Investment Commentary

STONEBROOKE
ASSET MANAGEMENT

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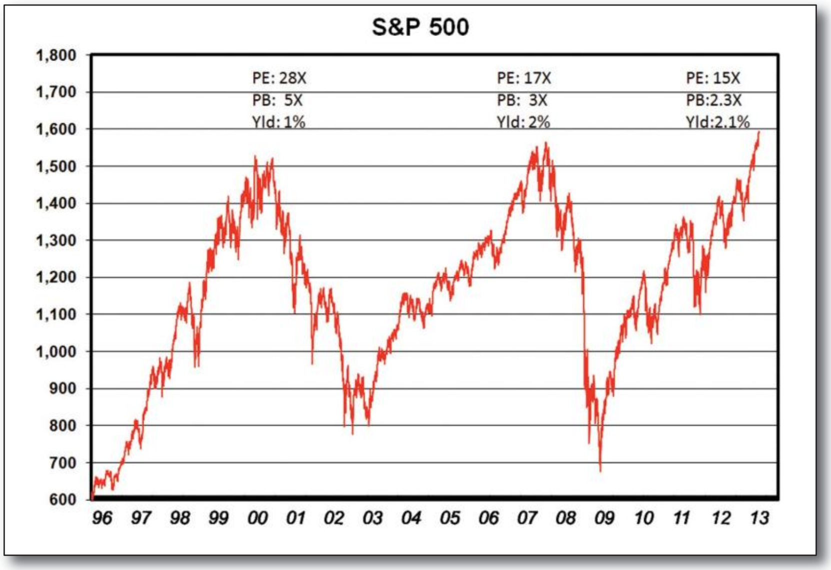
Here We Are Again - Market Peak?

It is hard to believe that it was just four years ago when stock markets around the world were at their panic lows. Here we are again (in the U.S. market at least), back at peak levels for the third time in the last dozen or so years. Below is a chart of the U.S. S&P 500 stock market index;



Throughout the rise in stock prices these last four years there has been a constant debate as to whether we are still trapped in a long-term *secular bear* market. Will we again witness another deep plunge, or has a long-term *secular bull* market now begun. The stakes could not be greater. A *secular bear* market wipes out close to all of the gains reached in the previous advance. Even the typical run of the mill bear market usually wipes out about half of prior gains.

As indicated in the chart, valuation levels are improving over time with each peak in stock prices. In 2000 for instance the average price earnings multiple (PE) was 28X, price to book value (PB) was 5X, and dividend yields averaged just 1%. Today in sharp contrast, the average PE multiple is 15X, PB multiple is 2.3X, and the S&P 500 sports a 2.1% dividend yield. Still, in order to return to historical averages these fundamental metrics need to improve and provide better value for investors.

It is important to remember that the poor rates of return experienced by most investors over the past 13 years has been the consequence of *an extremely overvalued market* back in 2000. The peak in stock prices in 2007 saw a return to high valuations but they were well below the extremes of 2000. Currently we are again approaching higher valuation territory and we doubt that levels will reach as high as they did in 2007.

There is likely one more good correction coming to get us back to valuations where a

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S&P/TSX : 12,750	*90 Day T-Bills : .97%*	*Oil : $97.23 US*	*Cdn $: .982 US*
S&P 500 : 1,569	*10 Yr Cda Bond : 1.76%*	*Gold : 1,596 US*	*Euro : 1.30 Cdn*

Market Peak? *(continued from page 1)*

secular bull market can begin. This typically begins at a point when valuation levels become severely depressed. If history is any guide, market valuations tend to move from one extreme to another over the course of longer term cycles.

We have been fortunate in avoiding the severity of the previous two devastating market plunges, in 2000-2002 and again in the 2008-2009 crisis. While we see all the making of another market setback around the corner we are comforted this time around by two main facts. 1) valuations have improved over the past dozen years and 2) the current low interest rate environment has further to run. The next market correction should not be as deep and punishing as the previous two.

An Artificial Market

In many ways the current market advance to new highs in the U.S. has been surreal. It somehow does not seem justified based on the recent economic evidence. The same big picture concerns are still present, with Europe in disarray and budget deficits and debt remain a serious fiscal issue. Investors are wondering if this is an artificial market. Many experts are on record voicing the same concerns.

According to David Stockman, former budget director under President Ronald Reagan, the U.S. economy is in a bubble inflated by "phony money" from the Federal Reserve and will burst within a few years. In his new book, Stockman writes that the Fed's QE policies following the 2008/09 financial crisis have flooded stock markets with cash while the "main street economy" remains weak. The combination, he wrote, is "unsustainable."

Rob Arnott, advisor to institutional investors and former editor of the Financial Analysts Journal, a leading institutional publication had this to say recently, "If you engage in fiscal stimulus, deficit spending, that money makes its way into the macro economy through the private sector. The private sector is reluctant to spend the money, and if they are reluctant to spend the money and invest for the future then it shows up in the form of heightened profitability. It's illusion".

Richard Fisher, president of the Dallas Federal Reserve has been an outspoken critic of quantitative easing (QE). He has called it "monetary Ritalin" and to quote him recently, "you've got a market that's hooked on the drug that you have been providing".

So investors should be wary and suspicious of what is quite likely an artificial market. A market that under the circumstances is difficult to accurately predict. Each day of rising stock prices reinforces the notion that money printing may just work after all - and can be gradually withdrawn down the road without any negative economic consequences.

