



INVESTMENT COUNSELLORS-PORTFOLIO MANAGERS

Buffett buys a railroad, India buys gold, Fed buys time *Markets rally*

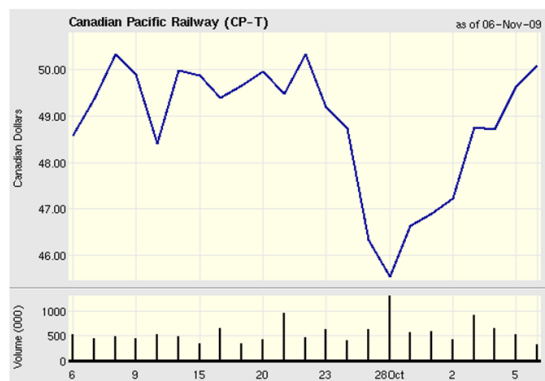
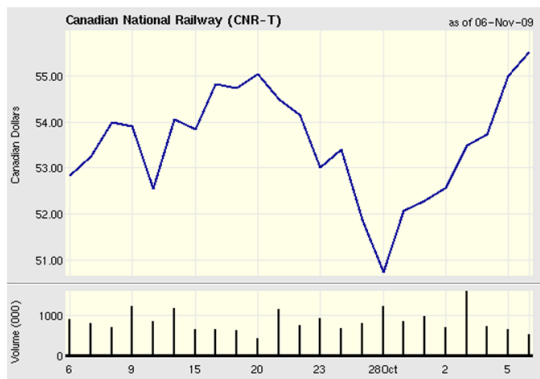
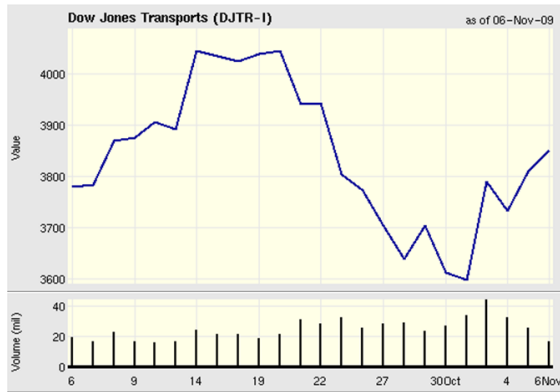
November 6, 2009 – Against a backdrop of reviving industrial activity Warren Buffet bought a railroad. On the other side of the world, the Reserve Bank of India, worried about the shaky value of its US-dollar holdings, bought 200 tonnes of gold. The US Federal Reserve Board bought some time, announcing that it expects to keep the federal funds rate near zero for an “extended period.”

Seeking to deploy some of Berkshire Hathaway Inc.’s US\$24.5 billion cash mountain, CEO Warren Buffett announced the purchase of the remaining 77% of railroad Burlington Northern Santa Fe Corp. that Berkshire didn’t already own. The US\$26.3 billion deal, Berkshire’s largest ever, involves US\$15.8 billion cash with the remainder in Berkshire shares. It’s basically a huge long-term investment (some say “bet”) in the gathering recovery of the US industrial base.

Mr. Buffett’s \$100 per share investment in rolling stock – Burlington Northern is one of the top four railroads in the US – comes at a 31% premium over recent prices. To many observers, that seems an unusual tack for the Oracle of Omaha to take. After all, Mr. Buffett has built his reputation as the world’s smartest (and richest) investor on time-honoured value-investing principles – in other words, you invest in companies trading well below fundamental valuation metrics.

While Burlington Northern doesn’t seem to fit the bill, it’s probably the only one that comes close enough in term of size for a Berkshire investment. And Mr. Buffett could have the last laugh here as well. With railroad volumes plunging to an historic rock bottom in the past year, and costs cut commensurately, any increase in the number of filled boxcars, flatbeds, hoppers, and tankers will flow right to the railroad’s bottom line. As the US economy begins to gain growth momentum, and fuel prices ratchet up, railroads will appeal to large shippers as more fuel-efficient and cost effective than traditional trucking. Berkshire’s \$100 per share payment for a solid-brand, well-managed company with a large market share may well seem like a bargain in 24 months’ time.

Railroad stocks, including Canadian National Railway Co. and Canadian Pacific Ltd., got a major lift from the Berkshire acquisition last week. So too did most transport stocks, as reflected in the Dow Jones Transports Index (see charts below).



