

Where to invest when consumers stay home

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Many are anticipating a return to a normal cycle of production, consumption and inflation. We believe that we face a near term that includes the threats posed by industrial overcapacity, skyrocketing personal savings and a corollary drop in consumption.

In such an environment investors would be wise to consider companies with pristine balance sheets, quality capital structure and the ability to generate cash flow. Before I provide recommendations, let's consider the economic environment.

It is commonly believed that it is a matter of time before widespread inflation returns due to central banks turning on the printing press.

The biggest risk could, however, be the threat of deflation rather than inflation. We know the monetary base of the United States has increased by US\$1.0-trillion and that an increase in money supply results in too much money chasing too few goods, causing prices, wages and inflation to rise. Compare this scenario to what is in existence today, and we find that the opposite is true. Demand for goods is falling while available credit is expensive.

As well, unemployment exceeds 9% and workers are accepting wage cuts. The return of immediate wage inflation seems unlikely. Note that wage inflation has always been a primary ingredient of inflation.

Historical examples do exist of periods when large increases in money supply were met by low prices and low interest rates. During the Great Depression, the monetary base doubled in size while prices dropped 19%. More recently in Japan, between 1997 and 2003, the money supply increased by 85% and yet inflation could barely keep above 0%.

Today, an additional case could be made that the effect on prices of free-flowing global trade makes the chance of inflation even less likely.

During previous recessions, as companies went bankrupt they ceased and thereby lowered economic production capacity. Recently, we have seen what can be considered "serial" bankruptcies.

An example of this is the airline industry in which some airlines have gone through bankruptcy three times. Today's recession sees a similar phenomenon with companies such as General Motors, Chrysler and Eddie Bauer, to name a few.

These companies are akin to the "walking dead." They find ways through bankruptcy to return from the dead. The direct effect of this is a continuous oversupply of goods and services, which causes prices to fall, and should create an environment of deflation in the near term.

Again historical examples exist. Between 1921-1928 deflation was running at 2%, yet growth and employment was positive for the period.

Lessening consumer demand also lowers the prospect of inflation. Currently, U. S. consumers are repairing their balance sheets. They are saving approximately 6% of their income. During the past decade, these same consumers saved little and propelled global growth through consumption.

Producers need consumers, specifically the U. S. consumer, to stop saving, increase spending and begin consuming the global overcapacity that exists. It is unlikely that consumers of other nations will be able to effectively replace the growth-generating consumptive powers of the U. S. consumer. Prior to the credit crisis the U. S. consumer was consistently 20% of global GDP.

If we believe in this deflationary scenario, how do we invest? In such an environment, companies should have balance sheets that are not overleveraged and have the ability to create cash flow. Some examples are Boardwalk REIT (BEIun/TSX) and Leon's Furniture Ltd. (LNF/TSX).

Others to consider are "toll booth" companies, as in everyone has to use them sometime. These companies are generally positioned to make money regardless of the economy. Utilities have this characteristic as do other companies such as Westshore Terminals Income Fund (WTEun/TSX), Rogers Communications Inc. (RCIb/TSX), and Cineplex Galaxy Income Fund (CGXun/TSX). As long as the economy chugs along even in a diminished capacity, these businesses should be able to do well and distribute a consistent yield to investors.

The next few years will be challenging. But these challenges, we believe, may come from the unexpected threat of a deflationary zombie economy and not from our usual suspect, inflation.