Investment Commentary

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Investors Fear Contagion

The situation in Greece is currently at the center of investors' attention. It is hard to fathom how a country the size of Greece can cause so much anxiety, especially as its sovereign debt issue is nothing new. However, it is no longer just about Greece. The market fears contagion will spread throughout Europe. Spain and Italy are perhaps next in line for a bailout. (**Italy has the world's third largest sovereign debt market**). Investors grow wearier by the day and fear the debt issue is just too onerous and that global economic activity is at risk.

Political posturing and inaction certainly have not diffused the issue. In fact politics has compounded it by drawing full media attention. For financial markets, it is the political haggling that is driving volatility. Markets hate uncertainty. They can and probably have adjusted to an inevitable slowdown. They just need the confidence that the debt crisis does not unravel and escalate into another shocking financial disaster similar to 2008/09. The bottom line is investors will continue to lose confidence if there is no permanent fix.

Further confusing the issue, Germany's Angela Merkel has stated that "Eurobonds are absolutely wrong". She is not in favour of "collectivizing debts". This is a major impasse and makes it difficult to believe the Europeans are capable of agreeing on a bailout plan.

Ironically, the risk maybe that Europe will do the right thing! They may let Greece "technically default" and renegotiate their sovereign debt with a partial write-down. It is hoped they will be able to contain any fallout. The risk of course is the very contagion they are trying to avoid as panic may erupt and spread to other countries and throughout the banking sector.

Eurobonds are indeed not the solution as it is a temporary measure and one that will evolve into an escalation of debt – just postponing the crisis. In any event, the framework is not currently in place to collectivize debt nor has a central guarantor been established. The markets therefore could continue to have this issue over-hanging for quite some time.

Renowned "Austrian School" economist Friedrich A. Hayek, a staunch pragmatic, long ago said… ***"To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it about."***

The correct long term solution calls for austerity and for governments to live within their means. Regardless, we are looking at a slower period ahead in Europe, and in much of the developed world.

Financial Casino

Recent volatility in the markets has become extreme and very unnerving; 200^{+} point days, either up or down, is now a common occurrence.

This is typical behaviour at turning points in market expectations. When conditions change relative to the consensus, markets can become very volatile as they adjust to the new reality. It is also important to understand that the dollar volume of trading is way out of proportion to the actual physical demand for many commodities – including oil, gold and silver. In the case of silver, for instance, the *annual* physical demand is in the area of 900 Million ounces. At the peak in silver trading when the price climbed to $50, contracts were traded representing 800 Million ounces *per day*! The speculation has reached insane levels.

Importantly, as commodity prices swing up and down the overall market gets pulled along. To suggest that there are fundamental and rational reasons for certain price moves is naïve. The average investor must be overwhelmed with the level of speculation in these markets. It must be looking more and more to many like a financial casino.

QE3: Delayed

Many pundits had expected U.S. Fed Chairman Ben Bernanke to announce QE3, when he spoke at the Jackson Hole conference in late August. Another $500 billion in excess reserves, at the very least, could have stabilized financial markets. Bernanke did propose "operation twist" which will attempt to keep longer term interest rates down. He also continues to insist the Fed has a range of other tools he could use should it become necessary.

For the moment, Bernanke appears unperturbed and resigned to letting financial markets find their own footing. Based on previous experience with QE1 and QE2, and very recent testimony, we remain convinced the Fed will use all the monetary tools necessary to keep the banking system liquid and the economy from contracting. Should additional monetary stimulus be needed, QE3 will be applied. In an election year the economy cannot fall back into an anemic state with little to no growth. Bernanke will be quick in starting up the printing press.

Gold is Not in a Bubble

To put the matter in perspective, the last time Gold went parabolic, in 1979/80, the price doubled in a matter of months and was valued at about 20% of all U.S. financial assets. Both the price of Bullion and the Dow Jones Industrial Average, were trading at the 800 level. Today, Gold represents about 5% of financial assets and at $1,600 trades well below the level of the Dow.

Gold has performed well this year in spite of the recent sharp correction. The general market pullback has landed many hedge funds in trouble. It is rumoured that investor redemptions are high and have forced the funds to sell indiscriminately including their profitable gold and silver positions.

We view the pull back in Gold as an opportunity and will consider adding to our positions as markets settle down.

Portfolio Strategy

In the U.S., the Economic Cycle Research Institute (ECRI), an independent firm with a commendable record of economic forecasting, has just announced their indicators are pointing to a recession.

There are two important factors we must take into consideration; 1) has the market completely discounted the slow period ahead, and 2) will the world's central banks take pre-emptive action and provide the fuel to lift financial markets.

While we have been tempted to reduce overall portfolio risk by trimming back equity positions by 10-15%, when we look at our individual holdings we find current price levels to be fairly attractive. Selling at these prices is difficult as we are convinced looking out six to twelve months such a decision will prove to be a mistake.

Having said that, we have drawn a *"line in the sand"*, by which we will not tolerate any further losses on a number of positions. Should we need to sell in the coming days and weeks we would also be prepared to quickly buy back these same positions, even at the risk of being "whipsawed" and buying back at higher prices. A penalty worth taking in these uncertain times!

It is normal to want to wait for the European crisis to resolve itself before increasing portfolio risk. However, markets do not usually wait for a green light. In a counterintuitive way they often recover while investors are still waiting convinced the doom and gloom has much further to go.

Present valuation levels are fairly attractive and corporate balance sheets are strong. Interest rates are low and there is plenty of liquidity in the banking system. Many stocks trade at low earnings multiples and have dividend yields well above the yields on long term bonds. Such a differential has not been witnessed for many decades.

With commodity prices having dropped sharply we are looking to increase our weighting in the Energy and Materials sectors. The sectors are down on the belief China is slowing and may even be heading towards a "hard landing". While China is shifting its efforts to focus on domestic consumption it will still continue to be a large importer of commodities as it builds out new cities and infrastructure.

In the bond market, prices have risen sharply as yields declined. The safe haven of government bonds has investors piling in aggressively. Just the same, one has to remember the deficit in the U.S. is huge and ultimately unmanageable. According to Rob Arnott, of Research Affiliates, 70% of bond auctions are taken up by the Fed!

Importantly, the bond market is artificially supported. Interest rates are therefore artificially low. In our view it will be a serious mistake to stay invested in longer term bonds once a recovery gets underway. As interest rates rise back to more normal levels bond investors will experience a significant loss of capital. We continue to recommend shorter term maturities.

Our strategy is now focused on minimizing portfolio risk. While we anticipate a good recovery bounce in the *short-term,* and believe the many solid values will result in rewarding returns over time, should conditions deteriorate we are prepared to assume a more defensive stance.