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"I'LL BE BACK"-THE RETURN OF INFLATION

Over the last 3 years since I have been writing columns for the Income Investor, one of the themes that I have referred to on several occasions has been the effect of inflation on the purchasing power of the income generated by the companies that have been recommended. The erosion of real income caused by inflation is not something that was attracting investors' attention until recently, but investors in the 1960s and especially the 1970s were very aware of the negative effects of the loss of value of their incomes. Conventional bonds ended up being known as "certificates of confiscation" as the 4-5% coupons on government bonds that were regarded as a reasonable return up to the late 1960s became completely inadequate when inflation was running at double those rates.

If readers visit the website of the Bank of Canada, they will find a wonderful inflation calculator which uses monthly Consumer Price Index (CPI) data from 1914 to the present to show changes in the cost of a fixed "basket" of consumer purchases. These include food, shelter, furniture, clothing transportation and recreation (quoting directly from the website's definition), and an increase in this cost, as the bank's website explains, is called inflation. Since 1914, the cost of the basket has increased 1972%, or at 3.2% p.a. over the last 94 years. Investors may disagree with the composition of the items in the basket, and the central banks' habit of leaving out food and energy to focus on core inflation is surely one of the most misguided policies of the last thirty years, but it has been calculated on a fairly consistent basis for almost a century, so most observers feel the general level and direction of the inflation numbers are valid.

If one looks at the last 40 years, since the election Pierre Trudeau in 1968, one can identify three distinct periods, which conveniently effectively coincide with the terms of our long standing prime ministers. The first, the Trudeau era, saw rising and high levels of inflation, with the index up 224% in the 16 years between 1968-84, equivalent to 7.6% p.a. The period was dominated by the two successive oil shocks in 1973-74 and 1979-80 and the entry of the baby boomers into the workforce, which in turn led to rising unemployment and slower economic growth combined with inflation, the dreaded "stagflation". It was made worse by comparison with the exceptionally strong growth of the previous post- war era from 1945-1973, which was combined with low inflation as the Bretton Woods structure of fixed exchange rates of gold backed currencies ensured excesses were not allowed to get too far out of line. In the 1970s, economists added the unemployment and inflation rates together to calculate what was known as the "misery index", which peaked at over 20% in the early 1980s.

Then came the middle period, when the arrival of Reagan and Thatcher and the adoption of market based reforms combined with Paul Volcker's terms at the US Federal Reserve (1979-87) to break the back of inflationary expectations, primarily by letting interest rates rise to unprecedented heights. For Canadians, the Brian Mulroney period from 1984-93 saw a sharp fall in inflation, with a rise of only 41.5% over the nine years, equal to 3.9% p.a. or almost half that of the previous 15 years. The real price of commodities fell steadily, helped by conservation efforts and the deepest recession since the Second World War, especially after the Saudis opened their taps in 1986 to pump as much oil as the world demanded, driving the price of oil down from U$40 per barrel to under U$20. the Berlin Wall fell along with communism, and the arrival of billions of new entrants into the capitalist economic system began reducing the cost of labour, partially by the threat of moving jobs offshore.

The final phase, represented by Jean Chretien's eleven years from 1993-2004, saw inflation fall to its lowest level in half a century as the cost of the basket of goods only rose 22% over the period, or 1.8% p.a., less than half that of his predecessor and a quarter of that during his mentor Trudeau's premiership. The price of oil fell to its lowest ever level in real terms since its discovery as a replacement for whale oil for lamps in the 1850s after the Asian Crisis and Russia's default on its debt in 1998 combined with globalization in China and India and the arrival of the internet to create a "flat world" in Thomas Friedman's phrase, reducing the price of manufactured traded goods on a continuous basis.

Thus the annual rate of inflation in Canada had fallen by more than 75% between the 1970s and the 1990s. Investors were happy to ignore it in their calculations and the stock market was re-rated, as they were willing to pay higher prices for the same dollar of earnings, with the Price/earnings (P/E) Ratio of the US S&P500 rising from 8 times earnings in 1982 when interest rates on long dated government bonds were 14% to 28 times in 2000 when the yield had fallen to 4%. But, as the Terminator said after inspecting the entrance to the police station where his victim was being held, inflation too announced "I'll be back" when oil doubled from U$20 per barrel in late 2001 when the worry was whether recession and deflation would arrive, to U$40 while Mr Greenspan at the Fed was cutting interest rates to 1% in 2003 and then leaving them there for a year. The real price of commodities of all types, whether energy, base metals, precious metals or soft (food) commodities have risen inexorably over the last 5 years.

