STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

Fall 2012

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QE to Infinity: Fed Out of Bullets?

With the markets anticipating the U.S. Federal Reserve's announcing of a new fixed program of quantitative easing, QE3, the Fed instead recently decided to provide *unlimited and open-ended* monetary support beginning with a monthly buyback of $40 billion in mortgage backed securities.

Investor applause was immediate with the stock and commodity markets roaring to the upside. What strikes us as atypical for the Fed is the timing of this announcement. On previous occasions of monetary easing, QE1, QE2, and "operation twist", the stock market was clearly in peril and threatened to take the economy down with it. Not so this time.

So why now? Why the need for what amounts to QE to Infinity? Is it election related? Is the Fed just weary of fixed programs and wanting more flexibility to act? Or perhaps the Fed is anticipating a difficult environment ahead with the need for greater stimulus?

The market's initial optimistic outburst is likely justified. So far, the printing of money has been positive for the financial markets. In the short term, many investors seem willing to believe the investment climate is now relatively risk free. However, perhaps there is an overestimation of the ability of Central Banks to fix things. Rising stock prices may be giving investors a false sense of security. In our judgment, the Fed has likely bought some time. Importantly, what can the Fed do for an encore? What if the stock market starts heading back down? Can money printing continue to support the stock market indefinitely and get the economy back on track? Or is the Fed finally out of bullets?

In our view the Fed's QE to Infinity policy is designed to give more latitude in buying bonds as the year-end approaches bringing with it the dreaded "Fiscal Cliff". Without any changes to the scheduled deep cuts in spending and increase in taxes, a severe economic contraction would be assured. We expect reason to prevail and for the U.S. to dodge the fiscal train wreck. It will be easier to make a few minor bipartisan changes to the budget and have a printing solution in place - QE to Infinity.

TSX 300 : 12,317	*90 Day T-Bills : .97%*	*Oil : $92.19 US*	*Cdn $: 1.02 US*
S&P 500 : 1,441	*10 Yr Cda Bond : 1.73%*	*Gold : 1,772 US*	*Euro : 1.26 Cdn*

A Weak Global Economy

According to the International Monetary Fund (IMF), the impact of fiscal austerity is “large, negative, and significant”. The Fund has recently reduced its forecast for the rate of global growth to 3.6% in 2013, down from 3.9%. Importantly, it now claims that austerity measures impact the economy much greater than previously thought. It cited the “fiscal multiplier”—the change in GDP growth that results from a change in a government’s deficit—was thought until recently to be 0.5. New IMF research now suggests a multiplier effect in the range of 0.9-1.7. In other words a deficit reduction of 1% could reduce GDP growth by up to 1.7% in some cases.

In the U.S. any meaningful recovery will have to include a rise in residential real estate prices. So far the home price index and high foreclosure rates are not a sign of encouragement, although it does appear the U.S. may have finally bottomed. Just the same, the housing sector is not expected to be a major driver of economic growth. Unemployment is expected to remain high and demand will still remain weak.

Central banks will be required to do the heavy lifting. In the past four years the U.S. Fed has expanded its balance sheet by over three times to almost $3 trillion. Worldwide, the story is the same. The top eight central banks have added stimulus of about $10 trillion, growing their balance sheets from $5 to $15 trillion. While QE is not a panacea it is hoped QE will inflate financial assets and stimulate demand and home prices indirectly via positive wealth effects.

Investors Remain Cautious

“Bull markets are born from pessimism”, remarked famed investor Sir John Templeton many years ago. For good reason, the majority of investors remain cautious of the stock market. Economic headwinds are well advertised and there is a general distrust of the financial markets. This anxiety can be observed in the high levels of cash savings amongst both individuals and corporations. Corporate cash holdings in the U.S. stand at a record $1.26 trillion. It is also high here in Canada, the subject of much criticism from our elected officials. Should the Central Banks succeed in igniting the world economies, the cash hoard would be beneficial in keeping momentum going. It is quite conceivable that the stock market may surprise on the upside for a much longer period of time than currently expected.

Another reason for optimism is the potential for more stimulus from China. According to some, there are plans afoot to open the door for more local government stimulus. In the midst of a ten year leadership transition, China’s new leaders will be keen to increase investment. After much concern China’s economy may be heading for a hard landing, a turnaround may be in the initial stages. Interest rates have already been slashed twice and recent M2 money supply appears to be on the rebound with a 14.8% growth rate in September. We will need to monitor the data on new loans and investment for confirmation economic growth is picking up.

Momentum Update

Avoiding financial panics that typically occur at the end of a business cycle is key to preserving and growing capital over time. Our momentum work is designed to alert us to changing market conditions. Importantly, just prior to the crash of 2008/09 there was a change in sector leadership with defensive sectors at first holding steady. They then succumbed to an absolute decline of nearly 30%. No sectors were spared from steep declines during that crisis. Currently we are not seeing any significant movement out of defensive sectors when the market sells off. In fact we continue to witness a see-saw battle between the "risk-on" aggressive sectors and "risk-off" defensive sectors. It is when they all start weakening together that we need to be concerned.

