The Rae Lipskie Partnership™ | Private Wealth Management

November 2010 Overview

IF MONEY MAKES THE WORLD GO 'ROUND, INTEREST RATES GREASE THE WHEELS. IN THIS ISSUE, WE TAKE A LOOK AT THE WORLD OF INTEREST RATES AND THEIR IMPACT ON INVESTORS.

Cash-Rich America

The United States is regularly portrayed these days a financial have-not, but it was recently reported that non-financial corporations in the U.S. held a record $1.9 trillion (yes, that's the one with nine zeros) in liquid, cash-type assets at the end of June. With this corporate cash horde available, investors might be forgiven if they have visions of dividends and share buybacks dancing in their heads. (For investors, those are even better than sugarplums.) At least as important for markets, when you add in the massive household cash reserves ($2.6 trillion in money-market funds alone), the numbers begin to look pretty impressive. It is important to note that these cash reserves, huge as they might be, are held at virtually zero yield. When will investors tire of such meagre returns?

Bond Mania

Those household numbers quoted above are pretty big, but they are smaller than they once were. Why? Because investors do want some return on their money and, it turns out, a return of their money so they have rushed for the safety of the bond market, buying $660 billion of bond funds alone since December of 2008. This bond buying frenzy has taken bond positions in funds to their highest exposure level since 1995. Back then, you might recall, we were in a slightly different interest rate environment with 5-year Canada bonds yielding an attractive 8% compared to the measly 2%+ available today. And this number is before fees, taxes and inflation. So the apparent obsession with bonds at today's miserably low interest rates is more than a little surprising. And what about equity funds? They are the reverse, having suffered net redemptions along the way, creating a headwind for stocks that buyers have, amazingly, blown through. Our opinion: bonds look overbought and stocks seem underowned.

Bond Issuers Feed the Mania

What's even more remarkable to us is the extent to which bond buyers have gone to satisfy their craving. Investors have been willing, for example, to buy 100-year (!) Mexican government bonds at a 5.75% interest rate. Do they know that a 1% increase in interest rates will cut the price of their holding by 20%? Closer to home, buyers are snapping up 40-year corporate issues at under 5% yield and 30-year Canada bonds at well under 4%. Wal-Mart recently issued $5 billion of bonds including a 3-year tranche at a 0.75% yield and a 5-year at 1.50%, rates that Bloomberg calls the lowest on record for a corporation. (An aside: to put Wal-Mart's $5 billion in perspective, that much reviled but much shopped-at behemoth's gain in revenues this year would form a company at about the 140 mark on the Fortune 500. My, my.)

Not All Bond Issuers Are Created Equal

If you want some of those high-yielding bonds from financial history, you can still get them in places like Greece, Ireland and Portugal. You might not like the quality since they are no Wal-Marts, but 'bond vigilantes' are forcing profligate governments to get their financial houses in order by driving their debt yields to untenable levels. Governments everywhere will need to pay attention; every cloud has a silver lining.

What Does This Mean For Investors?

Interest rates have gone from the peak 30 years ago to the valley today, providing mostly solid returns on bond investments over that time. Today, low rates help borrowers, the economy and the stock market but investors who need the safety and security of bonds in their portfolios are faced with the prospect of discouragingly low yields on their holdings. And if, as seems likely eventually, interest rates move up from these low levels, some periods could even see negative bond returns. For this reason, relatively short maturities seem prudent today, to mitigate that risk.

THE LEARNING CORNER

What about preferred shares?

What is the bond teeter-totter?

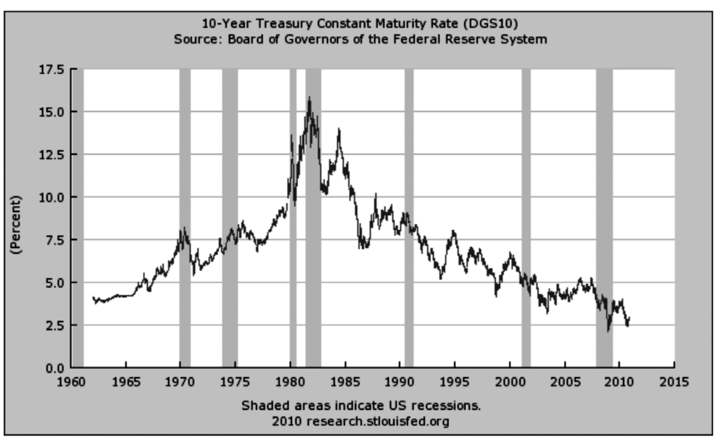
We include good-quality preferred shares in the fixed-income component of some client portfolios. Such holdings would generally be considered of slightly lower quality than the equivalent corporate bond because the bond issuer makes more definitive payment promises. But the preferred issuer's commitment is substantial and the shares hold some advantages over bonds, particularly on the yield side for taxable investors. This is so because of the dividend tax credit, which extends preferential tax treatment to dividend income. While this advantage remains appealing, it is shrinking somewhat as corporate tax rates are lowered, thus gradually reducing the personal after-tax retention rate on dividends from 77% in 2009 to 70% in 2012. The retention rate for interest income is expected to remain at 54%.

One aspect that affects both bonds and preferreds is the way that prices change as interest rates move up and down. Because this is an inverse relationship, the term 'teeter-totter' is sometimes used to explain the connection, i.e., as interest rates move up on one end, prices move down at the other and vice versa. It works because of the mechanism 'mark to market', which adjusts prices for changing circumstances. If, for example, we buy a bond yielding 3% and market rates rise to 4%, buyers will only pay us, at most, a lower price that equates to a 4% yield for them. Further, and scarier, the teeter-totter price end becomes more volatile as maturities lengthen. So, for example, every 1% rate rise would knock roughly 4% off the price of 5-year bond, 8% off a 10-year and 16% off a 30-year. While yields are higher on longer-term bonds and the bonds are expected to pay full value at maturity, this price risk is why we are generally maintaining relatively short bond portfolios.

