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Analyst Article

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OFF THE RECORD

*e*Research is pleased to provide an article written by Edmond G. Eberts of RAPPORT Capital Formation Strategists Inc.

This article is Mr. Eberts' 17th Annual Off-The-Record Exchange of Constructive Ideas.

In his paper, Mr. Eberts touches on the Canadian political scene, the U.S. and Canadian economic situation, the Canadian standard of living, the outlook for the stock market, and opportunities in a commodity/energy boom.

Some of the key excerpts from the article are quoted below:

Writing about the politically-induced follies and the ineptitudes of some of Canada's premiers, Mr. Eberts says, "Unfortunately, the overarching irony of political lunacy is likely to persist. I have my doubts as to whether any of these dolts will ever be prove to be a real leader, a person of courage, conviction, competence, and common sense."

In discussing the possible fall-out of Alberta's new royalty regime: "This will have a negative impact on the larger and smaller communities across Alberta." The Province of Saskatchewan "with its diverse natural resource reserves is positioned to give the rest of Canada a run for the big money and the best people."

On the U.S. dollar: "Its fall from grace amounts to a tectonic shift in the global hierarchy, a broad rebalancing of economic and political power."

On Canada: "With the economy rolling along, wages rising, business investment zooming, unemployment at the lowest level in more than three decades, and inflation in check, the outlook for the Canadian economy is exciting."

On the stock market: "Bargain buyers are contrarian. They look for miss-priced stocks and question how long it might take before they recover to a more respectable level. To the extent that judgement can be made, the better the chances of making a fortune."

Mr. Eberts, as always, is interesting to read, thought-provoking, challenging, and thoroughly entertaining.

We hope you enjoy the article.

Bob Weir,
Director of Research

17th Annual *Off-the-Record Exchange of Constructive Ideas*

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17th Annual *Off-the-Record Exchange of Constructive Ideas*

Ladies and gentlemen, mesdames, mesdemoiselles, messieurs – bienvenue, welcome to Rapport's seventeenth annual *Off-the-Record Exchange of Constructive Ideas* luncheon. We are delighted you are here, and we thank you for attending.

The purpose of these gatherings has always been to provide a reasoned assessment of the political and economic comings and goings, to evaluate the outlook for the stock market, and to discuss ways to take advantage of the emerging trends. To allow for a year-over-year assessment of our predictions, we adhere to a relatively standard format. We are proud of our track record and, to our knowledge, no other organization's commentary has proven to be so consistently close to the mark, and certainly not over so many years.

The essays collected in the books *Dithering Heights* and *Fighting Words* express our concerns and put forward recommendations as to how Canada might enhance its wherewithal. *Reflections of a Bay Street Cowboy* and its sequels, *Further* and *Penultimate Reflections*, bring together capital formation and investor relations strategy recommendations. The *Ultimate* volume is a year or two away from going to the printer. Meanwhile, our various and sundry papers on the ways of government and the creation of wealth will continue to be e-mailed to past, present, and prospective corporate clients, leading members of the investment community, and close friends. If you know someone who would gain by getting an up-to-date reading on where we stand, have them check us out at www.rapport.ca.

SEE HOW THEY RUN

Responsible governments are elected to balance assessments and expenditures. If that means raising income and property taxes or reducing services, so be it. The claim that Ottawa is refusing to lend direct support to municipalities could not be further from the truth. The federal budget update created room and flexibility for all other jurisdictions to increase their levies. Pray tell, how do the mayors and premiers think cynical whining is going to get them any more money, as there is no chance it will. Seeing as the advantages of the rapid rise of our dollar exceed transitory problems, the suggestion that the Bank of Canada step to the fore and implement measures aimed at offsetting the short-term toll taken is ridiculous. Instead, the critics should fess up to their own shortcomings. They must reduce the size and cost of the bloated bureaucracies, eliminate redundant programmes and interprovincial trade barriers, and consolidate the many securities commissions. Why do all these characters carry on bitching and begging as they do? Because it is free and they believe it improves their chances of being reelected.

