STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

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New Leadership at the Fed

In her first Congressional address, the new Chair of the U.S. Federal Reserve, Janet Yellen, commented; "We have been trying to push down interest rates, particularly longer-term interest rates. Those rates do matter to the valuation of all assets; stocks, houses and land prices. And so I think it is fair to say that our monetary policy has had an effect of boosting asset prices."

It cannot get any more obvious - *printing money and keeping interest rates low is lifting stock prices*. Importantly, Janet Yellen is also on record of being against stopping the housing bubble which led directly to the 2008 financial crisis. In her wisdom, "arguments against trying to deflate a bubble outweigh those in favor of it". So the Fed will likely watch passively while yet another asset bubble continues to grow to its logical end. The boom and bust cycle is very likely to repeat. Only the timing is uncertain.

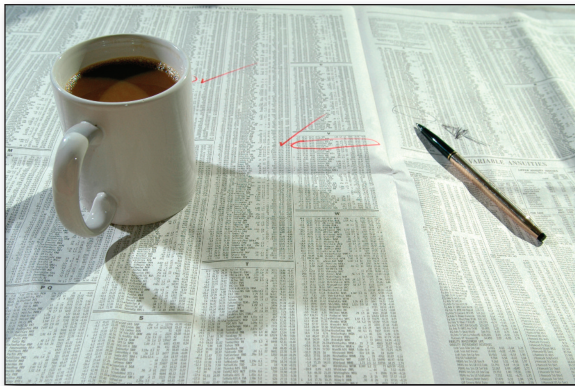
To give the Fed some credit, it is sticking with its tapering schedule. The taper equates to $10 Billion per month which would mean the QE stimulus program will end in the fall. However, should there be a setback in financial markets it is highly likely the Fed would again come to the rescue with another stimulus program. This has been the historical pattern of the last five years and explains why the Fed is currently on its fourth version of QE, having already supported financial markets with QE 1, 2 and "operation twist".

Janet Yellen has also confirmed the importance of the dual mandate at the Fed – to maximize employment and keep prices stable. With inflation low and expected to remain low the focus of attention is on employment. Regardless of whether tapering is successful, the Fed will continue their efforts to keep interest rates near zero until at least the spring of 2015. In this regard the new leadership looks a lot like the old leadership.

S&P/TSX : 14,261	*90 Day T-Bills : .90%*	*Oil : $101.58 US*	*Cdn $: .904 US*
S&P 500 : 1,872	*10 Yr Cda Bond : 2.46%*	*Gold : 1,292 US*	*Euro : 1.52 Cdn*

Seasonal Pattern; Sell in May?

Supposedly May through October is viewed as a seasonally weaker period for the stock market. At this time of year many commentators typically suggest investors should consider selling in May. While this six month period may have a statistical bias of underperforming one must take



into account that the period has been associated with some of the larger stock market declines in history. Of course those declines are very infrequent and therefore tend to skew the data. Nevertheless many investors believe in this pattern and so it does deserve monitoring, especially at a time when the market has advanced sharply and appears frothy. We may therefore reduce our exposure to the equity markets over the next six month period.

More importantly, consensus estimates are projecting first-quarter earnings growth to be a mere 1% for the S&P 500 companies. This is down from a 6.5% growth forecast at the beginning of the year. The brutally cold winter weather is being blamed for the poor showing. Corporate guidance going forward will understandably be watched more carefully. The consensus estimates are expecting a quick rebound in earnings.

With the markets already at elevated levels in both the U.S. and Canada, we will be monitoring events closely. A 10 to 15% correction at this stage would be healthy and allow for some of the excesses to unwind. The sell-off in February, although shallow, may have been a precursor of things to come. As mentioned, should a more serious correction ensue in the stock market, it is highly likely the Fed would respond with another flavour of QE. It would create an opportunity over the summer months to buy stocks at a cheaper price.

China Slowdown Finally Arrives

The often forecast slowdown in China may finally have arrived. The closely watched Purchasing Manager Index (PMI) recently declined below 50, which indicates a contraction in the manufacturing sector. Recent trade figures were also disappointing with both exports and imports down in the latest month. Non-performing loans are also rising in the banking sector, a sign the massive credit creation since the 2008 financial crisis may be showing some strains. Indeed, the new leadership in China appears determined to curb the credit abuse and rein in excessive lending. Reform of the banking sector is being avidly discussed in light of a number of bankruptcies of various investment trust and managed fund products.

In a bizarre way the weaker

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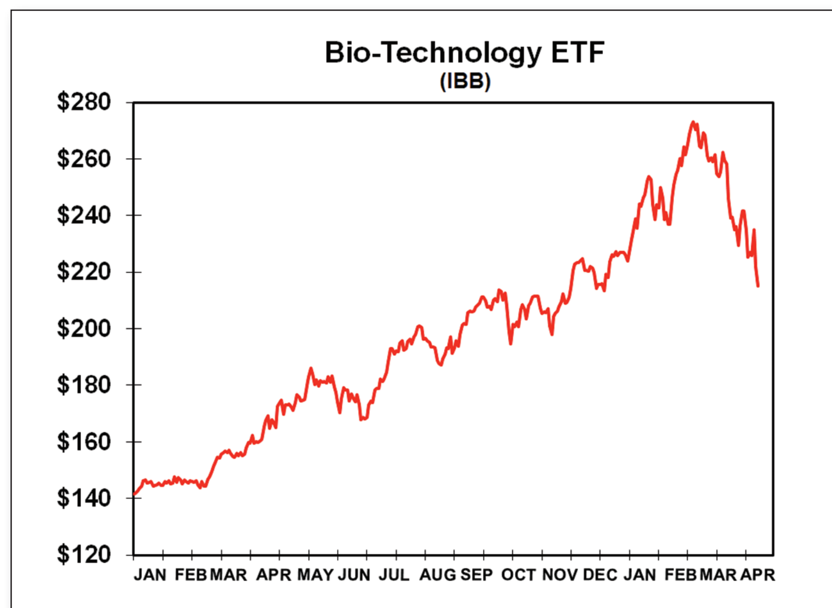
China Slowdown *(cont'd from page 2)*
economic numbers coming out of China are construed as positive. Investors believe it will encourage more stimulus – *a case of bad news being good*. The Chinese leadership, much akin to the high priests of money at the U.S. Fed, are of the belief it is better to stimulate today and deal with the consequences tomorrow, rather than reform and risk certain recession. The expansion of bank credit to stimulate the economy is therefore likely to continue.

