

Expecting the Worst

Worry kills. So don't do it. But some days we arrive at the office, we read the news, and we want to turn off the computer, sell everything or ignore everything and start the weekend early.

On Friday, we turned on our computer screens to read about the failing job rates in the US and Canada, the massive cut, in Manitoba Tel's dividend, soaring wheat prices and the new lows in the 10-year bond yield in the US. Then the equity markets fell. Apart from wheat urged ahead by Russian fires, all reflect deflationary trends. Such price trends are expected by QV.

Charting the 10-Year Treasury-Note Yield

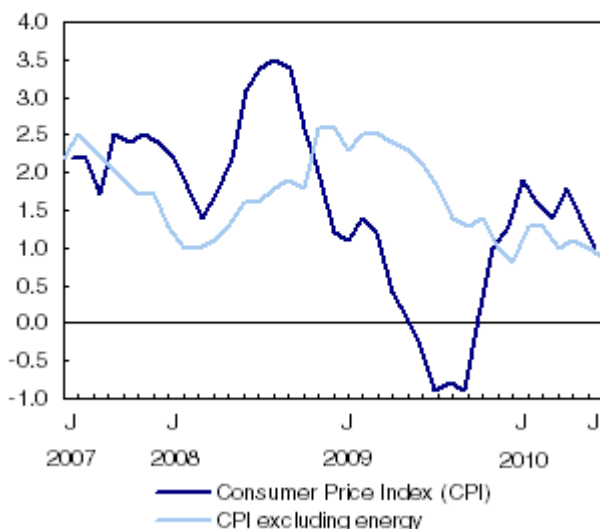
Since the end of March, US Treasury yields have fallen from 4.01% to 2.86% today. The 10-year Canada bond is trading at 3.07%. Canadian yields have followed US rates down since mid-April. Seen through the eyes of a bond manager, this is a brilliant outcome and we are delighting in the price boost this gives to our fixed income portfolios. Over the last three months, our model bond portfolio in our balanced fund provided a total return of 4.2% compared to a negative result in the S&P/TSX Index of 3.4%.

In parallel, consumer prices both sides of the border are slipping. The US CPI is running at less than a one percent annualized rate over the last 12 months. The chart below shows Canada's CPI dipping from a 1.9% annual rate in January to 1.0% in June.

Falling bond yields reflect sagging lending in the States. They pose a quandary about the lack economic growth and ultimate policy responses.

The 12-month change in the Consumer Price Index and the CPI excluding energy

12-month % change



Source: Statistics Canada

For QV, deflation may not be desirable but is a reasonable expectation in an excessively levered economy. One should expect falling prices and interest rates. Highly indebted borrowers experiencing a downturn in their income cannot service their debts at any price. It is the reason debt liquidation will likely continue to occur.

In an ironic turn, Ben Bernanke's concern over deflation and his policies of low rates and bond purchases to avoid that outcome seem to be exciting the very result he hoped to avoid. Low rates are failing to drive lending. Consumers in the US are not spending, they are saving. Grant's Interest Rate Observer (www.grantspub.com) notes spending rose less than one percent over the last 12 months, the lowest reading since the index was created in 1978. The broadest measure of money supply, much dependent on credit growth, shrunk 7.6% in the last three months and finally, "consumer credit, defined as the sum total of personal borrowing not secured by real estate, dropped by \$142 billion from its peak of \$2.6 trillion in July 2008. That this is the biggest such decline in seven decades might say more about the decades than it does about the liquidation." To our eyes this looks like a shrinking world.

The Elixir for a Future - The Magic of Compounding

Jim Grant provides an elixir for bad news in his sermon on deflation. He looks back to look forward on two of the companies held in QV's Global Fund - Johnson & Johnson and Kimberly-Clark. The exercise gives reason to come to work and turn on the computer screens. We will apply his analysis to our Canadian companies in future QV Updates.

Jim Grant notes JNJ has grown its initial dividend since its IPO in 1943 at a 15.7% annual rate and its equity by 11.5%. In the last decade, JNJ has grown sales, net income, and book value and dividends at 8.5%, 11.5%, and 12.1% and 13.5%, whereas share price appreciation has been 3.3%. Grant calculates the fundamental value of these companies in 2020, if the pattern of the past 10-year's growth were to continue. From these numbers, one may pencil in the price appreciation over the period.

<u>JNJ</u>	<u>2010</u>	<u>2020</u>
Price to Book	3.00x	1.02x
Dividend	\$2.16	\$6.83
Yield	3.4%	11.6%

<u>KMB</u>		
Price to Book	4.6x	3.4x
Dividend	\$2.66	\$5.53
Yield	4.20%	9.12%

Remember extrapolations may be deceptive and dangerous, but then again so are artificially low and accident-prone interest rates. Furthermore, we expect no repeat of the past decades growth rate. It just can't happen. However, for the long run, we would rather depend on companies with prudent policies and compounding assets than the alternatives.