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Tide no longer lifting all boats

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Illustrations: Color Photo: Peter J. Thompson, National Post / CIBC Asset Management's David Graham, left, Aurion Capital's Robert Decker, Marquest Asset Management's Gerry Brockelsby and Natcan Investment Management's Mark Jackson, seated.

Part two of Buy and Sell columnist Jonathan Ratner's Canadian equity roundtable with Gerry Brockelsby of Marquest Asset Management, Robert Decker at Aurion Capital Management, CIBC Global Asset Management's David Graham and Mark Jackson from NATCAN Investment Management. Additional questions and the panel's stock picks will be featured exclusively on financialpost.com tomorrow. ---

THE PANEL

David Graham, CIBC Global Asset Management
Graham oversees the management of a variety of funds, but is focused primarily on the CIBC Monthly Income Fund and value funds for both retail and pension clients.

Robert Decker, Aurion Capital Management
Aurion manages money in three areas -pensions, its high-net-worth LP products and more recently as a sub-advisor for Dynamic Aurion Tactical Balanced Fund and Dynamic Aurion Canadian Equity Fund.

Gerry Brockelsby, Marquest Asset Management
Marquest manages pooled funds for high-net-worth individuals. These include funds focused on resources, small-cap equity, large-cap equity and global asset allocation.

Mark Jackson, NATCAN Investment Management
NATCAN manages nearly all asset classes. Jackson is primarily responsible for the Altamira brands and products.

Q What are your views on the financial sector?

Brockelsby The financial sector had a 20-year run thanks to a strong bull market in bonds and equities, financial innovation and new products. Going forward, the industry will be more highly regulated within a more challenging financial market environment. The financial sector is not going to have the strong leadership it once had. I would sooner put my money in real productive assets which will benefit from the continuing industrialization of emerging markets.

Jackson There is opportunity for the Canadian banks if the government sticks to its guns and doesn't regulate. Down the road, if the U.S. government forges ahead and this follows globally, it becomes an indirect subsidy for the Canadian banks.

Decker They are trying to solve the root problem, which is the "too big to fail" issue. From where I sit, that is a function of regulation, rating agencies and government oversight. Don't create a fund to bail us out next time, just don't let them get too big to fail.

Jackson In Canada, we basically have five banks that control most of the market, so there is concentration. They are all too big to fail, but the regulation seemed to work well for them.

Brockelsby I think all of the re-regulation in the United States and Europe will make more and more international investors look at Canada. For many years, it has been U.S. policy to get everyone a house --no matter what. That's where Fanny Mae and Freddie Mac came from. Canada can say "why didn't we have this problem?" U.S. regulators and Congress will hopefully realize they were a major contributor to the problem.

Graham I don't know why you have to have more regulation and taxes as well. As for the Canadian banks, I don't think they want to rush into acquisitions, even with the limits being posed by regulators. If you listen to management, they really want to keep their capital levels in check. They are being cautious.

Decker As opposed to when they had to pay premiums in the past like with TD and Banknorth, now they can backfill those type of quality assets with acquisitions. They are really buying geographic footprint. For investors that think they missed the opportunity in bank stocks, they haven't. You're still getting 3% to 4% yields that will be enhanced by an increase in the dividend.

Graham With banks, everybody has been looking at the possibility of loan loss provisions coming down as the credit markets improve, but at the same time they have all been raising the prices of their products. This should translate into profits.

Jackson There is a recovery in the economy and the consumer. Lending has improved, there is better volume and spreads, as well as higher prices.

Brockelsby The good news is loans in the United States have turned up. So in the next few months, I think we are going to see the end of the doomsday scenario for the housing market in which the psychology is still negative while the fundamentals are improving. That's always bullish.

Jackson Some 80% of companies beat on earnings this quarter--that's because analysts are behind the curve.

Decker They are more behind the curve because of what they went through. The financial industry was ground zero of the blow-up.

Graham In previous recessions, central banks and governments told people to pay down their debts and repair their balance sheets. This time around, they reduced interest rates to zero so people don't have to worry as much. We're going into this recovery with consumer balance sheets that are almost as bad as before, so deleveraging will be a drag on the economic recovery for a number of years.

Q What is the outlook for China and commodities?

Decker China is the big determinant and the primary driver of sentiment around commodities. Unfortunately commodities have a great fundamental story, but a very risky financial overlay where speculators come and go. It's a risk-on, risk-off world. When risk is off, commodities are harmed disproportionately. Oil prices are hard to sustain fundamentally above US\$80 a barrel because there is tons of marginal production going on. Over the long run, there is not going to be cheap oil.

