

Remember China and India?

Remember the inundation of articles over the last few years promoting the notion of infinite demand in China and India for commodities. The Chinese population was reported to be moving into cities at the pace of one New York City a month.

Don Coxe, a well recognized Canadian strategist was an early proponent of commodity investing. In 2001, he acted upon one of his favourite sayings: "You should not invest in a story that's on page 1. Invest in the one that's on page 16 on its way to page 1." This page 16 story was to invest in commodities. The page 1 story he avoided was technology. He was absolutely right. The difficulty arose when many market participants shared Don Coxe's conclusion in the middle of 2008. Don wrote in July of 2008 the following:

"The commodity boom is about surging demand for real raw materials in scarce supply. That demand comes from the new middle and upper classes in countries with large foreign exchange funds and high savings rates. There are still investors who think tech stocks and bank stocks are of investment quality, whereas commodity stocks are lower-grade cyclical speculations."

Many people believed and some still do that "this time was different." Commodity stocks were no longer "cyclical speculations." We have spoken at length about the risks we see in the current market environment from collapsing credit. We believe the stock market indices can go lower. The commodities sectors, namely materials and energy stocks, have declined, but we feel generally they may have more to fall. The market needs to realize that the commodity prices seen at the peak will not return in the financial and economic situation we are currently experiencing.

As an example, Potash Corporation of Saskatchewan (POT) produces the three minerals required to produce agricultural fertilizer. Stories such as the May 19, 2008 article in the *International Herald Tribune* helped to propel POT to excessive levels. The authors describe the increasing demand in China and India for higher protein foods as income increases. This would lead to a transition from rice to wheat and to meat which require fertilizer. Potash rose to a peak of \$246 on this mindset. This translated into a price to book ratio of over 11 times and a price to earnings ratio of 18 times. Typically commodity stocks receive a low multiple on high or peak earnings. However, in this case, Potash received a high multiple on peak earnings resulting in an extremely high price. Since we have seen this company come down over 40%, one may assume it is time to buy. We would argue that it is still too early.

The price to book is currently 5.2 times compared to a historic norm of 1.5 times reflecting a continued belief that Potash will earn premium returns from demand from China and India. We do not believe this will occur. The demand for Chinese products has been decreasing. Recent statistics show Japanese exports to China have fallen 45% as demand for Chinese products have declined. Declining incomes in China and lower consumption of commodities will cause difficulty for all commodity producers like Potash.



We do see companies that provide opportunity. Canam is a leading Canadian structural steel fabricator producing products for the construction of large buildings, bridges and overpasses. Demand for its products has been decreasing as public and private entities are reducing their capital spending. Although Canam is in the materials sector with declining demand, they are well positioned. The balance sheet is in good shape with no debt maturities for three years. The company pays a 3.2% dividend on a payout ratio of only 21%.

The difference between Canam and Potash is expectations. The stock chart of Canam looks similar to the chart of Potash above. Canam did not rise as much as Potash, but it has come down from its peak of \$16.00 to the current price of \$5.00, resulting in a very attractive valuation of 0.5 times price to book.(this is 1/10th of the valuation of Potash)

We are looking for companies that are pricing in a worst case scenario rather than pricing in high expectations. As an analyst from National Bank Financial stated this week about Canam, we are trying to pick stocks that "win by not losing."