Investment Commentary

STONEBROOKE
ASSET MANAGEMENT

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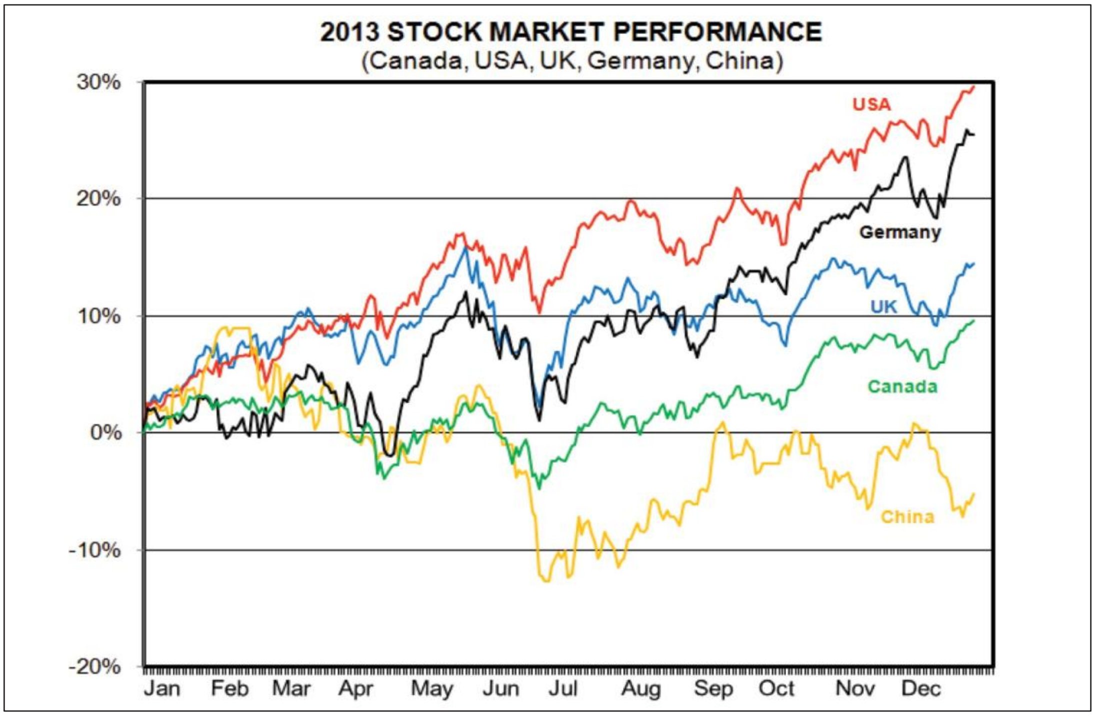
Summary – 2013

The Canadian stock market put in a respectable year in 2013 with the S&P/TSX Composite price index gaining 9.5%. In the U.S. the stock markets surged with the S&P 500 index up an astounding 29.6%. The bond markets on the other hand had one of their worst years on record as interest rates rose. Canadian 10 year bond yields ended the year at 2.8%, up from 1.8%. The DEX Universe Bond index dropped by 1.2%.

For the Canadian dollar it was a frustrating year as our Loonie tumbled 7% to close at $.935 to the U.S. dollar. The U.S. dollar was surprising strong against most currencies in 2013.

In commodity markets it was a mixed and volatile year. While the price of Oil ended the year up 7% to close at just over $98, it had been as high as $110. Copper, zinc, potash and other commodities experienced soft markets. For Gold it was a disaster as the price of bullion dropped by 28% to close at $1,205 USD. It was the first decline for gold in 12 years.



Of the major markets the U.S. led the way in 2013. In currency adjusted terms the performance was even more impressive as the U.S. dollar gained on most currencies except for the Euro. Japan (not shown above) for instance was up 57% locally but the Yen declined by about 18%.