Talking of political clowns, you have to question why Ontario voters re-elected a premier who broke most of his promises about not raising taxes. Or Newfoundland and Labrador's, who pledged to wean his province off dependence on federal welfare, yet has chosen bombast and continued craving for Ottawa's handouts. Though his militant shtick is wildly popular with the voters, talking tough with those looking to bring the Hibernia South and Hebron offshore oilfields into production has cost the provincial economy hundreds of millions of dollars. In the complete absence of a strategic plan to manage growth, or the fortitude to sit down at the negotiating table and talk, the premier of Alberta has decided to blindside the petroleum industry with draconian measures. It is unlikely he will admit to having made a mistake, as few politicians ever back down before the damage is done, vast sums of the money are funneled elsewhere and, in this case, the energy boom becomes unraveled. Unfortunately, the overarching irony of political lunacy is likely to persist. I have my doubts as to whether any of these dolts will ever prove to be a real leader, a person of courage, conviction, competence, and common sense.

Alberta's above-the-national-average growth rate and budget surpluses are in large part the consequence of its lower effective tax rate, being 39.2 percent, as compared to Canada's at 45.9 and Quebec's, the highest, at 49.8 percent. Despite the recent cuts announced by the federal government, the recommendations of the Alberta Royalty Review Panel will have a counterproductive impact affecting the entire industry and the province as a whole. A case in point is Canadian Natural Resources Limited, one of Canada's most successful companies. While the fallout from the new regime may not be as dramatic as first thought, the advent of additional royalty payments and weak natural gas prices will result in CNQ slashing its 2008 drilling budget by 38 percent, or $645 million. To offset production declines of 23 percent it plans to pursue better opportunities elsewhere. To contain cost increases it has pushed back the completion date for its $20-billion oilsands project by two years. Add Talisman Energy Inc.'s $300-million retrenchment plus those of many others and the total amount will far exceed the $1.4 billion the government hopes to collect. In keeping with the axiom of investment capital flowing to where it can make the most money and taking advantage of the strong Canadian dollar, EnCana Corp. has announced plans to spend $2.5 billion to buy out its unconventional natural gas partner in Texas. Petro-Canada has signed a US$4.5-billion deal with Libya's National Oil Corp. The trend to go offshore is likely to intensify if the legislation is passed. There is little chance they will return to drill marginally profitable wells in Canada. According to the Canadian Association of Oilwell Drilling Contractors, the rig utilization rate is projected to be but 50 percent during the historically busy winter season, an uneconomic 34 percent for all of next year. This will have a negative impact on the larger and many of the smaller communities across Alberta.

Fortuitously, the polls suggest the popularity of the Alberta Conservative Party has dropped to 33 percent, lower than at anytime in the past thirty-six years. The Liberal and NDP tallies are 14.5 and 8.0 percent. With fully one-third of the voters unmoved by any one of the three, and with the possibility that hordes will refuse to cast their ballot in the next election, the result may be a minority government with limited power to pass any new legislation. It is a wonder why the premier has yet to get the message. Is he not aware that after sixteen years in office, and in the midst of almost unprecedented prosperity, the incumbent NDP majority in Saskatchewan was recently defeated by the right-of-centre Saskatchewan Party? Or, that the Grey Cup champion province with its diverse natural resource reserves is positioned to give the rest of Canada a run for the big money and the best people? It is said the difference between the right and the left of the political spectrum is that the left thinks the right is evil, the right say the left is stupid. It would appear the reverse is fast becoming true in Alberta. Could it be that instead of enjoying two for the price of one drinks with the common folk at happy hour, Ed Stelmach and his advisors have taken to binging behind closed doors and have lost touch with reality. One thing for sure is that not a single oilpatch entrepreneur or employee with their life savings on the line will ever again vote for his party. Neither will their family members and friends.

