

China syndrome: the fallout could be severe

Invest in areas like the housing sector that are not influenced by Chinese demand

By Sunil Vidyarthi

There is but only one investment theme that permeates today's investment world, and that is China. It is the Chinese demand that has placed oil prices firmly over \$30 and metal prices near new highs. Even world deflation is squarely blamed on the Chinese.

I have yet to understand how such highly paid and widely educated professionals all over the world succumb to "group-think" on the investment scene. I suppose we never grow out of teenage enthusiasm for favorite music, rock star or fashion. What separates men from boys is the size and complexity of their toys.

Unfortunately, nearly all such obsessions in the stock market end, and usually end up nasty. More and more money pours in, driving up prices until one day we find out that the rose was not as rosy as we thought, or we find another to fuss over. I, for one, am trying to avoid playing in this sand box.

At the risk of losing some money, I would recommend shorting some well-chosen Chinese stocks, exchange-traded funds and even sectors that are especially enamored with this fad, like metals and even oil.

The only problem is, what do



Sunil Vidyarthi

you do with all that money? Short-term money gets you no better than two or three per cent in Canada, and much less in the United States. Tough to live on that.

No, the answer lies in finding sectors and stocks that have little to do with foreign demand, particularly China. My pick for now is the housing sector.

Make a call

There is some talk of a housing bubble. Vacancies are up even in residential markets and the commercial scene has yet to improve, not surprising as the manufacturing economy has been in a slump for over three years now.

At points like these you have to make a call, and the call is based on whether you think this is near the worse or if things could get much worse from here.

A lot of explanations float around for why housing has been so strong even during a recession. The one I find most believable is, at lower interest rates, it makes no sense to keep paying rent.

Now, if you put two and two together with what Federal Reserve in the U.S. has to tell you about keeping rates low, how can this possibly end so suddenly? It could slow down, and some parts

of North American real estate like California could take a tumble.

Perhaps the safer way to participate in the housing boom is not to buy real-estate properties but companies that service all of the stock that has been added to the soil. I am thinking of building material suppliers. Not much of a chance that companies like Home Depot or Lowe's have much to do with shenanigans abroad, either.

I particularly like **Lowe's Companies Inc.** (LOW-NYSE, \$52.31, 336-658-4000, www.lowes.com). Simply because Lowe's is taking market share from Home Depot and growing much faster.

Lowe's is a retailer of home-improvement products, with a specific emphasis on retail do-it-yourself and commercial business customers. The company specializes in offering products and services for home improvement, home decor, home maintenance, home repair and remodeling and maintenance of commercial buildings.

Good fundamentals

As of Jan. 31, 2003, Lowe's operated 854 stores in 44 states, with approximately 94.7 million square feet of retail selling space.

Its sales have risen from \$18.8 billion in 2001 to \$22 billion in 2002 and \$26 billion in 2003. For the nine months ended Oct. 31, revenues rose 17 per cent to

\$23.91 billion, and net income rose 28 per cent to \$1.47 billion.

Revenues reflect the addition of 14 million square feet of retail selling space. Net income also reflects higher margins due to product mix.

Why now? Well, someone did a study and found that if you like a company you should buy it when it is down (what genius?). Lowe's hit a high of \$60 in November and has since corrected to low \$50s.

The sell-off started in November for a couple of reasons. As the China mania took over, investors started to abandon most retail stocks, including Lowe's, which delivered a 30 per cent increase in profits. After a long hiatus, Home Depot, its archrival, produced a good quarter.

To boot, Lowe's is buying back shares. Analysts expect the company to earn about \$2.70 next year, which translates into a price-to-earnings ratio of 20 — historically low for a company that grew by 24 per cent for the last five years and is projected to keep up that pace.

If you are a fan of the PEG ratio (that is P/E to growth), then it is trading at a PEG of 1.09.

Other fundamentals are also excellent, with a price-to-sales ratio of 1.4, debt-to-equity of 40 per cent and return on equity of 20 per cent.

Dr. Sunil Vidyarthi is president of Value Sciences Inc