



## What is the bad news backwash? Read on. WEEKLY INVESTMENT PRE/ REVIEW -----February 25<sup>th</sup>, 2009.

- Talk of **nationalization of US banks** is giving rise to a lot of emotional debate and investor anxiety. Here's some facts to consider: there are over 7,500 banks in the US with several of the majors in troubled waters. Citigroup has received US\$45 billion in direct cash injections and hundreds of billions more in guarantees from Washington; the board has been told to scrap the corporate jet, spin off business units and make personnel changes. American International Group (AIG) is now owned 80% by the US government thanks to a \$150 billion lifeline and its CEO was handpicked by Washington. Fannie and Freddie are under "conservatorship". In other words, some diluted form of nationalization, which is really the government taking temporary charge of the most toxic situations to reduce the risk of outright bank failure, is under way. The government is recapitalizing struggling banks by buying convertible debt, which, only if converted because of the dire circumstances of the bank, will dilute common shareholders. The banks receiving the assistance do get a hyper-active shareholder to deal with (which is motivation enough to fix their problems). The US Administration has been very careful not to move to take outright control of any bank because it would hit the holders of senior and preferred stock, creating a wave of instability that in turn would undermine the rest of the 7,500 banks, insurance companies and credit unions. As for expropriation Hugo Chavez style, --- some hysterical investors see this as a possibility ---- clearly this is not being contemplated by the Administration as long as it wants to maintain any semblance of a capital market in the US. What all this discussion fails to acknowledge is that on a daily basis governments here or in the US already have the ability to exercise considerable oversight over and can actually control banks by regulatory means.

- This week is another week of **record financings by the U.S. Treasury**. Today, bond investors are being asked to digest an auction of \$32-billion (U.S.) in five-year U.S. Treasuries and tomorrow it's a \$22-billion sale of seven-year notes. The auctions represent new cash being taken in as no debt is being rolled over. The government financings follow yesterday's auction of \$40-billion in two-year notes of which \$17-billion was in new cash. The auction drew stronger-than-expected demand and, as one observer put it, "it is a signal of just how distressed the financial markets are that investors are willing to pile into two-year notes for less than 1 per cent." In our view it's a measure of how fearful investors are. A future rise in yields may signify the beginning of a real return in stock valuations.

-Meanwhile **corporate bond markets are heating up**: for example, Roche, the Swiss pharmaceutical giant has raised more than US\$30 billion through two record setting debt offerings in recent weeks. Roche's fundraising comes amid a boom in the markets for new corporate bond issues this year, in spite of the perceived credit crisis. Investors globally have already digested a record monthly volume in January of \$170 billion, according to Dealogic, and US\$114 billion in February. This activity too can begin to signal the gradual return of investor confidence.

-Remembering Warren Buffet's maxim to be greedy when others are fearful, it is time to be greedy by ignoring the Canadian Press headlines today announcing that the **TD Bank reported a first-quarter earnings** decline of 27%. The headline is true, but reports far from the whole story for investors. TD's earning actually exceeded analysts' expectations, and all of its business units were solidly profitable, including US operations. For us, what really mattered is that TD's ratio of reported earnings/ dividends and cash flow/ dividend for Q1 is 1.8 and 4.5 respectively (i.e. **TD has oodles of cash with which to keep paying dividends**). The yield on TD common stock dividend today is 6.9% (the yield offered on TD preferred share offering this week is only 6.25%) and is likely to remain. This makes TD stock a bargain and underlines the fact that it doesn't make sense for investors to continue to sit with enormous allocations to government bonds. As we do not buy single stocks, we'd either buy the sector or the TSX dividend ETF.

- Thanks **Ben Bernanke**: we now have a name for it ---- the thing we have been complaining about for some time. Of course we mean the constant regurgitation of (and demand by the public for) bad but expected news (i.e. it's not really news) by media and "opinion-makers" that serves to create self-fulfilling prophecies and highly charged negative markets like the ones we have experienced recently: Ben calls it the "adverse feed-back loop". That's too nice a term. We prefer just to call it **the bad news backwash**.

**For more info call Mark Kryzan or Terry Shaunessy at 403-802-3108.**

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