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Taper - The New Buzz Word

In yet another effort to be clear and transparent the U.S. Federal Reserve has given financial markets a new word to ponder – taper. Its current policy of quantitative easing (QE), or in plain English, printing money, cannot go on indefinitely. In a move obviously designed to test the waters, the Fed has suggested it may “taper” its QE program before the end of this year. Stopping QE outright could be problematic for financial markets and the economy at large. Tapering, or the gradual removal of QE, on the other hand sounds much more reassuring.

We believe the latest remarks about tapering are an acknowledgement by the Fed that financial markets in the U.S. have moved up too sharply. The Fed likely realizes that their policies could already be too accommodative – *interest rates have been kept low for almost five years*. Over the years the criticisms levied at all central bankers for printing money have been persistent. Instead of providing funding for the real economy the money is staying on Wall Street and bidding up financial assets. So when the Fed suggested recently it may be time to taper bond purchases, the reaction in the financial markets was swift. Bonds and stocks sold off quickly. Since then the stock market has been recovering however the bond market continues to correct as interest rates move higher.

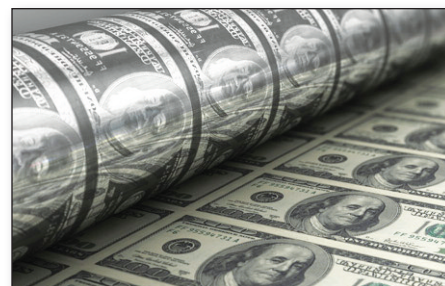
Financial markets no longer function on free market principles. Without free and



unencumbered markets financial assets are artificially priced. A low interest rate policy forces investors to make choices they would not ordinarily make. It promotes all kinds of improper investment behaviour, on both the

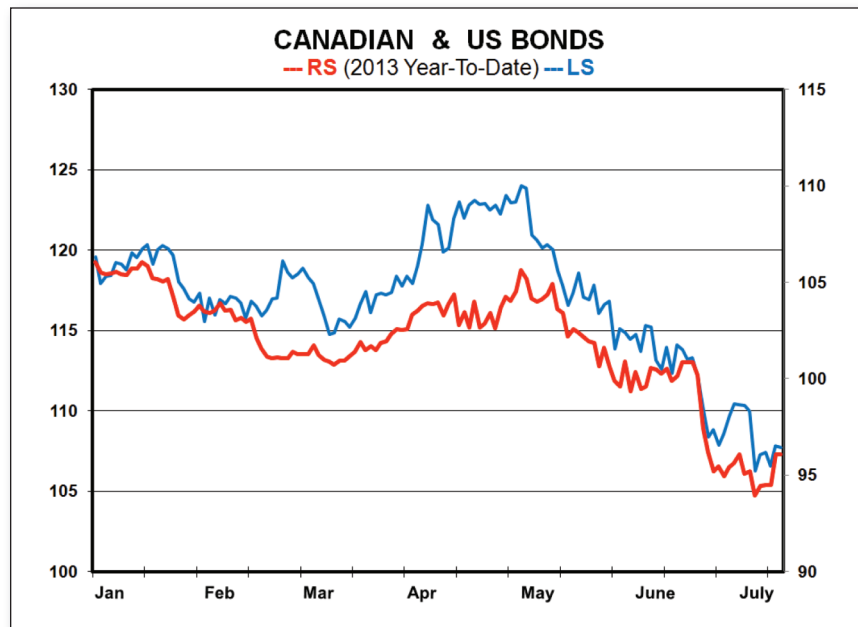
individual and corporate level. Supporting this notion of “artificial” markets, Bloomberg news recently reported that up to 25% of global central banks are buying stocks. This is an incredible development and brings a new twist to an old investment adage “Don’t fight the Fed”.

The Fed’s loose monetary policies have a history of elevating stock prices to extreme levels. The “bubble” peaks in 2000 and 2007 are a reminder of how well-intentioned policies can come to a brutal end. The current bubble has formed an extreme in the bond market and by extension has filtered over into stocks. The Fed is in an untenable position yet again. It seems destined to repeat the same mistakes. The mere suggestion of tapering sent markets reeling. There can therefore be no question QE has provided a major lifeline for financial markets. Removing it will be a challenge to say the least.



The Fed Cannot Control The Bond Market

Rising interest rates are pushing down bond prices. The chart below shows the decline in Canadian and U.S. intermediate term bonds as measured by the price of certain exchange traded funds. The yields, which move inversely to price have increased from a low of about 1.6% in May for ten year bonds to a current yield of 2.7%. (The difference in yields between Canadian and U.S. bonds are negligible).