A Year of Money Printing

Looking back a year ago it was not easy to feel encouraged about economic prospects and the outlook for financial markets. The "Fiscal Cliff" was a serious issue early on and affected investor confidence. By mid-year the U.S. Federal Reserve announced it would put the brakes on monetary stimulus – the so called "tapering" of their quantitative easing (QE) program. Interest rates soared in the bond

(cont'd on page 2)

S&P/TSX : 13,622	***90 Day T-Bills : .91%***	***Oil : $98.17 US***	***Cdn $: .935 US***
S&P 500 : 1,848	***10 Yr Cda Bond : 2.77%***	***Gold : 1,205 US***	***Euro : 1.47 Cdn***

A Year of Money Printing (cont'd from page 1)
market and the stock market plunged. The Fed then changed its mind and apologized. From then on, the U.S. stock market never looked back. Fueled by money printing the U.S. stock market went on to post the best calendar gain since 1998.

It is no coincidence that the Japanese stock market also posted incredible results. In local terms, it was the best performance of the major developed stock markets, up 57%. Not surprisingly, Prime Minister Shinzo Abe is printing more money over in Japan than they are in the U.S.

It is also no coincidence that many developing and emerging markets lagged in performance. There was no significant money printing in these regions. Stock markets were down either in local currencies or when translated into U.S. dollars; China (-6.8%), Russia (-5.6%), Brazil (-15.5%), India (+9%). The gain in India was offset by a 13% decline in the Rupee. **In 2013, stock returns were highly correlated with money printing.**

A Game of Confidence

A year like 2013 reminds us that the stock market remains very much a game of confidence. At the moment it is the belief in money printing that is driving up financial markets. How else can you explain a 30% gain in the U.S. market on an earnings growth of just 6%? Why are investors all of a sudden choosing to pay more for stocks? You certainly cannot attribute the rise in prices to a robust and vibrant economy, nor conclude the prospects for the corporate sector have suddenly brightened.

The Central Banks understand the importance of building and maintaining confidence. They will periodically issue press releases and give presentations in order to gauge market sentiment, a case in point being the "off again on again" tapering issue last year. This should reinforce the notion, and serve as a reminder to all investors that gains made in the stock market are never permanent or guaranteed.

As long as investors believe the world's Central Banks are in control and doing the right thing then confidence will remain. Memories are indeed truly short. The utter failure of the U.S. banking system the last time back in 2008-09 is testament to the fact Central Banks are not good stewards of the economy. They currently are providing a short-term liquidity fix and not much else.

U.S. Assets - A Relatively Safe Haven

Besides problems with deficits and low growth, and despite a highly controversial money printing program (QE), the U.S. dollar has been remarkably stable. The stock market is attracting foreign investors and even the bond market has not fared too badly as interest rates have risen only a moderate amount. In comparison the Euro zone still looks rather bleak. Austerity budgets continue to hamper growth as spending is cut and taxes are raised. In addition the rumours of a "bail-in", or the partial confiscation of bank deposits similar to what happened in Cyprus, is making the U.S. look rather good in comparison.

The U.S. Federal government deficit is expected to be $600 Billion this year, still a rather large sum however a significant improvement from the string of annual deficits that exceeded $1.5 Trillion just a few short years ago. Still, debts and deficits are a problem everywhere. Japan's debt, although internal, is much higher as a proportion of GDP. They continue to print in the UK and Europe. For now foreign holders of dollars appear complacent. This has certainly defied the consensus which has been bearish on the dollar for a good number of years.

The U.S. has a powerful wind at its back at the moment. An energy boom is in the making as a result of new fracking technology. Oil and gas production is rising impressively which is helping to improve the trade deficit. Although controversial this technology is having powerful results and of course it is beneficial for the U.S. dollar. So while excessive money printing by the Fed is indeed a worrisome development and in theory should be undermining the dollar, everything is relative. The U.S. just may have enough positive momentum going for it at the moment that outweighs the negatives. So the hazards of money printing may be delayed. For the time being the global supply and demand picture for dollars appears benign. The bond market continues to function with interest rates staying low and for now the Fed is getting away with funding the country's deficit. Further U.S. dollar strength could surprise the majority of investors in 2014.

