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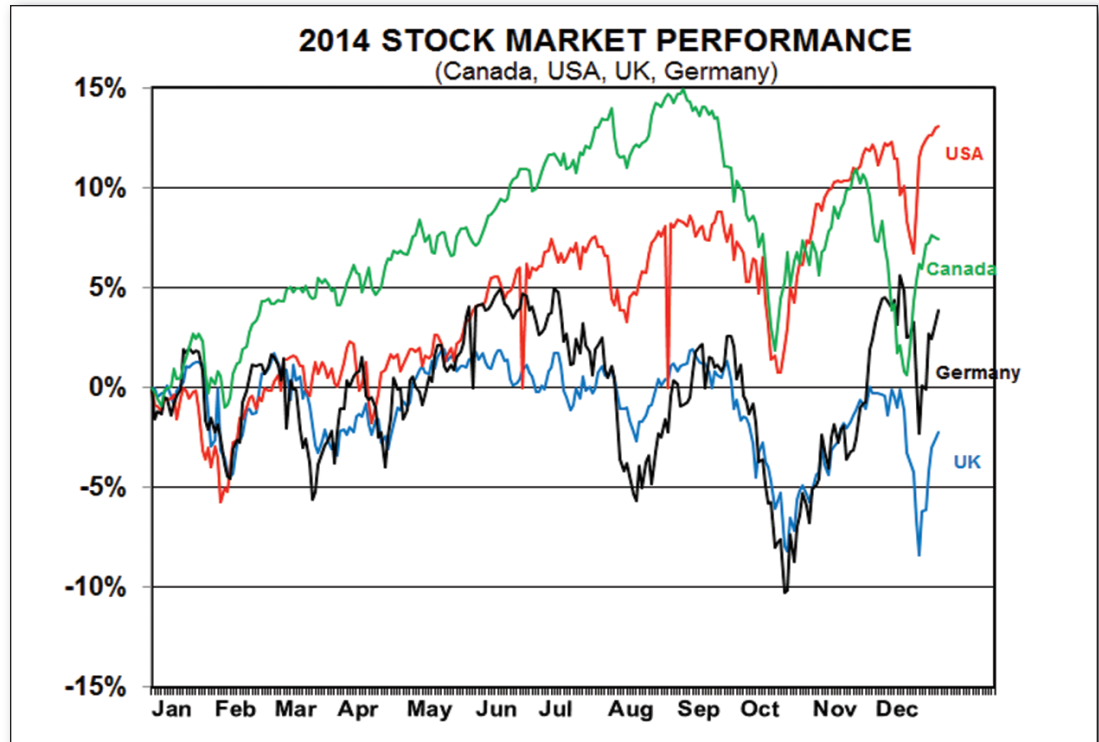
Summary 2014

The Canadian stock market managed to post a gain in what was a very volatile year. For 2014 the S&P/TSX Composite price index was up 7.4%. U.S. stock markets fared better once again with the S&P 500 index up by 11.4% (in US dollars). The bond markets recovered in 2014 as yields declined. The Canadian 10 year bond yield ended the year at 1.79%. The DEX Universe Bond index, a proxy for the bond market, performed well with a gain of 8.8%.

The Canadian dollar put in another disappointing year as it declined by 9% to close at \$.86 to the U.S. dollar. The U.S. dollar

continues to rise in value compared to most of the world's currencies.

For commodity markets it was a dismal year with the headline event being the crash in the price of oil. Remarkably, oil ended the year at US\$53.45, an incredible decline of about 50% from the summer peak. The decline was quick, falling from over US\$100. Most other commodities were also down for the year. Gold bullion held up fairly well closing little changed at US\$1,206. For the gold stocks however it was another poor year of performance with an average loss for the senior companies of close to 10%.