There are practical limits to the Federal Reserve's monetary policies. While they can control the short end of the curve for treasury bills they cannot control the market for longer dated bonds. At best the Fed has some influence over longer-term interest rates by setting and communicating long term inflation objectives. However it is the market, a broad spectrum of investors who hold and trade bonds, who are the final judge and jury as they form their own views on where interest rates are heading. These views incorporate a wide variety of factors including supply/demand, economic growth assumptions, inflation and currency forecasts.

So the recent rise in bond yields are the markets way of saying perhaps the Fed QE program was too much of a good thing. The talk of tapering caught the bond market by surprise. Large one way momentum trades in the reverse direction were likely sold off in a hurry. Going forward the bond market will now settle down and consolidate. The next move, either up or down, will likely be a move based on fundamentals. In our view the lows in bond yields are likely behind us. How fast and high they climb will ultimately depend

on economic factors. Bond investors would also be wise to make plans for an eventual end to the QE program.

Over in Europe, Mario Draghi of the ECB has indicated he will keep rates low for an "extended period of time". With high debt loads and anemic economic conditions, the last thing Europe needs is rising interest rates. However as in North America, bond yields have started to rise in Europe. Of concern is the quick rise in the periphery with Greek, Irish and Portuguese interest rates spreads rising again considerably.

In cycles past a rise in interest rates would normally be a positive sign. It would confirm a strengthening economy with the desire for increased consumer and business credit. This time around the economy is still weak and with high debt loads, an increase in interest costs is not a welcome development. We are monitoring events closely. Should interest rates continue to rise quickly, the financial markets would be vulnerable. Adjusting portfolio risk levels would be necessary.

Gold: Tarnished and Unloved

The price of gold and gold stocks have taken a severe tumble. Bullion dropped to a low of \$1,180 an ounce, before recovering recently to \$1,250. The decline has stunned investors and understandably the desire to sell and be rid of this poor performing asset has only escalated. Ironically though, the demand for physical gold, for coins and bars, has strengthened. Also, the various closed end funds holding physical gold have not received many calls for redemptions. There is a large disconnect between the financial “paper” markets and the physical desire to own gold.

We have been here before - twice in the past decade. The volatility in the price of gold and especially gold mining shares has been extreme to say the least. However it is the 1975-76 crash in gold which in our view is more similar to current conditions. (See chart below showing bullion and the Barron’s gold mining index). Gold had a good yet volatile move up throughout the first half of the 1970’s – a turbulent time for the general stock market. Then in 1975-76 as the stock market recovered, the price of gold bullion plunged 50% and gold mining stocks lost two thirds of their value. Similar to today, the rising stock market and declining gold price brought out the skeptics denouncing gold as a barbarous relic. Then, as the stock market weakened again, gold began a climb to what would become an eight fold increase in price, peaking in 1980. Gold mining stocks had a spectacular run and peaked well after the peak in bullion.

Jim Rogers, a well known and respected former hedge fund manager has had this to say; “I’m not selling my gold. I’m skeptical, even though I expect gold may go down even more to \$1,000 to \$900. A 50% correction would be \$960 or whatever it is. Now 50% corrections are quite normal in markets.”

