STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

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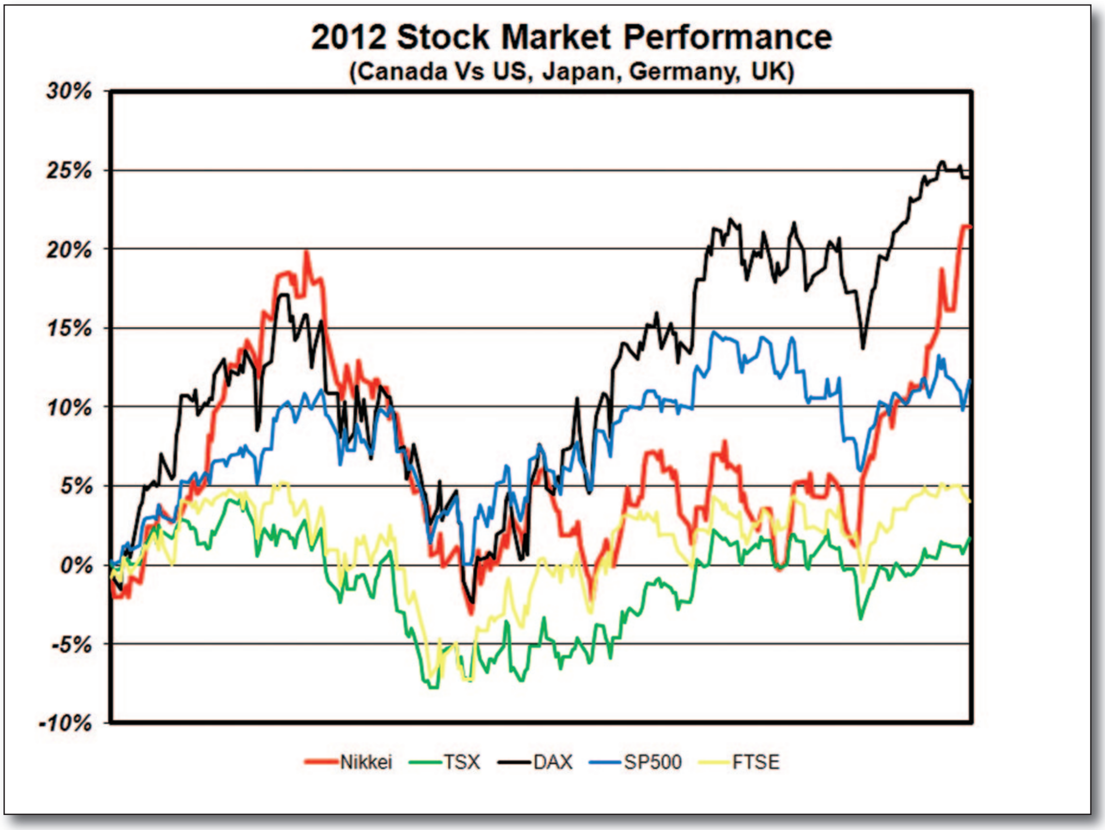
Summary - 2012

Once again the Canadian stock market underperformed the U.S. market in 2012. The S&P/TSX Composite *price index* ended the year up marginally by 4% while the S&P 500 index in the U.S was up 13.4%. The Cdn dollar edged higher in the year by 2.7% vis-à-vis the U.S. dollar, closing once again above par.

The bond market provided modest gains for investors as yields ended very close to where they began the year. The DEX Universe Bond index, a broad benchmark for Canadian bonds, rose by 3.6%. Canadian 10 year bond yields dropped to as low as 1.58% during the year and finished the year at a yield of 1.80%.

In commodity markets the price of Oil slipped during the year to end at $91.82, a decline of about 7%. In contrast Gold posted a modest gain of 7% to close at $1,675 in a year characterized by less volatile price swings generally for most commodities.



The Canadian stock market had one of the weakest returns in 2012. The chart above shows the performance of the Canadian market compared to the major stock market indices in the US, Japan, Germany and the UK.