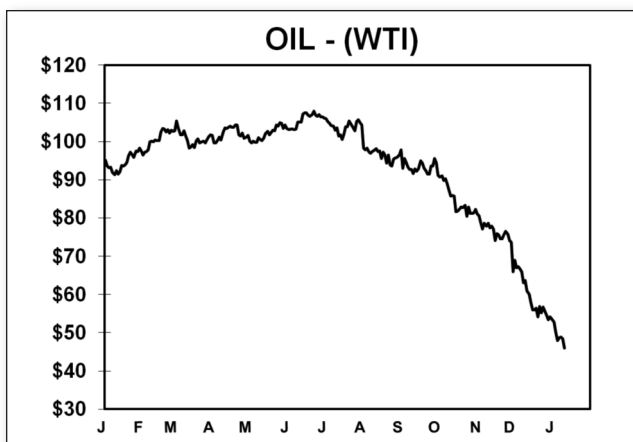


The chart above shows the performance of the Canadian stock market compared to the major stock market indices in the U.S., UK and Germany. The returns shown are in local currency. US stocks continue to outperform and with the US dollar rising against most currencies the outperformance is even more extraordinary.

Oil: Crisis and Opportunity

Without question the major economic event of the year has been the massive decline in the price of oil. In just a few short months the price dropped relentlessly from over US\$100 to now less than US\$50. The implications are obvious - 2015 will certainly see a serious drop in activity in the energy sector.

Drilling permits are already down substantially. Companies have started to slash capital spending plans. New activity will likely grind to a halt in many of the higher cost areas of production – namely shale fracking and oil sands.



A drop of this magnitude would normally be associated with a global economic recession. In the financial crisis of 2008/9 the price of oil plunged to about \$35. Understandably, there was a decline in the demand for oil. This time there is no drop in demand. The issue is one of supply. There is currently too much production.

It is difficult to comprehend how the price of the world's largest and most important commodity can be so volatile absent a macroeconomic triggering event. Importantly, the price of crude oil is not determined by physical oil contracts among oil companies and their clients. Rather it is determined in the financial or "paper markets" where speculators place bets on the future price of oil – based on expectations of supply and demand.

Central Banks In Control Mode

Since we first wrote on the possibility of financial markets being "manipulated", we have read quite a bit more on the subject from several very prominent market researchers. While certainly not a mainstream view, the likelihood that financial markets are manipulated or controlled in some fashion is gaining acceptance.

Conveniently, as the stock market was plunging in mid-October a Federal Reserve spokesman reassured investors saying, "a logical policy response at this juncture

in fact banks and hedge funds are behind 80% of the transactions in the energy futures market. They are there to make a profit and have no desire to take physical delivery. These futures traders amplify the price of oil and are responsible for the volatility we are seeing today. In recent years there had been a large inflow of speculative money from fund managers driving up the price. A reversal is now underway as these fund managers exit and drive the price lower. By some estimates, the *financial market* for oil is worth about 18 times the actual *physical market*.

Just a few short months ago the *financial market* bid up the price to over US\$100 fearing the threat of the Islamic State (IS) and renewed instability in the Middle East. Then all of a sudden the supply side caught everyone's attention. A series of events suddenly materialized; The easing of sanctions against Iran, higher production from Iraq, the resumption of Japan's nuclear program (reducing the need for energy imports), increase in shale production from the US, slowdowns in China and Germany. Lastly, the end of quantitative easing (QE) by the Federal Reserve in October, is thought to have reduced liquidity to the financial sector. So in the light of some glaring figures and events revealing too much production, the price collapsed by over 50%.

There are also the usual conspiracy theories purporting back room deals in an effort to punish Russia etc... Maybe. We believe however the Saudis are acting in their own long term interests. The intent is to curtail the production of high cost oil from shale and oil sands and to maintain market share. Unlike 1986, a time period often referred to lately in the news media, the Saudis are not "opening the taps". Moreover, the world is consuming a great deal more oil today, at roughly 93 million barrels per day compared to under 60 million barrels back in 1986. The world's present surplus production capacity is limited and an economic certainty is that lower prices will eventually drive up demand. Lacking an economic downturn, we expect the supply/demand imbalance to correct itself sooner than most expect.

may be to delay the end of QE". The market quickly rebounded. More recently another spokesman told reporters "raising rates would be a catastrophe". The market again rebounded assured that interest rates would stay low.

