STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

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Addicted to QE: Tapering be Dammed

In a move which surprised the vast majority of Fed watchers, Chairman Ben Bernanke recently decided not to “taper”, i.e. not to reduce the monetary stimulus program known as quantitative easing (QE). According to Bernanke “the Committee has some concern that the rapid tightening of financial conditions in recent months could have the effect of slowing growth….. and upcoming fiscal debates may involve additional risks to financial markets and to the broader economy.”

In a nutshell, the U.S. Federal Reserve decided to keep printing money because of a concern for rising interest rates and the fears over a government shutdown and the debt ceiling limit. Many pundits claim he is simply addicted to QE. Arguably, the massive amounts of monetary stimulus was necessary back in 2008 and 2009 at the height of the financial panic. It was successful in preventing the “great recession” from turning into a depression. However, increasing amounts of stimulus have been necessary to keep this recovery afloat. QE1 was followed by QE2 and 3 and each time the amount of stimulus was raised, leading to the current $85 billion a month.

All this money printing has yet to achieve the desired goal - a sustained and normal recovery. The increasing levels of stimulus cannot go on indefinetely. However, in the immediate term we are faced with a set of conditions that can potentially be both euphoric and troublesome. The continuation of QE could just lift markets to even greater heights with exhubriant investors jumping on board. On the other hand it would be troubling indeed if financial markets did not respond positively to the continued stimulus. A declining market may then actually baffle investors, and begin to reverse the high level of cash flows that have flowed into equity mutual funds year-to-date – approx $80 Billion. Incidently, this level of activity has not been seen since 2007, at the peak of the last cycle. Investors are notoriously late to the party, often buying on momentum nearer to the top. Quite like Ben Bernanke, investors are also addicted to QE.

U.S. Government Shut Down

The bitter feud between Republicans and Democrats over the budget has closed the doors of many federal government agencies and sent about 800,000 government workers home. Presumably common sense will prevail before too long and an acceptable compromise will be reached. If not the risk to the economy and to the confidence in financial markets will grow by the day.

As we go to print it appears the important “debt ceiling” will be extended. We think the odds of default are probably close to zero. It is troubling however that the politicians seem to need to play these games without regard for any economic consequences. Another short term band-aid solution will likely be put in place - essentially kicking

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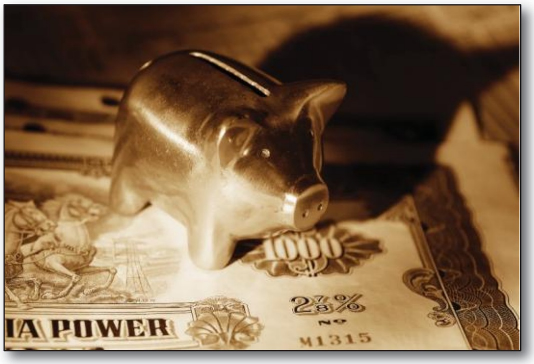
U.S. Government Shutdown (cont'd from page 1)

the can down the road. We are certain to revisit this issue again in the year ahead.

Financial markets have been conditioned to expect political grandstanding right up to the 11th hour. For this reason markets remain fairly steady in view of what seems to be a very severe impasse this time around. Ironically this "feedback loop" has the Republicans emboldened. They claim since the markets have not panicked there is no great consequence in a default. This is a dangerous conclusion. Confidence is lost very quickly and if the market suddenly decides default risk is too high the selling will be fast and furious. So while we believe the odds are low of a default, one just never knows. It is the last thing this still fragile economic recovery needs.

Bond Market – Safe for Now?

North American bond markets were in turmoil earlier this summer with 10 year government bond yields rising to almost 3%. The average duration bond portfolio dropped sharply in value. Since then investors have rushed for the exits and have withdrawn over $100 billion in bond funds and ETF's in the months of June, July and August (U.S. figures).



More than $1 Trillion had flowed into U.S. bond funds since 2009. Remarkably, the demand for bonds was strong right up to May, when the talk of Fed tapering suddenly frightened investors. The reversal was dramatic. As Bill Gross of Pimco, manager of the world's largest bond fund commented, "Why stick around if your team is down by seven runs with only a few innings left? Why invest in financial or real assets if bond prices could only go down, and/or stock prices could no longer be pumped up via the artificial steroids of QE". The stampede into bonds, and into many investments offering higher yields, has now abruptly stopped.

In the past two or three years the positive sentiment for bonds was unshakeable. As interest rates fell, bond funds performed well. The returns were considered to be guaranteed and steady. The media, and also the larger financial institutions, played a big role in convincing investors that bonds were safe and dependable; ideal for conservative portfolios. With interest rates at thirty year lows and bearing down on zero percent it was ridiculous to make such a claim. Bonds should no longer be considered safe investments over the long term.

