STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

Summer 2014

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Stocks Remain Expensive

Stock valuations in both the U.S. and Canada are at historically high levels. They have been exceeded only twice before in 1929 and in 2000. Valuations are now higher than just before the financial crisis of 2008/9. In the bubble peak of 2000, the senior companies in the U.S. high technology sector traded as high as 40 times earnings. The top stocks today are in bio-technology and are sporting price to earnings ratios of 30 times. Growth oriented companies may continue to rise in price and the Nasdaq stock index could very well surpass its old high of 5,000 (currently 4,400). It is the last remaining major index to do so. Consensus appears to believe the market can keep on rising to match 2000 valuation levels.

Stock prices are also expensive when measured against GDP. The total market capitalization to GDP ratio is a favoured measurement used by analysts. It is even favoured by Warren Buffet. It suggests U.S. stocks in the aggregate are currently 30% overvalued.

Nobel Prize-winning economist Joseph Stiglitz had this to say recently, "The reason the stock market is high, in part, is that interest rates are low…These very strong stock market prices are in a sense a symptom of the weak economy, not a symptom that we are about to have a strong recovery to our real economy."

Stock markets usually rise in sync with a strong economy and rising corporate earnings. The economic recovery, which has shown anemic growth since 2009 has slowed significantly this year. The widely forecasted spring and summer rebound has been peculiarly absent. Ironically the stock market may keep on getting more expensive in spite of less than robust fundamentals.

Are Low Interest Rates Critical?

In the typical business cycle Central Banks are by now in a tightening mode and have started to raise interest rates. In fact interest rates usually begin to rise in the first two or three years after a recession. They continue rising for another two or three years into the peak of the business cycle. This sets up the bust that leads into the next recession. We have now entered the sixth year of the recovery and according to U.S. Federal Reserve Chair Janet Yellen, interest rates will remain low for at least another year. This is historically unprecedented.

The low interest rate policy has been a direct reason stock prices have climbed higher. How will the stock market react to a rise in

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S&P/TSX : 15,146	***90 Day T-Bills : .94%***	***Oil : $106.1 US***	***Cdn $: .937 US***
S&P 500 : 1,960	***10 Yr Cda Bond : 2.24%***	***Gold : 1,322 US***	***Euro : 1.45 Cdn***

Low Interest Rates

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interest rates? A rise is normal and there should not be any major concern with a return to normal interest rates. While the stock market may welcome rising rates as a confirmation the economy is strengthening and on sound footing, this time it could be very different. Having kept interest rates so low for such a long time has encouraged greater risk taking and consequently has driven stock prices much higher than warranted. Rising rates may quickly scare off investors who have jumped into the stock market on the expectations of a continued low rate environment.

There are now concerns the Fed may increase interest rates sooner than anticipated. The recent employment report was better than expected. Nonfarm payrolls gained 288,000 jobs and the previous two months' data was revised up another 29,000. The U.S. Unemployment Rate declined 0.2% to 6.1%. Nevertheless former Pimco Co-CEO Mohamed El-Erian believes it's too early to be concerned about a rate rise because the Fed is still "very hesitant and doesn't want to move on monetary policy until its convinced that the economy has reached liftoff."

We believe a rise in interest rates may be the event that triggers an end to the stock market rally. While it appears to be still a year or so away, the situation can change quickly. Monetary policy is tightening as quantitative easing (QE) comes to an end in October. This may cause some turbulence in the market as large and active fund managers may reposition their holdings.

Canadian Outlook

The long harsh winter did not impact the Canadian economy as severely as the U.S., whose first quarter GDP declined 2.9%. Stronger energy prices boosted exports and profits, stimulating exploration and take-over activity. The decline in the Loonie to a low of $0.89 U.S. earlier in the year was beneficial to our export industries, (not so to consumers and snow-birds).

