Investment Commentary

Winter 2011

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2010 – Summary

2010 saw the recovery in financial markets continue, with the TSX Composite price index advancing 14% and the U.S. S&P 500 index climbing 15%. In Cdn dollar terms the gain in the U.S. was a more modest 10% as our dollar rose about 5% to close just over parity.

It was another good year for commodity prices, especially in agriculture. Wheat, corn, soybeans were all up strongly. Copper and other base metals rose to new highs. Gold bullion soared by almost 30% to close at $1,421 in U.S. dollars.

Bond market returns were best for longer-term instruments. Interest rates declined slightly and corporate yield spreads continued to narrow. The DEX Universe index, a broad measure for Canadian bonds, posted a return of 6.7%.

Fearless Forecast

This is potentially a very perilous time in the markets. Without the support of a very loose monetary policy in the U.S. prices of most financial assets would fall. Any forecast of where the markets are heading must come to grips with this reality. Forecast a more *normal* monetary policy and the outlook for stock and bond prices cannot be very encouraging.

The second round of quantitative easing, or QE2, is now in full swing and the Fed will be buying treasury bonds to the tune of $75 Billion per month. Our forecast, *predicated on the continued need for an aggressive monetary policy*, (the private economy remains sluggish), is for the stock markets to repeat the performance of 2010. Meaning, a sometimes halting stock market during the year, but a decent performance just the same.

In addition to the monetary easing, the Bush Administration era tax cuts have been extended and new spending initiatives will add another $350 billion in stimulus. In all, more than $1 trillion of additional funds, in the form of borrowed and newly created money, will be available to support the US economy. The impact should be positive, and will therefore likely lend support to global financial markets. The first half of the year appears to be poised for good market performance.

The next round of QE however, should one be needed, is not a certainty. There is a shift in the new Congress against the Federal Reserve initiatives. A new breed of Republicans and "Tea Party" members are demanding real change and accountability. At some point in 2011 there will be political pressure placed on the Fed to abandon its money printing policies. Until then, the waters appear calm.

Don't Fight the Fed

With Ben Bernanke clearly articulating a policy of supporting the financial markets, it would be foolish to try and second guess the Fed. As most money managers have learned over time, fighting the Fed is often a losing proposition. Still, trying to raise asset prices by printing money and holding interest rates low may work in the short term but it is not a viable long-term solution. Over time it risks creating another asset bubble, which will again lead to disappointment and despair for the average investor when it bursts.

Even though "artificial", the Fed policy is likely well-intentioned. There is no other immediate and painless option. As in the past with similar policies, the pain will come in time, and it will feel worse that the cure. For now however, we are encouraged that the policies will be beneficial for financial markets in the short term. We do not plan on fighting the Fed at this particular point in time.

Recurring episodes of deflation and then inflationary anxiety awaits investors as the U.S. Fed and other Central Banks go back and forth with quantitative easing. It will be a frustrating experience for at least this year and next. By then we hope the private economy will be substantially back on its feet and no longer in need of government stimulus.

Importantly, *the problems with debt and toxic assets have not gone away or been resolved. They have for the time being just been papered-over.*

Fixed Income Strategy

Interest rates have been rising in the past few months, and bond prices are falling. If this is due to economic growth and the desire for credit, then it is an encouraging event. However, if yields are rising because investors are concerned about a deteriorating U.S. fiscal situation, then there is a problem.

For now the market is focused on Europe, where interest rates are surging in the periphery countries. In aggregate, the US fiscal situation is worse than in all of Europe combined. The U.S. budget deficit hovers around 10% of GDP and the total public debt outstanding will soon exceed 100% of GDP. Interest rates are very likely to climb further in the U.S. this year. With the Canadian bond market over 90% correlated to the U.S. bond market, we will see interest rates rise here as well, depressing bond prices.

Recent figures indicate that China and Russia have sold U.S. bonds. With foreign investors finally starting to question U.S. fiscal soundness, the Fed may be forced to buy more than the $75 Billion a month in treasury securities as per QE2.

We continue to avoid longer-term securities convinced that it is just a matter of time before interest rates rise and return to normal levels. The risk is also very high that events spiral out of control, as now playing out in Europe. Rates could rise very quickly. We therefore still recommend short term bonds with maturities no longer than five years.

Equity Strategy

Sentiment indicators are pointing to a short term correction. These indicators show that investors are overly optimistic, due mainly to the recent market advance. These indicators work in reverse fashion, ie when everyone is extremely bullish; the market is prone for a setback.

It is amazing to us that investors have become so optimistic so quickly. The steady upward climb in stocks, in face of at best lukewarm economic news, is just too much for some to bear. Yet the flow of funds data is still not registering that investors are shifting a significant amount of savings into the stock market. Any setback should therefore be shallow.

Canada has been both wiser and more fortunate throughout this upturn. Deficits are manageable and the rise in commodity prices has been a boom for our exports and for capital investment. While we are not immune from the misguided monetary and fiscal policies in the U.S., investments in Canadian resource companies should prove rewarding as commodity prices continue to increase due to rising demand from the developing world. The only caveat to this otherwise favourable story is that China now has an inflationary problem and is pursuing stricter monetary policies. A slowdown in Asia may surprise investors and trigger a sell-off. It would then likely be a good opportunity to add positions to the Resource sector.

A higher Cdn dollar will make it difficult for our manufacturing sector to compete in the U.S. For this and other reasons we favour U.S. manufacturers with a global footprint.

Income trusts are now real companies again. 2011 marks the year they are obliged to restructure. Many have changed their payouts, lowering yields in the process. With capital risk now reduced, we will consider purchasing a number of companies, or perhaps an exchange traded fund offering a diversified basket. While yields are lower, the dividends are now much safer going forward.

Easy money policies may lead to yet another asset price bubble. The Fed hopes that by boosting stock prices it will encourage a positive chain of events leading to improved consumer spending, sustained strength in the economy, and finally a capital expenditure boom. While stock prices are perhaps relatively overpriced, for now we are inclined to *go with the flow*. We will of course monitor events closely should we see evidence compelling enough to change course and reduce portfolio risk.