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
www.stonebrooke.ca

TSX 300 : 12,434 | *90 Day T-Bills : .92%* | *Oil : $91.82 US* | *Cdn $: 1.005 US*

S&P 500 : 1,426 | *10 Yr Cda Bond : 1.8%* | *Gold : 1,675 US* | *Euro : 1.31 Cdn*

The Fiscal Cliff - Part 1

In a typical partisan political showdown, the automatic spending cuts and tax increases, aka the Fiscal Cliff, were avoided at the last possible hour saving the U.S. and by extension the global economy from certain recession. For the time being, an agreement to raise some taxes is in place. While it is a relief the U.S. has avoided strict austerity measures to tackle its gargantuan budget deficit, the fact of the matter is it must be addressed sooner or later. So the hard choices were only delayed and it looks as if Part 2 is right around the corner when Congress must approve another increase in the debt ceiling. The politicians will be squaring off soon enough and will likely unnerve financial markets in the process. Any serious resolution of the Fiscal Cliff will have a negative impact on the economy. Tax increases and spending cuts necessary to close the deficit are drags on the real economy. The Fiscal Cliff became a political and media circus event. The hard choices are still ahead in an otherwise mixed U.S. economic picture. The housing market appears to be improving however the labour market is still depressed and may possibly be worsening as there have been many recent layoff announcements at struggling firms.

With many issues still unresolved it appears to us there remain more hurdles for financial markets. The situation in Europe has calmed down for the moment though it can erupt at any time leading to a return of investor concern. Spanish banks have recently reported a jump in bad loans to over 10% of assets. This is an unmanageable figure and a bail out, although denied, appears more than likely. Market reaction has been surprisingly calm for now. If the realities in Europe are not dealt with quickly in an orderly way, then financial markets will force the politicians to deal with the issues in a disorderly way. We have seen this time and time again.

In Asia, Japan holds title as the largest debt miscreant. The gross debt/GDP ratio in Japan is now about 225% - the highest in the industrialized world. Japan's long running trade surplus has turned into a deficit for the first time and household savings have steadily declined to almost zero. While Europe remains foremost in investors' minds, 2013 could be the year when Japan grabs the headlines.

In Canada, household debt as a percentage of disposable income has risen to about 165%, very close to the levels that existed at the peak of the U.S. housing bubble. Canadian households are now more indebted than their American counterparts who in the last three years have been in the process of deleveraging. Furthermore, housing activity in Canada is at historical record levels as a percentage of GDP. The markets in Vancouver and Toronto especially show indications of overbuilding and overvaluation. A moderate decline in the housing market would be a material enough change at the margin to significantly cool economic activity.

Looking Ahead to the Next Peak

While it may be still too early to contemplate the next peak in stock prices and subsequently the next bust, it is important to recognize that the average bear market loss is about 30%. The two most recent cycle ending bear markets in the prior decade witnessed a drop of 50% from the peak. These prior peaks are very close to the current price level of the S&P 500 and have already been exceeded by the Dow Jones and the S&P/TSX Composite here in Canada.

In addition the last two cycle peaks were seven years apart: 2000 and 2007. Using simple math means the next peak in stocks could be as early as 2014. Looking out over the next year or so it is easy to build a case for a "bubble" to form in high dividend paying stocks. The money printers are keeping interest rates artificially low and aging investors are looking for high yields and safer investments. It is once more a recipe for excessively overpriced stocks.

Monetary High Jinks

Unlimited QE programs are now in place in the US, Europe, and Japan. There is no doubt the financial markets have so far been supported by Central Bank quantitative easing efforts.

By some estimates, in the last five years since the 2008 financial crisis, the world's top six Central Banks have printed more than $10 Trillion in new money. This expansion of Central Bank balance sheets has been unprecedented. In light of this fact there are two important questions that need to be asked: 1) why hasn't the global economy improved more significantly, and 2) why is there still very little inflation? It is precisely because of these two questions that there exists the ongoing need for more money printing!

Inflation of course works with a lag. It is a case of too much money chasing the same number of goods and services. Prices therefore rise. Printing money has historically always led to price inflation.

The other way to look at it is that the currency is losing purchasing power. It takes more currency to buy the same goods and services. The currency is therefore declining in value. As more money gets printed there is a real danger the population will lose confidence in that currency. A rush out of the currency can then quickly build momentum as investors seek alternatives in fear of losing purchasing power.

It has taken many years to tame the inflation that was not so long ago a normal and expected part of the economic fabric. Many believe we are currently in a period of disinflation that is expected to last for many years to come. It took years of rising prices in the 1970's before inflation was finally acknowledged. Under cover of fighting deflation, today global Central Banks have flooded the banking system with cash. Over in Europe, the head of the ECB Mario Draghi is on record stating they will do whatever it takes to keep the EU together. In Japan, newly elected Prime Minister Shinzo Abe has called for more monetary stimulus targeting a higher inflation rate.

