moreover, most trusts have a high percentage of floating rate debt which would force them to cut distributions.

I don't even want to begin to guess what would happen to the income trust sector in a recession.

Remember that cash is not a long-term investment holding. In one of every five years cash beats stocks and bonds. A year from now 4.75% cash may look much better than zero out of bonds; or who knows what out of the Ponzi-- I mean, income trust area.

If you would like to review your portfolio, please give me a call. I would also like to wish you a safe and happy holiday and a prosperous New Year!

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