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Money Printing in Overdrive

In a bold new effort to stimulate a moribund economy, the Bank of Japan has launched a massive increase in quantitative easing (QE). It will be buying bonds at a rate of over $90 Billion per month for a total of up to $1.4 Trillion. This is truly unprecedented. In comparison, adjusting for the differences in GDP, this is more than twice the amount of the US Federal Reserve's purchases. The goal is to lift the inflation rate to 2%. Not surprisingly, both the stock and bond markets have risen strongly while the currency has dropped sharply.

This could be the start of an even greater coordinated effort by the world's Central Banks to print more money. Positive economic results from the U.S. experiment with QE have so far been elusive. In fact recent economic numbers have slowed with the latest jobs report a huge disappointment. U.S. money supply figures have also unexpectedly weakened with M2 in contraction mode over the past three months. So far QE has only managed to lower borrowing costs and to lift stock and bond prices. It has not had the desired positive economic effects.

Rather than change direction when something isn't working, central banks appear ready to redouble their efforts. It is quite possible global financial markets could be in for a final and dramatic move higher.

Risk Management

The key to success in managing investment portfolios is to incorporate good risk-management principles, especially in late-stage bull markets. Neglecting to manage portfolio risk is potentially more punishing today because of the zero rate environment we are faced with.

In the past a balanced investment portfolio could count on capital appreciation from bonds to partially offset losses in stocks during an economic downturn. This and a prudent defensive orientation in stocks would go a long way in protecting capital. A fully invested, buy and hold strategy made a lot of sense when interest rates were higher.

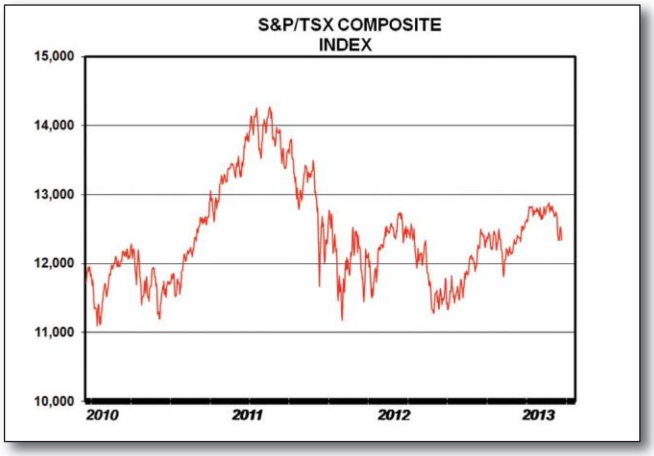
Risk management can often be suboptimal. The process involves hedging an investment portfolio for known events, which may or may not occur. The risk of inflation for instance can be hedged by investing in Gold and in holding shorter term bonds in the fixed income component of portfolios. If inflation is contained then the inflation protection was unwarranted and causes underperformance. This is in fact a strategy we have adopted and which we still conclude is appropriate and necessary. QE has all the potential to unleash inflation in the future and driving interest rates higher.

Risk management is also a proactive management process. It involves trying to determine appropriate equity weightings, whether to hold cash, and how best to diversify, with the ultimate goal of protecting and building capital over the long term.

Investors today appear to under-appreciate the risks they are taking in the stock market. Normally conservative investors are becoming impatient and are increasing risk at an improper time - not because investment prospects have materially improved, but simply because *they need the returns*.

Equity Strategy

In contrast to the positive market performance in the U.S. the Canadian stock market has failed to reach new highs. It is at breakeven for the year and as per the chart below of the S&P/TSX Composite, Canadian stocks have struggled now for the better part of three years.



The U.S. stock market is partially buoyed by a housing market that seems to have turned the corner. Further appreciation in home prices will certainly help confidence, especially for all those homeowners still under water on their mortgages – (where mortgages are greater than the value of the home). Housing is an important sector of the economy with direct influences on the broader consumer sector. As real estate activity picks up consumer spending increases for all kinds of household items.

In Canada, the residential real estate market is showing declining activity although prices do remain firm. Mortgage brokers are confirming the slowdown and the market has become very competitive. We are becoming somewhat concerned with the Canadian banking sector. While the banks are without question a model of strength and good governance, a decline in the growth of residential mortgage loans is concerning. Stock prices are always vulnerable to a change in expectations. We will be monitoring events carefully as we go forward and should conditions deteriorate we stand ready to reduce positions significantly.

We continue to advocate holding an investment in gold. However, as opposed to investing solely in the common stocks of mining companies we now favour a core holding in gold bullion for the longer term. The stocks have not performed well and have shown much greater volatility. As such they are at best, "trading vehicles" until proven otherwise. We plan on holding existing positions for now and will look for opportunities to reduce portfolio weightings on strength.

The outlook for bullion continues to be very positive. Non western Central Banks purchased a record amount of gold in 2012 and continue to buy more. The debasement of currencies continues ad nausea with an expansion of QE around the world. With the recent bail-in provisions to "save" Cyprus, bank deposits at the periphery of Europe are no longer assumed secure. From our perspective the environment for gold has only improved. Eventually the tide will turn and we should expect to see another significant advance.

We have considered buying "bear funds" or securities that do well when the stock market declines. The reason we hesitate is because of the QE policy of Central Banks. We also have a very clear memory of being too early in 2007, one full year before the financial panic of 2008/09. Our best guess is there is at least another year before we need to protect portfolios in any serious way. Until then the occasional short term transaction may be executed for moderate hedging purposes.

So while we are accepting some risk here in the face of a potential short term correction, we believe overall risk levels are tolerable. We are also continuing to build positions in higher dividend paying stocks and focus on the more defensive sectors. There are still opportunities to acquire or hold stocks with good value propositions in the Energy and Technology sectors. More solid evidence of real growth could return in the second half of the year. Stock prices in Canada could again gain ground as global economic growth would be beneficial for our commodity sensitive economy.

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