A Second Dip?

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Today's financial turmoil is hard to ignore, but there's cause for hope

Recently there has been no shortage of negative news - the global stock markets have been under heavy selling pressures. Given that the scars of the last recession/bear market in 2008 have not fully healed, a large number of investors lack confidence and have become paralyzed and fearful in the global economy and financial markets. While this market correction has distinctly different causes than the correction in 2008, it is a very worthwhile exercise to review some of the key indicators and fundamentals this time around to gain insight into future investment opportunities.

One of the major similarities this time is the dramatic rally in bond prices, and hence, record-low interest rates. United States long-term treasuries, as measured by the TLT Index, were up 30 per cent in the third quarter, the best-ever quarterly return since the Index was established in 2002. U.S. 10-year bond yields declined to 1.74 per cent—even lower than where they were at the height of the Lehman crisis in 2008. At the end of September, the yield spread between U.S. 10-year bonds, and the dividend yield on the Standard & Poor's 500 went negative (dividend yields were higher than bond yields) for only the third time since 1955, and the first time in negative territory since 2008.

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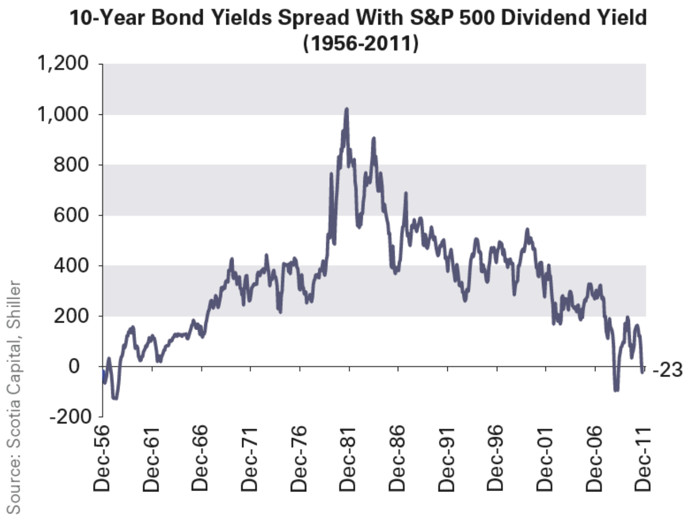

Yield Spreads (Scotia Capital)

Another example of the dramatic spread between dividend yields and bond yields here in Canada can be gleaned by comparing guaranteed investment certificate (GIC) rates at the Bank of Nova Scotia with the actual dividend yield on the underlying stock. The Bank of Nova Scotia is currently advertising three-year fixed GIC rates at 1.7 per cent interest. However, BNS common stock currently pays a 4.0 per cent dividend yield. The company has grown the dividend at 5.9 per cent per year over the last five years, and 11.2 per cent per year over the last twenty years. Lastly, we feel the dividend is very secure as Scotiabank only pays out about 40 per cent of its annual earnings in the form of a dividend. Even if the share price goes nowhere for the next three years, the dividend yield alone provides a significant pickup in after-tax return over a 1.7 per cent GIC.

While a number of Group of 7 and European Union member countries have been piling on debt and living beyond their means, the corporate sector has been generally prudent. With reduced debt, increased dividends and solid cash reserves, they are in a good position to weather the storm.

Even though the oil and gas business can be extremely cyclical, I thought it would be interesting to compare some of the financial metrics for Canadian Natural Resources Limited (CNQ) as they are in 2011 with where they were in December 2008.

Along the same lines, one of the sectors with low debt levels and growing cash flow is the technology sector, and by reviewing the same metrics for Intel, investors can get a sense of just how strong some companies are today. I also want to highlight the fact that both CNQ and Intel have raised dividends and returned cash to shareholders since 2008.

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CNQ	TTM*	2008
Total Current Assets	$2.8 billion	$3.3 billion
Long Term Borrowings	$9.3 billion	$13.0 billion
Operating Cashflow	$5.4 billion	$6.7 billion
Dividends Paid	$361 million	$208 million

Intel	TTM*	2008
Total Current Assets	$26.7 billion	$19.9 billion
Long Term Borrowings	$7.1 billion	$1.3 billion
Operating Cashflow	$21.2 billion	$10.9 billion
Dividends Paid	$3.9 billion	$3.1 billion

*Trailing Twelve Months

Source: Bloomberg

European governments and European banks have significant challenges ahead with the reality of a Greek default, bank re-capitalization, and serious government spending cuts and austerity for 2012 and beyond. However, economic indicators in the United States, China, and Canada, like auto sales, durable goods, the ISM (Institute for Supply Management) Index, jobless claims, and corporate earnings - while all somewhat sluggish - are not collapsing and are generally coming in better than expected. This indicates that we are not headed towards an economic recession and ensuing free fall in corporate earnings.

Volatility in financial markets is structurally higher in a globally interconnected world of computers and traders. Since 1940, there have been just 30 trading days when the U.S. stock market fell by 5.0 per cent or more. Half of those occurrences have happened since January 2000, and 30 per cent of these one-day trading extremes have occurred in the last 3.5 years.

The upside tells an even more volatile story as 50 per cent of all occurrences since 1940, when the stock market was up 5.0 per cent or more on one day, have occurred in the last 3.5 years. The average investor hold period for a New York Stock Exchange–listed stock went from seven years in 1960 to eight months today. Therefore, volatility in financially traded assets is likely here to stay, and it will continue to test our conviction and confidence when it comes to investing and maintaining a longer-term perspective.

The factors causing a de-stabilization in financial markets are different today than in 2008. Investors need to recognize this and allocate capital accordingly.

Investing in companies at a reasonable valuation with growing dividends provides attractive income for your portfolio in the short term when market volatility and one-off risk events dominate the headlines.

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Over a five-year time horizon, dividend yield and dividend growth accounts for almost 80 per cent of an investor's return, and given today's level of interest rates versus dividend yields, investors with a five-year time horizon should be allocating capital to global dividend growth stocks.

If you're interested in discussing dividend growth stocks for your portfolio, we extend an invitation to you to consult with one of our Portfolio Managers, at no obligation. We would be happy to assist you at 403-234-6118 or ctsang@mcleanpartners.com.

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