Investment Commentary

Spring 2011

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Triple Disaster in Japan

The earthquake, tsunami, and nuclear fallout are a disturbing sequence of events for Japan, and potentially its neighbours in the region. Tragically, the disaster has taken the lives of so many and created emotional hardship for an entire nation. However the Japanese are an industrious and pragmatic society. They will overcome and rebuild, and in doing so will lift their economy, the third largest in the world, back into a higher growth mode.

From disasters come opportunities. For Japan, it has been a long 20+ years of suboptimal economic growth. Deflation has characterized their plight in the two decades as the twin inflationary real estate and stock market bubbles burst back in 1990. The next three years should see a boost to their fortunes as the rebuilding effort gets underway.

QE3 – A Fed Dilemma

The U.S. Federal Reserve continues to struggle with its decision *to print or not to print*. Quantitative easing (QE2), is set to expire June 30th. There is a high degree of anticipation by investors that the Fed will either extend or announce a brand new monetary easing program, or QE3. The event is critical for financial markets, and indeed, Fed governors are already out in public voicing their opinions.

Richard Fisher, head of the Federal Reserve Bank of Dallas has concerns about the runaway deficits and the Fed’s stimulus policies. In a recent speech at the University of Frankfurt he said, "if we continue down on the path on which the fiscal authorities put us, we will become insolvent. The question is when".

“This is how bubbles are formed,” warns Thomas Hoenig, president of the Kansas City Federal Reserve Bank. “Rocketing land and energy prices are telltale signs … too much money sloshing around. When you put this much liquidity into the system, it has to go somewhere.” Hoenig has been an independent voice over the years, and is criticizing the Fed’s current monetary policies.

However, because of fiscal irresponsibility and a tenuous global economy, we are convinced the U.S. Federal Reserve will continue to print. Unfortunately, keeping interest rates near zero, the easy money won't go into savings. As a result we can look forward to higher oil prices, higher food prices, and eventually higher interest rates as inflation takes hold over the next few years.

The Fear Trade: Gold or Paper?

Many investors still believe gold to be the "fear trade". In other words buy gold if you believe in the end of the world. This is understandable as many in the media liken gold to an insurance play, citing many instances of gold rising on negative geopolitical events. However, any lasting advance for gold is always based on monetary factors. Whenever a central bank prints too much paper, gold will be accumulated and trend higher. The real fear investors should focus on is the fear of "excessive money printing", and for that an investment in gold in the current environment makes sense.

Additionally, both *individual and institutional investors* still own very little of it. Pension funds in particular! According to estimates by Shayne McGuire in his new book, Hard Money; Taking Gold to a Higher Investment Level, the typical pension fund holds about .30% of its assets in gold bullion and gold mining stocks - *an insignificant amount*. It is estimated that a 5% portfolio allocation in gold represents about $1.5 Trillion in pension assets. For perspective, the total amount of gold mined in one year, approx 80 million ounces, is valued today at just over $110 Billion. Institutional investors cannot position themselves in gold without sending prices soaring.

Finally, in a statement as close to official government policy that we are likely to hear, Li Yining, a senior economist at Beijing University and an advisor to the national parliament, says China should hedge against risks of foreign currency devaluations. Li has been quoted saying "China should increase its gold reserves appropriately, and China must take every chance to buy, especially when gold prices fall".

U.S. Economy on Government Support

The U.S. is stimulating the economy with very loose fiscal and monetary policies. While the private economy is benefiting from this stimulus, and the "headlines" portray an improving economy, there are still many fundamental challenges. In fact, net of all the new debt created since 2008, private sector spending has been very disappointing.

In a recent article, Madeline Schnapp, Director of Macroeconomic Research at TrimTabs, a highly respected U.S. capital markets research firm, observed that total government spending on social security, medicare, and unemployment insurance now equaled 35% of all private and public wages and salaries. This is up sharply from 21% in 2000. *To conclude from this statistic that economic growth depends on government support is a huge understatement*. U.S. GDP growth is not supported by real wealth creation.

In addition, the U.S. housing market remains under pressure. New home sales in February declined by 17% and are now at the lowest level on record. Foreclosure rates are expected to move much higher this year. The housing sector is moribund and a reflection of debt strapped consumers generally.

Portfolio Strategy

Regarded as one of the best bond managers, and manager of the world's largest bond fund, Bill Gross, of Pacific Investment Management (Pimco), made quite a statement by selling the majority of his holdings in U.S. treasury bonds. He is reportedly sitting on over $50 Billion in cash in a fund worth over $230 Billion, the most cash he has ever held. Bill Gross believes there will be no QE3 and that monetary easing will be reversed. We are not inclined to bet heavily against him, and therefore continue to recommend shorter-term bond positions across all client mandates. Interest rates must eventually go higher; therefore bonds are at risk of capital loss.

We look for the stock market to continue to produce respectable gains this year, short-term corrections notwithstanding. *At this juncture*, interest rates are low, the Fed is stimulating and the stock market is pointing higher. Investors are in a "buy the dip" mood, in the belief the Fed can and will continue to backstop the market and provide liquidity until the economy is on a sustainable path.

With the rebuilding in Japan, the resource sectors are set to be major beneficiaries. Most commodities will now be looked at more strategically. With the fear of supply shortages and rising prices, companies will now acquire greater inventories. Japanese companies themselves should directly benefit and importantly, they already represent fairly good value and, on balance, carry strong balance sheets.

Events in the Middle East and North Africa have driven the price of oil up to $108 a barrel; and as tensions there are expected to continue all eyes are focused with apprehension on Saudi Arabia. While Canadian oil stocks have firmed, they have underperformed the gains seen in the price of the commodity. Irrespective of the tensions, industry fundamentals are favourable and the long-term outlook is compelling. We foresee increasing positions in the Oil sector over time.

The technology heavyweights, Microsoft and Cisco have confirmed a slowdown in the government sector of their business. Still, we prefer holding positions in the larger cap companies with more modest growth potential than chase the higher growth names with lofty valuations. It is simply a desire to take less risk, as there is a *large relative difference in valuation levels*. For more diversification in the sector and an investment in Canadian technology companies, we like the iShares capped exchange traded fund (XIT).

As always, we continue to be alert for risks to an otherwise satisfactory outlook for stocks. It is important to monitor interest rates and the direction of the U.S. dollar. Should they begin to rise appreciably it will be necessary to reduce overall portfolio risk.