LOOKING TO THE FUTURE

The US unhooked its dollar from the gold standard in 1971, unilaterally rewriting the rules of international commerce in its favour. Its fall from grace amounts to a tectonic shift in the global hierarchy, a broad rebalancing of economic and political power. Though churlish to take advantage of a neighbour's misfortune, it would be crazy to ignore the edge its deteriorating business climate has inadvertently created. It is the result of mounting financial and macroeconomic uncertainties brought on by reckless lending, increased protectionism, security concerns, and strained international relationships. The TED spread between US Treasury yields and LIBOR, reflecting the lack of interbank confidence, recently hit a high before narrowing slightly. No matter what the central bank decides to do about interest rates, the angst will persist for some time to come. The market made the greenback into global money. What it giveth it can taketh away if the authorities fail to rein in record public and consumer debt the world no longer wishes to bankroll, to perpetuate fiscal discipline and a sound monetary policy.

With the economy rolling along, wages rising, business investment zooming, unemployment at the lowest level in more than three decades, and inflation in check, the outlook for the Canadian economy is exciting. In lieu of taking success for granted, we would be wise to understand how the Americans were able to cope when they once ruled the roost. Rather than standby and complain about the perils of their super-strong dollar, they globalized manufacturing and other operations by offshoring segments to lower-cost countries offering superior quality. As a result their world trade penetration rose. Foreign direct investment increased dramatically. Purchases of cost-saving machinery and equipment as a percentage of GDP jumped, and output surged 50 percent. Instead of exaggerating the drawbacks and underestimating the benefits of our good fortune, we must develop new approaches to doing business. The only question remaining is whether or not we have the gumption to rise to the occasion and realize our dreams.

Thanks to the natural resources and services sectors many tens of thousand of new jobs have been created. The mounting value of exports versus imports is resulting in more purchasing power, fueling consumer spending and housing starts. However, true prosperity depends on how efficiently we make what we do, and how much we are paid. GDP growth per person, adjusted for inflation, has been abysmal since 2002, up only 6.9 percent, compared to 8.4 percent in the US. Economists warn our standard of living could soon suffer if we fail to get a move on. Challenged industrialists have little choice but to do some serious cost-cutting, shutter out-of-date facilities, concentrate on employee training, and those interests where they hold a competitive advantage. The key to realizing long-term potential is innovation. According to the Conference Board of Canada we rank only fourteenth of the seventeen nations surveyed. We must develop new products people want to buy, narrowing the prosperity gap with the United States and slowing the rush of talented Canadians moving south. Lower corporate taxes leading to greater efficiencies, yes. But, with jobs-available signs hung everywhere, the belief that handouts, subsidies, and rebates should be provided to keep struggling industries alive is insane. When will we ever learn that the transfer of affluence by government is always a waste of hard-earned money, and that is to nobody's advantage.

The average OECD business tax rate is less than the current combined reckoning anywhere in Canada. Though the posted take in the US is higher, it is the world leader in loopholes! Small firms are the wellspring of a healthy economy. Their break has two significant pitfalls, by providing an incentive for the owners to avoid personal levies, and imposing a penalty on success by rewarding corporations for staying small. According to the Competition Policy Review Panel globalization is both a reality and an opportunity, and more needs to be done to strengthen our presence worldwide. A recent StatCan report concludes that foreign ownership has been a boon to Canada, transforming economic performance, driving wages, productivity, jobs, innovation and investment by making greater use of research, technology, and scale. There is no evidence of a hollowing-out of head-office employment in the wake of such takeovers, quite the contrary. Petty political reasons should not stand in the way of progress.

THE OUTLOOK FOR THE STOCK MARKET IS POSITIVE

Many of us have lived through a commodity boom, a credit crisis, and a housing crunch, but not all three at the same time. Throw in the Canadian dollar soaring to an unprecedented level, high-flying crude oil prices, and gold trading near its all time peak, it is not surprising investors are at a loss for words. Acclaim for the loonie's assent lies not only in Canada. It is also as result of three other factors: the absurd theories being bandied about that China and other nations are waging a self-destructive currency war against the greenback; fast-money speculation; and the discredited math of the misguided geniuses who created hundred of billions of dollars of new-fangled securities only they understood, and that are now worth a whole lot less. Given the gigantic sums of fees, commissions, bonuses, and severances paid, and the many conflicts of interest uncovered, the world's banking system and Wall Street's once-sterling reputations have been severely tarnished.