According to William White, former chief economist at the Bank for International Settlements, "This looks to me like 2007 all over again, but even worse. All the previous imbalances are still there. Total public and private debt levels are 30% higher as a share of GDP in the advanced economies than they were then……"

We are in the camp of investment managers that believe money printing has been the main reason behind the rise of financial assets, bonds in particular. The tapering issue is now critical and center stage. For the time being the Fed will continue to print money at the rate of $85 Billion per month. This should support the bond market. If not, and interest rates rise instead and begin to destabilize financial markets, we are of the opinion the Fed will quickly announce further supportive measures. The economy has turned soft and the last thing an outgoing Fed Chairman wants to see is a panic in the markets. Bonds should be a safer bet over the short term.

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Economic Concerns Rising

Recent data appears to suggest a weakening economy. Employment, housing and retail sales numbers are coming in softer than expected. This despite monetary stimulus which has added $1 Trillion in the past year to the Fed's balance sheet. It is perhaps understandable Bernanke was reluctant to taper. Removing any stimulus was probably viewed as too risky at this moment.

All the new money printing by the Fed has not managed to find its way into additional loan growth. As mentioned on many occasions; after a long period of indebtedness, where governments, corporations and consumers have borrowed too much money, a period of deleveraging then needs to take place as savings are rebuilt. (In fact the main reason inflation is so low is attributed in part to the reduction of debt in the private sector). So far the deflationary forces are still prevalent and economic growth remains lackluster.

Europe continues to believe that austerity measures are the solution to its debt problems. Alarmingly, a recent report from the IMF discusses the possibility of imposing a onetime "super tax" of 10% on savings across the Eurozone. The report cites this could be a solution to the debt problem and an alternative to imposing higher taxes and/or cutting spending. While plausible, it highlights the different attitude to the debt crisis by Europeans. They are determined to reign in the debt and pay their bills. Unfortunately the immediate consequence is a moribund economy.

In Canada, the economy is also slowing down. The employment reports have been mediocre with average monthly job gains at about 10,000. Our trade deficit keeps widening, partly the result of a weaker currency. Along with a purchasing managers' index barely above 50, the Canadian economy is in line to grow at an uninspiring 1%.

Portfolio Strategy

With the expectation there will be continued monetary stimulus over the next few months, both the stock and bond markets appear safe from any major volatility. However, as we enter 2014 the Federal Reserve will have a new Chairperson. Current Vice-Chair Janet Yellen, has been appointed to replace Ben Bernanke. While she is well known for her ardent support of QE, she may surprise everyone by taking a tougher stance on monetary policy than generally expected.

Importantly, we are in a high-liquidity/low-growth world. This is not a stable environment especially since the Fed is already on record of wanting to reduce liquidity by tapering the QE program. Financial markets are unlikely to be pleased when the time finally comes. We need to monitor developments in the U.S. very closely.

In fixed income markets we will continue to emphasize the purchase of short term corporate bonds maturing in the next three to five years. We also consider investments in higher dividend paying stocks to be attractive especially now that prices have drifted lower over the past few months. While interest rates may have moved up, the higher yield sectors still provide better income than bonds. As long as interest rates do not rise significantly, the shift out of bonds and into stocks is likely to continue. At the moment investors perceive bonds as undesirable and stocks should be the main beneficiary.

Present valuation levels in the U.S market are getting stretched. The price to earnings ratio (P/E) has risen this year as stock prices have climbed faster than corporate earnings. Many of the growth stocks trade at earnings multiples reminiscent of the pre crisis years. We are more comfortable holding less riskier positions in the Pipelines, Utilities, and Financial Services sectors where valuations are more reasonable and yields are higher.

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Portfolio Strategy (cont'd from page 3)

We are maintaining our positions in gold, even though the performance in this sector has been terrible year to date. At these lower price levels the downside risk appears minimal, although if the price of gold bullion does not begin to recover soon we would consider reducing weightings. Having said that, we remain of the view that gold is still a good long term hedge for investment portfolios. When gold finally recovers we believe the gains in stock prices are potentially explosive.

With a slower growth scenario, selectivity becomes more critical when purchasing stocks. Higher growth stocks, which typically trade at expensive levels, are particularly vulnerable to disappointing earnings. This can also present opportunities to pick up good companies at a cheaper price. We will be looking for this as well as more broadly based market timing strategies, in order to take advantage of what is likely to be a volatile, wider ranging market.

Technical Commentary

The chart below compares the S&P 500 in the U.S. with the stock markets in Canada and Emerging Markets. Over the past two years the outperformance of the U.S. is quite unmistakable. Some countries, primarily India and Brazil, have been in a bear market since the end of 2010 and are down over 30%.

The Emerging Markets and BRIC nations (Brazil, Russia, India and China) now deserve a closer look and there are many exchange traded funds (ETF) which can be purchased. Dividend yields are approximately 3.5% and the average P/E multiples are in the range of 12 to14 times. Compared to the S&P 500 which trades at about 20 times earnings, the value proposition certainly favours an investment in these foreign markets. The long term growth argument still holds and the advantage in diversification is also a compelling reason to allocate some capital to the emerging world. We are inclined to do so and may purchase either one or two countries or regions directly, or an ETF with broader exposure.

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