Our dollar is now recovering, closing in on $0.94 U.S. Not surprisingly with the price of oil also strengthening our dollar is again being regarded as a "petro-currency." The energy sector should continue to reap the benefits. The outlook for drilling and exploration, pipeline and infrastructure development are very encouraging. In contrast, the auto sector is losing new investment in capacity to Mexico whose output now exceeds Canada's. The auto-parts manufacturers have followed this trend in recent years, locating their plants closer to auto production. The trend of stronger growth in the West will continue.

Elections in Quebec and Ontario reinforced political stability in our most populated provinces. Both provinces elected majority governments with Quebec appearing to have repudiated separatism. Federal elections are due next year in 2015. It will be interesting to see if the rising Liberal tide can be maintained or if Canadians prefer the typical counter-balance and go with the historic norm of having different parties in office at the Federal and Provincial level.

Importantly, Canada remains a favorable investment destination. Our financial industry is strong and is the envy of most countries. Both the residential and commercial real estate sectors continue to be resilient. Infrastructure spending is being maintained and will likely expand. Recent inflation statistics indicate C.P.I. is well above 2%. This will affect indexed wages and pension payments. Most company CEO's in a recent poll acknowledge they will need to pay their employees more. Higher incomes should lead to greater discretionary spending.

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An Uneasy Complacency

In the last three months the stock market has slowly grinded higher without any significant down days. In fact there has only been one day with a greater than 1% change in either direction, which is very rare. This lower volatility is reflected in the VIX index, which measures volatility in the options market. It is sitting at a level below 12, which is a very low reading.

Trading volumes are also lower than usual. This is difficult to explain in view of the good and steady market appreciation. Investors should be much more active than they are. There seems to be a general atmosphere of complacency.

From the lows of March 2009 this bull market is now well into its fifth year, (it should be noted the previous bull market of 2003-2007 lasted five years). There are no obvious or immediate signs of danger and perhaps investors believe the Federal Reserve can be counted on to support the financial markets. Perhaps investors believe valuations can remain high indefinitely, contrary to all historical evidence.

Geopolitical tensions are rising, and the Federal Reserve is ending QE, withdrawing the stimulus punchbowl. At some point the complacency will certainly end and volatility will return. Markets rarely remain calm for extended periods of time.

Portfolio Strategy

The first half of the year has so for seen a good steady advance. Jitters at the start of the year have been replaced with a subdued confidence. As shown by the chart below comparing the U.S. and Canadian stock markets, at his juncture the Canadian market is outperforming. This is quite a turnaround from 2013 when the U.S. market far surpassed Canada in performance.

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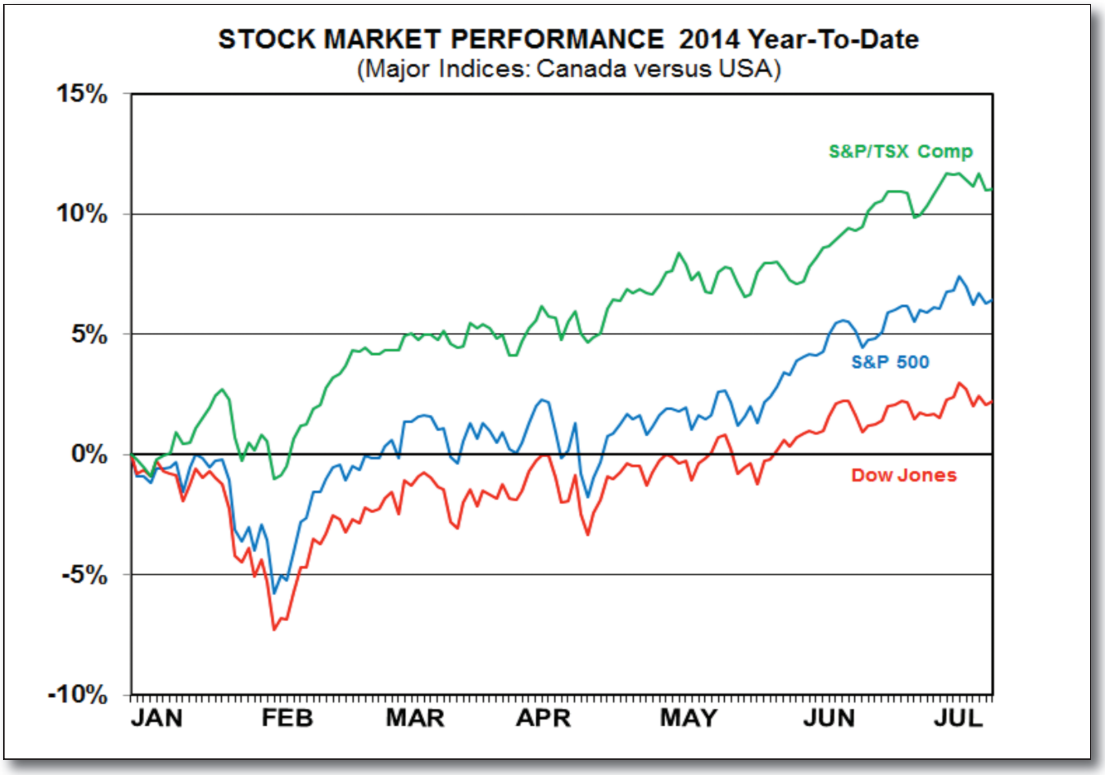

