Capital Cycles 2005

The cycles of capital can offer clues about potential investment opportunities in the coming year. From a bottom-up perspective, the outlook for 2005 is a story of signals, sectors and supply.

Finding value and preserving capital are challenging tasks for Canadian pension managers as we face 2005. Investment uncertainties abound, including fears of a global slowdown, high oil prices, lack of progress in Iraq, and China's changing role in the global economy. Canadian companies are being profoundly affected, as global forces dictate the prices of much of our output, the cost of our capital, and the competitiveness of our labour markets.

The global economy continues to expand, albeit unevenly, largely on the back of debt-fueled U.S. consumer demand and unprecedented deficit spending at the federal level. U.S. consumers will remain the key drivers in the global demand for finished goods, at least until their Eastern Hemisphere counterparts increase their ability or willingness to consume.

Much economic analysis is devoted to demand trends, but it may be the supply side of the equation that threatens the balance. Increasingly, there are two diametrically opposite streams of economic output comprising the supply equation.

One camp is experiencing large increases in unit production, accompanied by price deflation, such as semiconductors, auto parts and consumer electronics. These goods are being supplied at the "China price," a term first coined by The New York Times, and is ostensibly aimed at pricing goods at a level affordable to future Chinese consumers.

The other camp includes mostly basic materials, such as crude oil, North American natural gas, metallurgical coal and nickel among others, which are experiencing growing markets and strong price increases. Rightly or wrongly, supplies are perceived to be constrained or even contracting, despite, or maybe as a result of, increased output.

LONG-TERM CAPITAL CYCLES

At the heart of this dichotomy are capital cycles, and their allocation mechanisms. Capital tends to be attracted

to the highest expected returns, creating an environment of over-investment in some sectors, while denying capital to others. Witness the tech/telecom boom of the nineties, which saw unprecedented investment in silicon, fibre and intellectual property, whose cash returns proved difficult to measure.

In the 1970s and 1980s, mineral exploration, whether for metals or energy, attracted more than its fair share of available capital. The high inflationary expectations of the time created an environment of high expected returns from mineral commodities. A seemingly endless stream of exploration companies sprouted up on a global basis, with capital supplied by eagerly willing investors. When a resource was ultimately discovered, there was no shortage of major international conglomerates willing to develop the next phase.

Not surprisingly, significant new supplies of energy and metals caused surpluses and depressed prices. Years of low single-digit returns on capital employed followed, and caused resource-based global industries, like oil and gas, to re-evaluate their spending priorities. Exxon took over Mobil, British Petroleum consumed Amoco, and Western economies witnessed a protracted scenario of capital contraction ever since, during which capital budgets were rationalized and prioritized, and assets with less perceived impact divested or left fallow. This has in fact created an opportunity in Canada for smaller energy producers to efficiently exploit these otherwise capital-starved assets.

Smaller entrepreneurial energy producers are well positioned to exploit the downsizing by the major oil companies. Canadian companies such as Duverney Energy are being led by management teams spawned from the downsizing majors, whose assets they are now acquiring and developing through intense exploration. Within the larger picture of a negative capital cycle, they are applying seasoned management to high quality, familiar assets, and creating shareholder value in the process.

So where are we now? Metallurgical coal is a tight global market. Nickel, zinc and copper have seen their supply balances shift. Cold rolled steel, light oil and North American natural gas are all commanding price premiums. Against a backdrop of rising global demand, and lack of supply growth, producers of basic materials are now experiencing a prolonged new positive cycle, with much capital required to restore the supply/demand balance.

Barring an economic shock, 2005 could prove to be a strong year for basic materials, within a longer secular bull market for these commodities. Strategically, focusing on efficiently managed, low-cost producers such as Inco Ltd. can mitigate the risk involved in investing in commodity producers. In fact, history may prove that the last 20 years, which capture a majority of current active investment management experience, may have been a period of depression for commodity prices. This may cause a re-evaluation of our notion of long-term sustainable commodity prices, and the degree to which we weight them in our portfolios.

Paradoxically, the commodity that appears to be in significant over-supply, and available at cheap prices, is capital itself. This has led to a healthy environment for banks, the hub of the capital allocation system. They can access funds at cost levels not seen for decades, and re-distribute this same capital at high real rates, a recipe for strong cash-flow growth. Canadian banks in particular, like the Bank of Montreal, have devoted years to cost reduction, productivity enhancement and risk management through the application of

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technology. If these same banks can resist the temptation to deploy their capital into ill-fated growth initiatives, they can continue to achieve growing This article originally appeared in the December 2004 issue of Benefits Canada Magazine. It is reprinted here with the permission of Rogers Media. cash returns in 2005 and beyond.