CHARTING OUR TIMES

The attached chart shows the interest rate on a 10-year U.S. government bond going back over nearly 60 years. The chart is instructive mainly for the picture it presents of the long march up in the 1960's and 1970's followed by the even longer march back down over the last 30 years. The chart takes us through the long, painful bear market (yes, bears can prowl the bond market too) from 4% in 1962 to 16% in 1981 and then the wild bull ride to under 3% today. Given today's exceptionally low level of interest rates it is hard to believe the equally exceptional rates at the peak; it truly was a different world. And remember, this was for the world's best credit; every other issuer had to pay more (including Canada), substantially more in many cases.

Actually, it's not really that hard to believe those high rates since, sadly, some of us can recall that time all too well. That was the inflation era and the interest connection was there in spades, with the CPI chart looking very similar to this one, peaking at 15% in 1980. Most investors do not refer to them as 'the good old days' either. Yes, some fortunate people bought long-term bonds or annuities near the peak and lived happily ever after, but many investors were mauled by the bear already and deathly afraid of what might follow. A common example: In 1979 Mr. Investor bought these bonds at an incredible 10% yield (rates can't go higher!) only to sell them two years later at a scary 16% yield (rates are going higher!), suffering a 50% price drop. Today, low inflation and modest economic growth appear to support low interest rates, but we leave this picture with a caution from the 1970's: nobody saw it coming.



IN THE OFFICE

As year-end approaches, we want to remind you of a few tax-planning items.

Assuming you have RRSP contribution room, why wait until March 1 to make your contribution? The earlier you make your RRSP contribution, the sooner you will tax-shelter it and start it growing. And consider putting your contribution in on March 2 (or shortly after) for the following tax year.

If you are making charitable contributions of a sizable nature, consider donating shares with large gains. You will not only receive the donation receipt for deduction, you could also avoid capital gains tax. While donations must be made by December 31, if you decide to donate shares, please contact Sheila in our office before December 13 to allow for administrative processing time.

If you still haven't opened a Tax-Free Savings Account, you should think about doing so. This is a nice gift from the government: get your investments growing tax-free. As of next January (assuming you were older than 18 in 2009), you can put $15,000 into a new TFSA account ($5,000 per year for 2009, 2010 and 2011). Please speak with your manager about the benefits of a TFSA.

While this next point is not tax planning, it is a way to get some free money from the government. Registered Education Savings Plan (RESP) contributions made during the year are entitled to a maximum $500 Canada Education Savings Grant with a contribution of $2,500 per year per eligible child. (20% on any funds up to $2,500) Make sure your contribution is made by December 31 to get your 2010 grant.

QUOTE OF THE DAY

Joe went to the bank, asked to talk to the loan officer.
"What is your interest rate on a loan?" asked Joe.
"5%" replied the banker.
"What!" said Joe, "the bank down the street is advertising 3%."
"Then maybe you should borrow your money there."
"I would", replied Joe, "but they don't have any."

~Anonymous

We would like to take this time to remind you that you can help save a tree by having your newsletter emailed to you. If you would like to receive your newsletter electronically, please contact us at 519-578-6849, or toll free 1-888-578-7542, or via email at: **reception@raelipskie.com**

THE BIG PICTURE

Interest rates are highly influential in the financial world. They either support or impede economic activity, depending on their level and the demand for borrowing they generate. They affect currency levels globally. Their connection to the bond market is self-evident and they have a significant impact on the stock market as well, for several reasons: partly as a result of their economic impact; partly as a result of the discounting mechanism in equity models where low interest rates equate to higher equity values, and vice versa; and partly due to competitive alternatives whereby stocks are relatively appealing to investors when interest rates are low, and vice versa. As well, on a more intangible, psychological metric, the level of interest rates can create either a supportive, buoyant atmosphere (usually when rates are low) or a more discouraging environment in which people just aren't as happy. We prefer the former.

However, today we are in the seemingly unusual situation where interest rates are very low but people are also unhappy. In fact, though, it's not that unusual. Today, just as in similar past economic recoveries, medicinally low interest rates are meant to cure the recession's hangover, but the pain has not yet subsided. That pain comes from various sources, including still-high unemployment, the related housing concerns and sovereign debt levels. As corporate profitability and confidence continue to improve, companies will eventually get back to hiring mode (profits drive employment), which in turn should combine with record-low mortgage rates to support U.S. housing (now at its most affordable ever) and economic growth will moderate debt concerns. Low interest rates will assist all of these issues and will also encourage lenders to free up more funds for borrowers as they gain confidence.

The prime determinants of interest rates are the level of inflation, as lenders demand real returns above the inflation rate, and the level of economic growth, as credit demands expand and contract with economic activity. Right now, we are in a competitive environment with still significant slack in the system so inflationary pressures are low and credit demands are controlled. As a result, central bankers are willing to keep short rates very low and bond investors are willing to lend at historically low yields. But we suspect we are near an inflection point where rates are unlikely to go much lower and the path of least resistance becomes one of moderately higher interest rates. And if the underlying conditions proceed as expected, we think people will actually be happier for it.

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Rae & Lipskie Investment Counsel provides discretionary "fee-only" portfolio management for high net-worth individuals, endowments, and charities.

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