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Low Interest Rate Gamble

There is no question low interest rates have been instrumental in propping up the stock market. However, there is no guarantee that 1) rates will stay low, or 2) stock prices can stay propped up. According to John Hussman, a well regarded economist and money manager, "The belief in a close relationship between interest rates and stock yields is actually driven by the strong inflation-deflation cycle from 1970 to about 1998. Outside of this period, stock yields and interest rates have generally been negatively correlated."

So while there appears to be a high correlation between low interest rates, and the rise in stock prices, it is not always the case. Stocks can still be vulnerable in a low interest rate environment. The Japanese stock market is a great example of this. Interest rates have been practically zero for over two decades. That has not prevented their stock market from some serious declines over this time.

And from Bill Gross, co-CIO of Pimco and manager of the world's largest bond fund; "Investors are all playing the same dangerous game that depends on a near perpetual policy of cheap financing and artificially low interest rates in a desperate gamble to promote growth."

If one were to survey average conservative investors with retirement funds the findings would likely show a preference to invest safely in bonds or GIC's at 5 or 6%, as opposed to taking a chance in the stock market. A good majority would opt for the guaranteed fixed income return. When interest rates climb, the stock market will be vulnerable. Investors heavily positioned in the stock market are gambling that interest rates stay low. It is a gamble where the odds are beginning to rise against them.

Gold: Not So Precious

It was a terrible year for investors in gold as the price of bullion fell 28% in 2013. It was worse for stocks with the senior mining companies down about 50%. Investor sentiment is as negative as we have seen it in a long time. The business news channels are hard pressed to find anyone still remotely bullish.

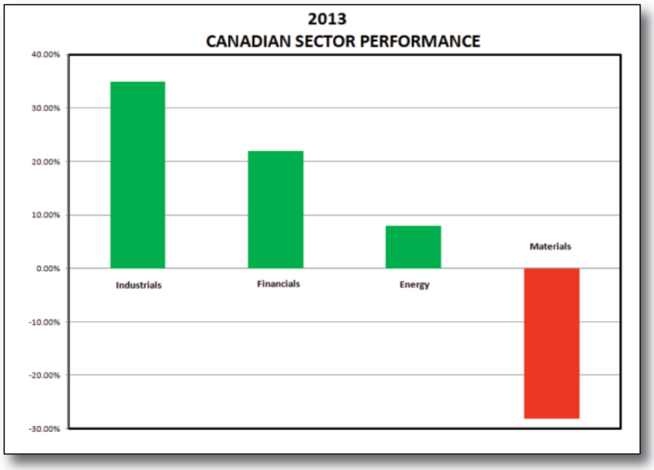
We have long advocated a position in gold and gold stocks. We believe it is still a good long-term hedge against what can only be described as reckless monetary policy. In 2013 it has cost us in performance. Rather than abandon the sector completely we will maintain the now smaller position in gold bullion and strive to be more selective and trading oriented with the gold mining stocks. It is quite obvious that investors currently prefer the general stock market and there is far less desire to own gold. This will likely change at some point and may require the differential valuations to become even more extreme than they are today. We intend therefore to keep a lower profile for now and patiently wait for the time gold resumes its upward trend. With many gold stocks down at price levels last seen in 2008, there is impressive leverage built into share prices once bullion is back in favour.

Gold is simply the best insurance against inflation, or deflation. In these uncertain and unusual times it deserves an allocation in every portfolio. "I would rather own gold than government bonds, high-yield bonds and equities. If this scenario [deflation] were to pass it would lead to even more money printing around the world," said Marc Faber, the contrarian Swiss investor.