A slowdown in China has consequences for the emerging markets generally, as does the ending of QE in the U.S. There is widespread concern of a flight of capital out of the developing world due to slower growth and the prospects of higher interest rates in the U.S. The massive U.S. stimulus over the years sent money abroad searching for higher yields. A reversal, even at the margin, may result in some short term volatility. However, emerging market valuations are quite attractive, especially compared to the expensive U.S. market. A large part of the risk has probably already been priced in.

Equity Strategy

The stock markets have witnessed some volatility in the first months of 2014. Canada is up marginally in the first quarter and has managed to outperform the U.S. The resource sectors are leading the way, a group which disappointed investors last year. A rebound from highly depressed levels was overdue and there has been some recovery in commodity prices such as natural gas. The energy sector is also benefitting from firming oil prices due in part to the tensions in the Ukraine. Going forward the broader resource sector needs a more robust level of global growth. Unfortunately, apart from the energy complex, the political standoff with Russia is anything but positive as rising tensions is threatening to undermine global trade relations. Growth in Europe, in particular, is of the most concern.

The adjacent charts are of two high flying growth sectors in the U.S., Bio-Technology and Social Media. In 2013 they were two of the better performing sectors in the stock market. So far in 2014 they have largely disappointed. Of course one could easily argue they should never have attained "nosebleed" valuation levels in the first place. Greed and a good story continues to appeal. By any definition these groups are now expensive and therefore speculative. An expensive stock carries with it higher risk. The share price will always be *(cont'd on page 4)*



Equity Strategy

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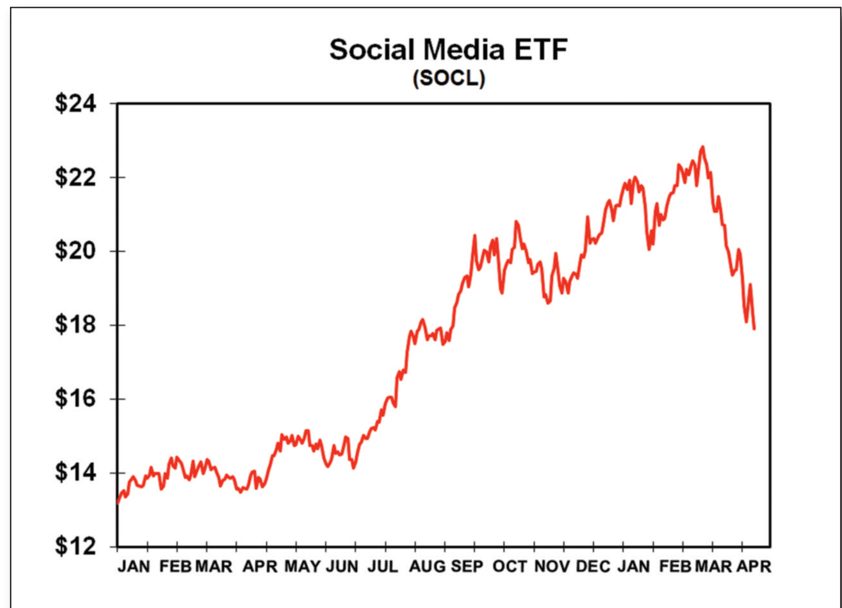
more volatile. We would only hazard an investment in these growth sectors, and a minor one at that, should valuations return back down to more reasonable levels.



Back in the dot com craze in the late 1990's, the entire Nasdaq index doubled in price in the final year (it then proceeded to crash by 75%). Today we still have some room to go on the upside to match that performance. The great unknown is whether investors push stock prices back up to those extreme values once again. On the other hand maybe the peak has been reached. Similar to the dot com craze the correction in today's high flying Bio Tech and Social Media stock groups may be the catalyst for the beginning of a deeper correction in the general market within the next year.

Investors do have a habit of repeating the same mistakes. At the moment they are feeling confident the Fed is in their corner. They expect any decline in stock prices will be aggressively met with monetary support. Any decline therefore continues to be a buying opportunity. It is difficult to disagree with this argument until interest rates climb much higher and/or we are farther along in the business cycle. For this reason we do not see a major risk yet that would have us materially shift out of stocks. A rotation out of the high growth and popular momentum stocks is more likely. The safer defensive sectors where prices are more reasonable and dividend yields higher may be the beneficiaries of such a rotation. We are well positioned in these sectors to benefit.

The last word goes to the highly regarded Jeremy Grantham, a value manager at GMO with an impeccable long term record, "The next bust will be unlike any other, because the Fed and other central banks around the world have taken on all this leverage that was out there and put it on their balance sheets. We have never had this before. Assets are overpriced generally. They will be cheap again."

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