Unsettling is the fact that, in places like Great Britain and North America in particular, a significant portion of this capital is being channeled toward the real estate development boom. Plan sponsors may find themselves uncomfortably overweighted to real estate, when direct investments in property and mortgages are added to an equity and bond portfolio tied to an economy already highly reliant on the wealth created by rising real estate valuations.

While the overall trend is worrisome, the process creates opportunities for smart companies. Shoppers Drug Mart, for example, has capitalized on the availability of prime sites being abandoned by grocery chains, as it consolidates its operations, and develops larger superstores. Shoppers has a proven track record in effective merchandising, which coupled with access to prime locations, is a formula for impressive cash-flow generation.

In the past few years, institutional investors have been looking for cash flow in the form of yield from their investments. Income trusts, sporting high relative yields, have emerged in 2005 as a pressing issue for pension investors, who are awaiting provincial legislation in Ontario to follow Alberta's lead and limit the liability to unit holders of trust-structured companies. This structure makes the analysis of these companies somewhat complicated, which suggests that a thorough review of income and royalty trusts, before the legislation is passed, is a worthwhile exercise.

Ironically, income and royalty trusts are the fastest growing segment of the Canadian capital market. Yet, they represent by definition, a contraction in capital availability. They distribute free cash flow to unit holders, as opposed to re-investing capital in their businesses. Trust structures have evolved, however, to include growing companies that reorganize as a trust primarily to attract low-cost capital.

A high portion of the operating cash flow is still paid to unit holders, so management and the board must go back to the unitholders and the markets to finance expansion (or make any significant changes in corporate assets). There is an inherent appeal to pension investors in this process, as it imposes a fiduciary duty on the board to maximize cash returns to unitholders, and places a high degree of visibility on corporate governance.

Yellow Pages and Gateway Casinos are two recent examples of this phenomenon. Both are stable, profitable businesses whose assets fit well within the trust structure, yet operate in industries with opportunities for growth. Investment in either trust makes sense, based on the cash returns from current operations, but the repeatability of their business models makes a strong case for expansion, and warrants their desire to access new capital from investors. This article originally appeared in the December 2004 issue of Benefits Canada Magazine. It is reprinted here with the permission of Rogers Media.

The traditional alternative for yield-oriented investors is, of course, bonds. In assessing fixed income markets, it is wise to pay heed to the guidance provided by the chairman of the Federal Reserve. The Fed has stated that it will increase U.S. short-term interest rates at a "measured" pace, commenting lately that the recovery had "gained some traction." It has voiced concerns regarding deflation in the past year, but is clearly pre-empting inflationary trends at present.

Interestingly, rates at the long end of the Treasury market moved down over the year, which seems to be at odds with a growing economy and rising rates in general. However, the picture is clearly different than in late 2003. The U.S. economy has "traction" now and inflation has come off its floor. The long end of the Treasury market is vulnerable to a downward correction (lower bond prices, higher yields).

In Canada, GDP growth is in an acceleration phase, the economy is operating near full capacity and consumer price inflation is rising. Since monetary policy has always been tighter in Canada than in the U.S., the Bank of Canada may not raise rates as aggressively as the Fed, but rates are forecast to rise nonetheless. In terms of strategy, North American government bonds have been performing well, but valuations remain stretched.

As in 2004, money managers will continually seek opportunities in investment-grade corporate bond markets, where credit improvement provides potential for capital gain as well as yield. A steady recovery in profits and cash flow and improving balance sheets are at the root of this trend towards higher credit ratings for corporate issuers.

Capital cycles are by definition long-term, and tend to send clear signals when they shift. Industries experiencing high rates of return, such as oil and gas production and refining, should be associated with public announcements of increased capital spending and supply expansion. This hasn't happened yet.

Pension managers should look to these sectors to find companies achieving capital efficiencies in their operations and generating cash flow in excess of capital requirements. Conversely, sectors which have attracted significant capital, such as real estate, can be expected to experience diminishing returns, and plan sponsors should be aware of their total weighting to this industry. Sponsors should also be watching the legislative calendar with respect to their ability to invest in trust-structured companies if cash return on their portfolio is a concern, as bond returns should be stable, but low.

Capital cycles are difficult to measure, but 2005 should prove to be an educational year. **BC**

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