In the end, those who have been patient enough to hold some gold will be rewarded. There have been two large moves in gold stocks over the past twelve years. We believe a third major advance is only a matter of time and will likely come when investors are again disillusioned with governments and realize they need to diversify their wealth from the probable loss of purchasing power brought about by excessive money printing.

Portfolio Strategy

The Canadian stock market lagged in performance in 2013 mainly due to the heavier concentration of resources in our economy. This can be seen in the adjacent chart which shows the performance of the top weighted sectors; Financials (35%), Energy (25%), Materials (12%), and Industrials (8%). These top four groups represent a total of 80% of the S&P/TSX Composite stock index. The Materials sector significantly underperformed, led by declines in commodity prices and especially a decline in gold. (cont'd on page 4)



For many emerging markets it was a similar experience. Underperformance was mainly due to declines in commodity prices brought about by a slowdown in global growth. At this juncture investing in certain overseas markets makes sense. Underperformance in these markets means valuation levels are more attractive and if the forecasts for global economic growth are to be believed then a recovery in economic sensitive sectors and resources should follow. Besides, certain sectors, notably the Financials, U.S. Technology and Healthcare, are looking very pricey and so the relative valuations make for a more compelling investment.

Japan had a remarkable year in 2013. New tax free savings plans will encourage investors to channel more money into the stock market. This could be a multi-year trend. Stimulus monetary policies will likely continue to underpin stock prices. On any correction in the Japanese market we may consider the purchase of an exchange traded fund. Even with the spectacular rise last year, the Nikkei stock index is still down 60% from its all time peak made more than two decades ago.

The surge in the U.S. stock market means valuation levels are now very stretched. 2013 was a year where Price/Earnings multiples expanded. Earnings did not. Investors are willing to bid up stocks to levels reminiscent of the last two major peaks in 2000 and 2007. A fully invested equity portfolio is becoming more difficult to justify.

Many experienced value managers which we would describe as prudently growth oriented, are now building up cash positions. Even Warren Buffett is reported to be again holding $40 Billion in cash. He apparently is not in a hurry to spend it. Many business executives are beginning to get nervous. Billionaire Carl Icahn, a well known and influential investor had this to say…"I'm very cautious on equities today. This market could easily have a big drop". He then added…"I think I'll have an opportunity to buy the positions I want to own 20-30 percent lower if I'm patient, so I'm going to be patient. I don't feel the need to deploy capital just because I've got excess cash."

In addition, according to a global poll conducted last year by Citi Private Bank, wealthy families have about 39 percent of their assets in cash. There are two ways of interpreting this finding. 1) there is a good deal of cash still sitting on the sidelines ready to enter the stock market, or 2) as insider selling reports suggest, the cash is there strategically and refuses to buy at these lofty levels, waiting instead for a better opportunity to invest at lower prices.

It certainly appears that a classic "bubble" in stock prices is where we are heading. It will be the third such bubble in 15 years. The timing of course is unknown however the math is quite sobering. Let's even assume a best case scenario and the market advances another 50% in the next year or so. That puts the S&P 500 at an extreme peak of about 2,700. A 50% decline thereafter, which has been the experience during the last two "busts", would put the index back down to 1,350 – **25% below where it is today!**

Ideally, in the next several months some steam is let out of the U.S. market and a healthy correction will occur. This could then very well provide a better opportunity to buy stocks. A speculative bubble would also be deferred. Our strategy then would likely be to deploy more funds into the U.S. market. It appears capital is looking to concentrate in the U.S. It remains a safe haven in the eyes of the world, at least for now.

Importantly, we can expect 2014 to be a more volatile year due to the fact the market is much more expensive. However the risks seem manageable provided interest rates stay low and monetary stimulus continues courtesy of the Fed. A good portion of our equity holdings are in defensive categories and we continue to emphasize higher dividend paying securities. We believe these securities would ride out any adverse event and should show good steady returns over time. This may be the year we need to reduce portfolio risk in a significant way. Until such time we will monitor events closely and are optimistic 2014 can produce satisfactory portfolio returns.

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