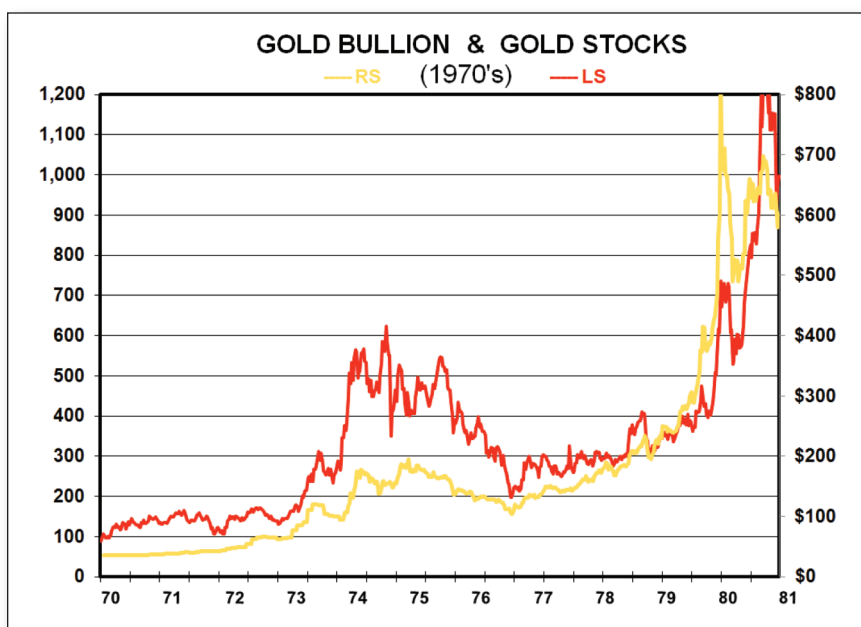


Normal or not, 50% corrections are frightful. We have seen this before or worse in technology, oil and gas, and real estate markets. Now it is gold which is tarnished and unloved. Extreme negative sentiment presents an opportunity. While timing the exact bottom is always tricky we believe triple digit gains in gold stocks await the patient investor over the next two or three years.

The consensus appears to have faith in central bankers printing unprecedented amounts of money. It is precisely because of the money printing, and the need to print more, that gold will eventually recover. Absurdly, one month of the Fed’s QE program, \$85 Billion, buys over 2,000 tonnes of gold at current prices. If we thought the politicians would get serious about fiscal reform to tackle the debt and deficits, and

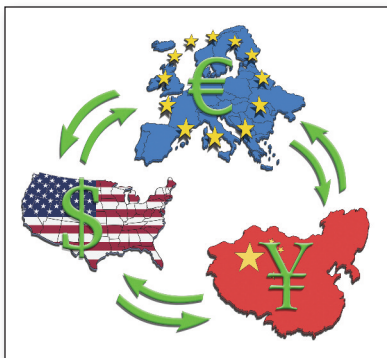
the global trade and currency systemic risks were solved, then there would be no need for a position in gold.

Year-to-date, China has imported almost 50 percent of the world’s annual mine production. There is strong demand for physical gold from many other central banks. While there are many so called market experts eager to discredit gold and forecasting the end of the bull run, these experts have voiced the same arguments for over ten years and missed the advance from \$250 to \$1,900. Conditions today are actually more favourable for gold.



A Global Pause in Growth

The U.S. economy continues to slow. The latest revision to GDP shows the economy growing at just 1.8%. Excluding a build-up in inventories, goods produced but not sold, growth was a dismal 1.2%. Weakness in consumer spending, business investment, and exports, were offset by growth in the auto and housing sectors. The recent employment data was mixed. A gain of 360,000 part-time jobs came at the expense of a loss of 240,000 full-time jobs. Not exactly a sign of a robust economy.



growth is sluggish. The credit boom of the past few years, responsible for the higher economic growth rates, may be in the process of contracting. Allegations have surfaced of improper lending. Apparently many loans were channeled into all kinds of uneconomic and bogus projects. While this is nothing new, Chinese authorities now admit that the credit driven boom has resulted in “unproductive investments” and significant loan losses have piled up at the major government controlled banks. The new leadership in China faces significant challenges. A greater than anticipated economic slowdown in China would not be welcome news for the global economy.

There is renewed concern over China’s growth prospects. Exports continue to disappoint and import

Equity Strategy

The interest rate sensitive groups, Pipelines, Utilities and REIT’s, have been negatively affected by the rise in interest rates. Rising interest rates are usually problematic for these groups as they compete with fixed income securities. However rates are not rising due to demand for credit or a strengthening economy. The mixed signals with QE are to blame. We believe interest rates will likely stay low enough that investments made in interest rate sensitive groups will still provide reasonably good and safe returns over the next year.

We continue to recommend holding a 5 to 10% position in gold and gold mining shares. We remain convinced there is merit in owning gold, especially now at these lower price levels. Furthermore any weakness in equity markets may be positive for gold as was the case in the 1970’s.

The resource and materials sectors are performing poorly and this is reflected in the poor performance generally in the Canadian stock market. The Canadian dollar also continues to slip and is now down about

6% this year. While investments in emerging economies have generally not performed well, diversifying outside Canada still makes sense. We will be looking for opportunities on further weakness, especially in some of the Asian markets.

Global business confidence is slowing. Many large industrial companies are seeing slow sales and some are beginning to cut jobs in order to maintain profit margins. The technology sector is also sluggish with many firms indicating disappointing results from China, and Europe where conditions remain weak. As we are now in the corporate reporting season, many large multinationals will give us a clearer outlook. Investor expectations for corporate profits could change going forward as a slowdown is confirmed. We are staying cautious in the event there is a pullback in stock prices. A breakdown in interest-sensitive sectors has been a forerunner to a breakdown for stocks in general. A defensive posture overall makes sense at this time and this is a good opportunity to keep accumulating higher paying dividend stocks, which have recently declined moderately in price.

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