Portfolio Strategy

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This year the energy group is leading the way and resources generally have rebounded after a dismal performance last year. In the U.S. the fixation with growth stocks appears to be waning. Popular stocks like Amazon, Tesla, and Twitter are stalling. These companies may have a bright future but are showing very little if any earnings today. We would generally avoid most of the popular growth stocks as they are too expensive for our liking.

Merger and acquisition activity has picked up as companies are anxious to "buy" growth. Mergers bring synergies and eliminating duplications leads to higher earnings. Many deals are currently tax-driven as companies then relocate to international tax havens. Typically there is a higher occurrence of M&A activity towards the latter part of the business cycle. The last extensive takeover binge was back in 2007, headed by private equity through the issuance of massive amounts of debt.

According to the Bureau of Economic Analysis, corporate profits in the U.S. declined by 9.8% in the 1st quarter. Earnings growth is what drives the market and yet the decline was quickly discounted. Analysts are already cutting both revenue and earnings growth for the second half of the year, lowering forecasts to growth of 1.6%, down from 3% only 2 months ago. The lowered expectations for corporate profits is at odds with the generally more optimistic economic forecasts. And with stock markets near their highs we certainly have a strong reluctance to increase portfolio weightings. At the margin, we will instead be looking to trim positions.

This is a challenging environment. The stock market is expensive and the risk of capital loss is therefore high. We have a preference for safer and traditionally more conservative companies in the utilities and pipeline sectors as well as financial services. Companies with higher dividend yields should continue to do well as investors struggle to find higher income producing investments.

In the fixed income markets we continue to position client accounts in shorter term bonds with an average maturity of less than five years. Unfortunately the bond market offers very minimal returns at these low interest rates. Many companies have recently issued preferred shares in the five year area. We are recommending, and will be adding positions, to this fixed income category. The yields are more attractive than what can be found in the corporate bond market for similar securities. Since preferred shares rank behind bonds in the event of a wind-up, it is important to purchase companies with good quality ratings.

The bond market has rallied this year and completely fooled the majority of market participants who were convinced yields would rise. It is quite likely the bond market has now fully priced in a weaker economy. More recently, inflation has surprised on the upside and the core rate has climbed well above 2%. Bond yields are therefore unlikely to decline further. And should the economy strengthen, as expected, bond prices will edge lower. As a result, investing in shorter term bonds makes sense as there is less risk to capital in the event of a rising interest rate scenario.

We expect volatility will return again before the year is out. A moderate correction would be healthy and would likely be an opportunity to purchase stocks at cheaper prices. In the meantime we continue to recommend an emphasis on safer, higher dividend paying securities.

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