Brockelsby A seasonal impact in commodity prices has changed because of China. It used to be that people bought commodities stocks in August and sold them in early March. Since 2000, this traditional seasonal pattern has been significantly influenced by the Chinese New Year. In the case of oil, four months prior to Chinese New Year oil has declined 9%, while four months following Chinese New Year it has rallied 12%. Copper is following this similar pattern. So this seasonal peak of March has now been extended to May and June.

Graham China has demonstrated that it is quite capable of controlling its economic growth. We expect demand for commodities to grow with the economic recovery. Whether China grows at 11% or 9% shouldn't make much difference to the outlook for commodity prices. The materials sector, however, has been quite volatile as investors worry that Chinese authorities will tighten too much.

Jackson The major events that would pull the market down will probably not be driven out of China. It would more likely be something like the European market unraveling or sovereign debt issues. A new regulatory environment and higher taxes --those things we're already expecting. I don't see it being an earnings issue either. For Canada, I don't think it's China because at the end of the day, even if China goes from 12% or 13% growth to 8% growth, it is compounding every year. It is more oil demand, more copper demand, more of everything that is needed to support growth in their economy.

Brockelsby In January 2010, China signed a free trade pact with seven of the Asian Tigers. This

trading block represents 1.7 billion people. China's growth rate will continue to be relatively strong between 7% and 10% range and this new free trade pact will help support this growth rate.

Q What are some of the biggest risks and important themes out there?

Decker The rising interest rate environment is obviously the threat. So even in financials, you have to have earnings growth. That earnings growth has to be organic, not just letting the yield curve make your money for you. If you're a bank, you're going to have to create loan demand, or create products if you're an investment manager. That's why I believe growth is the next theme. Because it's scarce, it will be highly prized. To me, the risk is in interest-rate sensitive stocks.

Brockelsby The technology area is ripe with opportunity because capital expenditures are positioned to come back after several years of under spending. The mobile Internet service providers are experiencing congestion due to the explosion in data transmission. The solutions will require a spending boom in both hardware and software to manage the costs and deliver client needs with a profitable business model. There are many Canadian companies involved in this sector which will benefit.

Jackson There are lots of areas to find growth. You're going to have cyclical growth with companies taking their operating costs down. I also see growth in technology from a capital spending boom and even as it gets more normalized. The places where I see challenges are mostly interest-rate sensitive--utilities, some of the telecom names that actually have to spend money will be challenged to deliver growth, and in insurance. If you have a good balance sheet, as a lot of resource companies do, with the way commodity prices have reacted they can use this to get growth. They will probably have to do so through M&A because growth on the exploration side is a long process. They are not on the same treadmill as oil companies are in terms of finding resources in the ground and getting cash flow pretty quickly.

Brockelsby With the technological development of multi fracking horizontal wells, older resource plays in the western Canadian basin have become economic again. We particularly like the oil-prone Viking play at Dodsland in Western Saskatchewan. The easily accessible oil pools were developed several years ago by conventional vertical drilling. Over time, income trusts accumulated most of the land particularly Baytex, Penn West and Crescent Point.

Decker Companies are finding ways to create organic growth in this slow-growth economy. Dollarama is a good example of that. They've found a niche and they're exploiting it. It can be a service, it doesn't have to be a physical product. Companies are moving into the new media space or areas where advertising spending is heading such as mobile marketing.

Graham If you look at each of the recessions over the past 20 years, because of growing global debt, with

each recovery it has taken a lower level of interest rates to slow the economy down again. My main theme has been to focus on yield. Investors have been reluctant to take risk since equity markets tumbled in 2008, but they also haven't liked the low money-market returns. We felt over the past few months that stocks that offered solid, stable or even growing dividends would become an investor focus, and so we tried to align our portfolios in this direction.

Jackson Whereas from March 2009 to the beginning of this year, all boats were rising. You could throw money at the market and do okay. Now the risk is you have to get the stock picking right because we may be in a sideways market.

Q What about gold?

Jackson You're not going to get the kind of growth out of Barrick that you saw out of Red Back, for example. Then you get to a point that Barrick needs to buy a name like that because they have no growth. Why would you want to be on the buying side of that equation? You're only going to pay too much.

Graham I have been underweight the large-cap golds. They have not performed well over the past year. It seems investors want to buy ETFs directly or the small-cap golds that might be taken over. Gold itself seems to perform well when investors worry about inflation, or more recently when they have been concerned about the fall in the U.S. dollar, but I don't see many inflation concerns today with companies still operating well below capacity, and today the U.S. dollar looks like it will remain strong.

Decker Gold got very popular as it got linked to the currency play. That trade got very crowded. I'm actually impressed with the performance of gold since then. When people got nervous about the euro, they bought gold, so physically there is a demand from paper assets that falls into the gold market. But the real sweet spot for gold is when either there is a position of duress for safety or when things are too good and there is an inflationary bias for the economy. I think we are probably going to be staying between those two states for a very long period.

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