

*A disciplined approach could avoid big disappointment*

# CHOOSE WISELY

*David Graham, CFA*

**THOUGH EQUITY MARKETS WERE** down dramatically in 2008 (the S&P/TSX Composite Index fell by 33 per cent in total returns for the year), it makes sense to be constructive about the outlook for 2009.

There is plenty of evidence of value in the markets:

☛ The price-to-trailing earnings ratio for the index is only about 9 times, certainly at the lower end of the historical range.

☛ The price to book value ratio is about 1.5 times, and more than one-third of North American stocks are now trading below book value. This is the highest ratio since the late 1980s.

☛ Dividend yields are greater than bond yields for the first time since the 1950s.

Still, there is no question that



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we're in a recession. The National Bureau of Economic Research (NBER) has declared that the U.S. has been in recession since December 2007.

The average recession since 1948 has lasted 10.4 months. This one is already long by historical standards. The consensus view seems to be that this recession will end either in late 2009 or early 2010. Our concern is that despite a commitment to get the economy going again, this recession could be both deeper and more prolonged than any since World War II.

Historically stock markets reach the bottom four to eight months before corporate earnings do. As investors start to anticipate an earnings recovery, the market rises.

The S&P/TSX Composite Index did in fact reach a bottom in mid-November of 2008 after dramatic September and October declines and the index has rallied by about 20 per cent at end of the year.

Some investors have returned to the cyclical sectors – energy and materials. While we believe equities could perform well over

the longer term – five years or more – we are still concerned about the performance of equities in the next six months.

Many top-down market strategists expect corporate earnings in Canada to decline by about 30 per cent in 2009. Our main worry is that corporate earnings will fall more than forecast.

We are entering a period of excess capacity in many industries, which could lead to both price competition and lower production rates.

The demand for most commodities is currently much less than the supply, so it is difficult to predict where commodity prices will settle.

I am also concerned that this slowdown is global, including Asia and Europe, and the U.S., with all its problems, that will have to pull the world out of the slowdown.

## A MEASURED PACE

Consequently, our approach for our balanced portfolio in the CIBC Monthly Income Fund, will be to increase the weight in equities, but at a measured pace.

We currently favour bonds over equities. While we could miss a rally, we could also avoid a big disappointment. We expect continued volatility in the market so we plan to add positions case-by-case when the stock price seems unusually low, rather than on a sectoral basis.

We also believe sell discipline will be important this year as the markets go through periods of enthusiasm and disappointment. It will be an exercise in monitoring to catch the best value and to avoid disappointment. Our strategic focus will be the following:

◆ **Buy good companies with strong franchises.**

A strong franchise should lead to higher market share and better margins.

In the energy sector, we own **ARC Energy Trust** (TSX, AET.UN, \$16.48) which has a strong franchise in natural gas due to the success of its exploration and development near Montney in northeastern British Columbia.

We also own **Crescent Point Energy Trust** (TSX, CPG.UN, \$22.93), in our portfolio. It has large holdings of land in the Bakken Formation in Saskatchewan, where it is believed there are vast reservoirs of oil.

In the consumer area, we own **Shoppers Drug Mart** (TSX-SC, \$44.55), which, in our view, has a solid franchise in the prescription business across Canada, and has successfully grown its higher profit cosmetics business.

◆ **Buy companies with predictable earnings.**

We believe companies with more stable and predictable earnings could perform better in the next few months.

In our opinion, the telecommunication companies, **BCE Inc.** (TSX-BCE, \$25.06) and **Telus Corp.** (TSX-T, \$34.00), and the cable companies, **Rogers Communications** (TSX-RCI.B, \$33.49) and **Shaw Communications** (TSX-SJR.B, \$20.58), should exhibit solid earnings.

While customers may cut back on parts of their businesses in tough times, the majority of revenues should be secure in our view.

◆ **Buy stocks with high yields and the prospect of growing dividends.**

Historically, dividends have been a key factor in total returns over time.

In a market that we expect will move sideways, dividend income has an extra appeal. We own **Fort Chicago Energy Partners** (TSX-FCE.UN, \$7.77) and recently added **Cineplex Galaxy Income Fund** (TSX-CGX.UN, \$13.01) to the portfolio. Both of these trusts have double-digit distribution yields.

In the case of Fort Chicago, 50 per cent owner of the Alliance gas pipeline, the distribution payout is about 80 per cent of distributable cash flow.

Cineplex and Galaxy cinemas have more than two-thirds of the movie audience market share in Canada and its film business has historically been quite recession proof. The trust has done an excellent job of increasing revenues from concessions, alternative events and in-theatre advertising, and has developed an excellent online audience and loyalty program.

Both of these income trusts say they will maintain most, if not all, of their distributions even if they eventually become taxable and convert to corporations.

## FINANCIALS OVER COMMODITIES

We favour financials over commodities. Canadian financial stocks are still hurt by perceived risk of exposure to credit problems even though they have weathered the storm better than most of their foreign counterparts.

Demand for loans could be flat

and there is little doubt that loan losses will increase as this recession continues. Despite this, we believe the banks and insurance companies have adequate capital to weather the storm.

In fact, most banks have recently raised equity. The banks and insurance company stocks have good yields and we believe their dividends are safe.

On the other hand, most commodity-oriented companies may have several quarters of weak pricing due to the current supply/demand imbalance, as well as declining sales volumes if the economic downturn continues.

There have been encouraging economic signs recently, including improving credit spreads and an uptick in ocean-going shipping rates.

But these positive signs are still offset by the continued fall in house prices and the rise in unemployment.

The normal growth one might expect from the massive government stimulus is probably going to be muted by the retrenchment in consumer spending.

Our overriding view is that we would rather miss some of the potential recovery than to be too exposed if things get worse. That is why we are being constructively cautious. ▼

*prices are from January 23, 2009*

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