The scarier the headlines and the more uncertain the future seems, the greater the panic and inclination for otherwise intelligent people to dump perfectly sound investments and go into hiding. Wealth beckons those who respond in a decisive manner, knowing history has proven that the pressing problems of the day are more than likely in the process of being resolved – such as the gaffe about income trusts in Canada, structured investment vehicles and the mortgage maelstrom in the United States. Bullish investors point to declining interest rates and a flood of new money continuing to fuel the world's economy. The bearish ones fear the Federal Reserve Board will be unable to fend off a global liquidity impasse. It used to be that the Canadian economy was inextricably linked to that of the US. If their's sneezed, our's caught the cold. As Canada is the only significant country to record a surplus and reduce its debt outstanding in each of the past five years, that is no longer true. The strong performance of the loonie and the relative weakness of the greenback prove we can fend for ourselves, and not have to suffer the intolerable embarrassment of dollarization.

If failure sows the seeds of success the rating agencies are bound by shame to do a more thorough job of assessing risk, the bond buyers to seek an informed second opinion before jumping aboard a financially engineered new issue. Cursory equity research and technical chart gazing will no longer be enough to do the trick. This means issuers will have to be more forthcoming with pertinent information about present and prospective performance, and provide clear descriptions of accounting estimates. If one ever hopes to enjoy the spoils afforded those with industry-leading multiples of cash flow and earnings, keep the story current and never stop repeating it to those positioned to get it across to existing and Johnny-come-lately investors.

Earnings expectations have been slipping amid growing credit woes and economic outlook concerns, and the stock market has fallen in step. While multiples are roughly in the mid-range of historical norms, they shine when compared with bond yields, which have been sinking as investors flee equities in favour of the stability for fixed-income securities. Ten-year governments in both Canada and the US are yielding about 4 percent, the so-called earnings yield for stocks stands at 5.6 percent for the S&P 500, and 5.4 percent for the S&P/TSX composite. Based on earnings estimates for the coming year, they are even more favourable at 6.5 and 6.1 percent. Spreads this wide have typically been followed by rallies of more than 16 percent, on average, in the subsequent twelve months. The critics say these yields are based on artificially high "adjusted" numbers, whereas astute investors count on reported earnings as their guide to undervalued stocks. However, with more than half the companies listed on the TSX having lost ground in 2007, the odds are the next move will be up.

In current dollars, crude oil first hit US$100 in April 1980. Geopolitical uncertainly was the primary factor. The stunning and largely unexpected growth in demand in an increasingly prosperous world is now the cause. Interestingly, today's near-record valuation has not triggered a recession as it did in 1973, 1980–1981 and 1990. Rising drilling costs, lack of access to many prospective basins, more challenging exploration plays, and changing fiscal terms have elevated the sustainable price needed to earn a 15 percent return, from US$30 just a few years ago to US$70 today. Despite government inducements and technological promise, the impact of ethanol as a substitute for gasoline will remain minimal, as it takes more energy to produce than it provides. All of which suggests the outlook for the WTI price is positive. Low prices are the best cure for what ails natural gas. Drilling budgets get cut, depletion crimps supply, and those with financial means acquire additional reserves on the cheap, demand increases, and prices rise. Bargain buyers are contrarian. They look for mispriced stocks and question how long it might take before they recover to a more respectable level. To the extent that judgment can be made, the better the chances of making a fortune. People often confuse the cyclical and secular case. By and large, commodity companies do not earn their cost of capital over the cycle. They are trading versus longer-term vehicles. CEOs should take advantage of the good times to raise equity capital so as to be positioned to pounce when times are tough. At this point in time the S&P/TSX Capped Energy sub-index reflects the worst-case scenario. Investors stand to get a big bang for their buck by buying the best of the best of these stocks or royalty trust units today!