Over at the European Central Bank, President Mario Draghi said, "The ECB Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate." They are looking to buy as much as 500 billion euros of bonds. (cont'd on page 3)

Central Banks In Control Mode *(cont'd from page 2)*

QE is an ongoing attempt to liquefy the financial industry and to keep interest rates down and stock prices up. All the world's major Central Banks are participating. Six years into the recovery and there is continued pressure by monetary authorities to placate the markets and keep them moving upwards.

The stakes now appear to be rising with announcements of the outright purchasing of stocks. When the bank of Japan increased their QE program last year by 30% they also announced a stock buying program increasing the allocation in the government pension fund by 10%.

From Korea, Heung Sik Choo, the former Central Bank's deputy governor, stated *"We need to reconsider the investment universe for central banks. We may need to break away from rigid fixation on bonds of the highest credit ratings, and become more open-minded about expanding the investment sphere into non-traditional asset classes."*

The Swiss central bank is on record of buying stocks and reported it had \$72 Billion, or 15% of its foreign exchange assets invested in stocks.

With the full support of the world's central banks it certainly appears the financial markets will maintain their upward bias, at least for another year. However it also appears we are again on the way to forming another stock market bubble - with the inevitable bust. The lessons of history are being ignored once again. At some point investor confidence will be lost and economics will take over and overwhelm central bank meddling.

Importantly, the major lesson learned from the crash in oil should be that all asset markets are equally vulnerable. They can rise and become overvalued on great expectations and then crash when perceptions change and reality sets in.

Canadian Outlook

"Disquieting" was our previous description of Canada's economic situation, *prior to the collapse in the price of oil*. The Western provinces and Newfoundland now face rising unemployment as a result of cancelled oil sands projects and curtailed offshore development. Pipeline projects to new energy markets will be delayed, likely further obstructed by local issues and political posturing now that oil prices are down. Government revenues, at all levels, will be adversely affected as long as energy prices remain depressed.

The Bank of Canada has finally acknowledged the overvaluation of residential real estate in our major urban markets. The negative wealth effect of a house price decline in Western Canada has already been reflected in the shares of mortgage lenders and other financial companies, retailers and developers.

The benefits of cheaper fuel costs to consumers, transportation providers, and industry will be a partial offset to the weakness in the energy sector, especially in Central Canada where our population is concentrated. The lower dollar should stimulate manufacturing in Ontario and Quebec, and also aid tourism on a net basis. The Canadian dollar is now closer to purchasing power parity which should discourage cross border shopping.

Much of these benefits depend upon how long the oil price remains depressed. The Loonie is regarded as a petro-currency and will move in the same direction as energy prices. The positive effects for Central Canada may be short lived.

The Risk Level Is High

"In the short run, the market is a voting machine, but in the long run it is a weighing machine." — Benjamin Graham, author of *The Intelligent Investor*, the definite book on value investing.

In the short term investors can and have often acted irrationally. The result is that financial markets become mispriced, either depressed or wildly expensive. In the longer term however prices will tend to return to fair value, having been both over and undervalued along the way. The above quote by Benjamin Graham, perhaps best described as one of the founding fathers of "value investing" should be heeded by investors today.

Following the crowd always seems like the safest strategy.

Deviating from the crowd is always more uncomfortable especially when you are on the wrong side of an upward move. Most investors do not attempt to manage portfolio risk. They are content to ride the market up and down. (It is easier to lose collectively than to take an uneasy stance counter to the herd).

Stock prices are no longer cheap. In terms of price to earnings they are at historical highs at a time when corporate earnings margins are also at all-time highs. The total stock market capitalization as a percentage of GDP is currently nearing 130%. It has only been higher than this once before in history, in 2000 at the peak of the "dot-com" bubble. The ratio at that time rose to about 150%. It is certainly a much higher risk environment for stock investors.