Courtesy CTVglobemedia

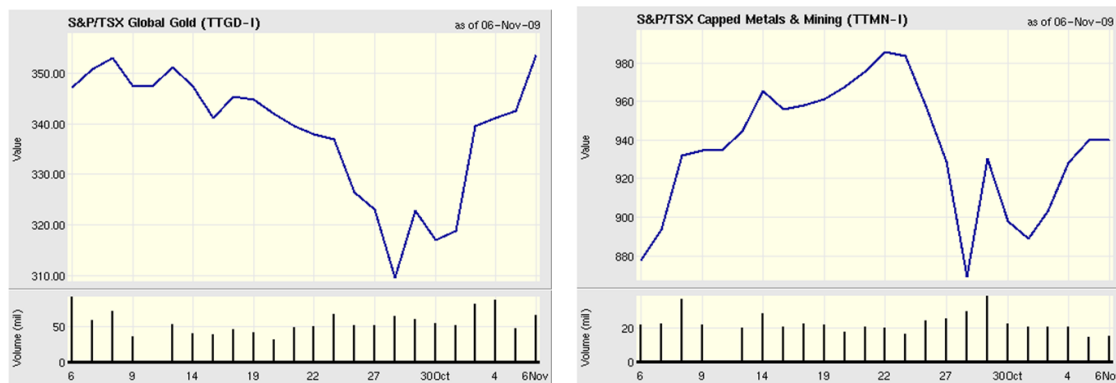
If the acquisition of Burlington Northern is a play on the growth of the American economy for the long term, it looks like Berkshire won't have to wait too long before seeing returns. The US Institute for Supply Management reported that its October manufacturing index climbed to 55.7, the third consecutive monthly increase and the highest level since April 2006. Any reading above 50 indicates growth in the manufacturing sector. And the US Commerce Department reported that factory orders rose in September, the fifth such increase in the past six months.

The surge in manufacturing over the past three months has been accompanied by a boom in productivity, as output per hour worked increased at an annual 9.5% rate in the third quarter. Very simply, companies are now about as efficient as they can get without ramping up hiring. Productivity cannot grow at such a blistering pace indefinitely. The pattern is pretty much the same in the early stages of a recovery, with growing output followed by increasing employment and rising wages. Indeed, the ISM also reported that its October employment index rose for the first time in 15 months. That won't have an effect on the recent 10.2% unemployment rate just yet, but it's an early sign of stabilization in the labor market as the pace of job loss eases.

Meanwhile, the price of gold spiked to a high of US\$1,100 per ounce on Friday, as expectations of more central bank buying kept the price aloft. Last week, the Reserve Bank of India bought 200 tonnes of gold from the International Monetary Fund, at around US\$1,045 per ounce, as a way to diversify foreign reserve holdings away from the US dollar. The purchase represents fully half the amount that the IMF was willing to sell, and took most observers by surprise by its scale.

Because the sale of gold was off-market, it actually provided price support for the precious metal, as traders looked for signs of another large sale to the Chinese central bank, which has also been seeking a way to diversify foreign reserves away from the greenback.

The continuing ascent of gold lent more support to the global gold mining stocks, and helped give a boost the S&P/TSX Metals & Mining Index, which had been flagging in the last week of October.



Courtesy CTVglobemedia

The US Federal Reserve kept its benchmark federal funds rate near zero, last week, and affirmed its intention to keep rates “exceptionally low” for an extended period. While acknowledging that “economic activity has continued to pick up,” it implied that the economy was not nearly strong enough to contemplate a rate increase anytime soon, as long as the economy showed “low rates of resource utilization, subdued inflation trends, and stable inflation expectations.” The implication, of course, is that absent any of these conditions, rates would be likely to rise.

Whether the Fed's status quo low-rate policy exacerbates the so-called international "carry trade" (borrowing US dollars at low rates and reinvesting in fast-growing emerging markets) and contributes to equity and real estate asset bubbles abroad remains to be seen. The Fed's concern now is the revival of the domestic economy, which is just in the first stages of responding to the Fed's giant liquidity I.V. bag.

This is not to say that central banks are leaving the monetary taps wide open. Moves are afoot to curtail so-called quantitative easing. The European Central Bank announced last week that it will withdraw some liquidity operations, while the Bank of England put the brakes on its bond purchase program. And some smaller central banks, like Australia and Norway have already raised rates. Straws in the wind? You bet! Watch for the first indications of rate hikes early next year.

Stock markets rallied strongly last week, following two weeks of skidding prices. The S&P/TSX Composite Index advanced 3.1% on the week, while the Dow Jones Industrial Average and the S&P 500 Composite both gain 3.2% from the previous Friday's close. The Dow Industrials once again broke the 10,000 level, but on declining volume through the week.

A rising market against the release of high unemployment numbers may indicate that the jobless level is at or near a peak. Though heightened market volatility is very likely to characterize trading to the end of the year, greater investor confidence that economic recovery has taken root is likely to push prices generally higher to the end of the year. ■

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