Investment Commentary

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Contact Us

Stonebrooke Asset Management Ltd.

WaterPark Place
20 Bay Street
Suite 1205
Toronto, Ontario
M5J 2N8
Tel: 416-850-2172
Email:
info@stonebrooke.ca

QE to Infinity

The stock markets have all strengthened this past quarter. September was a particularly strong month in the U.S. in the belief the Federal Reserve is ready to pursue more quantitative easing (QE), or *money printing*. The Fed is anxious with Chairman Ben Bernanke recently describing the economic outlook as "unusually uncertain". At the latest Fed committee meetings he stated the Fed was "prepared to take further policy actions" if necessary. The interpretation is that another round of QE is coming.

The advice from several prominent investment research houses is to BUY - as the liquidity provided from the Fed will serve to lift prices of both stocks and bonds. Whether true or false, the positive spin is on. Better to get in *before* the main event (QE) as financial markets are guaranteed to rise *and may even explode to the upside*. So goes the argument. If on the other hand QE doesn't materialize then this too is bullish as it will have proven to be unnecessary. The economy is actually just fine and there is no need for monetary stimulus. A win-win situation!

Now all that remains is the Fed's newly created cash, or not! Buying on rumors or in this case guessing on government actions to lift financial markets, may seem a bit unsettling. But it is just another chapter in the infamous "Greenspan Put", as it was known, back in the days when Alan Greenspan was Chairman of the US Federal Reserve. He would support the financial markets at every crisis. This resulted in the protracted and reckless expansion of risk taking, until in the end (2008), the large investment banks had to be bailed out en masse.

We have no doubt that if push comes to shove the Fed will once again support the markets and provide liquidity. They may need to print money on a grander scale, and some have suggested upwards of $2 to 3 Trillion may be in store. What is not factored into the equation are any of the consequences in doing so. The opinions on Bay and Wall Street are generally optimistic. On the other hand, there is a vocal minority with the view that printing money is a desperate act that will end with hyperinflation. To support their cause they point to the many "paper" currency regimes in the past that have accumulated debts beyond their ability to pay.

While we share the concerns, like everyone else, we are uncertain of the outcome. In the meantime we are content to "speculate" on improving fundamentals, or technical market action. But to risk capital based on the hope of a further round of quantitative easing is a bit of a stretch. It is fraught with unknown risks and goes against basic economic principles. Otherwise, why not QE to infinity!

Gold

Rising to new highs, the price of bullion has pushed through $1,300 US per ounce. It is remarkable to see the price of gold easily defy all the naysayers in the mainstream media.

Gold is beginning to act like a currency. Increasingly, investors the world over are looking for protection from the inevitable devaluation of the U.S. dollar. In fact, the debasement of all currencies vis-a-vis Gold is possibly the next big theme - helped along by QE.

At this point the market has been orderly - a nice linear trend line without too much volatility. It is unclear why this is the case as gold has historically been very choppy. Some have suggested there is at least one large buyer ready to take any and all bids, thus putting a floor under the gold price. We expect prices to go higher simply because nothing has changed fundamentally to fix the global monetary system. It remains challenged and there is now more pressure for currency devaluations around the world in order to boost export markets - and ultimately to pay down large government deficits and service debts. According to Brazilian Finance Minister Guido Mantega, we are witnessing an *"international currency war"* - where countries devalue their currencies in order to improve their competitiveness. This is a positive environment for gold and while a return to choppy markets is likely, we expect much higher prices for gold in the year ahead.

Less Bullish Expectations

The mistake investors often make is in thinking the stock market correlates tightly with economic news, whether good or bad. It all depends on the price level and on market expectations. The difficulty comes in trying to judge both of these variables, especially over a shorter time frame. It has been our judgment for awhile that the economy would underperform relative to generally more bullish expectations. We have been concerned of an economic “double dip” back into recession. Curiously, that concern has grown and expectations are now *much less bullish*, yet the stock market has brushed aside all deteriorating signs. The economy may just slow and we will eventually muddle through. At least expectations have been lowered, and so the risks to financial markets are likely lower as well.

As we had anticipated, the U.S. dollar has reversed and is now losing ground to the Euro and Yen. The Canadian dollar has also strengthened. The expectations for the U.S. dollar are now much less bullish, especially now that the U.S. appears set on more QE. The easy solution, to print money, will not go over well in creditor countries that hold vast amounts of U.S. treasury bonds. China and Japan especially will be harmed. Vocal protests coming out of Asia have been the norm over the past year but realistically, short of economic retaliation that is self-defeating, there is little they can do. Again, as expectations are less bullish for the U.S. dollar, a continued decline may not jeopardize financial markets. As long as the path of decline is orderly the net benefit accrues to the U.S.

Not Your Average Bond Market

Yields have declined again as investors rush to buy bonds. Many have described this as a “bond bubble” in the making. This may not be an ordinary market development based solely on a desire for income and safety of capital.

Due to the size of the deficits, many suspect that the large banks and the government are colluding in the bond market. The big U.S. banks have been huge beneficiaries of U.S. monetary policy, exchanging illiquid bonds for cash created out of “thin air”. The banks have invested the cash and are flush with treasury bonds on their balance sheets. Whether by their own accord or by unspoken agreement, they cannot continue to purchase bonds forever. The banks will act in their own self interest when yields rise and bond prices start to fall.

With an increase in savings domestically, the U.S. is now less reliant on foreign investors for new bond purchases. However, they still need to maintain confidence. Should foreigners lose faith, both the dollar and treasury bonds are at risk. The perception of safety is beginning to change. The sheer size of the U.S. financing requirement is an obvious hurdle.

Government authorities are determined to keep rates low. We know the Fed is looking to print money and debase the currency. Fed actions help explain their recent comment – “we do not have enough inflation”. They should be careful for what they wish for! In the meantime we continue to hold shorter term maturity bonds. The desire to inflate is disturbing and we therefore expect interest rates to rise over time.

Equity Strategy

Investing based strictly on fundamentals is often a frustrating exercise. In many cases valuations seem compelling enough and the company delivers by reporting decent results, yet the stock price performs poorly. Many of the U.S. technology heavyweights, Microsoft, Intel, Cisco, are prime examples of this. For these companies, stock prices today are at about the same level as in 2003! Profitability has expanded over the years and price/earnings ratios are now very reasonable. Research in Motion is another example. It can be purchased for under 10 times earnings – an incredibly cheap price for a growth company. While many analysts believe the company is a “value trap” and competition will shrink margins, the doom and gloom scenario is probably already priced into the stock. The market seems to go to extremes on either side of the pricing spectrum – more so than it normally does.

We are maintaining our positions in gold and basic materials as they are performing well. Having said that, we may do some short-term trading should these positions become over-extended. We are likely to increase our holdings in the technology sector in the months ahead and will continue to look for opportunities in higher dividend paying securities as a means to increase income in balanced portfolio mandates, and for added security overall.