Investment Commentary

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In This Issue

- QE On Hold
- U.S. Austerity Out of Sync
- China Slowdown Revisted
- Gold Tarnished
- Portfolio Strategy

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QE On Hold?

Much has been written about Quantitative Easing (QE) or money printing by Central Banks. It has single handedly been the saviour of the world's fragile banking and sovereign debt crisis. It is certain that without it, the recession in the U.S. would have been deeper and prolonged, with obvious consequences for Canada. Ben Bernanke, Chairman of the Federal Reserve, recently implied as much in testimony to the U.S. Senate. However, QE now appears to be on hold. Just released minutes of the Federal Reserve committee meetings (the FOMC) in March show a reluctance for additional monetary easing. Furthermore, according to the minutes *"Most participants did not interpret the recent economic and financial information as pointing to a material revision to the outlook for 2013 and 2014"*. Slow and steady is the status quo.

After a good solid first quarter advance in the stock market and, on apparently strengthening U.S. economic data, investors are now a bit perplexed. While the consensus opinion on the economy seemed to be it was recovering on its own, there was an undercurrent of optimism fueled by the belief another round of QE was never far away. Over the past few months Ben has certainly hinted there may be a need for more QE.

The Fed's next meeting is at the end of April. Investors now face an uncertain period of time. If QE remains on hold it is uncertain if commodity prices and the stock market can continue their uptrend. On the other hand if a QE program is announced, as many still believe, it should act to buoy financial markets for the balance of the year.

The European Central Bank and Bank of Japan are now taking a page from the Fed playbook. The amount of money printing in Europe should keep markets there stabilized for the time being. While the progress in Europe is more hopeful, there are still deep political divisions to overcome. Disturbingly, interest rates are now beginning to creep up again. More QE may be necessary in Europe.

U.S. Austerity Out of Sync

Unlike many European countries, austerity measures have been put on hold in the U.S. this year. Congress has continually kicked the budgetary can down the road.

Consequently, a significant fiscal contraction looms for 2013 as tax cuts expire and automatic spending cuts kick in to close the huge deficit gap.

By some estimates the resulting fiscal contraction, consisting of both tax increases and spending cuts, would be in the neighborhood of 3.5% of GDP. This is a massive austerity program and not one that the market has paid any attention to.

The U.S. is out of sync with most of the indebted world. In the first year of a new presidential term there will be a greater likelihood of dealing with the hard unpleasant realities. With an economic contraction starting in 2013 a very real possibility, it is likely the financial markets will begin to get anxious again later this year.

In Canada the recent Federal budget is a reminder of how well our finances are compared to our neighbour to the south. The announced spending cuts of over $5Billion and a three-year austerity plan to *balance the budget* is an exercise in fiscal responsibility deeply lacking in the U.S.

China Slowdown Revisited

The long rumoured slowdown in China may finally have arrived. While we are not in the "hard landing" camp we have always wondered how China could continue to grow year after year at rates well above 10%, especially in the past three years with the U.S. and Europe, their major export markets, bordering on recession.

China has built a lot of infrastructure in the past three years as their export markets slowed. The domestic expansion however could not go on forever. The residential real estate market peaked last year and there have been steady monthly declines in prices. Building activity has consequently slowed.

Barclays Capital has reported that China buys some 40% of the annual global demand for copper, aluminum and nickel. A slowdown in their economy would certainly put pressure on all commodity markets. Some of the larger mining companies have confirmed a reduced demand for iron ore (used for steel making). As the Canadian economy is dependent on resources, it would be vulnerable to a slowdown in China. It is a situation which needs careful monitoring.

Gold Tarnished

The confusion surrounding QE has had a negative effect on the price of gold bullion. There is also less fear among investors of a banking collapse and a generally improved level of confidence. Gold as an investment "hedge" is therefore less appealing. The gold mining companies have suffered most and have been out of favour since last September and now trade at valuation levels not seen in many years. We have been patient and still believe there is tremendous potential for this sector. We are convinced the price of gold can only rise over time and are thus willing to tolerate some underperformance from this group in the full knowledge that the rewards are potentially very lucrative.

The longer term environment for gold is truly quite positive. Low real interest rates and the probable need to continue printing vast sums of money are powerful forces supporting gold. We view the current state of affairs as just another short-term correction. It may persist until the summer months when gold usually resumes its upward trend.

Portfolio Strategy

The Canadian stock market continues to underperform the U.S. market. In the past 15 months the performance differential is almost 20%. (U.S. stocks were flat in 2011 while the TSX was down about 10% and the U.S. outperformed again in the first quarter by almost another 10%). While the slowdown in China may explain the pressure on the resource sector, resource prices are actually still quite firm. For some inexplicable reason the share prices are much weaker than the underlying commodity prices would suggest. Another glaring difference in performance is the technology sector, where the U.S. has shown remarkable strength, led by a handful of large cap stocks including Apple Inc. A pause or mild correction may now be at hand as prices are off their highs. Importantly, U.S. outperformance may be an enduring theme. Therefore, a stronger presence in U.S. stocks will likely need to be considered. Exchange traded funds that are currency hedged would be most attractive.

We have been looking for an entry point to invest further in companies with higher dividend yields. They have generally lagged in performance year-to-date as the market rebounded. Market volatility will likely rise again and the opportune time to get more defensive in higher yielding securities may be fast approaching. We learned last year and also in 2010 that when volatility spikes, the correction in stock prices can quickly eliminate months of hard earned gains. Rotating into higher yielding stocks will reduce portfolio volatility. We expect to do so in the months ahead.

In the bond market, we may have already witnessed the lows in interest rates. As the economy strengthens bond prices are likely to continue their downward trend. Portfolio positions remain primarily in short to medium-term bonds in order to safeguard capital.