We have observed a few changes in our momentum work. While the defensive sectors are still doing relatively well there has been a positive movement in the cyclical and growth sectors. Gold, Energy and Technology have all moved up into the top rankings. All in all however there is not an extreme dispersion in values. We have also noticed that in the past year the rise in cyclical sectors has been a temporary phenomenon. In the weeks ahead there may be the need to reduce or eliminate positions already held. Adding new positions is still premature.

Portfolio Strategy

In the fixed income markets we intend to occasionally purchase medium to longer term bonds for trading purposes, *not for long term retention*. Interest rates have moved up a bit in the long end of the bond market as yields have risen from their lows earlier this summer; the 10 year government of Canada bond troughed at 1.6% in July and reached almost 2% in September.

For the bulk of fixed income investments we continue to stay the course in the short end of the market with maturities under three years. Interest rates are being manipulated. QE is a money printing operation keeping interest rates down through the purchase of bonds. In our view this is a ticking time bomb so long as the U.S. deficit issue remains unaddressed. A bond panic that quickly lifts interest rates up is entirely possible. Of course a bond panic is impossible to predict with any accuracy. One can only monitor bond yields day in and day out and stay on top of market developments. Our sense is that a quick rise in interest rates is still a good distance ahead. The economy is slow, the problems in Europe is attracting capital to the U.S. as a safe haven, and further QE should work to keep rates down for now.

While cash in the bank yields very little, the search for yield has become almost feverish as investors try and find investments with high income yields. Unfortunately many stocks with high yields also come with a high risk of capital loss.

We have increased our holdings in some of the higher dividend paying stocks and have chosen companies which we believe have less price risk. At the moment the prognosis for 2013 is fading and a short term pullback in the stock market would not be surprising. We may increase cash positions for reasons of safety should it appear the markets are weakening. Should a pullback occur it may set up for a good buying opportunity. We have a reasonable amount of confidence the Central banks will again be able to keep markets afloat for the next year or so, notwithstanding the usual volatility along the way.

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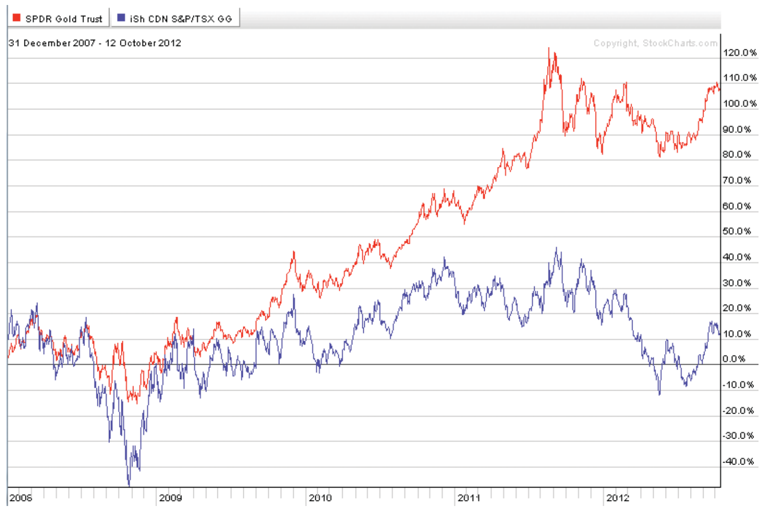
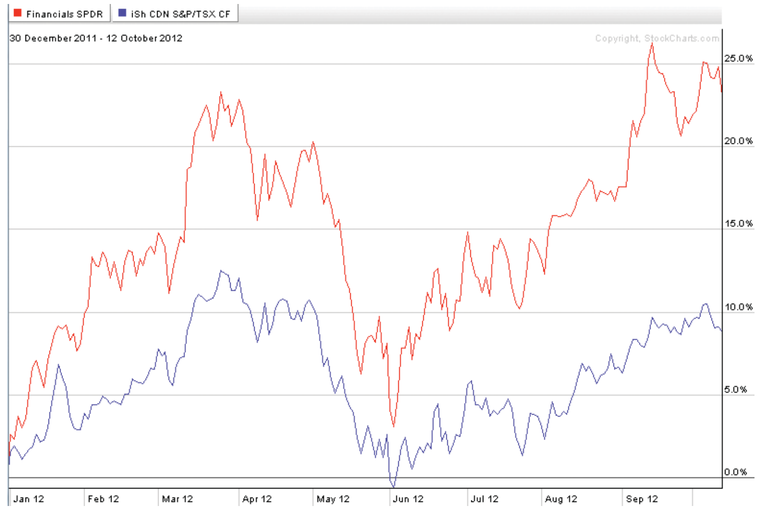
Technical Commentary

Gold bullion has resumed its climb recently posting a $200 per ounce increase. The mining stocks have finally awoken and have moved up strongly. However, as per the five year chart below, in the last 18 to 24 months the stocks have not kept pace with bullion. With a Fed policy of unlimited money printing, the desire for gold as a hedge is growing. The stocks may now pick up the pace.



The financial stocks in the U.S. have been outperforming the Canadian banking sector year-to-date. For the U.S. banks this may just be a recovery move from overly depressed levels. On the other hand the Canadian banks appear to be stalling and this may be due to the slowing Real Estate sector. Canadian banks could be facing a more difficult environment in 2013.



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