STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

Fall 2014

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A Long Overdue Correction

Stock markets around the world have declined sharply. The speed of the decline has been alarming and many investors are naturally worried if another financial panic is around the corner. While the speed of the decline has been breathtaking, the magnitude of the overall decline should not be surprising. The stock market has been rising steadily for three years without a significant correction. It was long overdue and needed to let out some steam.

So while there may be more downside we do not believe a major decline is in store. A financial panic akin to 2008/9 is not on the horizon. At the extreme we believe the stock markets could experience a decline similar to 2010 or 2011, when stocks in aggregate corrected by about 15 to 20%.

There are no visible signs of a classic economic peak. In fact this has been one of the slowest business cycle recoveries with no evidence of any major excesses in the economy. Interest rates and inflation are very low. Furthermore the credibility and influence of Central Banks still appears unshaken. They have the wherewithal to stimulate without fear of creating inflation. We fully expect an intervention, should financial markets become highly unstable.

Also, taking a lesson from three previous two-term U.S. presidential cycles, suggests crashes and financial panics tend to appear in the third or fourth year of the second term. Ronald Reagan, Bill Clinton, and George W. Bush all served two terms and toward the end of their second term were faced with financial crises. The 1987 crash took place in the third year of Reagan's second term. The 2000-2002 panic began in the fourth year of Clinton's second term. The 2008 financial meltdown began in 2007, the third year of Bush's second term.

Similar to the two term presidents before him, Barack Obama will look to stimulate and delay a downturn on his watch until market forces overwhelm his administration's best efforts. Fortunately the economy is not at risk of overheating and therefore higher interest rates are not required. A healthy correction in stock prices now should be seen as an opportunity and may very well extend the cycle. This would be far better than a continued steep climb leading to another uncontrollable and inevitable crash.

However uncomfortable it may feel in the short term, market corrections are part and parcel of investing in the stock market and this one was long overdue. So some further volatility can be expected and may lead to an additional 5% to 10% decline. From these levels we would also expect support to appear from value based investors, many of whom have sizable cash positions.

S&P/TSX : 14,961	*90 Day T-Bills : .92%*	*Oil : $91.20 US*	*Cdn $: .896 US*
S&P 500 : 1,972	*10 Yr Cda Bond : 2.15%*	*Gold : 1,217 US*	*Euro : 1.42 Cdn*

Geopolitical Risks on the Rise

Stock markets are likely also alarmed by the rise in geopolitical tensions. While not new, the Russian intervention in the Ukraine and the ISIS threat in Syria and Iraq are becoming a deepening concern.

The U.S./Russian relationship has been strained with Europe caught in the middle. Sanctions have turned the climate hostile and is starting to take an economic toll. Germany's economy, the largest in Europe, continues to slow after a 4% August plunge in industrial output. Factory orders are slipping with a falling demand for German exports. Business confidence indices are down, the direct result of sanctions.

Protests and independence movements are gaining ground. Scotland's referendum bid was narrowly defeated. Spain too has a growing separatist movement, in Catalonia. Protests in Hong Kong have perhaps the greatest potential to disrupt the status quo. The Chinese reaction will be carefully watched. Strong-armed tactics will not go over well and could undermine trading relations.

While the sanctions imposed on Russia are affecting the European economy, Russia is a smaller player on the international stage. China is another matter. An economic showdown over Hong Kong would definitely spill over into financial markets as investors rightly conclude a disruption in world trade is detrimental to our global economy. The inherent risks are mounting.

Canadian Outlook Disquieting

For the third time this year Canada experienced a monthly trade deficit in August of $610 Million compared with a surplus of $2.2 Billion in July. The energy component declined 5.8% on weaker oil and gas prices while autos and parts were down 11.2% due to lower volumes. Automotive imports are gaining market share especially from Korean brands which have no factories in Canada.

While U.S. unemployment has fallen to a post-recession low of 5.9%, the lowest since July of 2008, Canadian unemployment remains stubbornly higher with the recent number down to 6.8%. (Youth unemployment is estimated to be almost double). The Canadian labour market stands to benefit from the lower Canadian dollar, as will corporate profits. However consumer debt is already at a record ratio of 1.6 times annual income and can only be sustained by low interest rates, rising home equity, and liberal bank lending. While these trends may continue to be supportive, they are getting long in the tooth.

The decline in the price of oil is troublesome. A WTI price of $80 US is breakeven for many new oil projects. The oil industry will be reevaluating capital spending plans for 2015. A decline in activity is assured should the price of oil not recover over the next few months. Overall, Canada's economic growth rate appears to be stalling, especially with energy and infrastructure spending in Western Canada now in doubt.

US Dollar Up Strongly

In a somewhat surprising development, the U.S. dollar has risen sharply over the past few months. Since July, the broad dollar index is up a quick 7%, gaining on the Loonie, Euro and Yen. Consensus opinion had been negative with many pundits warning of an imminent crash. Indeed many financial books on the best sellers list have forecast such an outcome. Perhaps it is just a case of poor timing rather than poor research and analysis. For now the world seems to be enamored with the U.S. dollar.