Even in Canada, which, with its exports of almost all of these groups of commodities, has seen the Canadian dollar appreciate against the US dollar by 65%, has begun to feel the effects. While the strong loonie has seen reduction in traded goods prices such as autos, clothing and electronic equipment, inflation the Martin-Harper period of the last 3 years to April 2008 has risen by 6.5%, equal to 2.1% p.a., the first increase over an extended period of time since the 1970s. As with tropical storms which begin as a cloud no larger than a person's hand on the horizon and turn into a fully fledged storm within a few minutes, the rising tide of inflation (to mix weather metaphors) is steadily advancing, and the decision of the Bank of Canada's Governor, Mark Carney, to leave interest rates unchanged at 3% this month while every economist expected him to reduce them at least 0.25% shows that, like Ben Bernanke at the Fed and Jean Claude Trichet at the European Central Bank, Canadian authorities are well aware of the dangers of a repeat of the 1970s.

How does an investor protect themselves against inflation? Unlike the 1970s, there are now “real return” or inflation-protected bonds, issued by the Federal and some provincial governments in Canada and by the US Treasury and other European and Asian governments. These will add the increase in the CPI to the principal value of the bond each year, meaning that the coupon paid on the bonds will also rise, but they have several disadvantages. The major one is that the adjustment in the value of the principal is treated by the CRA and US IRS as income in the year it occurs, even though the investor will not receive the adjustment until the bond is sold. Therefore they are only suitable to be held in tax free accounts such as RRSPs or pension funds. Secondly, a scarcity of issues has meant that the price of such bonds has been bid up and the rate of inflation that the adjustment reflects is fairly low, usually around 2%. Lastly, the coupon on the bonds is low, reflecting the fact that there is no inflation premium built into the yield unlike conventional bonds. Real return bonds are therefore not a practical solution to providing inflation protected income, although they will preserve the real value of the capital invested, if held in a tax free account.

In the recommendations I have made over the last 3 years, my intention has generally been to look at companies that can grow their distributions over time to at least preserve the real value of the income stream to the investor. This obviously does not apply to the 2 high yield bond recommendations made in 2005, CHC Helicopters and Shaw Communications, although the stocks have increased their dividends. Both have paid over 7% p.a., but in the end, the bond holder will only receive the annual coupon and the nominal value of the bond upon maturity. Every investor should own some bonds if the coupon is high enough to at least keep pace with an expected level of inflation, as they tend to move in a different direction from stocks thus reducing the overall volatility of the portfolio, but they are there effectively as ballast, to reduce the both sudden movements in the portfolio and investors’ nervousness.

Ironically, the tow highest yielding recommendations, Keystone (10% yield) and Penn West (12.5%) have been the only equities not to increase their pay-outs since being recommended here and, in the case of Keystone, to reduce it by 16%, although as it has been transformed into dividend income, taxable investors should not be worse off. This demonstrates again that buying a stock with a lower yield and some ability to grow it over time will usually be the better choice than buying the stock with the highest yield. Recent pick Sun Life (Feb 2008) has also not had a chance to raise its quarterly dividend, but every other one of the 13 selections has raised its payout, even if by as little as 2.8% (AltaGas, selected Oct 2006), which also distributed one free share AltaGas Utility group during the period.

While not every stock will increase its pa-out 1000% in under 3 years (Canadian Oil Sands, which raised its quarterly payment from $0.10 to $1 between March 2005 and Dec 2007), all of them have at least matched the rise in the CPI since recommendation. In general, the income trusts have raised their payouts least, reflecting their higher initial payouts and the introduction of taxation on trusts in Dec 2010, with AltaGas, BFI Canada, Primaris and Teranet all raising heir payouts less than 10%. Other small increases either reflect recent picks, such as Scotiabank’s 8% increase since selection in

July 2007 or a sale, with ING Canada and CIBC increasing their payouts by 8% and 13.9% respectively between selection in 2005 and sale during 2007. The remainder have seen double digit increases ranging from 12% for Consumer WaterHeater since Jan 2006 and the mid teens for the Keg and Davis + Henderson through more than thirty percent for TransCanada and Liquor stores to 42% and 54% for Boardwalk and Power Financial and ending with 84% for CN Rail, the lowest yielding of the selections, In the end, the best protection against inflation for income investors is stocks that pay rising dividends, reflecting their ability to pass on some of their pricing pressures, or, in the case of TransCanada and Canadian Oil Sands, the benefit they receive from rising raw material costs. Dividends are also the second most tax effective form of income, and, sadly, capital gains are not as assured as dividends!