Portfolio Strategy

The deterioration in the outlook for the energy sector is only starting to sink in. Past experience suggests oil will recover to the marginal cost of production which varies widely in North America. Most producers of conventional oil require about US\$50.00 per barrel to cover cash costs. The cost of oil sands projects are considerably higher and entail greater capital investment.

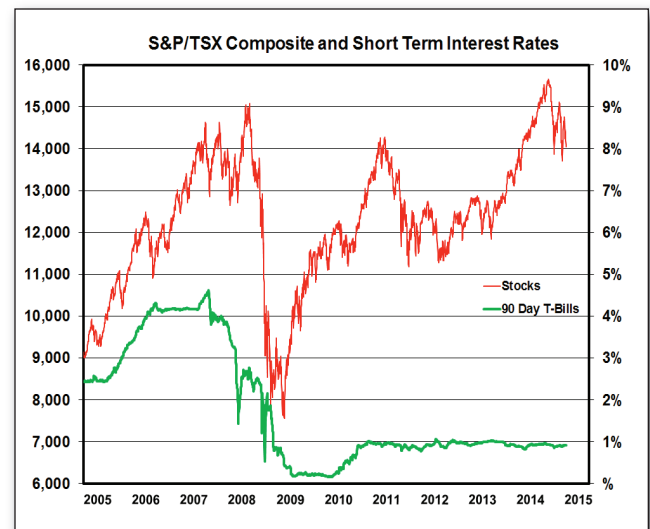
The stock prices for some industry participants have collapsed. Our best estimate is that the market is discounting a West Texas Intermediate (WTI) oil price on its way to US\$40 with no immediate recovery. A snap back rally to the \$70 dollar range will result in a powerful rally in share prices. While perhaps this is too optimistic, a price of \$60 before year-end is not unrealistic. By then demand would have certainly risen fueled by lower prices and OPEC may have resolved their differences and reduced production quotas.

In our view companies that have manageable debt levels and lower payout ratios are now attractively priced. They are still profitable at \$50 oil and are able to grow production. We would avoid those companies that over-expanded and are now saddled with higher cost operations. In the longer term however the economics in the North American oil patch has changed considerably. Having witnessed a price collapse without a corresponding economic decline is quite alarming. With a recession likely within the next two years, we doubt the oil sector can offer decent returns for the risk taken. Portfolio weightings should be reduced over time.

The Canadian chartered banks will be challenged to show earnings growth in 2015 due to loan quality, exposure to the energy sector and residential real estate. Personal debt levels, including mortgages, auto financing and credit card balances, are now over 1.5 times personal income. Loan arrears and defaults will certainly rise if interest rates and or unemployment rises. Our banks pay generous dividends in the range of 45 to 55% of earnings and so downside risk should be moderate in the absence of a major economic shock. We will likely maintain our positions in the banking

sector and expect to earn dividend yields of 4% with modest capital appreciation.

Apart from shorter term opportunities in the oil patch and other commodity and cyclical sectors we will be changing our strategy gradually to incorporate a deflation bias. Utilities, Financials, Consumer and Technology sectors are our sectors of choice. Companies with higher dividend yields will generally continue to be the largest positions in our portfolios.



We are under no illusions that the market offers fair value for investors. Quite the opposite. To that end we will begin to position portfolios more defensively as the year unfolds. We are monitoring interest rates closely as we suspect any rise will be followed by a negative market reaction. The adjacent 10 year chart shows the S&P/TSX Composite Index compared to short term interest rates. In 2007 interest rates rose to 4.5% before the market finally peaked. While markets may initially choose to ignore a rate rise, investors will eventually react with alarm on a reversal in trend. We are much closer to the peak in stock prices and fundamental valuation metrics are stretched. A value driven and careful approach to stock selection, as we reduce portfolio risk, should still bring positive returns in 2015.

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