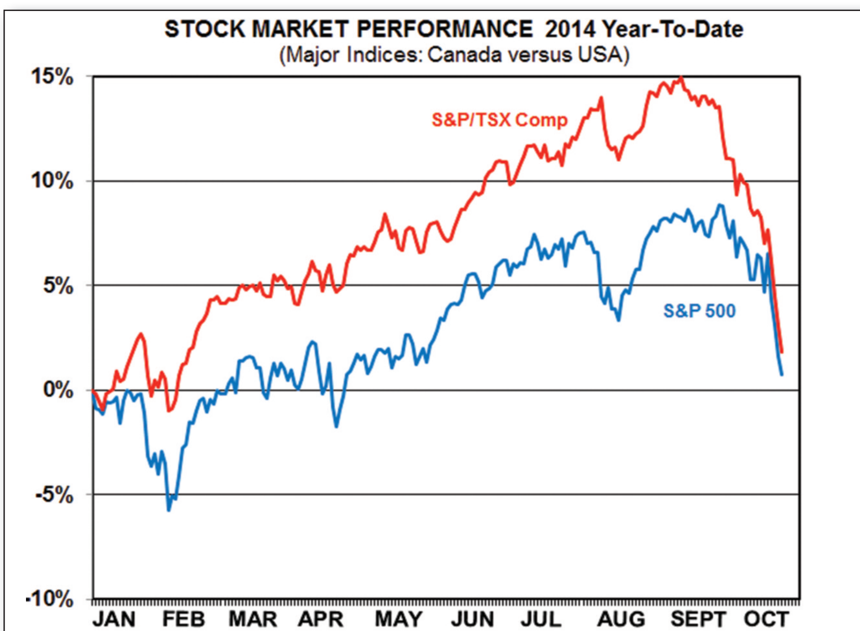
A key reason is that global political tensions have risen. Russia's stance in the Ukraine and renewed conflict in Iraq and Syria are unsettling. Understandably, with the world becoming an inhospitable place there is a flight to the safety of the U.S. dollar. Europe is also slowing and lacks any clear leadership. The perception is one of a directionless jumble of feuding states. In this light the U.S. economy is relatively more attractive and the U.S. dollar is assuming its traditional role as the global reserve currency.

Mario Draghi, the head of the European Central Bank, has again hinted he is willing to do "whatever it takes". In other words, the EU is likely on the verge of an expansionary monetary policy. In contrast the U.S. is getting ready to stop printing as it unwinds its Quantitative Easing (QE) program. The perception therefore is that of a stronger U.S. economy that will be the first to increase interest rates. Hence the U.S. dollar is responding positively.

Importantly, while the Federal Reserve may be ending the QE program, monetary policy is still accommodative. Interest rates are to remain low for another year. A decline in the stock market will likely be met with additional stimulus, which is generally unexpected. The continued climb in the U.S. dollar is therefore tenuous. The positive momentum could reverse itself quickly.

Portfolio Strategy

The adjacent chart shows the year-to-date performance of the Canadian and U.S. stock markets. The quick drop in stock prices has almost given back all of the gains for the entire year.



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Portfolio Strategy *(cont'd from page 3)*

The next chart shows the performance of two exchange traded funds, XFN and XEG. The Financial and the Energy sectors are the two heavyweights in the S&P/TSX stock index. As can be observed, the current correction in the stock market has been much more damaging to the Energy sector. Also, since 2010, it has been a poor performer and has shown more volatility.

QE coming to an end is a contributing factor to the volatility we are witnessing. QE and the zero interest rate policy has provided the liquidity to prop up stock prices. Raghuram Rajan, the head of India's central bank had this to say recently, "We have had ultra low interest rates for close to six years, and at some point you have dug a hole so deep in terms of asset prices that any attempt to get out of this has an immediate effect on asset prices."

According to Robert Shiller, distinguished professor of economics at Yale, "I suspect that the real answers (to high stock prices) lie largely in the realm of sociology and social psychology - in phenomena like irrational exuberance, which, eventually, has always faded before. If the mood changes again, stock market investments may disappoint us".

Incidentally, Shiller's CAPE ratio, a measure of stock prices using corporate earnings averaged over ten years, is at 25. It has only been higher in 1929, 1999, and 2007, right before major stock market plunges. Of course timing is never perfect; the ratio can and often does remain high for extended periods of time.

The correction has landed almost half of the stocks on the NASDAQ exchange in a bear market, defined by being down by at least 20%. The S&P 500 and the Dow Jones have performed relatively better during the decline. This is a typical characteristic as the larger capitalized stocks tend to be safer. The rise in the U.S. dollar, however, will be challenging for larger companies. Earnings for the third and fourth quarter may begin to disappoint due to lower foreign exchange results in international markets. Forward guidance for the fourth quarter and 2015 are also likely to be lower than expected given the slowdown in Europe.

As far as gold is concerned, we believe the positive fundamentals over the long term remain in place. China certainly agrees. They continue to accumulate physical gold month after month. There is ongoing concern with the longer-term viability of the US dollar. It was not so long ago that the U.S faced a debt ceiling crisis. The debt problem has not gone away and continues to grow. Gold is still a good hedge against both the ongoing monetary and fiscal recklessness in the U.S. and elsewhere.

By most measurements valuation levels for stocks are high. Excessive money printing has propelled stock prices well ahead of potential earnings growth. For this reason it is important to review the allocation of stocks and bonds in investment portfolios. Over time, many investors climb up the risk ladder either knowingly, or often unknowingly, and end up with a higher equity exposure than they should.

Our strategy is twofold. We have been mitigating some of the risk in the stock market by purchasing higher dividend yielding securities. We have also pared back some positions over the past three months and slightly lowered equity weightings. Importantly, while we do not expect a major decline in stock prices at this time, we must be prepared to be more trading oriented going forward. With higher stock valuations we can expect more volatility heading into 2015.

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