As long as the money printing does not cause any immediate inflation or even the expectation of inflation, then it will be expanded indefinitely. Central Banks are attempting to manage and finesse the financial markets in an effort to buy time. At some point however their actions will reignite inflation.

Equity Strategy

Looking back at the historical evidence, current stock market valuation levels are on the expensive side. For instance they are elevated as a share of the economy (as a percentage of GDP), price earnings multiples are at the higher end of the range, and companies on average also have the highest profit margins in history. However, while perhaps pricey, provided earnings growth keeps up and interest rates remain low there is no reason to expect a *significant* decline in stock prices. We would characterize the environment ahead as still risky and prone to volatility, however stocks, especially those with higher dividend yields remain favourable overall.

Our equity strategy is twofold: Firstly, an emphasis on companies with higher dividend yields; and secondly the selection of companies and sectors that show good momentum and technical strength. For the latter it will be important to make periodic changes as the market lends itself to periodic shifts from defensive "risk-off" investments to more aggressive "risk-on" industry segments. Our momentum work should guide us in making a few transactions this year to take advantage of the market's "mood swings". While the longer-term back testing of the momentum strategy is quite good, over the past several months we have witnessed very choppy markets without clear signals for opportunistic trading. We expect this is a transitory period.

While we believe 2013 can offer decent upside it will not be in an easy linear fashion. We expect a volatile

(continued on page 4)

Equity Strategy *(continued from page 3)*
ride as has been in evidence these past three years. Portfolio risk-management will continue to be important as we are in the later stages of the bull market - previous cyclical market peaks were in 2000 and 2007.

We continue to see a bright future for gold and gold stocks even though it has been a difficult twelve to eighteen months for gold stocks. It is easy to lose patience in an investment that has not worked out over the short term. With the likely need for unlimited currency printing in the years ahead we cannot fathom how Gold can continue to be neglected by the majority of investors. We expect Gold to trade much higher and we should profit handsomely before too long.

As shown in the chart on page one Canadian stocks underperformed last year and have done so vis-à-vis the U.S for the past two years. With the risk of a slowing Canadian economy led by the housing sector we will be looking to diversify more of our equity investments into both the U.S. and overseas markets.

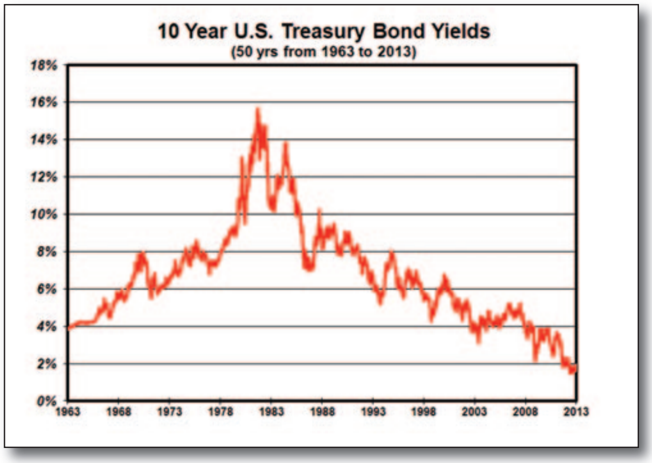
Fixed Income Strategy

So far the U.S. is able to monetize its deficits without panicking the bond market. That could change at any time and interest rates could start heading higher very quickly. For the time being as long as yields stay low there is no option but to stay relatively protected with shorter-term maturities.

The U.S. Federal Reserve's quantitative easing experiment is aimed at driving bond yields down in order to encourage borrowing and spending in the private sector. So far the economy has responded with a very subpar recovery and is once more threatening to slow.

By some estimates the Fed's QE program over the coming year could mean the purchase of an additional $1 trillion of Treasury bonds. The Fed is on record as saying it intends to continue printing money until the unemployment rate reaches 6.5%. It is strange therefore that recently released minutes of the last FOMC meeting reveals comments that the Fed may need to halt bond purchases well before the end of the year.

While we do not believe this is likely in 2013, we must be prepared for the inevitable rise in interest rates. Investors may sooner rather than later start to bail out of bonds. An end to the Fed's supportive bond-buying program could bring selling pressure driving up interest rates.



The chart above spans many business cycles and shows numerous occasions where after a long decline in interest rates bond yields suddenly jumped upwards. We believe at some point in the next 1 to 2 years bond yields will again head higher. Additionally the long decline from the 1980 peak in interest rates has probably run its course. How much lower can interest rates reasonably go?

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 www.stonebrooke.ca